MARITAL PROPERTY CHARACTERIZATION AND REIMBURSEMENT AND FRAUD ON THE COMMUNITY

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I. INTRODUCTION

In estate planning or estate administration, the identification of marital property issues and the proper resolution of those issues can be a critical part of the process. If the estate planning client is married, the community or separate nature of the estate may affect the plan that is adopted. If the estate planning clients are married, these issues can complicate the planning. Following the death of a married individual, the community or separate nature of the marital estate may dictate who gets what by reason of the first spouse's death. Obviously, the determination of what is community or separate can lead to conflicts between the surviving spouse and the deceased spouse's successors in interest.

The purpose of this paper is to address the first step in resolving any marital property issue, the determination of the separate or community property character of the marital estate. Necessarily, that determination may also lead to "reimbursement" issues and also raise "fraud on the community" issues. A comprehensive study of these topics is too much for one CLE paper and the time allocated to one CLE presentation. So, this paper presents its own process of placing the practitioner in a better position to "spot" and "address" characterization issues and what some commentators refer to as the "evil twins": "reimbursement" and "fraud on the community."

<u>Note</u>: *Unless specifically addressed, this paper assumes in the discussion that the spouses have not entered into a specific agreement to alter the character of their marital assets.*

II. EFFECT OF MARRIAGE ON PROPERTY – AN OVERVIEW

Generally, as soon as a couple marries, each and every item of property of either spouse will be presumed to be community property. An asset acquired prior to marriage, as well as any property acquired during the marriage as separate property (e.g., a gift or inheritance), can remain a spouse's separate property, if the community property presumption that attached on marriage can be overcome by clear and convincing evidence. Tex. Fam. Code § 3.003. *See* V, *infra.*

A. Future Acquisitions

However, the spouses' respective salaries and other forms of compensation (i.e., employer contributions to retirement plans) will be community property. The income being generated by community property or their respective separate properties will be community property. Any other assets purchased by either spouse will be presumed community property unless proven to be separate property (i.e., traceable to existing separate property). Tex. Fam. Code §§ 3.001 - 3.002.

B. Management/Control

A spouse's separate property is generally subject to the spouse's "sole management and control." Some community assets are subject to the spouses' "joint management and control" (i.e., the joint community), and a particular spouse may have "sole management and control" of other community assets (i.e., a spouse's special community). Tex. Fam. Code §§ 3.101 – 3.104.

C. Unilateral Gifts

Any unilateral gifts by a spouse (inter vivos or nonprobate) of the spouse's special community property to a child, a child by a prior marriage, or other third party may later be found by a probate or divorce court to have been a breach of a duty owing by the spouse to the other spouse and a "fraud on the community." Tex. Fam. Code. § 7.009. A spouse's unilateral attempt to transfer joint community property to a third party may be void or voidable as a matter of law. *See* Tex. Fam. Code § 3.102. *See* VIII, *infra*.

D. Debts

Further, if a spouse incurs a tort debt, the creditor may be able to enforce any resulting judgment against any and all community property even if the other spouse did not have personal liability for the debt, and the creditor is able to take advantage of the community presumption. A breach of contract claim against one spouse exposes the other spouse's one-half interest in the joint community and the contracting spouse's special community to liability as well. Tex. Fam. Code §§ 3.201 - 3.203. *See* III, G, *infra.*

E. Divorce

Generally, community property is subject to an equitable division by the divorce court and separate property is not. *See* Tex. Fam. Code § 7.001. *See* Note following III, H, *infra*.

<u>Note</u>: *While contractual alimony can be incorporated into a divorce decree, absent such an agreement, the Texas divorce court cannot award alimony to a spouse. Alimony is contrary to Texas public policy. A limited form of alimony, "maintenance," is available in certain defined situations. See Tex. Fam. Code §§ 8.001 – 8.059.*

F. Death of First Spouse

Upon the first spouse's death, the deceased spouse has testamentary power over the decedent's separate property and one-half of the community property. The surviving spouse retains his or her own separate property and one-half of the community. Tex. Prob. Code § 37. In addition, the surviving spouse may have homestead rights and/or rights to an "allowance" or to certain exempt personal property. Tex. Prob. Code §§ 270 – 293. *See* III, H, I, *infra.*

G. Reimbursement Issues

Whether the marriage eventually terminates in death or divorce, its dissolution will be even more complicated due to the possibility of reimbursement issues accruing during the marriage and maturing upon its termination. Tex. Fam. Code §§ 3.401 – 3.410. *See* VII, *infra*.

H. Pre-Marital and Marital Agreements

Most of the rules of marital property management, liability, management and disposition, and the complications they create, can generally be avoided in a well-crafted pre-marital agreement or marital agreement. Through such an agreement, parties intending to marry can agree to create a "community free" marriage where all property is the separate property of one spouse or both spouses and eliminate other spousal rights. Tex. Fam. Code §§ 4.001 – 4.010, 4.101 – 4.106.

III. THE INCEPTION OF TITLE RULE AND OTHER KEY CONCEPTS

The characterization of property as either community or separate is usually determined by the inception of title rule (i.e., the facts and circumstances then existing dictate whether it is separate or community). *Smith v. Smith*, 22 S.W.3d 140, 145 (Tex. App.—Houston [14th Dist.] 2000, no pet.) (op. on reh'g). "Inception of title occurs when a party first has a right of claim to the property by virtue of which title is finally vested." *Boyd v. Boyd*, 131 S.W.3d 605 (Tex. App.—Fort Worth 2004, no pet.).

An understanding of the inception of title rule and other key concepts are essential.

A. Nature of Community Property

Community property is a form of co-ownership that can only exist during a marriage that is valid under Texas law (i.e., between a husband and wife). If an asset is community property, it is owned in equal undivided interests by the spouses. The spouses are not tenants-in-common or joint tenants; rather, they simply own their respective community property interests, regardless of whether record legal title is in one spouse's name or both spouses' names. *See Howard v. Commonwealth Building & Loan Ass'n*, 94 S.W.2d 144, 145 Comm'n. App. (1936), where the court explained that, where title to a community asset is held in one spouse's name, that spouse has legal title, and the other spouse has equitable title, explaining: "That one in whose name the title is conveyed holds as trustee for the other. *Patty v. Middleton*, 82 Tex. 586, 17 S.W. 909 (1891)."

Note: *Separate property, or a separate property interest in property, is owned exclusively by the owner spouse. Tex. Fam. Code §§ 3.001, 3.002. Spouses may co-own separate property as tenants-in-common or as joint tenants with rights of survivorship. Tex. Prob. Code § 46. An asset may be owned proportionately as separate and community property creating what Texas courts have called a "unique tenancy" between the marital estates. Tex. Fam. Code §§ 3.001, 3.002.*

B. The Community Presumption

Generally, all assets of the spouses on hand during the marriage and upon its termination are presumed to be community property, thereby placing the burden of proof on the party (e.g., a spouse, or that spouse's personal representative, or the heirs/devisees of the spouse) asserting separate character to show by "clear and convincing evidence" that a particular asset is, in fact, separate. Tex. Fam. Code §§ 3.001, 3.003. *See* VI, *infra*.

C. The Claim for Reimbursement

Reimbursement between the marital estate usually arises when one spouse's separate property is improved through the expenditure of community funds. Reimbursement may also be applicable if separate funds are expended to benefit community property. In addition, the expenditure of community time, talent and labor—in excess of what is necessary to reasonably manage one's separate property—may create a community claim for reimbursement to the extent that the excess time, talent or labor is not compensated. Another common reimbursement situation is where one spouse separately owns an insurance policy on that spouse's life, uses community property to pay the premiums, but upon the insured spouse's death, the proceeds are payable to a third party rather than the surviving spouse. Tex. Fam. Code §§ 3.401 – 3.410. *See* VII, *infra*.

D. The Income Rule

In most community property jurisdictions, income generated by a spouse's separate property (i.e., rents, dividends, interest, etc.) is the owner's separate property. In *Arnold v. Leonard*, 273 S.W. 799 (Tex. 1925), the Texas Supreme Court held that the legislature could not define the rents and revenue from the wife's separate property as her separate property, but could exempt those assets from the debts of the husband. Accordingly, in Texas, income from separate property is community property absent an agreement of the spouses. *See* V.B., *infra.*

E. Special Community Property

The term "special community property" was originally defined by Texas courts as that portion of the community estate that was under the wife's exclusive control and not liable for the husband's debts. *Moss v. Gibbs*, 370 S.W.2d 452 (Tex. 1963). Today, it is common practice to refer to the community assets subject to either spouse's "sole management, control and disposition" under Section 3.102(a) as his or her "special community property" (e.g., income from the spouse's separate property, solely managed community property or a spouse's compensation for services).

F. Managing Spouse as Trustee

In *Arnold v. Leonard*, *supra,* the Court explained ". . . that the statutes empowering the husband to manage the . . . community assets made the husband essentially a trustee. A breach of that fiduciary duty can result in a "fraud on the community" claim when the marriage terminates. *See* VIII, B, *infra.*

G. Marital Liabilities

The Texas Family Code creates an "in rem" system of marital property liability. A spouse's separate property and special community property, as well as the joint community property, are liable for that spouse's debts during the marriage. If the liability is a tort debt incurred during the marriage, the other spouse's special community property is also liable for the debt (however, the other spouse's separate property is exempt).

If the debt is not a tort debt incurred during the marriage, the other spouse's separate property and special community property are exempt during the marriage from the debt unless the other spouse is personally liable under other rules of law. In which event, the other spouse's property (i.e., that spouse's special community and separate) is liable as well. Tex. Fam. Code §§ 3.201 – 3.203.

<u>Note</u>: *The marriage relationship, in and of itself, does not make one spouse personally liable for the debts of the other spouse. Tex. Fam. Code § 3.201. The death of a spouse does not change that result. Under Section 37, the deceased spouse's separate property and one-half interest in any community property passes to the decedent's heirs and/or devisees subject to the claims of the decedent's creditors. Section 156 goes further and explains that the community assets which were subject to the deceased spouse's sole management, or the couple's "joint management" remains liable for the decedent's debts. Further, the decedent's one-half interest in the community assets that were subject to the surviving spouse's "sole management" passes to the decedent's heirs and/or devisees subject to the decedent's debts. Unless the surviving spouse is also personally liable for a particular debt, the survivor's one-half interest in the survivor's "sole management" community is not liable for the deceased spouse's unsecured debts under Section 156.*

H. Death of a Spouse

When a married resident of Texas dies, the marriage terminates and community property ceases to exist. Nonprobate assets pass to the designated beneficiaries. Tex. Prob. Code § 450 (but *see* VIII, *infra*). Death works a legal partition of the community probate assets;

the deceased spouse's undivided one-half interest in each such asset passes to his heirs and/or devisees, and the surviving spouse retains her undivided one-half interest therein. Tex. Prob. Code § 37. A spouse's testamentary power is limited to that spouse's separate property and undivided one-half interest in the community property. *Avery v. Johnson*, 108 Tex. 294, 192 S.W. 542 (1917).

Note: *Prof. Joe McKnight, one of the principal authors of the Matrimonial Property Act of 1967 and its follow-up family code provisions, explained that the surviving spouse owns an undivided one-half interest in each item of the community [probate] property of which she cannot be deprived at her husband's death without her consent. "But on divorce the situation is different. If it is stipulated that a 50-50 division of the community is appropriate, the [divorce] court may achieve this by awarding a group of community assets (both halves) to the husband and another group of assets of equal value to the wife. An objection that this process operates as a taking or forced trade of a spouse's property interests will not be successful (cf. Eggemeyer v. Eggemeyer, 554 S.W.2d 137 (Tex. 1977)." See McKnight and Reppy, Texas Matrimonial Property Law, pg. 288 (The Michie Company 1983). See also Wright v. Wright, 274 S.W.2d 670 (Tex. 1955). See also* Oldham, *Texas Marital Property Rights*, p. 480 (Carolina Press, 2011).

I. Formal Administration

Upon the death of the first spouse and even though record legal title reflects that some community assets are held in the decedent's name, some are held in the survivor's name and others are held in both names, the surviving spouse and the heirs and/or devisees of the deceased spouse are, in effect, tenants in common as to each and every community probate asset, unless the surviving spouse is the sole distributee of some or all of the deceased spouse's one-half interest in such assets. If there is an administration of the deceased spouse's estate, the personal representative is granted the authority to administer the community assets which were subject to the couple's joint management and control and the community assets which were subject to the deceased spouse's sole management and control in order to pay the decedent's debts payable from such community assets. The surviving spouse can retain possession of the community assets which were subject to such spouse's sole management or control, but the decedent's one-half interest in such assets passes to the decedent's heirs/devisees charged with the decedent's debts. Tex. Prob. Code §§ 156, 177 (subject, of course, to Tex. Prob. Code §§ 270-285).

When administration is completed, the surviving spouse is generally entitled to her one-half interest in each and every remaining community probate asset. Tex. Prob. Code § 37. Of course, the deceased spouse's will may put the surviving spouse to "a widow's election," but that is a topic for another presentation. *See Wright, supra*.

J. Quasi-Marital Property

According to the Texas Family Code, the separate property of a spouse that was acquired while the spouses were not residing in Texas, but what would have been community had they resided in Texas at the time of acquisition, will be treated in a divorce proceeding as if it were community property. Tex. Fam. Code § 7.002. *See Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982). A 2003 amendment to Section 7.002 treats as separate property any community property that was acquired while the couple resided in another state that would have been separate had they resided in Texas at the time of its acquisition.

Quasi-community property is still treated as separate if the marriage terminates by reason of a spouse's death. *Estate of Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987). Presumably "quasi-separate" property would be treated as community property if the marriage terminates by reason of a spouse's death, if the reasoning of the *Hanau* case, *supra*, is followed.

IV. THE PROCEDURAL RULES

In promotions for its 2012 Marriage Dissolution Institute, the State Bar of Texas touts the significance of the *Boyd* case quoted in III, *supra*. The *Boyd* case is a divorce case, but can be used as precedent in some probate court controversies. However, one key difference in marriage dissolution between divorce courts and probate courts must be identified: community property is to be divided by the divorce court on an equitable basis, whereas the death of the first spouse effectively partitions each community asset into two equal undivided portions. *See* III, H, *supra*. But there are common denominators for both situations.

A. The Burden of Proof

"Under Texas law, property possessed by either spouse during or on dissolution of the marriage is presumed to be community property, absent clear and convincing evidence to the contrary. . . . In order to overcome the community presumption, the burden is on the spouse claiming certain property as separate to trace and clearly identify the property claimed to be separate. *See Estate of Hanau v. Hanau*, 730 S.W.2d 663, 667 (Tex. 1987) (citing *Tarver v. Tarver*, 394 S.W.2d 780, 683 (Tex. 1965)." *Boyd, supra*, at 612.

B. Tracing

"Separate property will retain its character through a series of exchanges so long as the party asserting separate ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to property that, because of its time and manner of acquisition, is separate in character. *Cockerham v. Cockerham*, 527 S.W.2d 162, 168 (Tex. 1975). . . . The burden of tracing is a difficult, but not impossible, burden to sustain. *Latham v. Allison*, 560 S.W.2d 481, 484 (Tex. Civ. App.—Fort Worth 1977, writ ref'd n.r.e.). Tracing involves establishing the separate origin of the property through evidence showing the time and means by which the spouse originally obtained possession of the property. *Ganesan v. Vallabhaneni*, 96 S.W.3d 345, 354 (Tex. App.—Austin 2002, pet. denied)." *Boyd, supra*, at 612.

C. Commingling

"If the evidence indicates that separate and community property were so commingled as to ". . . defy resegregation and identification," the community presumption prevails. *Hanau*, 730 S.W.2d at 667. When tracing separate property, it is not enough to show that separate funds could have been the source of a subsequent deposit of funds. *Latham*, 560 S.W.2d at 485. Moreover, as a general rule, mere testimony that property was purchased with separate funds, without any tracing of the funds, is insufficient to rebut the community presumption. *Zagorski v. Zagorski*, 116 S.W.3d 309, 316 (Tex. App.—Houston [14th Dist.] 2003, pet. denied) (op. on reh'g); *Bahr v. Kohr*, 980 S.W.2d 723, 729 (Tex. App.—San Antonio 1998, no pet.); *McElwee v. McElwee*, 911 S.W.2d 182, 188 (Tex. App.—Houston [1st Dist.] 1995, writ denied). Any doubt as to the character of property should be resolved in favor of the community estate. *Akin v. Akin*, 649 S.W.2d 700, 703 (Tex. App.—Fort Worth 1983, writ ref'd n.r.e.)." *Boyd, supra*, at 612.

Note: *In* Horlock *v.* Horlock, *533 S.W.2d 52 (Tex. App [14th Dist.] 1975, writ dism'd. w.o.j.), where the husband was not able to overcome the community presumption, equity was served by reimbursing him for the separate estate that served as the foundation upon which the community estate was built.*

D. Reimbursement

Typically, reimbursement claims arise when community property is used to enhance separate property. However, if separate property is used to enhance the value of the community estate, including the reduction of debt secured by community property, the spouse whose separate property was used also has an equitable claim of reimbursement. *See In re Marriage of Royal*, 107 S.W.3d 846, 850 (Tex. App.—Amarillo 2003, no pet.). "When a separate estate is the claimant, the spouse seeking economic contribution [reimbursement] has the burden to prove, by clear and convincing evidence, that the funds expended to reduce the community debt were separate funds. Moreover, a spouse seeking economic contribution [reimbursement] must bring forth sufficient evidence for the factfinder to resolve the claim. *See Langston v. Langston*, 82 S.W.3d 686, 689 (Tex. App.—Eastland 2002, no pet.)." *Boyd, supra,* at 613. If a spouse is seeking a community claim, it follows that the burden of proof is preponderance of the evidence.

Note: *In 2009, the Legislature amended the Texas Family Code and eliminated claims for economic contribution, and in effect codified the concept of "equitable reimbursement"; thus, the commentary in IV, D, is an interpolation of the court's opinion. See VII, infra. However, the principles discussed in the Boyd case still have relevance, but in the context of reimbursement.*

E. Nature of Evidence

After reviewing the trial record, the *Boyd* court held that the husband's oral testimony that property was purchased with separate property (without other evidence of tracing) was insufficient to overcome the community presumption, and his oral uncontroverted testimony that he used separate property to benefit community property did not constitute evidence to support a claim for economic contribution [reimbursement]. *Boyd, supra*, at 617.

F. Observations

The *Boyd* case is a divorce case primarily focusing on the evidence needed to overcome the community presumption in order to prove that an asset is separate property or that a claim for reimbursement exists. *Boyd, supra*, at 612. However, the court in *Boyd* also states: "The major consideration in determining the characterization of property as community or separate is the intention of spouses shown by the circumstances surrounding the inception of title." *Scott v. Estate of Scott*, 973 S.W.2d 694, 695 (Tex. App.—El Paso 1998, no pet.). However, it is this author's opinion that such statement is misleading. In some situations, the spouse's intent may be significant or even controlling, but in others, the intent cannot be established or may be irrelevant in view of the parameters set by Art. XVI, Sec. 15 of the Texas Constitution. *See* V, *infra*.

V. THE TEXAS CONSTITUTION

The Supreme Court of Texas in *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925) and *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902) made it clear to practitioners and the legislature that it is the

Texas Constitution that ultimately defines what is separate or community property—not the legislature (under the "rule of implied exclusion") or the parties involved (under the "mere agreement rule"). Accordingly, in order to properly characterize marital assets in Texas, it is necessary to understand the Texas Constitution.

A. Article XVI, Sec. 15

"All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; provided that persons about to marry and spouses, without the intention to defraud preexisting creditors, may by written instrument from time to time partition between themselves all or part of their property, then existing or to be acquired, or exchange between themselves the community interest of one spouse or future spouse in any property for the community interest of the other spouse or future spouse in other community property then existing or to be acquired, whereupon the portion or interest set aside to each spouse shall be and constitute a part of the separate property and estate of such spouse or future spouse; spouses may also from time to time, by written instrument, agree between themselves that the income or property from all or part of the separate property then owned or which thereafter might be acquired by only one of them, shall be the separate property of that spouse; and if one spouse makes a gift of property to the other that gift is presumed to include all the income or property which might arise from that gift of property; spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse; and spouses may agree in writing that all or part of the separate property owned by either or both of them shall be the spouses' community property."

B. The True Test for Community

It is important to note that the Texas Constitution does not define community property. *Arnold v. Leonard, supra*, explained the significance of the Texas constitutional approach to characterization: if an asset does not fall within the constitutional definition of separate property, it must be community property — "the rule of implied exclusion." A logical extension of this rule leads to a more practical definition for the term "community property": *that property of the marriage that is not proven to be separate property.*

The court in *Graham v. Franco*, 488 S.W.2d 390 (Tex. 1972), resorted to a more historical Spanish/Mexican approach and affirmatively defined community property as ". . . that property is community which is acquired by the works, efforts, or labor of the spouses. . . ." *See also Whittlesey v. Miller*, 572 S.W.2d 665 (Tex. 1978); *Bounds v. Caudle*, 560 S.W.2d 925 (Tex. 1977), holding modified by *Prince v. Prince,* 732 S.W.2d 316 (Tex. 1987).

Notwithstanding these later cases, the author is of the opinion that "the rule of implied exclusion" remains the true test of what is community property. The affirmative test mentioned in *Graham* has been used only in those situations where the implied exclusion rule would have worked an awkward result, such as in personal injury recoveries.

C. Traditional Means of Creating Separate Property

Consequently, the first step of characterization is ascertaining the facts and circumstances surrounding the acquisition of an asset -- "the inception of title rule." *Creamer v. Briscoe*, 101 Tex. 490, 109 S.W. 911 (1908). The second step is determining whether those facts and circumstances place the asset within the definition of separate property. Prior to the 1980 Amendment to Art. XVI, Sec.15, there were limited means of creating separate property in Texas. Separate property was limited to:

1. PREVIOUSLY EXISTING

Property owned prior to marriage. Tex. Fam. Code § 3.001.

2. GRATUITOUS TRANSFERS

Property acquired during marriage by gift, devise or descent. Tex. Fam. Code § 3.001.

3. TRACEABLE MUTATIONS

Property acquired during marriage which was traceable as a mutation of previously owned separate property. *Love v. Robertson*, 7 Tex. 6 (1851).

4. MARITAL PARTITIONS

Property resulting from the partition of presently existing community property. Tex. Fam. Code § 4.102.

5. CERTAIN CREDIT ACQUISITIONS

Property acquired on credit during marriage is separate property if the creditor agreed to look only to separate property for repayment. *Broussard v. Tian*, 156 Tex. 371, 295 S.W.2d 405 (1956).

6. CERTAIN PERSONAL INJURY RECOVERIES

Personal injury recoveries (other than for loss of earning capacity). Tex. Fam. Code § 3.001.

D. 1980 Amendment

The 1980 amendment to Art. XVI, Sec. 15 was truly a watershed moment; it authorized the creation of separate property in significant new ways and also redefined the "mere agreement rule." Today, it can be said that the spouses cannot alter the character of a marital asset in a manner inconsistent with Art. XVI, Sec. 15.

1. PREMARITAL PARTITIONS

Persons intending to marry can partition and exchange community property not yet acquired. *See also* Tex. Fam. Code § 4.003.

2. SPOUSAL PARTITIONS

Spouses may now partition and exchange not only presently existing community property but also community property not yet in existence into the spouses' separate properties. *See also Tex. Fam. Code § 4.102.*

3. INCOME FROM SEPARATE PROPERTY

Spouses may also agree that income from one spouse's separate property will be that spouse's separate property. *See also* Tex. Fam. Code § 4.103.

4. SPOUSAL DONATIONS

A gift by one spouse to the other spouse will be presumed to include the income generated by the donated property so that both the gift and the future income from the gift are the donee spouse's separate property. *See also* Tex. Fam. Code § 3.005.

E. 1987 Amendment

The 1987 amendment to Art. XVI, Sec. 15 did not authorize a new way to create separate property. Rather, it simply allowed spouses to create survivorship rights with their community property.

F. 1999 Amendment

The 1999 amendment to Art. XVI, Sec. 15 permitted spouses to convert by agreement separate property into community property beginning on January 1, 2000.

G. Observations

Today, in order to properly characterize the assets of a marriage in either an estate planning or administration situation, the practitioner will need to be thoroughly familiar with the ever changing rules of characterization and be alert to the possibility that an asset believed to be "separate" cannot be proven to be separate, or that in either a premarital or marital agreement the parties have changed the legal result. For example, income from separate property is not always community property.

VI. THE COMMUNITY PRESUMPTION

Notwithstanding the significance of the substantive rules of characterization, the importance of the community presumption cannot be ignored. Generally, all assets of the spouses on hand during the marriage and upon its termination are presumed to be community property, thereby placing the burden of proof on the party (e.g., a spouse, that spouse's personal representative, or the heirs/devisees of the spouse) asserting separate character to show by "clear and convincing evidence" that a particular asset is, in fact, separate. Tex. Fam. Code § 3.003.

A. Clear and Convincing Evidence

A "clear and convincing evidence" standard is somewhere between "preponderance" and "reasonable doubt". *Faram v. Gervitz-Faram*, 895 S.W.2d 839 (Tex. App.—Fort Worth 1995, no writ). However, the Texas Supreme Court has held that the requirement of a clear and convincing evidence standard is another way of stating that a legal conclusion must simply be supported by factually sufficient evidence. *See Meadows v. Green*, 524 S.W.2d 509, 510 (Tex. 1975) (a decision prior to the 1987 amendment to the predecessor to Section 3.003, which codified the clear and convincing evidence standard.)

B. Compare Management Presumption

The fact that an asset is held in one spouse's name only, or is in the sole possession of a particular spouse, is not determinative of its marital character. This only raises a presumption that the asset is subject to that spouse's sole management and control, while the community presumption dictates it is presumptively community. Tex. Fam. Code § 3.104.

C. Form of Title

The fact that record title is held in a particular way due to certain circumstances may cause the community presumption to vanish in favor of a rebuttable separate presumption. *See Smith v. Strahan*, 16 Tex. 314 (1856); *Higgins v. Johnson*'s *Heirs*, 20 Tex. 389 (1857); *Story v. Marshall*, 24 Tex. 305 (1859). The other spouse may not be allowed to rebut the presumption if that spouse was a party to the transaction. *Lindsay v. Clayman*, 151 Tex. 593, 254 S.W.2d 777 (1952).

D. Multiple-Party Accounts

Whether the multiple party account is held in both spouses' names or in the names of a spouse and a third party, the account is presumptively community property to the extent of a spouse's ownership of the account as determined under Chapter II of the Texas Probate Code. However, the exact marital property character of multiple-party accounts is determined in part by the form of account used by the depositing spouse.

1. DEFINITION

A multiple-party account is defined as a contract of deposit of funds between a depositer and a financial institution. It includes checking accounts, savings accounts, certificates of deposit, share accounts and *other like arrangements*. The term "financial institution" now includes "brokerage firms that deal in the sales of and purchases of stocks, bonds, and other types of securities." *See* Tex. Prob. Code **§** 436 (1), (3).

2. P.O.D. AND TRUST ACCOUNTS

Special community property of a spouse is deposited by that spouse into a "P.O.D. account" or "trust account" with the depositing spouse as the original payee or trustee.

a. The account remains community property during the existence of the marriage. An asset purchased with funds in the account would be community property.

b. Upon the death of the depositing spouse, the account belongs to the P.O.D. payee or the trust account beneficiary; however, if that person is not the depositor's surviving spouse, the surviving spouse may assert a claim equal to one-half of the funds by alleging that the depositing spouse committed actual or constructive fraud on the community interest of the surviving spouse.

c. Upon the death of the non-depositing spouse, the account is a considerable probate asset and belongs one-half to the surviving depositing spouse and one-half to the heirs or devisees of the deceased spouse, subject to administration, since the account is not controlled by a contract provision in that event.

d. Upon the death of the P.O.D. payee or the trust account beneficiary who is not the non-depositing spouse, the account remains community property since the P.O.D. payee or trust account beneficiary must survive the depositing spouse to receive the account.

3. JOINT ACCOUNTS/ CONVENIENCE ACCOUNTS

Community property is frequently deposited into joint or convenience accounts.

a. The account is community property, and assets purchased with funds in the account are presumptively community property. Depending on the circumstances, one spouse's withdrawal of funds may be considered to be a gift by the other spouse so that an asset purchased with the withdrawn funds is the donee spouse's separate property, but the burden of proof will be on the "donee" to prove the donative intent of the other spouse.

b. Upon the death of either spouse, the account is a probate asset and belongs one-half to the surviving spouse and one-half to the heirs or devisees of the deceased spouse, subject to administration.

4. JOINT ACCOUNTS WITH SURVIVORSHIP RIGHTS

Community property can be deposited into a "joint account with [valid] survivorship rights" between the spouses.

a. During the existence of the marriage, the marital property character of the account and assets purchased with such funds will be community, unless the account is a "46b special account" - an account that partitioned the account into the spouses' separate properties.

b. Upon the death of either spouse prior to the 1987 amendment, the community account was considered to be a probate asset subject to administration and belonged one-half to the surviving spouse and one-half to the heirs or devisees of the deceased spouse subject to administration, unless the account was a "46b special account"; in which event, the separate account belonged entirely to the surviving spouse.

c. Upon the death of either spouse subsequent to the 1987 amendment, the community account belongs to the surviving spouse, if the survivorship agreement was signed after November 3, 1987.

5. <u>JOINT ACCOUNTS AND THIRD PARTIES</u>

Special community funds of a spouse can be deposited into a "joint account" or a "joint account with survivorship rights" of one spouse and a third party who has not made any deposits.

a. During the existence of the marriage, the account remains community property. Withdrawal of funds by the third party may be a gift by the depositing spouse, if donative intent is established. Any such withdrawal may be in fraud of the non-depositing spouse's community property rights.

b. Upon the death of the depositing spouse, the account is a probate asset and belongs one-half to the surviving spouse and one-half to the heirs or devisees of the deceased spouse subject to administration, if there is not a valid survivorship agreement.

c. If there is a valid survivorship agreement, upon the death of the depositing spouse, the account belongs to the third party, but subject to the possible imposition of a constructive trust to remedy a possible fraud on the community property rights of the non-depositing spouse.

d. Upon the death of the non-depositing spouse, the account is a probate asset and belongs one-half to the surviving spouse and one-half to the heirs or devisees of the deceased spouse subject to administration, thereby effectively terminating the contractual survivorship rights of the third party as to the deceased spouse's one-half.

e. The death of the third party prior to the death of either spouse would not affect the ownership of the account because the third party must survive the depositer to assume ownership of the account. It remains the spouses' community property.

f. An attempt by one spouse to unilaterally deposit joint community funds into such an account may be void insofar as the survivorship rights of the third party are concerned.

6. <u>IMPORTANCE OF SIGNATURE CARDS</u>

It is readily apparent that to properly characterize the community or separate nature of the assets of a husband and wife, the attorney must closely examine the couple's existing signature cards, as well as their signature cards of the past, in order to accurately trace the ownership of their accounts, as well as assets purchased with the funds deposited into multiple-party accounts.

7. 900 LB. GORILLA RULE

The terms of the deposit agreement provided by the financial institution may even negate some, if not all, of the rules promulgated by Chapter XI and change the ownership interests and relative rights of the parties to the account. Further, the parties to the account may have no choice other than to accept the financial institution's forms.

8. THE 46b TRAP

The impact of the "46b trap" should be considered. Assume a married couple deposited community property into a "46b special account"—an account that contained both partition and survivorship language per Section 46 prior to the 1987 amendment. Subsequently, they purchased Blackacre with funds in the account, and the land appreciated in value during the marriage.

a. In the event of divorce, Blackacre would not be subject to a "just and right" equitable division by the divorce court since it would not be community property because it was a mutation of the "46b account."

b. In the event of a spouse's death, only the deceased spouse's interest in Blackacre would receive the tax-free "step up" in income tax basis. The surviving spouse's interest would not receive the "step up" since Blackacre was not community property.

E. Personal Injury Recoveries

The recovery for personal injuries sustained by a spouse during marriage is presumed to be community property, except to the extent the injured spouse can prove by clear and convincing evidence what portion of the recovery is actually separate property. The Family Code defines a recovery to be separate, except for loss of earning capacity. Tex. Fam. Code § 3.001. Personal injury recoveries for loss of earning capacity during marriage are defined as community property. Tex. Fam. Code § 3.001(3).

Note: *Notwithstanding this statutory provision, the author is of the opinion that actual "lost earnings" should be deemed community property while "loss of earning capacity" should be considered separate property. Lost earnings are properly characterized as community property since the community estate will be liable for payment of medical expenses and will suffer as a result of losing one spouse's community earnings. However, characterizing the recovery for lost earning capacity as community property requires a presumption that the husband and wife will remain married indefinitely. In reality, should the spouses divorce following the injury, community recoveries will be divided on a just and right basis; or should the non-injured spouse die, his estate will be entitled to one-half of the entire recovery. Since the primary purpose of a personal injury recovery is to compensate the injured spouse, classifying lost earning capacity as community property and giving the non-injured spouse a one-half interest therein may leave the injured spouse with only a fraction of the amount awarded. The potential for such a situation clearly warrants a distinction between lost earnings and lost earning capacity, which characterizes the former as community and the latter as separate. Notably, it has been established that a recovery for medical expenses is community property. Graham v. Franco, 488 S.W.2d 390 (Tex. 1972).*

VII. REIMBURSEMENT

Reimbursement between the marital estates usually arises when one spouse's separate property is improved through the expenditure of community funds or community time, talent and labor. Reimbursement may also be applicable if separate funds are expended to benefit community property. The increased importance of this concept over the last thirty years is due to the *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982) and *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) cases, as well as legislative interference in recent years.

A. Claim of Reimbursement

The law related to reimbursement evolved very slowly from the first case addressing the issue, *Rice v. Rice*, 21 Tex. 58 (1858), until 1982. During that period of time, the Texas courts applied the equitable theory of reimbursement to recompense one marital estate, usually the wife's separate property or the community estate, when funds from that estate were utilized to benefit another marital estate, usually the husband's separate property.

B. Measure of Reimbursement

Once the right of reimbursement was established, the Texas courts have failed to be precise in determining the measure of reimbursement. Over the years, three distinctive means of measurement evolved.

1. <u>"COST OF THE IMPROVEMENT"</u>

In *Rice, supra,* the Texas Supreme Court held that the measure of reimbursement was the original *cost of the improvement* paid for by the community.

2. <u>"ENHANCED VALUE OF THE IMPROVEMENT"</u>

In *Clift v. Clift*, 72 Tex. 144, 10 S.W. 338 (1888), the Texas Supreme Court applied a measure of reimbursement based on the *enhanced value* of the property at the time of the dissolution of the marriage due to the improvement paid for by the community.

3. <u>"LESSER OF COST OR ENHANCED VALUE"</u>

In *Dakan v. Dakan*, 125 Tex. 305, 83 S.W.2d 620 (1935), the Texas Supreme Court seemed to favor a method of reimbursement which would compensate the community for either the *cost* of the improvement or the *enhanced value, whichever was less*.

C. Application at Death

The *Dakan* court also held that the community claim for reimbursement existed at the owner's death, thereby placing the surviving spouse to an equitable election (i) to accept any benefits conferred in the will and waive the claim, or (ii) to assert the claim and waive any benefits under the will. It would also follow that the claim exists upon the death of the non-owner, thereby imposing a duty on the personal representative to pursue the claim against the surviving owner/spouse.

D. Case Law Developments

There have been several cases since *Cameron* and *Eggemeyer* which have significantly added to the concept of reimbursement.

1. <u>VALLONE</u>

In *Vallone v. Vallone*, 644 S.W.2d 455 (1982), the Texas Supreme Court expanded the concept of reimbursement to include situations where one spouse, the owner of the business, had expended an inordinate amount of uncompensated community time, talent and labor to increase the value of the owner's separately owned closely-held corporation.

2. <u>COOK</u>

In *Cook v. Cook*, 665 S.W.2d 161 (Tex. Civ. App.—Fort Worth 1983, writ ref'd n.r.e.), the court of appeals neatly categorized a number of situations where the right of reimbursement can arise involving one spouse's separate real estate.

a. Principal Reduction

Wherever one spouse uses the property of one marital estate to retire the principal of a previously existing purchase money debt of an asset of another marital estate, the contributing estate is entitled to recover its share of the exact dollar amount contributed, regardless of the underlying asset's increase in value. *But*, *see* the *Penick* case, *infra*.

b. Interest and Taxes

Wherever one marital estate contributes funds to pay either the interest on the purchase money indebtedness secured by an asset of another marital estate or the ad valorem taxes owing due to such asset, a balancing test is applied to determine whether the contributing estate enjoyed the current benefits of income or occupancy as quid pro quo for the payment of current expenses.

c. *Improvements*

Whenever one marital estate expends funds to improve the assets of another estate, the contributing estate is to be reimbursed for the enhancement in value due to the expenditure as provided in the *Clift* case. *See* the *Anderson* case, *infra*.

3. JENSEN

In *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984), the Texas Supreme Court reinforced the principle that the expenditure of community time, talent and labor by one spouse on separate property does not convert separate property into community property except in very limited situations. *See Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676 (1953). Nevertheless, the expenditure of community time, talent and labor in excess of what is necessary to reasonably manage one's separate property can give rise to a community right of reimbursement to the extent that excess time, talent or labor is not compensated. The Court did not provide a precise measure of reimbursement.

4. ANDERSON

In *Anderson v. Gilliland*, 684 S.W.2d 673 (1985), the community had expended approximately $20,000 to build a home on the separate property of the husband. At the time of the husband's death, the home was found to have enhanced the husband's separate property by $54,000. The Supreme Court stated:

We hold that a claim for reimbursement for funds expended by an estate for improvements to another estate is to be measured by the enhancement in value to the benefitted estate. *This rule is more likely to insure equitable treatment of both the contributing and benefitted estates in most situations.* [emphasis added]

5. PENICK

In *Penick v. Penick*, 783 S.W.2d 194 (Tex. 1988), the Supreme Court held that advancements of community funds to either reduce the principal on purchase money indebtedness secured by separate property or to make capital improvements on separate property are to be measured by the same test – the enhancement in value to the benefitted estate. In addition, the Court directed the trial court to take into consideration benefits received in return by the community estate. How does paying off the balance of a note payable enhance the value of the pledged assets?

6. HEGGEN

Although it is in the nature of a claim against the individual spouse, a reimbursement claim can be secured by the court imposing an equitable lien against the property benefitted. An equitable lien can even be imposed on the residential homestead to secure reimbursement for community funds expended on taxes, purchase money or improvements. *Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992).

Note*: The 1995 amendments to the Texas Constitution expanded the types of debts that can be secured by the homestead.*

7. OTHER CASES

There have been a number of cases citing *Vallone*, *Jensen* and *Anderson*. *See generally Allen v. Allen*, 704 S.W.2d 600 (Tex. App.—Fort Worth 1986, no writ); *Hernandez v. Hernandez*, 703 S.W.2d 250 (Tex. App.—Corpus Christi 1985, no writ); *Wren v. Wren*, 702 S.W.2d 250 (Tex. App.—Houston [1st Dist.] 1985, writ dismissed w.o.j.); *Jones v. Jones*, 699 S.W.2d 583 (Tex. App.—Texarkana 1985, no writ); *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism'd w.o.j.). In *Jacobs v. Jacobs*, 687 S.W.2d 731 (Tex. 1985), the Supreme Court addressed the proof issues related to *Vallone* and *Jensen*. One court of appeals case, *Trawick v. Trawick*, 671 S.W.2d 105 (Tex. App.—El Paso 1984, no writ), appears to extend *Vallone* and *Jensen* to estate administration situations.

E. Additional Applications

1. LIFE INSURANCE

Reimbursement can arise in other situations. One of the more common situations is where one spouse separately owns an insurance policy on that spouse's life and uses community property to pay the premiums; upon the insured spouse's death, the proceeds are payable to a third party. In *McCurdy v. McCurdy*, 372 S.W.2d 381, (Tex. Civ. App.—Waco 1963, writ ref'd), the court held that the community was entitled to reimbursement in the amount of the premiums paid by the community.

2. OTHER APPLICATIONS

It does not appear that *Anderson* changes or should change the measure of reimbursement for either a *Jensen* or *McCurdy* situation. It should also be recognized that the *Vallone* and *Jensen* type of reimbursement may exist in a situation where the non-owner spouse expends an inordinate amount of uncompensated community time, talent and labor to enhance the separate property of the other spouse. As in *Jensen*, the focus should be on the value of the services rendered and actual compensation received. For further study, *see* Fred C. Weekley, *Reimbursement Between Separate and Community Estates*, 39 *Baylor L. Rev*. 945 (1987).

F. Legislation

The 1999 legislature added a new Subchapter E to Chapter 3 of the Texas Family Code and created, in effect, a new type of reimbursement - “statutory reimbursement.”

1. 1999 LEGISLATION

Financial contributions made with community property that enhanced the value of separate property during the marriage created an “equitable interest” of the community estate in the separate property. Tex. Fam. Code § 3.401 (1999)

a. *Equitable Interest Defined*

However, an equitable interest did not create an ownership interest; it created a claim against the spouse who owns the property that matured on the termination of the marriage. Tex. Fam. Code § 3.006(b) (1999). Compare, however, the language in § 3.403(b) (1999), and note the inconsistency.

b. *Amount of Claim*

The claim was measured by the "net amount of the enhancement" in value of the separate property during the marriage. Tex. Fam. Code § 3.401(b) (1999). If community funds were used to discharge all or a part of a debt on separate property, the statute described a formula to compute the amount of the claim. Tex. Fam. Code § 3.402 (1999).

c. Equitable Lien

The court was instructed to impose an equitable lien to secure the claim. The statute also indicated that the lien could be assessed against other assets as well. Tex. Fam. Code § 3.406 (1999).

d. No Offsetting Benefits

Where statutory reimbursement is appropriate, the use and enjoyment of the property during marriage did not create offsetting benefits. Tex. Fam. Code § 3.405 (1999).

e. Life Insurance

The 1999 statute raised serious questions related to its application to life insurance situations. For example, where there was a separately owned policy, but community funds were used to pay some of the premiums, was this a § 3.401 (1999) financial contribution? Did § 3.401(b) (1999) or § 3.402 (1999) apply? Or did the *McCurdy* case still apply?

f. Effective Date

According to language in the statute, the changes in law made by the relevant portions of the Act, HB 734, apply only to a suit for dissolution of a marriage pending on September 1, 1999, or filed on or after that date. Did this mean that statutory reimbursement was limited to divorce actions? Following the death of a spouse, a reimbursement claim may arise in a probate proceeding, or in an independent cause of action. Most commentators believed it applied in probate situations.

2. 2001 LEGISLATION

HB 1245 (2001) contained a major overhaul to subchapter E. For example, statutory reimbursement was no longer referred to as an "equitable interest." Rather, it was referred to as a "claim for economic contribution."

a. Intent

Section 1 of HB 1245 clearly stated that economic contributions by one marital estate for the benefit of another created a claim for the contributing marital estate in the property of the benefitted estate—"claim for economic contribution."

b. Economic Contribution Defined

Economic contributions arose in six statutorily defined situations related to use of one marital estate's funds to reduce the principal amount of debt secured by another marital estate or to make capital improvements to another marital estate. Tex. Fam. Code § 3.402(a). Economic contribution did not include expenditures for ordinary maintenance or repair, or for taxes, interest or insurance, or for the contribution of time, toil, talent or effort (i.e., *Jensen*-type claims). Tex. Fam. Code § 3.402(b).

c. The Formula

Section 3.403(h) described a formula to be used in economic contribution situations. *See* Gagnon, *Statutory Reimbursement: The Equitable Enigma*," State Bar of Texas, Advanced Family Law Course, Aug. 2001, and Goodman, *Guest Commentary*, State Bar Section Report—Family Law, Vol. 2001-2 Summer.

d. Use and Enjoyment

The use and enjoyment of the property during marriage did not create a claim of an offsetting benefit. Tex. Fam. Code § 3.403(e). For example, the couple's occupancy of the separate property home of the husband that was improved with community funds was not an offset.

e. Equitable Lien

In divorce situations, an equitable lien was imposed to secure payment of the claim. In death situations, a party of interest had to request the imposition of the equitable lien. Tex. Fam. Code § 3.406. The equitable lien could be imposed on any assets of the owner of the benefitted property; the court was not limited to the benefitted property itself.

f. Claims for Reimbursement

The claim for economic contribution did not eliminate from Texas law the traditional claim for reimbursement except in those fact situations that were statutorily defined claims for economic contributions. Tex. Fam. Code § 3.408(a). In fact, the statute gave examples of the more traditional claim for reimbursement—payment of unsecured liabilities and *Jensen*-type claims. Tex. Fam Code § 3.408(b). Claims for reimbursement were to be resolved using equitable principles, including "use and enjoyment" offsets. Tex. Fam. Code § 3.408(c), (d). A 2007 amendment to the section placed the burden of proof on the party seeking the offset. Tex. Fam. Code § 3.408(e).

g. Marital Property Agreement

Marital property agreements executed before or after September 1, 1999 (the effective date of the 1999 legislation) that waive or partition traditional reimbursement claims will be effective to waive claims for economic contribution. Tex. Fam. Code § 3.410.

3. 2009 LEGISLATION

SB 866 (effective 9/1/09) contained another major overhaul to subchapter E. There are no longer "claims for economic contribution."

a. Intent

What had been defined separately as claims for economic contribution and statutory claims for reimbursement are now combined as "claims for reimbursement."

b. Reimbursement Defined

A claim for reimbursement includes: (i) payment by one marital estate of an unsecured liability of another marital estate; (ii) inadequate compensation for the time, toil, talent and effort of a spouse by a business entity under the control and direction of that spouse; (iii) what had been considered claims for economic contribution under former § 3.402(a); and (iv) the reduction by the community property estate of an unsecured debt incurred by the separate estate of one of the spouses. Tex. Fam. Code § 3.402(a). Economic contributions previously arose in six statutorily defined situations related to use of the marital estate's funds to reduce the principal amount of debt secured by another marital estate or to make capital improvements to another marital estate.

c. Equitable Principles

A claim for reimbursement is to be resolved by using equitable principles, including the principle that claims for reimbursement may be offset against each other if the court determines it to be appropriate. Tex. Fam. Code § 3.402(b). However, reimbursement for funds expended by a marital estate for improvements to another marital estate be measured by the enhancement in value to the benefited marital estate. Tex. Fam. Code § 3.402(d).

d. Use and Enjoyment

Generally, the use and enjoyment of property is to be offset against a claim for reimbursement for expenditures to benefit a marital estate. However, a party may not claim an offset for use and enjoyment of a primary or secondary residence owned in whole or part by the separate estate against contributions made from the community estate to benefit the separate estate. Tex. Fam. Code § 3.402(c). The party seeking an offset to a claim for reimbursement has the burden of proof with respect to the offset. Tex. Fam. Code § 3.402(e).

e. Surviving Spouse's Election

If the owner spouse devises the benefited separate property to the other spouse, the other spouse should not be able to accept the devise and also assert a claim for reimbursement. The correct analysis may be to explain that the surviving spouse is put to an election. Even if the benefited property is devised to a third party, the other spouse may have to elect between accepting what other assets were devised to him or her and asserting the claim for reimbursement.

f. Equitable Lien

Section 3.406 authorizes (rather than requires) the court, on dissolution of a marriage, to impose an equitable lien on the property of a benefited marital estate to secure a claim for reimbursement against that property by a contributing marital estate. It also authorizes (rather than requires) the court, on the death of a spouse, on application for a claim for reimbursement brought by the surviving spouse, the personal representative of the estate of the deceased spouse, or any other person interested in the estate, to impose an equitable lien on the property of a benefited marital estate to secure a claim for reimbursement against that property by a contributing marital estate.

Note*: Apparently, an equitable lien can no longer be imposed on any assets of the owner of the benefited property; the lien appears to be limited to the benefited property itself.*

g. Equitable Claims

Notwithstanding the repeal of Section 3.408, surely the new law does not eliminate from Texas law traditional claims for reimbursement.

Note*: Despite some apparent confusion on the part of some courts (see Lewis v. Lewis, 1999 Tex. App. LEXIS 4920 (Tex. App.—Houston [1st Dist., no pet.], "waste of community assets" should be considered a type of fraud on the community, not a claim for reimbursement.*

h. Non-Reimbursable Claims

The statute still describes some nonreimbursable claims—payment of child support, alimony or spousal maintenance, living expenses of a spouse or child, contributions or principal reductions of nominal amounts, and student loan payments. Tex. Fam. Code § 3.409.

i. Marital Property Agreement

Marital property agreements executed before or after September 1, 2009, the effective date of the 2009 legislation, which waive or partition reimbursement claims or claims for economic contribution will be effective to waive claims for current claims for reimbursement. Tex. Fam. Code § 3.410.

G. Death of Claimant Spouse

Upon the death of the spouse who has a community reimbursement claim (or claim for fraud on the community – *see* VIII, *infra*), against the surviving spouse, the claimant spouse's one-half interest in the claim passes to that spouse's heirs or devisees.

1. DUTY OF PERSONAL REPRESENTATIVE

If the heir or devisee is not the other spouse (or if the estate is insolvent), the personal representative may have a duty to pursue the claim against the surviving spouse.

2. LIQUIDITY PROBLEMS

The existence of the claim may result in a much larger estate than had been anticipated. The deceased spouse's interest in the claim is included in the deceased spouse's gross estate for estate tax purposes and may cause an immediate liquidity problem.

3. CONFLICT OF INTERESTS

The existence of the claim may create a conflict of interest for both the personal representative and the attorney who are attempting to represent the entire family.

H. Claimant as the Surviving Spouse

Upon the death of the other spouse, the asset which is the subject of the community claim for reimbursement will remain the owner's separate property and pass under the owner's will or by intestate succession; however, the claim of the surviving spouse continues to exist, as does any claim that the deceased spouse committed a fraud on the community or attempted to unilaterally transfer joint community property prior to death. *See* VIII, *infra*.

1. CONFLICT OF INTERESTS

Either situation can create a conflict of interest (i) between the surviving spouse and the decedent's heirs or devisees, or (ii) between the heirs or devisees where the heirs or devisees of the separate property are not the same as the heirs or devisees of the community property. This potential conflict can be particularly troublesome for the personal representative or attorney who attempts to represent all members of the family.

2. ELECTION

The doctrine of equitable election may force the surviving spouse to (i) assert the claim and waive any and all benefits under the will, or (ii) accept the benefits conferred in the will and forego the claim. The doctrine of equitable election is applied where any devisee received a benefit and suffers a detriment in a will. Accordingly, the election concept might work against any party involved.

3. OTHER PROBLEMS

The existence of such a claim with an uncertain value is likely to delay the administration of the estate and create liquidity problems.

VIII. WRONGFUL TRANSFERS

It is not unusual to discover, following the death of the deceased spouse, that the decedent made a nonprobate disposition of community property to a third party or that the surviving spouse had made an inter vivos gift of community property to a third party. The third party may be a child of the couple, a child by a prior marriage, a charity or an elderly parent or a paramour.

The Texas Family Code generally grants to the managing spouse the power, with or without consideration, to transfer to a third party 100% of that spouse's *special* *community property* without the joinder, the consent or even the knowledge of the other spouse. *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist] 1991, writ denied). Joint community property is different.

A. Consequences of Joint Management

If the subject of the nonprobate disposition or gift was the couple's joint community property, it is arguable that the purported disposition is void as to the other spouse because the spouse attempting the disposition simply did not have the power to make the disposition without the joinder or consent of the other spouse. Tex. Fam. Code § 3.1002(b). The attempted disposition may even be void as to the disposing spouse's one-half interest in the proper. If the transaction is not void or voidable as a matter of law, or if the other spouse previously authorized the disposing spouse to generally manage the property and then there was a nonprobate disposition or gift, it would appear that the analysis should be similar to the one applied to the unilateral transfer of special community property—"fraud on the community analysis." *See* VIII, B-H, *infra.*

However, the Texas Supreme Court has not yet definitively determined whether one spouse can assign his or her own undivided one-half interest in joint community property to a third party without the joinder of the other spouse. The view more consistent with the overall statutory scheme would void such a unilateral attempt as an attempt to unilaterally partition; partitions require the joinder of both spouses. The courts of appeals are divided. *See Williams v. Portland State Bank*, 514 S.W.2d 124 (Tex. Civ. App.—Beaumont 1974, writ dism'd); *Vallone v. Miller*, 663 S.W.2d 97 (Tex. App.—Houston [14th Dist.] 1983, writ ref'd n.r.e.); *Dalton v. Don J. Jackson, Inc.*, 691 S.W.2d 765 (Tex. App.—Austin 1985, writ ref'd n.r.e.).

B. Fiduciary Obligation

As to the special community property of a spouse, the managing spouse's power is limited by a fiduciary obligation owing to the other spouse due to the existence of the marital relationship. A trust relationship exists between the spouses as to the special community property controlled by each spouse. *See Carnes v. Meador*, 533 S.W.2d 365 (Tex. Civ. App.—Dallas 1975, writ ref'd n.r.e.). This special relationship has many of the characteristics of a private express trust: (i) <u>identifiable property</u> – a spouse's special community property; (ii) <u>separation of legal and equitable title</u> – the managing spouse has legal title and the equitable title is owned equally by both the spouses; and (iii) <u>fiduciary duty</u>. While not defined by the intent of a settlor, the Texas Trust Code or the common law, and while not the same, nor nearly as extensive, as the duties generally imposed on trustees of express trusts, the managing spouse's power of management is limited by the duty not to commit "fraud on the community."

C. The Managing Spouse's Duty

The managing spouse has the duty not to commit a fraud on the community property rights of the other spouse (i.e., not to dispose, transfer or diminish that spouse's special community property in fraud of the other spouse's rights to that property). *See Matter of Marriage of Moore*, 890 S.W.2d 821 (Tex. App.—Amarillo 1994, no writ) and *Jackson v. Smith*, 703 S.W.2d 791 (Tex. App.—Dallas 1985, no writ), where the court refers specifically to the fiduciary relationship that exists between spouses.

D. Burden of Proof

Because the managing spouse has the power under the Texas Family Code to dispose of that spouse's special community property, the burden is on the other spouse to raise the issue of fraud on the community when the marriage terminates. That spouse may seek to establish that the managing spouse's action with respect to the managing spouse's special community property amounted either to "actual" or "constructive" fraud.

For example, to establish that the managing spouse's gift to a third party amounted to actual fraud, the other spouse must prove that the gift was made with the primary purpose of depriving the other spouse of that asset. Constructive fraud is established where a gift is found to be "unfair" to the other spouse. *See Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Civ. App. — Houston [14th Dist.] 1975, writ dism'd w.o.j.). Texas courts have also set aside a gift as constructively fraudulent if the gift was capricious, excessive or arbitrary. *See Carnes v. Meador*, *supra*, and *St. v. Skipper*, 887 S.W.2d 78 (Tex. App.—Fort Worth 1994, writ denied).

Once the issue of constructive fraud is raised, the cases suggest the burden switches to the managing spouse to prove that the gift was fair to the other spouse. *See Murphy v. Metro. Life Ins. Co.*, 498 S.W.2d 278 (Tex. Civ. App.—Houston [14th District] 1973, writ ref'd n.r.e.), and *Givens v. The Girard Life Ins. Co.*, 480 S.W.2d 421 (Tex. App.—Dallas 1972, writ ref'd n.r.e.). *Jackson v. Smith*, *supra*. Factors to be considered in determining whether there has been a constructive fraud include (i) the size of the gift in relation to the total size of the community estate, (ii) the adequacy of the remaining community assets to support the other spouse, and (iii) the relationship of the managing spouse to the donee. *See Horlock v. Horlock*, *supra*. Another court described the factors to be considered as (i) whether special circumstances justify the gift and (ii) whether the community funds used were reasonable in proportion to the remaining community assets. *Givens, supra*. Most of the cases in this area involve excessive or capricious consumption of community assets, or gifts of community assets to third parties as the basis of constructive fraud on the community. *See* Stewart Gagnon, Kathryn Murphy, Ike Vanden Eykel, *Texas Practice Guide - Family Law*, §§ 16:8–16:95 (West).

E. Remedies, Generally

The managing spouse's abuse of managerial powers of community assets affects not only the equitable division of the remaining community estate upon divorce, but can result in the awarding of a money judgment for damages to the other spouse when the marriage terminates in order to recoup the value of the other spouse's share of the community lost through the managing spouse's wrong doing. *See Mazique v. Mazique*, 742 S.W.2d 805 (Tex. App.—Houston [1st Dist.] 1987, no writ). *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied); *Matter of Marriage of Moore*, 890 S.W.2d 821 (Tex. App.—Amarillo 1994, no writ). A judgement for money damages against the transferee may also be possible. See *Madrigal v. Madrigal*, 115 S.W.3d 32, 35 (Tex. App—San Antonio 2003, no pet.) (citing *Estate of Korzekwa v. Prudential Ins. Co. of Amer.*; 669 S.W.2d 775, 778 (Tex. App.—San Antonio 1984, writ dism'd); *Hartman v. Crain*, 398 S.W.2d 387, 390 (Tex. Civ. App.—Houston 1966, no writ). Courts have also used their equitable powers to impose a constructive trust on community assets given to third parties. See *Carnes v. Meador, supra* and *In re Murrell*, 1998 Tex. App. LEXIS 7603 (Tex. App.—Amarillo 1998, no writ) where the court found constructive fraud and explains that the equitable title to the property transferred to a third party was still community property.

F. The Schlueter Case

In *Schlueter v. Schlueter*, 975 S.W.2d 584 (Tex. 1998), the Texas Supreme Court emphasized that fraud on the community is not a separate tort cause of action, but is a form of fraud cognizable within the equitable division of the community estate. Consequently, punitive damages are not appropriate. According to *Schlueter*, a money judgment for actual damages can be awarded to allow the wronged spouse to recoup the community estate loss due to the other spouse's fraud on the community; the amount of the judgment is specifically referable to the value of the lost community and cannot exceed the total value of the community estate.

Relying on *Schlueter*, the Texas Supreme Court has recently ruled that a wife, whose husband had committed a fraud on the community prior to their divorce, was not able to hold a lawyer liable for conspiracy with the husband to commit the fraud. The court reaffirmed the *Schlueter* rationale (i.e., there is no independent tort cause of action for wrongful disposition by a spouse), noting that it is hard to see how the community has been damaged if one spouse retains the fruits of the fraud, and finally held that, if the spouse cannot be held liable for the tort and punitive damages, neither can a co-conspirator. *Chu v. Hong,* 249 S.W.3d 441 (Tex. 2008), *rev'g* 185 S.W.3d 507 (Tex. App. – Fort Worth 2005, no pet.). The fraudulent sale was found to be void and the buyers were divested of ownership; interestingly, the lawyer represented the buyer.

<u>Note</u>: *In 2011, the Texas Legislature enacted Tex. Fam. Code § 7.009, which purports to codify and clarify the <u>Schlueter</u> decision. This statute requires a divorce court to "reconstitute" the community estate by placing a value on the community asset wrongly transferred and adding it back to the value of the existing community estate. It is a divorce concept—not a probate concept.*

G. Death of a Spouse

In the event the marriage terminates by reason of the death of a spouse, the managing spouse should be liable to the estate of the other spouse, or the estate of the managing spouse should be liable to the other spouse, for any actual damages suffered by the other spouse arising from a fraud on the community. For example, if $100,000 of community assets were wrongfully transferred by the managing spouse to a third party, the other spouse, or that other spouse's estate, has a claim for money damages in the amount of $50,000, an amount equal to the other spouse's one-half community interest in the $100,000 wrongfully transferred. If the managing spouse, or the managing spouse's estate, does not have sufficient assets to satisfy the claim for damages, the court may impose a constructive trust on the third party donee in order to retrieve one-half of the community asset that had been wrongfully transferred to the donee. *Carnes v. Meador, supra*. *See Osuna v. Quintana*, 993 S.W.2d 201, 209 (Tex. App.—Corpus Christi 1999, no pet.) discussing the difference in remedies in death and divorce situations.

1. <u>THE HARPER CASE</u>

In *Harper v. Harper*, 8 S.W.3d 782 (Tex. App.—Fort Worth 1999, pet. den.), the court cites *Schlueter* for the holding that ". . . fraud on the community exists outside the realm of tort law and cannot be brought as an independent cause of action . . ." before holding that punitive damages are not recoverable. The only damages being sought against the managing spouse in *Harper* were punitive damages since the estate of the other spouse had already received half of the sales proceeds (plus interest) in satisfaction of the other spouse's interest in the property at issue. *Harper* and *Schlueter* do not hold that the other spouse cannot seek actual damages where the managing spouse commits a fraud on the community.

Note: *Some have argued that Harper is authority for the proposition that "fraud on the community" does not survive the death of a spouse. That is clearly not the holding in Harper.*

2. EXAMPLES

a. Assume that a husband gives his mother his special community car, or a husband designates his child by a previous marriage as beneficiary of an insurance policy that is the husband's special community property, or a husband deposits special community cash into a bank account payable at his death to his paramour. Upon the husband's death, the car is still owned by the husband's mother and the proceeds of the policy and the funds on deposit belong to the designated third party beneficiary, unless the transfer to the mother, child or paramour is set aside as to the wife's one-half interest because the transfer is found to have been in fraud of the surviving spouse's rights. The court should, however, first attempt to make the wife whole by an award of money damages out of the husband's estate, if fraud on the community is established.

b. If the wife dies first, any cause of action for fraud on the community belongs to her successor in interest, the personal representative of her estate, or her heirs or devisees. However, the life insurance policy and the bank account, being the husband's special community property, are simply partitioned by reason of the wife's death, as probate assets. The wife's successor may then elect to pursue the fraud claim against the husband concerning the car. Of course, if the husband is the wife's sole heir or devisee, the claim is extinguished unless the wife's estate is insolvent since the claim is an asset subject to the wife's debts under Tex. Prob. Code § 37.

H. Street v. Skipper

In *Street v. Skipper*, 887 S.W.2d 78 (Tex. App.—Fort Worth 1995, writ denied) a special community property life insurance policy was payable to the insured spouse's probate estate, and his wife correctly argued that the husband did not have the power to devise by will her one-half of the policy proceeds to his devisees. In effect, the wife was arguing that the proceeds payable to the estate were probate assets, and she was entitled to one-half of the proceeds without needing to prove fraud on the community. In other words, the husband did not have the authority to devise the wife's one-half interest in community property, which is a fundamental concept.

However, the court held that the controlling issue was whether or not the husband had committed fraud on the community. It then considered the fact that the value of the total community estate, including the life insurance policy, was approximately $4,600,000 and that under the will the wife would retain and/or inherit more than half of that amount by reason of her husband's death. In addition, she received a portion of the husband's separate property, including her homestead rights in his separate property home. The court concluded that a fraud on the community had not occurred. The result may have been correct, but the reasoning was not. While the husband did not have the authority to devise his wife's one-half of the proceeds, perhaps it was her "election" to take under the will that estopped her from asserting her right to her one-half of the proceeds.

1. THIRD PARTY DESIGNATION?

Would the result in *Street* be different had the husband designated the third party as the direct beneficiary of the policy rather than designating his estate? Arguably not. Such a change in facts raises the issue of fraud on the community, and assuming the wife still retained or inherited in excess of one-half of the value of the community by reason of her husband's death, the result would depend on the overall "fairness" of the situation. *See Jackson v. Smith*, *supra* and *Redfern v. Ford*, 579 S.W.2d 295 (Tex. Civ. App.—Dallas 1979, writ ref'd n.r.e.). *See* II, F, 4, *infra*.

2. TWEAKING THE FACTS

Would the result in *Street* be different had the wife not received at least one half of the total community estate and a significant devise of the husband's separate property? For example, assume that the third party had been designated the beneficiary of the community-owned insurance and was also the sole devisee under the husband's will. In other words, the wife retained only her one-half of the community probate assets and her homestead right of occupancy in the husband's separate property home. Obviously, that situation is the classic example of the commission of a fraud on the community.

3. ELECTION?

However, how would the analysis differ had the husband devised to his wife a portion of his half of the community property or some of his separate property, but the value of what was devised to the wife was less than the value of her one half of the insurance proceeds payable to a third party? Absent actual fraud, the answer appears to depend in part on the fairness factors to be considered in determining if the insurance designation amounted to a constructive fraud on the community.

The tougher theoretical question may be whether the wife can assert her claim of fraud on the community (or her right to one-half of the proceeds under the partition approach) and still retain the property devised to her in the will. In other words, will she be required to, in effect, "elect against the will" in order to pursue her community interests devised to a third party?

I. Illusory Transfers

In *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968), the Texas Supreme Court held that a husband's creation of a revocable trust with his special community property was illusory as to his wife's one-half community interest therein since the husband had, in effect, retained essential control over the trust assets. The key factor was the revocability of the trust. Accordingly, the wife was able to set aside the trust as to her one-half interest upon her husband's death.

Query: *To date, the illusory transfer argument has been applied only to revocable trusts. Would it also apply in theory to any revocable nonprobate disposition (e.g., a POD bank account)?*

J. Fraud on Creditors

Certain transfers between spouses and transfers to third parties may be set aside by creditors under both Texas and federal law. *See* the Uniform Fraudulent Transfer Act, Tex. Bus. & Comm. Code §§ 24.001-24.013 and the U.S. Bankruptcy Code, 11 U.S.C. § 544(b).

Note: *The definition of creditor includes a spouse who has a claim.*

K. Federal Preemption

In *Barnett v. Barnett*, 67 S.W.3d 107 (Tex. 2001), the Texas Supreme Court held that a wife's claim for constructive fraud on the community and her corresponding claim for the imposition of a constructive trust following her husband's death were preempted by ERISA. In that case, a husband had designated a third party as the beneficiary of a life insurance policy that was part of an employee benefit plan covered by ERISA.

Although the policy was community property, the wife's claim in *Barnett* was based on Texas law (i.e., "fraud on the community") that had a connection with an ERISA plan and was, accordingly, preempted. The court explained that the application of Texas community property laws would interfere with the national uniformity of a matter central to ERISA plan administration. Thus, in the absence of actual common law fraud, the court found that Texas' concept of "fraud on the community" had no counterpart in federal common law.

IX. RETIREMENT PLANS

In *Allard v. Frech*, 754 S.W.2d 111 (Tex. 1988), the Texas Supreme Court confirmed that an employee's spouse has a community property interest in the employee spouse's employee benefit package. *See also Valdez v. Ramirez*, 574 S.W.2d 748 (Tex. 1978). The employee benefit package of a working spouse is a form of compensation and acquires a community character during marriage.

A. Application of the Apportionment Rule

Texas cases have consistently held that the community or separate character of an employee's retirement plan depends on an "apportionment" approach rather than the "inception of title rule". The "apportionment" approach gives the non-employee spouse an increasing community property interest in the employee's plan during marriage. *Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983) and *Dessommes v. Dessommes*, 543 S.W.2d 165 (Tex. Civ. App.—Texarkana 1976, writ ref'd n.r.e.). While the apportionment approach should preserve an employee's separate interest in a retirement plan owned prior to marriage, the application of the rule over the years has resulted in the loss by employees of significant portions of their defined contribution plans. For example, in *McClary v. Thompson*, 65 S.W.3d 829 (Tex. App.—Fort Worth 2002, pet. denied), the court of appeals stated that... "to determine the portion as well as the value of a defined contribution plan that is community property, courts subtract the amount contained in the plan at the time of the marriage from the total contained in the account at divorce." *See also* West Group, Texas Family Law Service, § 22:29 (2004). In other words, if this statement is accurate, any appreciation in value during the marriage of what was originally a separate 401K plan, a profit-sharing plan, or an ESOP becomes community property because the employee is not permitted to trace the assets in any such plan at the beginning of the marriage into what is still in the plan at the time of divorce.

B. Tracing the Separate Interest

An employee should be permitted to trace the assets in the plan on the date of the marriage into their "traceable mutations" in existence at the time of divorce. Definitive case authority for this position is lacking since most authority is found in court decisions involving defined benefit plans and not defined contribution plans. *See Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983); *Taggart v. Taggart*, 552 S.W.2d 422 (Tex.

1977); and *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976) (defined benefit plans are to be apportioned based on the relative time periods). Subsequent courts of appeals have failed to consistently distinguish defined contribution and defined benefit plans. *Iglinsky v. Iglinsky*, 735 S.W.2d 536 (Tex. App.—Tyler 1987, no writ) and *Hatteberg v. Hatteberg*, 933 S.W.2d 522 (Tex. App.—Houston [1st Dist.] 1994, no writ), recognized the differences.

However, *Pelzig v. Berkebile*, 931 S.W.2d 398 (Tex. App.—Corpus Christi, 1996, no writ), *Baw v. Baw*, 949 S.W.2d 764 (Tex. App—Dallas 1997, no pet.), and *Smith v. Smith*, 22 S.W.3d 140 (Tex. App.—Houston [14th Dist] 2000, no pet.), have all taken the position that the community interest in a defined contribution plan is calculated by subtracting the value of the plan as of the date of the marriage from the value of the plan as of the date of the divorce. It is important to note that the tracing rules do apply to mutual funds in general. *See Bakken v. Bakken*, 503 S.W.2d 315 (Tex. App.—Dallas 1973, no writ), which recognized that increases in mutual fund shares as either separate or community property depend on whether the increases were due to dividends or capital gain distributions.

C. Section 3.007

A 2005 addition to the Texas Family Code was intended to resolve many of the tracing issues described above by recognizing the different types of plans.

1. <u>DEFINED BENEFIT PLANS</u>

A spouse, who was a participant in a defined benefit retirement plan, was deemed to have a separate property interest in the monthly accrued benefit the spouse had a right to receive on normal retirement age, as defined by the plan, as of the date of marriage, regardless of whether the benefit had vested. The community property interest in that same plan was to be determined as if the spouse began to participate in the plan on the date of marriage and ended that participation on the date of dissolution or termination of the marriage, regardless of whether the benefit had vested. Tex. Fam. Code § 3.007(a), (b). However, in 2009, HB 866 repealed subsections (a) and (b) of Section 3.007, effective September 1, 2009, and apparently returns the application of the apportionment approach to defined benefit plans back to case law.

2. <u>DEFINED CONTRIBUTION PLANS</u>

A defined contribution plan is presumed to be entirely community property. However, the separate property interest of a spouse in a defined contribution retirement plan may be traced using the tracing and characterization principles that apply to nonretirement assets. Tex. Fam. Code § 3.007(c). Subsection (c) was left unchanged by HB 866 (2009).

3. <u>OTHER PLANS</u>

Even more details are involved if the plan is an employer provided stock option plan or an employer provided restricted stock plan. *See* Tex. Fam. Code *§* 3.007(d), (e). Subsection (d) was amended by HB 866 (2009), which also repealed subsection (f).

X. EFFECT OF DEATH ON RETIREMENT PLANS

As explained in IX, *supra*, unlike most marital assets, the separate or community character of an interest in a retirement plan is determined using "apportionment" instead of the traditional "inception of title rule." Under Texas law, the community property interest of a participant is defined as the participant's community property subject to the participant's "sole management and control."

A. Federal v. Texas Law

Upon the death of the employee spouse, Texas case law has held that the other spouse retains an interest in the community portion of the employee spouse's retirement plan. In addition, federal law mandates that the other spouse be the beneficiary of a "qualified preretirement survivor's annuity" for many ERISA plans.

Upon the death of the employee's spouse prior to the employee's retirement, the Texas Supreme Court has held that the deceased spouse's heirs and devisees succeed to that spouse's one-half of the community portion of the employee spouse's interest in the plan, if there has not been a valid nonprobate disposition of the same. *See Valdez* and *Allard, supra*.

However, while ERISA does not expressly address what happens when the spouse dies before the employee retires, the Retirement Equity Act of 1984 ("REA") amended ERISA in order to introduce mandatory spousal rights in many retirement plans;, as a result, the choice of the form of benefit received from such a plan is no longer solely the employee's choice under federal law.

The *Valdez* and *Allard* cases involved federal civil service retirement benefits and a private company's retirement plan. Accordingly, a little known section of the Texas Government Code was not applicable. That section states that the death of a spouse of a member or retiree of the Texas public retirement system terminates the spouse's interest in that retirement system. Tex. Gov't Code § 804.101. A federal court has interpreted the statute to define the spouse's statutory property interest as one that terminates upon the death of the spouse and for that reason held that the statute does not violate Article 66, Section 15 of the Texas Constitution. *Kunin v. Feofanov*, 69 F.3d 59 (5th Cir. 1995).

B. Retirement Equity Act of 1984

Prior to REA, federal law granted the participant's spouse very few rights to share in the participant's retirement benefits. REA's legislative history reflects Congress' "community property type" view that marriage is a partnership and that retirement benefits are derived from the contributions of both spouses. For example, REA requires that the participant's retirement benefits in a pension plan be paid in the form of a "qualified joint and survivor annuity" ("QJSA"), if the participant survives until retirement age. If a vested participant in such a plan dies before retirement, REA makes the surviving spouse a plan beneficiary with an interest called a "qualified preretirement survivor annuity" ("QPSA"). The mandatory spousal rights mandated by REA can be waived by the participant's spouse. Internal Revenue Code, 26 U.S.C.A. § 401(a), 417.

C. Covered Plans

The QJSA and QPSA requirements apply to all defined benefit plans, money purchase plans, any defined contribution plan to which IRC Section 412 applies (excluding profit sharing plans), some 403(b) annuity arrangements (excluding IRAs and SEPs), and certain other defined contribution plans (profit sharing and stock bonus plans) that either do not satisfy the conditions delineated in IRC Section 401(a)(11)(B)(iii) or are considered to be a "transfer plan" under 26 C.F.R. § 1.401(a)-20, Treas. Reg. § 4016)-20.

<u>Caveat</u>*: The "ERISA rights" of the participant's spouse are governed by not only ERISA (U.S.C.A. Title 29) but also the Internal Revenue Code (U.S.C.A. Title 26),*

as well as the I.R.S., Departments of Labor and Treasury interpretations of the two. The result is an incredibly complicated set of rules that do not lend themselves to easy explanation. Accordingly, a participant should inquire as to what are the spouse's rights in the participant's particular plan. The plan itself may even mandate a result different from the one prescribed by federal law.

D. Defined Contribution Plans

As explained above, some defined contribution plans, like 401K plans, are not subject to the QJSA and QPSA requirements. Accordingly, most do not offer a survivor's annuity, but if the participant dies before retirement, the participant's spouse is the presumed beneficiary of the entire death benefit, unless the spouse has waived this right. However, if the participant retires prior to death or termination, the participant can elect any option that is available under the plan without spousal consent. If the defined contribution plan is subject to the QJSA and QPSA requirements, spousal consent is necessary in order to retire and elect an option other than a QJSA. If the participant dies prior to retirement, the spouse, absent a waiver, is entitled to an annuity for life, the actuarial equivalent of which is not less than 50% of the portion of the account balance of the participant to which the participant had a non-forfeitable right. *See* 29 U.S.C.S. § 1055(e)(2).

E. Defined Benefit and Money Purchase Plans

Since defined benefit and money purchase plans are subject to the QJSA and QPSA rules, a spousal waiver is required in order for the participant to elect out of either requirement. If not waived, the spouse is, generally, entitled to an annuity for life. If it is a QPSA, the payments cannot be less than the amounts which would be payable as a survivor's annuity under the QJSA rules under the plan. If the participant dies after retirement, the spouse's annuity cannot be less than 50% (or greater than 100%) of the annuity that would be payable during the joint lives of the participant and spouse and that is the actuarial equivalent of a single annuity for the life of the participant. *See* 29 U.S.C.S. § 1055(d), (e).

F. IRAs and SEPs

Individual retirement accounts ("IRAs") and simplified employee pensions ("SEPs") are not subject to the QJSA and QPSA requirements because they are not governed under ERISA. [Reg. 1.401(a) - 20, Q & A 3(d). However, the participant's agreement with the financial institution serving as custodian may require spousal consent to the beneficiary designation in the event of the participant's death.

G. Spouse's Death

As explained above, an employee spouse is, in effect, required to select a "qualified joint and survivor annuity" for all pension plans and some other types of plans, unless the employee and the employee's spouse agree to another beneficiary designation. The employee's spouse is also the presumed beneficiary for other plans. ERISA also provides that retirement benefits may not be assigned or alienated. 29 U.S.C. § 1056(d). § 401(a)(2) of the Internal Revenue Code also provides that the benefits must be for the exclusive benefit of the employee.

While Texas courts have not yet definitely resolved the question of whether federal law preempts Texas law upon the death of the non-employee spouse, it can be assumed that *Allard* and *Valdez* have been preempted by federal law. *See Ablamis v. Roper*, 937 F.2d 1450 (9th Cir. 1991); *Meek v. Tullis*, 791 F.Supp 154 (W.D. L.A. 1992), finding preemption. On the other hand, in *Boggs v. Boggs*, 82 F. 3d 90 (5th Cir. 1996), the Fifth Circuit agreed with the lower court and found that Louisiana community property law was not preempted. However, the United States Supreme Court ruled on June 2, 1997 that Louisiana law was preempted by federal law. *Boggs v. Boggs*, 520 U.S. 833, 117 S.Ct. 1754, 79 AFTR 2d 97-960 (1997).

H. *Boggs v. Boggs*

In *Boggs*, the participant, Boggs, a resident of Louisiana, was married to Dorothy until her death in 1979. At her death, two-thirds of her estate passed to their sons. Boggs married his second wife, Sandra, in 1980 and retired in 1985. At retirement, Boggs received: (i) a lump sum distribution that was "rolled over" into an IRA; (ii) shares of stock from an employee stock option plan ("ESOP"); and (iii) a monthly lifetime annuity. After Boggs died in 1989, his sons filed an action under Louisiana's community property laws to obtain their share of Dorothy's interest in Bogg's retirement benefits. The U.S. Supreme Court ruled that, notwithstanding state law that allowed Dorothy to devise to her sons her community interest in Bogg's retirement benefits prior to his retirement, Dorothy's testamentary transfer was a prohibited assignment or alienation under 29 U.S.C.S. Section1056(d)(1).

Had Boggs and Dorothy's marriage ended in divorce, the Court acknowledged that a state divorce court's division of the participant's ERISA benefits would have been effective since ERISA's QDRO provisions allow such a division. The dissent even noted that, after divorce and the entry of the QDRO, the employee's spouse can devise that spouse's interest. The Court did not hold that ERISA preempts a state's community property laws in general. The Court's holding is that the heirs and devisees of a non-participant spouse cannot succeed to that spouse's community interest in the participant's ERISA benefits when the spouse dies before the participant retires.

The purpose of the anti-alienation provisions of ERISA are to ensure the economic security of the surviving spouse. Therefore, if the participant's spouse dies under these circumstances, the spouse's interest in the participant's ERISA plan is effectively terminated.

I. Post-Retirement Benefits

Assume a Texas participant retired prior to the non-participant's death and received (i) a lump sum distribution which was "rolled over" into an IRA, (ii) shares of stock from an ESOP, and (iii) a monthly annuity; further, assume the participant and the participant's spouse had been married during the entire period of the participant's employment. It is this author's belief that all of the post-retirement benefits are community property subject to the participant's sole management and control under Texas law. If the couple then divorces, all of the post-retirement benefits would be subject to just and right division by the Texas divorce court. *Boggs* does not mandate a different result. In fact, the *Boggs'* holding supports this conclusion since, after retirement, the benefits are not subject to ERISA's anti-alienation provisions. The justification for federal preemption in *Boggs* is not applicable following the employee's retirement and the distribution of the retirement benefits.

1. <u>NON-PARTICIPANT'S DEATH</u>

If the marriage terminates not in divorce, but because of the non-participant's death, her interest in the annuity, if any, terminates by the very nature of the annuity. *See* VI, B-E, supra. However, the non-participant's one-half interest in the ESOP stock should pass to her heirs or devisees, absent some nonprobate contractual arrangement. Likewise, her one-half of the IRA should pass to her heirs or devisees, absent some nonprobate contractual arrangement. The anti-alienation rules of ERISA do not apply to IRAs. Some argue that *Boggs* extends ERISA's anti-alienation rules to IRAs, but it does not. The IRA in *Boggs* was funded after the death of the non-participant spouse when the participant later retired. At the time of Dorothy Bogg's death, the ERISA benefits were still undistributed and in the possession of the plan administrator. The Supreme Court even noted that, had they divorced, Dorothy could have devised to her sons any interests she may have acquired in the benefits through a QDRO.

2. <u>PARTICIPANT'S DEATH</u>

If the marriage terminates because of the participant's death after retirement, the participant's interest in the annuity terminates, but the annuity may continue for the spouse's benefit. *See* XX, B-E, *supra*. The participant's community one-half interest in the ESOP stock passes to his heirs or devisees, and the non-participant spouse retains her half, absent some contractual nonprobate disposition. His interest in the rollover IRA likely passes to the designated beneficiary of the IRA, if any; otherwise, she retains her one-half interest, and the participant's one-half passes to his heirs or devisees. Any attempt by the participant to assign more than his half of the stock or the IRA to someone else would be subject to the "fraud on the community" rule.

J. Non-Rollover IRAs

Such IRAs are not subject to ERISA's anti-alienation rules and are not subject to the *Boggs* ruling. At the participant's death, her interest in the non-rollover IRA likely passes to the designated beneficiary of the IRA, subject to the "fraud on the community rule"; otherwise, the non-participant spouse retains his one-half interest, and the participant's one-half passes to her heirs or devisees.

K. Conclusions

Although an IRA or other assets may be traceable to an ERISA plan distribution, the participant's retirement and subsequent distribution by the plan administrator to the participant or the participant's custodian terminates ERISA's control and *Boggs* application. *See* Patricia Brown, *The Mind Boggling Bog Broadened by Boggs – A Practitioner's Approach*, ALI-ABA, Feb. 25, 1999; S. Andrew Pharies, *Community Property Aspects of IRAs and Qualified Plans, Probate & Property* (Sept/Oct 1999); Steven E. Tritten, *The Better Half of Your Retirement Plan Distributions*, ALI-ABA, May 20, 1995. All three agree with this author's conclusions. Thus, free of federal preemption, the marital property rights of the participant and the participant's spouse in the distributions after retirement are governed solely by Texas law.

XI. FAMILY BUSINESS OWNERSHIP

The use of modern business entities, such as corporations, partnerships and limited liability companies, has become an integral part of family estate planning. One popular technique is for family members to contribute assets to a family limited partnership in exchange for interests in the partnership. A partnership interest acquired prior to marriage should remain the client's separate property during the marriage. In other words, the assets contributed to the partnership, as well as assets acquired by the partnership, should remain partnership assets and not become marital assets of the owner and the owner's spouse during the subsequent marriage.

Note: *In any separately-owned, closely-held business enterprise where a spouse is involved in the management, if the spouse is not paid reasonable compensation for services rendered during marriage, the other spouse may have a Jensen claim for reimbursement.*

A. Entity Theory

The assets contributed to the partnership become the assets of the partnership, and the partners receive partnership interests. The marital character of a spouse's interest in a partnership created during marriage should depend on the separate or community nature of the assets contributed in exchange for the interest itself. If an interest in the partnership was acquired as a gift, the interest itself is, of course, the separate property of the donee spouse. The assets of the partnership, including undistributed income and profits, belong to the entity, and do not take on a separate or community character under normal circumstances. See Tex. Bus. Org. Code § 152.056; (*see also) Harris v. Harris*, 765 S.W.2d 798 (Tex. App.–Houston [14th Dist.] 1989, writ denied). Caution should be taken in the day-to-day management of the partnership to avoid claims for reimbursement because of the expenditures of uncompensated time, talent or labor or contributions of community property to the separate property business.

B. Distributed Profits

When the partnership distributes profits to its partners, the profits distributed to a married partner are community property, whether the partner's partnership interest is separate or community property. This result can work a conversion of what would ordinarily be the separate property into community property. For example, if a spouse contributes separately owned oil and gas royalty interests into a partnership, the royalties collected by the partnership and then distributed to the partners as partnership profits are community property. Had the spouse not contributed the royalty interest to the partnership, the royalties received would have been the owner's separate property. See *Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.—Dallas 1987, writ ref'd n.r.e.). The *Marshall* case has been cited for the proposition that all partnership distributions during marriage are community property. However, some commentators argue that a distribution in excess of current or retained earnings or other distributions of capital should be separate property. See Jack Marr, *Business and Divorce*, 34th Annual Marriage Dissolution Institute (2011).

C. Comparison to Corporations

Partnerships, limited partnerships and limited liability companies are treated as entities under Texas law. The owners do not own the entity's assets; they own interests in the entity similar to shares of stock in a corporation. A divorce court cannot award specific partnership assets to the other spouse. *Gibson v. Gibson,* 190 S.W.3d 821 (Tex. App.—Fort Worth 2006, no pet.). Non-liquidating distributions by the entity to the owners generally take on a community character like ordinary cash dividends distributed by a corporation to its shareholders. But, do established corporate law concepts, like the alter ego/reverse veil piercing, *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App.—Fort Worth 1968, writ dism'd w.o.j.), and reimbursement for the expenditure of community time, talent and labor like in *Jensen* apply to these new entities as well?

Reverse veil piercing has been held to be inapplicable to partnerships. *See*

Lifshutz v. Lifshutz, 61 S.W.3d 511 (Tex. App.—San Antonio 2001, pet. denied). Marr notes that the same rule may apply to limited partnerships and limited liability partnerships. *See Marr*, *supra*.

However, Marr observes that the concept has been applied to limited liability companies. (*See McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573 (Tex. App.—Houston [1st Dist.] 2007, pet. denied).

Note: *2011 legislation confirms that LLC interests may be community property. See Tex Bus. Org. Code § 101.1115. New legislation also incorporates corporate veil piercing standards in certain LLC situations. Tex. Bus. Org. Code § 101.002.*

D. Reverse Veil Piercing

Notwithstanding the "entity" rule, the assets of a separately owned corporation have been held by Texas courts to be part of the community estate and subject to a just and right division by the divorce court in some situations. (*See Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.—Fort Worth 1985, writ dism'd w.o.j.); *Spruill v. Spruill*, 624 S.W.2d 694 (Tex. App.—El Paso 1981, writ dism'd w.o.j.); *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App.—Fort Worth 1968, writ dism'd w.o.j.).

While the cases are not numerous and the theories used to justify the result are not always consistent, reverse veil piercing is a reality. In its landmark case, *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986), the Texas Supreme Court explained the basic theories that can be used to disregard a corporate entity: alter ego, sham to perpetrate a fraud, or actual fraud. The court further explained that reverse veil piercing is an equitable doctrine that can be used to prevent an unfair and unjust result.

In *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex. App.—San Antonio 2001, pet. denied), the court purported to explain the elements necessary to disregard the corporate entity. First, there must be a finding that the corporation is the alter ego of the shareholder (i.e., there is a unity between the corporation and the shareholder). Second, the shareholder's use of the corporation must damage the community estate beyond that which could be remedied by a claim of reimbursement. While some courts have required that the shareholder must be the sole shareholder, other courts have not. See *Zisblatt*, *supra*.

The *Lifshutz* court also suggested that the use of the corporation must also have had a negative impact on the community estate. In other words, even if the corporation is the shareholder's alter ego, the corporation may not be disregarded unless community property was transferred to the corporation.

E. Sole Proprietorships

Continuing to operate the "business" as a sole proprietorship during the marriage is likely to result in a commingling of separate and community assets, so that over time the "business" becomes community property because of the client's inability to trace which of the business assets were owned prior to marriage or traceable to assets owned prior to marriage. However, if the sole proprietorship is converted into an entity, like a corporation, prior to the marriage, proper management and record keeping can maintain the client's stock in the corporation as separate property and the assets of the corporation as corporate assets, not marital assets. Caution should be taken in the day-to-day management of the corporation to avoid claims for reimbursement.

F. Partnership Formation

Some divorce lawyers take the position that a general partnership interest acquired during marriage is always community property. See Marr, *supra*, citing one case decided over twenty-five years ago, *York v. York*, 678 S.W.2d 110 (Tex. App.—El Paso 1984, writ ref'd n.r.e.). Marr's article does state that the regular rules of characterization do apply to shares of corporate stock, limited partnership interest, interests in limited liability partnerships and interest in limited liability companies. The better view is that the separate or community character of the partner's interest (like shares of stock) should depend on the character of the consideration used to acquire the interest (i.e., capitalize the entity), if any. If separate consideration, the investment should be separate.

For example, if a general partnership is created at the time of the partners' "handshake" rather than at the time the partnership agreement is signed, the individual partner's interest in the partnership becomes property at that time and is likely to be community property under the inception of title rule. It was not acquired by gift, devise or descent; and if the "idea" or "concept" was an intangible that did not have a separate or community charter, the partnership interest would appear not to be traceable back to any separate property of the partner.

On the other hand, if the general partnership is not created until the partnership agreement is signed, the partner's interest is more like a shareholder's stock in a corporation, and it should be the partner's separate property, if separate property was contributed by the partner to the partnership in exchange for the partner's interest.

XII. MARITAL PROPERTY RIGHTS IN IRREVOCABLE TRUSTS

The private express trust is a unique concept and one that is frequently misunderstood by members of the public and practitioners alike. The common law established that the trust is not an entity; it cannot own property; it cannot incur debt. Although it may be treated as if it were an entity for some purposes, it remains today a form of property ownership. *See* Tex. Trust Code § 111.004(4). Certain other common law principles remain relevant today. For example, a person serving as trustee is not a legal personality separate from such person in his or her individual capacity. A person serving as trustee is not the agent of either the trust, the trust estate or the beneficiaries of the trust. Finally, the trust assets are not considered to be the property of the person serving as trustee; such assets belong in equity to the beneficiary. These principles can affect the marital property rights of the parties.

A. The Private Express Trust

One noted authority describes the private express trust as ". . . a device for making dispositions of property. And no other system of law has for this purpose so flexible a tool. It is this that makes the trust unique. . . . The purposes for which trusts can be created are as unlimited as the imagination of lawyers." III, IV, *Scott on Trusts* (3d. ed. 1967).

1. <u>DEFINITION</u>

A trust, when not qualified by the word "charitable," "resulting" or "constructive," is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of the intention to create the relationship. Restatement (Third) of Trust § 2. (2003)

2. CREATION

According to Section 112.002 of the Texas Trust Code, a trust may be created by: (i) a property owner's declaration that the owner holds the property as trustee for another person; (ii) a property owner's inter vivos transfer of the property to another person as trustee for the transferor or a third person; (iii) a property owner's testamentary transfer to another person as trustee for a third person; (iv) an appointment under a power of appointment to another person as trustee for the donee of the power or for a third person; or (v) a promise to another person whose rights under the promise are to be held in trust for a third person.

3. REVOCABLE OR IRREVOCABLE

Inter vivos trusts are further divided into two categories: revocable and irrevocable. A revocable trust is one that can be amended or terminated by the settlor. An irrevocable trust, in contrast, is one that cannot be amended or terminated by the settlor for at least some period of time. The presumption regarding the revocability of inter vivos trusts varies by jurisdiction. For example, in Texas all inter vivos trusts created since April 19, 1943, are revocable unless the trust document expressly states otherwise; while in some other states, trusts (including Texas trusts created prior to April 19, 1943) are deemed irrevocable unless the trust document states otherwise. Tex. Prop. Code Ann. § 112.051. *See* Restatement (Second) of Trusts, § 330; Bogert, *Law of Trusts and Trustees*, § 998 (1983).

Note: *If the trust is revocable, it is deemed "illusory" and is effectively ignored for marital property purposes (i.e., the "trust veil" is pierced). See Land v. Marshall, 426 SW.2d 841 (Tex. 1968). See VIII, I, supra.*

B. Beneficial Ownership

While record legal title to the assets of the trust is held by the trustee, equitable title — true ownership — belongs to the beneficiaries. For example, trust law generally exempts the assets of the trust from any personal debt of the trustee not related to the administration of the trust. This exemption even applies if the trust property is held by the trustee without identifying the trust or the beneficiaries. The rationale behind this exemption is the concept that the assets of the trust really belong to the beneficiaries. *See* Tex. Prop. Code § 101.002 and Tex. Trust Code § 114.0821. These principles confirm that trust assets belong to the beneficiaries and not the trustees. Accordingly, a trustee's spouse generally does not acquire any marital property interest in trust property, but spouses of the beneficiaries may, depending on the circumstances.

C. Interests of the Settlor's Spouse

The creation and funding of an inter vivos trust by a settlor may or may not remove the trust assets from the reach of the settlor's spouse. If (i) the trust is irrevocable and (ii) the settlor has not retained an equitable interest in the trust estate, the assets of the trust really belong to the beneficiaries and no longer have either a separate or community character insofar as the settlor's spouse is concerned. If the transfer of community assets in order to fund the trust is found to have been in fraud of the interests of the settlor's spouse, the spouse may be able to reach the assets of the trust like any other assets transferred to a third party, free of trust, but in fraud of the community interests of the wronged spouse. *See* VIII, *supra*.

D. Settlor's Retained Interest

If the settlor creates an irrevocable trust and retains a beneficial interest in the trust assets, the rights and remedies of the settlor's spouse would appear to be similar to the rights of the settlor's creditors. Creditors can generally reach the maximum amount that the trustee can pay or distribute to the settlor under the terms of the trust agreement, even if the initial transfer into the trust was not in fraud of creditors. For example, if the settlor retains an income interest in the trust assets for the rest of the settlor's life, creditors can reach the retained income interest, and if the settlor retains a general power of appointment over the entire trust estate, creditors can reach the entire trust estate. *See Bank of Dallas v. Republic Nat. Bank of Dallas*, 540 S.W.2d 499 (Tex. Civ. App.—Waco 1976, writ ref'd n.r.e.). If the settlor retains an income interest for the remainder of the settlor's lifetime, the creditors can reach the income interest, but not the fixed remainder interest already given to the remaindermen. If the trustee has the discretion to invade the principal for the settlor, the extent of the settlor's retained interest will probably be the entire trust estate. *See Cullum v. Texas Commerce Bank Dallas, Nat. Ass'n.*, 05-91-01211-CV, 1992 WL 297338 (Tex. App.—Dallas Oct. 14, 1992) (not designated for publication). The inclusion of a spendthrift provision will not insulate the settlor's retained interest from the settlor's creditors. *See* Tex. Trust Code § 112.035 and *Glass v. Carpenter*, 330 S.W.2d 530 (Tex. Civ. App.—San Antonio 1959, writ ref'd n.r.e.).

1. <u>MARITAL PROPERTY ISSUES</u>

The application of these principles in the marital property context would suggest that any income generated by the trust estate would still be deemed community property if the settlor retained an income interest in the trust which, for example, was funded with the settlor's separate property. However, in a recent case where the trust was funded with the settlor's separate property prior to marriage and the trustee was a third party who had discretion to make income distributions to the settlor, the trustee's discretion prevented the trust's income from taking on a community character until the trustee exercised its discretion and distributed income to the settlor. The wife in a divorce action had claimed that all of the trust assets were community property since the income generated during the marriage had been commingled with the trust corpus. *See Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App.—Fort Worth 1996, writ denied) and *Matter of Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.—Texarkana 1978, writ dism'd w.o.j.). Some older cases support that same result. *See Shepflin v. Small,* 4 Tex. Civ. App. 493, 23 S.W.432 (1893, no writ) and *Monday v. Vance*, 32 S.W. 559 Tex. Civ. App. 1895 no writ).

2. <u>OTHER FACTORS</u>

Had the trust been funded with community property without the consent of the other spouse, the other spouse could challenge the funding of the trust as being in fraud of the community. Had the assets been subject to the spouses' joint control, the other spouse could argue that the transfer was void since the other spouse did not join in the transfer. Had the settlor retained a general power of appointment, the other spouse could argue that the transfer of community property into the trust was "illusory" as to her community interests therein. *See* VIII, I, *supra*. Accordingly, the only safe conclusion to reach is that the proper application of marital property principles should depend on the nature and extent of the retained interest and perhaps the timing of the creation of the trust.

E. Interests of the Non-Settlor Beneficiary

Because a beneficiary of a trust owns a property interest in the trust estate created by a settlor who is not the beneficiary, the ability of the spouse of the beneficiary to establish a community interest in certain assets of the trust should depend on the nature of the beneficiary's interest. Equitable interests in property, like legal interests, are generally "assignable" and "attachable," but voluntary and involuntary assignees cannot succeed to an interest more valuable than the one taken from the beneficiary.

1. COMPARISON TO CREDITORS' RIGHTS

Again, a review of the rights of creditors of the beneficiary appears relevant. For example, if the beneficiary owns a remainder interest, a creditor's attachment of the beneficiary's remainder interest cannot adversely affect the innocent life tenant's income interest. On the other hand, if the beneficiary is only entitled to distributions of income at the discretion of the trustee for the beneficiary's lifetime, a creditor of the beneficiary cannot attach the interest and require the trustee to distribute all the income. In fact, a creditor may not be able to force the trustee to distribute any income to the creditor since it would infringe on the ownership interests of the remaindermen.

2. PRINCIPAL

The original trust estate (and its mutations and income generated prior to marriage) clearly is the beneficiary's separate property as property acquired by gift, devise or descent, or property acquired prior to marriage. Distributions of principal are likewise the beneficiary's separate property. *See Hardin v. Hardin,* 681 S.W.2d 241 (Tex. App.—San Antonio 1984, no writ).

3. DISTRIBUTED INCOME

If the discretionary income beneficiary is married, it would logically follow that distributed income should be considered separate. The exercise of discretion by the trustee, in effect, completes the gift. The result may be different if the beneficiary is the trustee or can otherwise control the distributions. On the other hand, if the trustee is required to distribute the trust's income to the married beneficiary, the income could be considered community once it is distributed since it arguably could be considered income from the beneficiary's equitable separate property. *See Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. App.—Corpus Christi 1997, no pet.). However, there is recent case authority that holds that trust income required by the trust document to be distributed to the beneficiary is the beneficiary's separate property, at least where the trust was created prior to the marriage. *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex. App.—Tyler 1996, no writ). *See also Matter of Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.—Texarkana 1976, no writ), and *Wilmington Trust Co. v. United States*, 753 F.2d 1055 (5th Cir. 1985).

1. UNDISTRIBUTED INCOME

Undistributed income is normally neither separate nor community property. *See Matter of Marriage of Burns*, *supra; Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App.—Fort Worth 1967, writ dism'd w.o.j.), and *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd). However, if the beneficiary has the right to receive a distribution of income but does not take possession of the distribution, such retained income may create marital property rights in the beneficiary's spouse. *See Cleaver, supra*. Depending on the intent of the beneficiary in allowing the distribution to remain in the trust, such income (and income generated by the retained income) may be considered to have taken on a community character or may be considered to have been a transfer to the other beneficiaries of the trust and subject to possible fraudulent transfer on the community scrutiny.

F. Spendthrift Trust

Texas law permits the settlor of a trust to prohibit both the voluntary and involuntary transfer of an interest in trust by the beneficiary prior to its actual receipt by the beneficiary. In fact, the settlor may impose this disabling restraint on the beneficiary's interest by simply declaring that the trust is a "spendthrift trust." Such a restraint is not effective if the beneficiary has a mandatory right to a distribution, but simply has not yet accepted the interest. Further, such a restraint is not effective to insulate a settlor's retained interest from the settlor's creditors. *See* Tex. Trust Code § 112.035. This rationale suggests that the settlor's intent as to the nature of the beneficiary's interest may be relevant in determining whether the beneficiary's spouse acquires a community interest in the trust estate, the undistributed income or any distributed income.

G. Powers of Appointment

If the beneficiary has the absolute authority under the trust agreement to withdraw trust assets or to appoint trust assets to the beneficiary or the beneficiary's creditors, the beneficiary is deemed to have the equivalence of ownership of the assets for certain purposes. For example, such beneficiary would appear to have such an interest that cannot be insulated from the beneficiary's creditors by either the non-exercise of the power or a spendthrift provision. An appointment in favor of a third party could be found to have been in fraud of creditors. *See Bank of Dallas, supra*. While inconsistent with the common law, which treated the assets over which a donee had a general power as belonging to others until the power was exercised, application of this modern view may treat the assets over which a married donee has a general power as the separate property of the donee, but any income generated by those assets may be community property.

1. <u>SPECIAL POWERS</u>

Many beneficiaries are given limited general powers (i.e., "Crummey" and the so-called "Five or Five" power, both of which permit the beneficiary to withdraw a certain amount from the trust estate at certain periods of time).

2. <u>LAPSE OF POWERS</u>

If the beneficiary allows the withdrawal power to lapse, can the creditors still go after that portion of the estate that could have been withdrawn or can the beneficiary’s spouse claim either a possible community interest in the assets allowed to continue in trust, or the income thereafter generated? In other words, does the lapse of the power make the beneficiary "a settlor" of the trust? The Legislature has answered some of these questions. Section 112.035 of the Texas Trust Code was amended by the Legislature in 1997 to confirm that a beneficiary of a trust is not to be considered a settlor of a trust because of a lapse, waiver or release of the beneficiary's right to exercise a "Crummey right of withdrawal" or "Five or Five" power.

3. <u>ASCERTAINABLE STANDARD</u>

If the beneficiary's power of withdrawal is limited to an ascertainable standard (i.e., health, support, etc.), creditors who provided goods or services for such a purpose should be able to reach the trust estate, but not other creditors. Further, it follows that any income distributed for such purposes, but not so expended, may be community since such expenses are normally paid out of community funds. *See* VII, E, *supra*.

4. NON-GENERAL POWERS

A beneficiary's power to appoint only to persons other than the beneficiary, the beneficiary's creditors and the beneficiary's estate are generally deemed personal to the beneficiary and not attachable by the beneficiary's creditors. It would also follow that such a power would not give the spouse any interest in the trust estate. However, if the power is exercised to divert community income from the beneficiary, could it be subject to possible fraud on the community scrutiny?

Note: *See Sharma v. Routh, 302 S.W.3d 355 (Tex. App.—Houston [14th Dist] 2009, no pet.), for an example of a divorce case where the court examines the nature of the spouse's interests in irrevocable trusts to determine their marital character.*

XIII. FINAL CAVEAT

Through a well-crafted pre-marital or marital agreement, parties intending to marry, or existing spouses, can agree to create a "community free" marriage where all property is the separate property of one spouse or both spouses and eliminate other spousal rights, but that's a topic for another day.