TEXAS FAMILY PROPERTY: INTEGRATING TRUSTS AND ESTATES AND MARITAL PROPERTY LAWS

Thomas M. Featherston, Jr.
Mills Cox Professor of Law
Baylor University
School of Law
Waco, Texas

State Bar of Texas
Advanced Estate Planning and Probate Course
June 2008

TABLE OF CONTENTS

A TRUSTS AND ESTATES LAWYER'S VIEW OF TEXAS MARITAL PROPERTY LAW

Thomas M. Featherston, Jr.

I. INTRODUCTION

The trusts and estates practice in Texas continues to evolve. Less emphasis is placed on tax planning in view of increased exemptions and the unlimited marital deduction and even a possible (though increasingly unlikely) permanent repeal of the estate tax. More emphasis is placed on asset preservation in view of non-tax concerns such as the impact of incapacity and the claims of creditors and spouses.

Marital property planning and administration is increasingly more important and complicated. The integration of trusts, estates and marital property has coined a descriptive term: Family Property Law. In fact, one of the more popular law school texts is named Family Property Law, Cases and Materials on Wills, Trusts and Future Interests, Waggoner, Alexander, Follows and Gallanis (Foundation Press 4th Ed.)

A. Flexibility in Planning

In other words, clients are asking more frequently for techniques that preserve not only what was brought into the marriage but also what is going to be accumulated during the marriage. In these situations, a client typically states that the planning goal is to insulate "my estate" from (i) the claims of my spouse in the event of divorce, (ii) the claims of my spouse, or my spouse's heirs and devisees, in the event of death, and (iii) the claims of my spouse's creditors during the marriage and in the event of bankruptcy or death.

Fortunately, Texas law now provides effective and practical means whereby a couple planning to marry, or an already married couple, can alter by agreement the traditional rules of marital property characterization, management and liability. Both "community free" and "all community" marriages are possible in Texas today. Accordingly, one focus of this article is on those agreements where the character of property, as either separate or community, is changed to accomplish these specialized estate planning purposes.

B. The Default Rules

Of course, the beginning point in a study of this type is a review of the basic rules of marital property characterization, management and liability, as well as what normally happens to the marital estate upon the dissolution of the marriage by reason of a spouse's death or the couple's divorce.

C. Federal Preemption

The independent nature of Texans generally and Texas lawyers specifically frequently leads Texas lawyers to the conclusion that, once Texas law and principles are applied to a situation in order to determine the answer to a trusts and estates or marital property question, the solution is at hand. *However, Texas law may lead to a Texas solution, but the Texas solution may not be the correct answer because Texas law may have been preempted by federal law.*

Professor William R. Trail explains: "The source of federal preemption is the 'Supremacy Clause' of the United States Constitution. That clause provides: '[t]his Constitution, and the laws of the United States which shall be made in Pursuance thereof; and all treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every state shall be bound thereby . . . .' U.S. CONST. Art. VI, cl. 2. Federal law will supersede state law 'to the extent it is believed that such action is necessary' to achieve the federal government's purpose. *See City of New York v. FCC*, 486 U.S. 57, 63 (1988). In this context, federal law includes not only legislation by Congress, but also includes regulations of federal agencies. If an agency acts within its congressionally delegated authority, the agency's actions may preempt state regulations. *See Louisiana Public Serv. Comm'n v. FCC*, 476 U.S. 355, 369 (1986). 'Federal regulations have no less preemptive effect than federal statutes.' *Fidelity Federal Savings & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 153 (1982).

In view of concerns regarding comity and federalism, federal preemption is not favored. There is a 'basic assumption that Congress did not intend to displace state law.' *Maryland v. Louisiana*, 451 U.S. 725, 746 (1981). This presumption against preemption ensures that the delicate balance between federal and state government 'will not be disturbed unintentionally by Congress or unnecessarily by the courts.' *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977). The presumption has particular significance where it is asserted that federal law should displace areas 'traditionally regarded as properly within the scope of state superintendence.' *Hillsborough County v. Automated Medical Laboratories, Inc.*, 471 U.S. 707, 715 (1985); *Florida Lime & Avacado Growers, Inc. V. Paul*, 373 U.S. 132, 144 (1963)." William R. Trail, *Federal Courts: An Examination of the Federal Judicial System and Federal State Relations*, 2nd Edition (2000).

II. CHARACTERIZATION

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 which ultimately defines what is separate or community property and not the legislature or the parties involved. 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 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 which is not proven to be separate property. See* II.G, *infra*.

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).

Absent an agreement of the parties and notwithstanding these 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*, 109 S.W. 911 (Tex. 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. <u>PREVIOUSLY EXISTING</u>

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

2. <u>GRATUITOUS TRANSFERS</u>

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

3. <u>TRACEABLE MUTATIONS</u>

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

4. <u>MARITAL PARTITIONS</u>

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

5. <u>CERTAIN CREDIT ACQUISITIONS</u>

   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. <u>CERTAIN PERSONAL INJURY RECOVERIES</u>

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

D. 1980 Amendment

The 1980 amendment to Art. XVI, Sec. 15 authorized the creation of separate property in new ways:

1. <u>PREMARITAL PARTITIONS</u>

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

2. <u>SPOUSAL PARTITIONS</u>

   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 Sec. 4.102.

3. <u>INCOME FROM SEPARATE PROPERTY</u>

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

4. <u>SPOUSAL DONATIONS</u>

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 Sec. 3.005.

E. 1987 Amendment

The 1987 amendment to Art. XVI, Sec. 15 did not authorize a new way to create separate property. It simply allowed spouses to create survivorship rights with their community property. *See* X, *infra*.

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. *See* VIII, *infra*.

G. 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, 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 Sec. 3.003. A "clear and convincing evidence" standard is somewhere between "preponderance" and "reasonable doubt". *Faram v. Gervitz-Faram*, 895 S.W.2d 839 (Tex. App.—Ft. 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 Sec. 3.003 which codified the clear and convincing evidence standard.)

1. <u>MANAGEMENT PRESUMPTION</u>

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 and 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 Sec. 3.104.

2. <u>FORM OF TITLE</u>

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).

3. <u>TRACING</u>

The community presumption prescribed by Sec. 3.003 requires the party asserting that a particular asset is separate to prove the facts that justify that legal conclusion by "clear and convincing evidence." Their burden can be met by tracing an existing asset through its mutations to its original separate property source. Hopefully, the spouse has maintained records of asset acquisitions, sales, purchases and other transactions and kept segregated bank accounts for separate deposits with interest payable to a different community account. Separate property will retain its separate character through a number of mutations so long as contemporaneous records have been retained. *Rose v. Houston*, 11 Tex. 324 (1854). A detailed discussion of tracing is beyond the scope of this article. For further discussion, *see* Gagnon and Patierno, "*Reimbursement and Tracing: The Bread and Butter to a Gourmet Family Law Property Case.*" 49 <u>Baylor Law Review</u>, 323.

4. <u>COMMINGLING</u>

Sizable separate estates have been lost during marriage because the owner could not meet the statutory burden of proof. This usually occurs when separate and community property were so mixed that they could not be resegregated Thus, the separate assets became "commingled" and lost their separate identity. The spouse whose separate estate has been lost may have a claim for reimbursement when the marriage terminates. *Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Civ. App.—Houston [14th Dist.] 1975, writ dism'd w.o.j.) *See* XV.K., *infra*.

5. <u>COMMUNITY OUT FIRST RULE</u>

According to many commentators, where community funds and separate funds are deposited in a single account and there is an absence of contemporaneous records accounting for the separate and community funds thereafter expended, it is generally presumed that community funds are first withdrawn whether the withdrawals are used for the support and maintenance of the family or the purchase of property. Further, the funds remaining in the account remain separate to the extent the account balance never drops below the amount of separate funds deposited. This presumption is consistent with the community presumption in that any investments so acquired are presumed community absent clear and convincing evidence to the contrary. *See* Stewart Gagnon, Kathryn Murphy, Ike Vanden Eykel, Texas Practice

Guide - Family Law, Secs.Sec. 8:308–8:330 (West). However, this author is not aware of a definitive case which says "community our first" is the law.

H. Quasi-Marital Property

According to the Texas Family Code, the separate property of a spouse which 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 Sec. 7.002. *See Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982). A 2003 amendment to Sec. 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. *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.

I. Personal Injury Recoveries

Personal injury recoveries for loss of earning capacity during marriage are defined as community property. Tex. Fam. Code Sec. 3.001(3). 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.

J. 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 in either a premarital or marital agreement the parties changed the legal result. For example, income from separate property is not always community property.

III. MANAGEMENT OF MARITAL PROPERTY

Unlike characterization, rules relating to the management of marital property are within the rulemaking authority of the legislature. *Arnold v. Leonard, supra.* During the marriage, the Texas Family Code prescribes which spouse has management powers over the marital assets.

A. Texas Family Code

1. <u>SEPARATE PROPERTY</u>

Each spouse has sole management, control and disposition of his or her separate property. Tex. Fam. Code Sec. 3.101.

2. <u>SPECIAL COMMUNITY PROPERTY</u>

Each spouse has sole management, control and disposition of the community property that he or she would own, if single, including personal earnings, revenue from separate property, recoveries for personal injuries and increases and revenues from his or her "special community property." Tex. Fam. Code Sec. 3.102(a).

3. <u>JOINT COMMUNITY PROPERTY</u>

All other community property is subject to both spouses' joint management, control and disposition – "the joint community property." Tex. Fam. Code Sec. 3.102(b).

B. The Marital Opportunity Theory

Some have argued for application of what may be called the "marital opportunity" theory, a concept related to the "corporate opportunity" concept of corporate law. Advocates argue that any investment opportunity arising during the marriage is community property, and a spouse breaches the fiduciary duty owing the other spouse by taking advantage of the marital opportunity and making the investment separate by investing separate funds. Proponents and opponents alike can cite *Norris v. Vaughan*, 260 S.W.2d 676 (Tex. 1953).

1. <u>THE BETTER VIEW</u>

The better view, in the opinion of the author, and the one more consistent with established law, is one which gives the owner of separate property the right to invest separate property as the owner deems appropriate and to expend a reasonable amount of time, talent and labor in the management of the separate estate, without the fear of breaching a fiduciary duty owing the other spouse, or converting separate property into community property, or without the fear of creating a claim for reimbursement for the other spouse. *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984). Investing separate funds rather than community property should not be considered a breach of fiduciary duty, or a fraud on the community, by the managing spouse absent extraordinary circumstances. See III, E, *infra* and XIV *supra*.

2. CLOSELY HELD BUSINESSES

An extension of the "marital opportunity" theory is the argument that any business entity formed by a spouse during marriage is community property because the spouse's idea, or the partners' initial concept, that later evolves into the formation of the business entity has its inception during the marriage. The better view is that the separate or community character of the shares of stock or the partner's interest should depend on the character of the consideration used to capitalize the entity, if any. If separate consideration, the investment is separate.

The original idea or concept is more closely analogous to a spouse's education, a license to practice a profession, or professional goodwill acquired during marriage; it is an intangible that is neither community nor separate property. *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972); *Frausto v. Frausto*, 611 S.W.2d 656 (Tex. Civ. App. San Antonio 1980, writ dism'd w.o.j.). Further, the other spouse's "community interests" are effectively protected through the concepts of "reimbursement," if the owner spouse is not adequately compensated by the entity for the owner's time, talent and labor, and "reverse veil piercing," if the entity is the owner's alter ego or it is operated as a sham. *See* XIV, *infra* and XVIII, *infra.*

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. Such a partnership interest is analogous to a shareholder's stock, which is separate property, if acquired with separate property.

C. Other Factors

1. HOMESTEAD

An important statutory exception prohibits the managing spouse from selling, conveying or encumbering the homestead without the joinder of the other spouse, even if the homestead is the managing spouse's separate property or special community property. Tex. Fam. Code Sec.5.001.

2. POWER OF ATTORNEY

The above described powers of management can be modified by the parties through a power of attorney. The Family Code also provides that joint community property can become the subject of one spouse's control if the spouses so provide by power of attorney or other agreement. Tex. Fam. Code Sec. 3.102. There is authority that suggests that such an agreement can be oral. *LeBlanc v. Waller*, 603 S.W.2d 265 (Tex. App.—Houston 1980, no writ). A written power of attorney can be made to continue the authority of the agent even if the principal becomes incapacitated. *See* Tex. Prob. Code Secs. 482 and 484.

3. INCAPACITY

In the event of the incapacity of the managing spouse as to special community, or of one of the spouses as to joint community property, the competent spouse may petition the probate court pursuant to Sec. 883 of the Texas Probate Code for authority to manage the entire community estate without a guardianship. A guardianship may be needed for the incapacitated spouse's separate property. *See* XV, *infra.*

4. CONFLICTING AUTHORITY-THIRD PARTY AGENT

If a third party has been designated as a spouse's agent under a durable power of attorney and the spouse is later declared incapacitated by the court and a guardian qualifies, the authority of the agent terminates. The agent is then required to deliver the spouse's assets to the guardian. The competent spouse would then appear to have the opportunity to become community administrator and assume authority to demand possession of the community assets unless such spouse would be disqualified to serve as guardian. Accordingly, a spouse who does not wish the other spouse to assume authority over his or her assets, either as guardian or as community administrator in the event of incapacity, needs to execute a "pre-need" guardianship designation pursuant to Sec. 679. This designation could expressly disqualify the other spouse as guardian under Sec. 681(9) and as community administrator under Sec. 883.

D. Dispositions Between Spouses

It has become commonplace for spouses to arrange certain marital assets so that prior to the death of the first spouse, or upon the death of the first spouse, the asset belongs to the donee spouse without going through probate administration.

1. INTER VIVOS GIFT

One spouse may give to the other spouse either the donor's separate property or the donor's interest in their community property, thereby making the asset the donee spouse's separate property. *Bradley v. Love*, 60 Tex. 472 (Tex. 1883). Since 1980, such a spousal gift raises a presumption that the future income generated by the donated property will also be the donee spouse's separate property. Tex. Fam. Code Sec. 3.005. A spouse may transfer to the other spouse the transferor spouse's one-half community interest in community property held in either spouse's name or in both names without going through the steps of a "partition and exchange." *In re Marriage of Morrison*, 913 S.W.2d 689 (Tex. App.—Texarkana 1995 writ denied).

2. PARTITION

Spouses may partition or exchange between themselves all or any part of their community property then existing, or to be acquired, into their respective separate properties. A 2005 amendment corrected some confusion created by a 2003 amendment and now confirms that the spouses may also partition the future income generated by the property that has been partitioned. Tex. Fam. Code Sec. 4.102. *See* VIII *infra.*

3. INCOME AGREEMENT

Since 1980, spouses may agree that income from separate property will be the separate property of the owner spouse. Tex. Fam. Code Sec. 4.103. *See* VIII *infra.*

4. LIFE INSURANCE

A spouse can purchase a life insurance policy on his or her own life and designate the other spouse as beneficiary. Whether the policy was community or separate, the proceeds belong to the survivor upon the insured's death. *Martin v. McAllister*, 63 S.W. 624 (Tex. 1901).

5. EMPLOYEE BENEFITS AND OTHER RETIREMENT ACCOUNTS

A married employee can designate the other spouse as beneficiary of the employee's retirement plans whether the employee's interest in the plan is community or separate property. This result is even mandated by federal law for certain qualified retirement plans. I.R.C. Sec. 417(b). *See* XIX and XX *infra.*

6. SURVIVORSHIP RIGHTS

The 1987 amendment to Art. XVI, Sec. 15 allows spouses to enter into survivorship arrangements for their community property assets. Legislation prescribes the formalities required in order to have a valid agreement as to their community assets. See X, *infra.* Spouses can also utilize "P.O.D. accounts" and "trust accounts" as means of transferring community property from one to another pursuant to Chapter XI of the Texas Probate Code. *See* XI, *infra.* Spouses, like other parties, can enter into survivorship agreements for their separate property assets. Tex. Prob. Code Sec. 46 (a). *See Hilley v. Hilley*, 342 S.W.2d 565 (Tex. 1961).

7. SEC. 450 OF THE TEXAS PROBATE CODE

Section 450 of the Texas Probate Code can apparently be utilized by spouses, as well as other individuals. This section confirms traditional non-probate dispositions and opens the door for other creative non-probate dispositions. Tex. Prob. Code Sec. 450. Mutual fund accounts were added to the list in 2001.

E. Fraud on the Community

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).

1. MANAGING SPOUSE AS TRUSTEE

In what is arguably the most significant community property case ever decided by the Texas Supreme Court, *Arnold v. Leonard*, 273 S.W. 799 (Tex. 1925), the court defined the legislature's role in determining the rules of characterization, management and liability of marital property and also explained ". . . that the statutes empowering the husband to manage the . . . community assets made the husband essentially a trustee, accountable as such to the . . . community." *See* also *Howard v. Commonwealth Building and Loan Assn.*, 94 S.W.2d 144 (Tex. 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 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 (Tex. 1891)."

2. FIDUCIARY OBLIGATION

As to the special community property, 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. App.—Dallas 1975, writ ref'd n.r.e.). This special relationship has many of the characteristics of a private express trust: (i) identifiable property – a spouse's special community property; (ii) separation of legal and equitable title – the managing spouse has legal title and the equitable titled is owned equally by both the spouses; and (iii) fiduciary duty – 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."

3. 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 In Re 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.

4. 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] 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 *Street v. Skipper*, 887 S.W.2d 78 (Tex. App.—Ft. Worth 1995 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. Metropolitan Life Ins. Co.*, 498 S.W.2d 278 (Tex. App.—Houston [14th] 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, Secs. 16:8–16:95 (West).

5. 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.], no writ). *Massey v. Massey*, 807 S.W.2d 391 (Tex. App.—Houston [1st Dist.] 1991, writ denied); *In re 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.*; 669 S.W.2d 775,778 (Tex. App. -San Antonio 1984, writ dism'd); *Hartman v. Crain* 398 S.W.2d 387, 390 (Tex. 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.

6. THE *SCHLUETER* CASE

In *Schlueter v. Schlueter*, 975 S.W.2d 584 (Tex. 1998), the 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 entered to allow the wronged spouse to recoup the community estate lost 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*, Tex. Sup. Ct. Journal Vol 51, pg 569 (2008). The fraudulent sale was found to be void and the buyers were divested of ownership; interestingly, the lawyer represented the buyer.

7. 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 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.

8. THE HARPER CASE

In *Harper v. Harper*, 8 W.S.3d 783 (Tex. App.—Ft. 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. *See Barnett v. Barnett*, 67 S.W.3d 107 (Tex. 2001) where the Texas Supreme Court confirmed that the other spouse had a cause of action under Texas law for constructive fraud on the community after the managing spouse died, but that it was preempted by federal law. See III.E, *infra*.

9. EXAMPLES

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 which 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.

10. PROBATE v. NONPROBATE DISPOSITIONS

In *Street v. Skipper, supra*, a special community life insurance policy was payable to the insured spouse's probate estate and his wife argued that the husband did not have the power to devise her one-half of the policy proceeds to a third party. 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 proof of fraud on the community. The court held that the controlling issue was whether or not there had been a fraud on the community and 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.

11. THIRD PARTY

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. 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 appears to depend on the overall "fairness" of the situation. *See Jackson v. Smith, supra* and *Readfern v. Ford*, 579 S.W.2d 295 (Tex. App.—Dallas 1979, writ ref'd n.r.e.).

12. 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.

However, in the previous hypothetical, 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.

13. ELECTION?

The tougher theoretical question may be whether the wife can assert her claim of fraud on the community 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 the fraud claim? *See* XII, E *infra*.

F. 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 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. 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.

G. The Effect of Preemption

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 following the rationale of the recently announced *Egelhoff* case by the U.S. Supreme Court. *See* V. I *infra.*

H. 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 non-probate disposition (e.g., a POD" bank account)?

I. Lack of Partition

Historically, Texas law has not encouraged non-probate dispositions of property upon the owner's death. In 1848, the Texas legislature "abolished" joint tenancies. Law of March 18, 1848, ch. 103, Sec. 12, 1848 Tex. Gen. Laws 129. Anglo-American common law at the time presumed that co-ownership of property included the "right of survivorship"— upon the death of one co-owner, the property vested in the surviving co-owner. Texas law created a presumption of "tenancy in common" rather than "joint tenancy"; however, co-owners could agree to create survivorship rights— convert a tenancy in common into a joint tenancy with rights of survivorship. *Chandler v. Kountze*, 130 S.W.2d 327 (Tex. Civ. App.-1939, writ ref'd).

1. <u>STATUTORY BACKGROUND</u>

In 1955, the Texas concept of co-ownership described above was incorporated into the Texas Probate Code with the enactment of Sec. 46 of the Texas Probate Code. Until 1989, Sec. 46 was even captioned as "Joint Tenancies Abolished."

This Texas approach to co-ownership merged nicely with its community property system which created a form of co-ownership between spouses as to their community property. Historically, when the first spouse died, the "community" ceased to exist and the deceased spouse's one-half interest in the community property passed *probate* to the decedent's heirs/devisees and the surviving spouse retained an undivided one-half interest, thereby creating a tenancy in common between the surviving spouse and the decedent's heirs/devisees, unless the surviving spouse was the sole heir or devisee. Until 1987, it was even unconstitutional for spouses to create survivorship rights in their community property. See *Hilley v. Hilley*, 342 S.W.2d 565 (Tex. 1961) and X, infra.

2. <u>BAD CASE LAW</u>

Today, however, it is common practice for property to avoid *probate* (i.e., pass non-probate) upon the death of its owner. The legislature has even encouraged "non-testamentary" transfers. *See* Tex. Prob. Code Sec. 450. However, some courts and practitioners do not always properly apply the principles evolving from a merger of Texas' community property system and the rules relating to non-probate dispositions generally. For example, in *Haas v. Voight*, 940 S.W.2d 198 (Tex.App.—San Antonio, 1997, writ. denied), the court of appeals relied on two old cases that were not only effectively overruled by a later amendment to the Texas Constitution but were not good precedent for the facts before the court, even if the cases had not been overruled. *Hilley v. Hilley, supra* and *Williams v. McKnight*, 402 S.W.2d 505 (Tex. 1966) both held that the spouses could not create "rights of survivorship" among themselves with their community property regardless of which spouse died first (i.e., a joint tenancy) without first partitioning the community property into their separate properties because the Texas Constitution did not authorize that type of transaction. In 1987, Art. XVI, Sec. 15 was amended to authorize spouses to create "rights of survivorship" among themselves with their community property.

In *Haas*, the issue was not whether spouses had created "rights of survivorship" among themselves regardless of which spouse died first; the question was whether the husband could make a non-probate disposition of a community asset to a third party by depositing community funds into a "joint account with rights of survivorship" with his son. The son did not acquire an ownership interest in the account by his father making the deposit since the son had not contributed to the account. Tex. Prob. Code Sec. 438(a). The account remained the community property of the husband and wife until the husband's death, when according to the terms of the account agreement, ownership passed to the son. Tex. Prob. Code Sec. 439(a).

Ignoring Chapter 3, Subchapter B of the Texas Family Code and Chapter XI of the Texas Probate Code, the court of appeals held that this disposition failed because the community asset had not been partitioned by the spouses. The issue should have been whether the husband had properly exercised his power of management granted by the Texas Family Code. Entering into the survivorship agreement with the bank was either (i) within the husband's authority because the community funds were subject to his "sole management, control and disposition" or (ii) not within his authority, and therefore, void because the community funds were subject to the "joint management, control and disposition" of the husband and wife.

If the community funds were subject to the husband's "sole management, control and disposition," the question should have become whether he had committed a "fraud on the community" or whether the account was "illusory". See III, D and E, *supra*. The failure of the husband and wife to partition the funds should not have been the determinative factor.

J. Void Transfers

The Texas Supreme Court has not yet 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. Jackson*, 691 S.W.2d 765 (Tex. App.—Austin 1985, writ ref'd n.r.e.). It would certainly follow that such a transaction would be void as to the other spouse's one-half interest. Compare *In the Matter of the Marriage of Morrison, supra.*

K. 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 Secs. 24.001-24.013 and the U.S. Bankruptcy Code, 11 U.S.C. Sec. 544(b).

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

IV. MARITAL PROPERTY LIABILITY

In *Arnold v. Leonard, supra*, the Texas Supreme Court held that ". . . the Legislature may rightfully place such portions of the community as it deems best under the wife's separate control, and . . . it may likewise exempt the same from payment of the husband's debts, without the exemption being open to successful constitutional attack by either the husband or his creditors."

A. Statutory Plan

The legislature's rules of marital property liability are found in Sec. 3.202 and Sec. 3.203 of the Texas Family Code.

1. SEPARATE PROPERTY EXEMPTION

A spouse's separate property is not subject to the liabilities of the other spouse. Tex. Fam. Code Sec. 3.202(a).

2. SPECIAL COMMUNITY EXEMPTION

A spouse's special community property is not subject to any of the liabilities incurred by the other spouse prior to the marriage or any nontortious liabilities of the other spouse incurred during the marriage. Tex. Fam. Code Sec. 3.202(b).

3. OTHER RULES OF LAW

The above exemptions exist unless both spouses are personally liable under "other rules of law." Tex. Fam. Code Sec. 3.202(a) and (b).

4. CREDITOR'S RIGHTS

A spouse's separate property and special community property and the spouses' joint community property are subject to any liabilities of that spouse incurred before or during the marriage. In addition, the special community estates of both spouses are subject to the tortious liabilities of either spouse incurred during marriage. Tex. Fam. Code Sec. 3.202 (c) and (d).

5. ORDER OF EXECUTION

Sec. 3.203 gives the court discretion in determining the order in which marital assets will be taken in satisfaction of a spouse's liabilities. Tex. Fam. Code Sec. 3.203.

B. Observations

It appears that the legislature contemplated a logical liability system which depends on a multiple step process to determine which assets are liable for which debts: First, whose debt is it? It is either the debt of the husband, the debt of the wife or both spouses' debt. Second, when was the debt incurred? It was incurred either prior to or during the marriage. Third, what type of debt is it? It is either tortious in nature or nontortious. Fourth, are there any other substantive, non-marital rules of law which would make one spouse personally liable for the debts of the other spouse? After answering these four questions, one can look to Sec. 3.202 for the proper result.

C. Community Debt

Despite the plain import of the statutory plan enacted by the legislature, the courts and commentators alike continue to create confusion for the practitioner by referring to the term "community debt" as if the community were an entity separate and apart from the spouses, which "entity" could own property and incur debts.

1. COCKERHAM

In *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975), the Texas Supreme Court explained that ". . . debts contracted during marriage are presumed to be on the credit of the community and thus are joint community obligations, unless it is shown the creditor agreed to look solely to the separate estate of the contracting party for satisfaction."

It is the author's opinion that the court erroneously cited as its authority for the concept of "community debt" the cases of *Broussard v. Tian*, 156 Tex. 371, 295 S.W.2d 405 (1956) and *Gleich v. Bongio*, 128 Tex. 606, 99 S.W.2d 881 (1937), which held that property acquired on credit is community property unless the creditor agreed to look only to separate property for repayment. These cases addressed the characterization of the property acquired on credit and do not support the "community debt" concept.

2. JUDICIAL/LEGISLATIVE INCONSISTENCIES

References to "community debts" imply that the "community" is liable for the debt (i.e. all community property can be used to satisfy the debt); it also suggests that both spouses are personally liable because they are the community. This result is inconsistent with legislative mandate and the statutory plan of Sec. 3.202 of the Family Code. For example, a wife's special community property is not liable for the husband's contractual debts unless she is liable under another substantive rule of law. Marriage itself does not create joint and several liability. *See* IV, D., *infra*.

3. TOTALITY OF THE CIRCUMSTANCES

Cockerham also seemed to extend the facts and circumstances under which one spouse could be held liable for the debts of the other spouse by announcing, in effect, a "totality of the circumstances" test and thereby placed at risk all of the assets of either spouse whenever either spouse incurred a liability during the marriage, a result obviously not contemplated by the legislature in enacting the predecessor to Sec. 3.202.

4. ANTI-COCKERHAM LEGISLATION

1987 legislation should be interpreted as putting an end to the *Cockerham* test. Texas Family Code Sec. 3.201 provides that one spouse will be personally liable for the acts of the other spouse only if the other spouse acts as the agent of the otherwise innocent spouse or the other spouse incurs a debt for "necessaries." Tex. Fam. Code Sec. 3.201. In addition, the predecessor to Sec. 3.202 was amended to refer specifically to the predecessor to Sec. 3.201 in determining when one spouse's special community property would be liable for the debts of the other spouse. Hopefully, this legislation will place the determination of marital property liability where it belongs - the statutory plan of Sec. 3.202. The courts of appeals appear to be accepting the legislative mandate. *See Montemayor v. Ortiz*, 208 S.W.3d 627 (Tex. App.—Corpus Christi 2006, no writ) and *Carr v. Houston Business Forms, Inc.*, 794 S.W.2d 849 (Tex. App.—Houston [14th Dist.] 1990, no writ).

D. Other Factors

1. JOINT OBLIGATIONS

Of course, both spouses may sign a contract or commit a tort which would make them jointly and severally liable and thereby subjecting all of the marital assets to liability.

2. VICARIOUS LIABILITY

The law has defined situations where any person can be held personally liable for certain acts of another. These situations include the following relationships: respondeat superior, principal/agency, partnership, joint venture, etc. These special relationships can exist between husband and wife and can impose vicarious liability on an otherwise innocent spouse. *See Lawrence v. Hardy*, 583 S.W.2d 795 (Tex. App.—San Antonio 1979, writ ref'd n.r.e.). However, the marriage relationship alone is not sufficient to generate vicarious liability. Tex. Fam. Code Sec. 3.201.

3. DUTY TO SUPPORT

Each spouse has a duty to support the other spouse and a duty to support a child generally for so long as the child is a minor and thereafter until the child graduates from high school. Tex. Fam. Code Secs. 2.501 and 154.001. Accordingly, all marital assets are liable for such "necessaries." Prior to 2007 legislation, unless otherwise agreed in writing or ordered by a court, a parent's child support obligation ended when the parent died. SB 617 amends the Family Code to provide that court ordered child support obligations survive the obligor's death. Tex. Fam. Code Sec. 154.006. New sections of the Family Code now also provide that the obligor's child support obligations will be accelerated upon the obligor's death and a liquidated amount will be determined using discount analysis and other means. Tex. Fam. Code Sec. 154.015. An amendment to the Probate Code makes the liquidated amount a class 4 claim. Tex. Prob. Code Sec. 322. The court can also require that the child support obligation be secured by the purchase of a life insurance policy. Tex. Fam. Code Sec. 154.016.

4. TAX LIABILITY

Because each spouse only owns one-half of the community income, notwithstanding the rules of management, if the spouses file separate income tax returns, each spouse is to report one-half of his/her community income and one-half of the other spouse's community income, thereby becoming personally liable for the tax liability of one-half of the total community income. However, it appears as if the IRS can attach (i) one-half of the special community property of the other spouse and (ii) all of the deficient spouse's special community property to satisfy the tax liability of the deficient spouse. *See Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989).

5. EXEMPT PROPERTY

Of course, the family homestead and certain items of personal property are generally exempt from most debts, notwithstanding the Family Code rules. Tex. Prop. Code Secs. 41.001 and 42.001. Such exemptions may extend beyond the death of the owner if the owner is survived by a constituent family member. Sec. 42.0021 of the Texas Property Code also exempts certain retirement benefits.

6. EFFECT OF DEATH

The death of a spouse can change the statutory framework of marital property liability. For example, the Texas Probate Code appears to allow the decedent's one-half interest in the other spouse's special community property to be reached in order to satisfy a nontortious debt incurred during marriage by the decedent. *See* XIII, B *infra*.

V. DISSOLUTION OF THE MARRIAGE

While a detailed study of the termination of a marriage by reason of divorce is beyond the scope of this paper, it is necessary to remember that the basic rules of marital characterization, management and liability continue only during the marriage. Community property cannot exist without a marriage. Accordingly, when the marriage terminates by either death or divorce, community property ceases to exist, and generally either the probate court or the divorce court will resolve the characterization, reimbursement, management, waste, fraud on the community and liability issues that arose during the marriage.

A. Just and Right Division at Divorce

The Texas Family Code directs the court in a divorce proceeding to award child custody, provide for child support and divide the "estate of the parties" in a just and right manner. Tex. Fam. Code Sec. 7.001. The Texas Supreme Court has limited the term "estate of the parties" to community property only. *See Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) and *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982). There is an exception related to the concept of quasi-community property (generally separate property acquired while the couple was residing in another state but which would have been community had they been residing in Texas). On the other hand, quasi-separate is not divisible. *See* Tex. Fam. Code, Sec. 7.002(b). *See* II, H *supra*.

B. Liability for Waste/Fraud

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. *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); *In re Marriage of Moore*, 890 S.W.2d 821 (Tex. App.—Amarillo 1994, no writ). 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* III.E, *supra*. In *Schlueter v. Schlueter*, 975 S.W.2d 584 (Tex. 1998), the 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. A money judgment for actual damages can be entered to allow the wronged spouse to recoup the community estate lost due to the other spouse's fraud on the community. Courts have also used their equitable powers to impose a constructive trust on community assets given to third parties to bring the assets back into the authority of the divorce court. *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 community. *See* III, D *supra*.

C. Maintenance

While permanent alimony is still contrary to public policy in Texas, in 1995 the legislature authorized a form of post-death non-contractual alimony as part of its welfare reform package to provide for the "minimum reasonable needs" of an ex-spouse who is unable to be self-supporting or who is custodian of a child who requires special care. In order for the court to order such "maintenance" payments, the couple must have been married at least ten years. Monthly payments cannot exceed $2,500 or 20% of the payor's monthly income and cannot extend for more than three years unless the payee spouse is disabled. Maintenance can also be ordered in certain other instances where the payor has been convicted (or received deferred adjudication) for an act of family violence. Payments terminate upon the death of either spouse, the remarriage of the payee spouse or the payee spouse's cohabitation with another. *See* Tex. Fam. Code Secs. 8.001-8.108.

D. Rights of Creditors

While the divorce court can impose on one spouse or the other the responsibility for satisfying a particular debt insofar as the relative rights of the divorcing couple are concerned, such allocation of responsibility does not insulate the "non-responsible" spouse from the debts for which such spouse was personally liable insofar as the creditor is concerned. Further, the assets which could be used to satisfy a creditor's claim prior to divorce can still be reached by that creditor after divorce. The net effect is to leave the "non-responsible" spouse with a claim for indemnification against the responsible spouse. *See Stewart Title Company v. Huddleston*, 598 S.W.2d 321 (Tex. App.—San Antonio 1980), aff'd, 608 S.W.2d 611 (Tex. 1980) (per curium) and *Anderson v. Royce*, 624 S.W.2d 621 (Tex. App.—Houston [14th Dist.] 1981, writ ref'd n.r.e.).

E. Spousal Tort Claims

The doctrine of interspousal immunity was abolished as to intentional torts in *Bounds v. Caudle*, 560 S.W.2d 925 (Tex. 1977) and as to unintentional torts in *Price v. Price*, 732 S.W.2d 316 (Tex. 1987). Accordingly, tort claims are becoming commonplace in divorce actions and can be anticipated in future probate proceedings as well; if successfully asserted, the injured spouse can attach non-exempt separate property.

F. QDROs

Retirement plans regulated by ERISA may not, however, be effectively divided on divorce unless the divorce court enters a "qualified domestic relations order" pursuant to ERISA. "QDRO" is used to describe the order that divides most defined benefit, defined contribution, profit sharing and other plans. The divorce court retains, in effect, continuing jurisdiction to enter such an order. Tex. Fam. Code Sec. 9.101 - 9.105. After the QDRO is entered, a certified copy of it is typically delivered to the plan administrator for approval. If accepted by the plan administrator, the plan administrator is bound to abide by its terms. If rejected by the plan administrator, the trial court can enter an amended or corrected order that satisfies ERISA requirements. *See* Stewart Gagnon, Kathryn Murphy, and Ike Vanden Eykel, *Texas Practice Guide – Family Law,* Chapter 6 (West).

G. Other Federal Benefits

Like in ERISA, Congress has authorized state divorce courts to divide military retirement, *Koepke v. Koepke*, 732 S.W.2d 299 (Tex. 1987); military disability, *U.S. v. Stelter*, 567 S.W.2d 797 (Tex. 1978); federal workman's compensation, *Anthony v. Anthony*, 624 S.W.2d 388 (Tex.App.—Austin 1981, writ dism'd); civil service retirement pay, *Adams v. Adams*, 623 S.W.2d 500 (Tex.App.—Fort Worth 1981, no writ). On the other hand, certain federal benefits are not divisible by a state divorce court. These include fleet reserve pay, *Sprott v. Sprott*, 576 S.W.2d 653 (Tex. Civ. App.—Beaumont 1978, writ dism'd); military readjustment benefits, *Perez v. Perez*, 587 S.W.2d 671 (Tex. 1979); railroad retirement benefits, *Eichelberger v. Eichelberger*, 582 S.W.2d 395 (Tex. 1979); social security benefits, *Richard v. Richard*, 659 S.W.2d 746 (Tex.App.—Tyler 1983, no writ); Veterans Administration benefits, *Ex Parte Johnson*, 591 S.W.2d 453 (Tex. 1979); and National Service Life Insurance, *Wissner v. Wissner*, 338 U.S.655 (1950).

H. Effect of Divorce on Planning

The divorce of a testator (or other dissolution of the marriage) generally voids all provisions in the testator's will in favor of the now former spouse and the former spouse's relatives who are not also relatives of the testator. Tex. Prob. Code Sec. 69. Similarly, beneficiary designations found in life insurance policies and retirement plans in favor of the former spouse are rendered ineffective. Tex. Fam. Code Secs. 9.301 and 9.302. Neither of these sections of the Family Code addresses the former spouse's relatives. HB 1186 (2005) created a new Chapter XI-A, Provisions Applicable to Certain Nontestamentary Transfers in the Texas Probate Code, and Sec. 472 effectively voids all provisions in a revocable trust only in favor of the settlor's former spouse, much like Sec. 69 voids the provisions in a will in favor of the testator's former spouse, but Sec. 472 does not address the former spouse's relatives. It is anticipated that Chapter XI-A will be extended in future legislation to multi-party accounts, joint tenancies and other nontestamentary trusts.

I. Federal Preemption

Notwithstanding Tex. Fam. Code Secs. 9.301 and 9.302 which generally void the designation of an ex-spouse as the beneficiary of a life insurance policy or a retirement plan, Federal law appears to preempt the application of those two Texas statutes in situations involving life insurance policies and retirement plans provided by an employer and governed by ERISA.

1. *Egelhoff v. Egelhoff*

In *Egelhoff v. Egelhoff*, 532 U.S. 141, 147, 121 S.Ct. 1322, 1327, 149 L.Ed.2d 264 (2001) a resident of the State of Washington obtained a divorce but did not change the designation of his former wife as the beneficiary of a group life insurance policy. Upon Egelhoff's death, his ERISA plan administrator paid the policy proceeds to his former wife. His children then sued her to recover those proceeds, based on a state statute that revoked a designation of a spouse as the beneficiary of a life insurance policy upon divorce. The Supreme Court held that ERISA preempts state law, reasoning, that state law was at odds with ERISA's directives that a plan administrator must make payments to the beneficiary designated by the plan participant. The Supreme Court also explained that:

> Requiring ERISA administrators to master the relevant laws of 50 States and to contend with litigation would undermine the congressional goal of "minimiz[ing] their administrative and financial burden[s]." ... [D]iffering state regulations affecting an ERISA plan's "system for processing claims and paying benefits" impose precisely the burden that ERISA pre-emption was intended to avoid.

The Court's determination that state law was preempted was unaffected by the fact that the plan administrator in Egelhoff had already paid the proceeds to the decedent's former wife, and that the suit was against her, not the plan administrator.

2. Federal Common Law

In *Keen v. Weaver* 121 S.W.3d 721 (Tex. 2003), the Texas Supreme Court ruled that, notwithstanding the *Egelhoff* case, a former spouse was *not* entitled to the death benefit of the employee's pension plan after the employee failed to change the beneficiary designation following his divorce. The court of appeals had already reversed the trial court's ruling in favor of the former spouse by reasoning that the Texas redesignation statute, *applied as federal common law*, prevented the former spouse from receiving the ERISA benefits. Compare *Heggy v. Trading Employee Ret. Account Plan*, 123 S.W.3d 770 (Tex.App.—Houston 14 Dist. 2003 pet denied).

The Texas Supreme Court in *Keen* concluded that, while Tex. Fam. Code Sec. 9.302 was preempted by ERISA, the former spouse, as part of the original divorce proceeding, had effectively waived her interest in the employee's ERISA benefits. The waiver was enforceable under federal common law in that ERISA's anti-alienation provisions did not apply to such a waiver. It is interesting to note that the U.S. Supreme Court denied the former spouse's writ of certiorari. *See Keen v. Weaver*, 540 U.S. 1047, 124 S.Ct 808, 157 L. Ed. 2d 695 (2003).

VI. PREMARITAL AGREEMENTS - FORMALITIES

Since 1980, Texas law has permitted persons intending to marry to enter into a wide variety of property agreements that can convert what would otherwise be community property and therefore subject to the claims of certain creditors of both spouses, or subject to division by a divorce court, or partition by a probate court, into a spouse's separate property. A spouse's separate property is generally exempt from the creditors and claims of the other spouse.

Of course, the ability to accomplish this result depends initially on satisfying certain formality requirements as specified in the Uniform Premarital Agreement Act.

A. Uniform Premarital Agreement Act

The 1987 Legislature repealed the provisions of Chapter 5, subchapter C, of the Texas Family Code and replaced these provisions with the Texas version of the Uniform Premarital Agreement Act. It does not appear that the Texas legislation attempted to change what parties intending to marry could accomplish in a premarital agreement since the power to contract in these matters is ultimately controlled by the Texas Constitution, and the 1980 amendment had already significantly expanded the parties' power to contract. The Uniform Premarital Agreement Act did affect the formal requirements and enforceability of premarital agreements. Among other technical changes, there was a dramatic shift in the burden of proof when the validity of an agreement is placed in question.

B. Formalities

As under prior law, a premarital agreement must be in writing and signed by the parties. It need not be witnessed, acknowledged or sworn to. It is enforceable without consideration. Tex. Fam. Code Sec. 4.002. It becomes effective on marriage. Tex. Fam. Code Sec. 4.004. It can be amended by a written agreement of the parties. Tex. Fam. Code Sec. 4.005.

C. Burden of Proof

Under prior law, the burden of proof was imposed on the party seeking to enforce the agreement to establish by clear and convincing evidence that the other party gave "informed consent" and that the agreement was not obtained by fraud, duress or overreaching. Now, the burden of proof is placed on the party asserting the agreement's invalidity. Tex. Fam. Code Sec. 4.006.

D. The Opponent's Burden

The party opposing the agreement must now prove that (i) the agreement was not entered into voluntarily or (ii) it was unconscionable when it was executed and the opponent was not provided with a fair and reasonable disclosure of the proponent's financial situation, or did not waive such disclosure and did not have adequate knowledge of such situation. In other words, there is a statutory presumption of validity.

1. INVOLUNTARINESS

The issue of involuntariness (i) relates to the issue of whether the opponent entered into the agreement "freely" and (ii) incorporates effectively the possible contractual defenses of competency, fraud, misrepresentation, duress and coercion as evidenced by the terms of the agreement or the surrounding facts and circumstances. Other relevant factors may be the opponent's understanding of the agreement at the time it was executed and whether the opponent had adequate time to consider the terms of the agreement prior to execution. *See* Fullenweider and Rainey, "Litigating Premarital Agreements," Advanced Family Law Course, State Bar of Texas (1988).

2. UNCONSCIONABILITY

Sec. 4.006(b) provides that the issue of unconscionability is a question of law to be decided by the court, not the jury. The relevant factors for the court to consider may include the negotiating atmosphere, the relative bargaining abilities of the parties, and over-reaching by a party, as well as the legality of the contract and whether or not it violates public policy. Fullenweider and Rainey refer to the Uniform Premarital Agreement Act, 9(b) UCA 20, to include factors such as concealment of assets and sharp dealing not consistent with the obligation of marital partners to deal fairly with each other. *See* Fullenweider, *supra*. However, it is important to remember that, according to Sec. 4.006(b), even an unconscionable agreement can be enforced if it was entered into voluntarily by an opponent who was either provided fair and reasonable disclosure or who waived such disclosure or who did not already have adequate knowledge of the financial situation of the proponent.

3. WAIVER

Generally, in order to be valid, a waiver of a statutory right must be a voluntary and intentional release of the right. It must be clear, specific and unequivocal. The party signing the waiver must have full knowledge of its consequences. However, Fullenweider and Rainey report that waiver issues in this context generally focus on the negotiations, disclosures and intentions of the parties at the time of the agreement. Fullenweider, *supra*.

4. FAIRNESS

Notwithstanding the discussion of involuntariness and unconscionability, it is important to remember that there is no requirement that a premarital agreement be fair in order to be enforced. In *Chiles v. Chiles*, 779 S.W.2d 127 (Tex. App.—Houston [14th Dist.] 1989 writ denied), the court held: "Parties should be free to execute agreements as they see fit and whether they are 'fair' is not material to validity." Accordingly, Texas law currently appears to require only that a premarital agreement be fairly entered into and not that it be fair in application to both parties.

5. COMMON LAW DEFENSES

In *Daniel v. Daniel*, 779 S.W.2d 110 (Tex. App.—Houston [1st Dist.], 1989, no writ, the court discussed whether old Sec. 5.46's comparable section for marital agreements, old Sec. 5.55, abolishes common law contract defenses (e.g. such as fraud, duress and competency) and concluded that it did not. However, the predecessor to Sec. 4.006 eliminated the common law defenses for agreements executed on or after Sept. 1, 1993, but they still appear to be incorporated into the concepts of involuntariness or unconscionability.

6. CHECKLIST

In their article, Fullenweider and Rainey include a thorough checklist of over 80 questions to consider with a client or on deposition. This checklist was originally published by Arnold Rutkin in the Family Advocate (Winter, 1984). The questions are divided into six categories: (i) Is the agreement the product of an arms-length transaction or an equal bargaining position? (ii) What was the status of the parties before the agreement was signed and at the time of enforcement? (iii) Was there adequate legal representation for both parties? (iv) Was there full and complete disclosure before the agreement was signed? (v) Was either party pressured to sign the agreement through undue influence, duress or coercion? (vi) Was there legal consideration or adequate consideration for the waiver of statutory or common law rights in the agreement itself?

E. Retroactivity

Several cases have indicated that the new burden of proof applies to agreements entered into prior to the effective date of the 1987 changes. *See Sadler v. Sadler*, 769 S.W.2d 886 (Tex.1989). The author is of the opinion that these opinions lack thorough analysis and do not reflect what the law should be. For example, the two courts of appeal placed too much reliance on *Sadler* – a per curiam decision. The new burden of proof should apply only to those agreements entered into after the effective date, particularly if the agreement was executed during the marriage.

F. Statute of Limitations

The statute of limitations applicable to any breach of the agreement is tolled until the marriage is terminated. Equitable defenses, such as laches and estoppel, are, however, preserved. Tex. Fam. Code Sec. 4.008.

G. Assistance of Counsel

Neither old law nor new law requires that the parties be represented by legal counsel at the time of the agreement; however, the lack of independent counsel representing the opponent is likely to continue to be an important factor in determining an agreement's enforceability.

VII. PREMARITAL AGREEMENTS SUBSTANCE

Prior to 1987, the Texas Family Code granted blanket authority to parties to enter into such agreements as they desired, subject, of course, to the limitations of the Texas Constitution and other public policy concerns. The Uniform Premarital Agreement Act, which includes a laundry list of subjects that can be addressed in a premarital agreement, was adopted in 1987. Today, the parties can still enter into such property agreements as they may desire but still subject to the limitations of the Texas Constitution and certain public policy concerns.

A. Mere Agreement Rule

In 1902 the Texas Supreme Court announced what has become known as the *mere agreement rule.* "The question whether particular property is separate or community must depend upon the existence or nonexistence of the facts, which, by the rules of law, give character to it, and not merely upon the stipulations by the parties that it shall belong to one class or the other." *Kellet v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902).

1. CONSTITUTIONAL LIMITATIONS ON THE POWER TO CONTRACT

The net effect of the mere agreement rule was that the constitutional definition of separate property limited the flexibility of spouses and those about to marry in their property agreements.

2. PARTITION OF COMMUNITY PROPERTY

In *King v. Bruce*, 145 Tex. 647, 201 S.W.2d 803 1947), the Texas Supreme Court ruled that the Texas Constitution did not permit spouses to partition their community property into undivided separate interests. The Legislature responded with the 1948 amendment to Art. XVI, Sec. 15, which permitted the partition of presently existing community property by spouses.

3. PARTITION OF EXPECTANCIES

The 1948 amendment to Art. XVI, Sec. 15 did not encourage the widespread use of premarital agreements because only spouses could partition and exchange presently existing community property. To have an effective premarital agreement, the parties needed to be able to partition and exchange community property not yet in existence. This need was satisfied by the 1980 amendment to Art. XVI, Sec. 15.

4. MODERN APPLICATION

Today's rule is that an agreement which attempts to change the character of property in a manner not authorized by the Constitution is void.

B. Sec. 4.003, Texas Family Code

Currently, parties to a premarital agreement are authorized by statute to contract with respect to:

1. The rights and obligations of each of the parties in any of the property of either or both of them whenever and wherever acquired or located.

2. The right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage and control property.

3. The disposition of property on separation, marital dissolution, death, or the occurrence or nonoccurrence of any other event.

4. The modification or elimination of spousal support.

5. The making of a will, trust, or other arrangement to carry out the provisions of the agreement.

6. The ownership rights in and disposition of the death benefit from a life insurance policy.

7. The choice of law governing the construction of the agreement.

8. Any other matter, including their personal rights and obligations, not in violation of public policy or a statute imposing a criminal penalty.

C. Standard Provisions

It is common for premarital agreements to simply confirm the status of Texas law. For example, the parties agree that certain itemized assets brought into the marriage and their mutations are to remain the owner's separate property. They may also confirm that anything acquired during marriage by gift, devise or descent will be separate property. They may even agree that such separate property will not be subject to a just and equitable division at divorce. *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) and *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982).

D. Income from Separate Property

Parties may decide to agree that income from separate property is the owner's separate property as authorized by the 1980 amendment to Art. XVI, Sec. 15. Since the Constitution expressly authorizes only spouses to make such agreements and not persons intending to marry, it may be advisable to term such an agreement as a partition since both spouses and persons intending to marry can partition community property not yet in existence (i.e., future income from separate property). Accomplishing this result through a partition, however, may not be necessary since by statute a premarital agreement becomes effective on marriage; thus, spouses are really making the agreement. Tex. Fam. Code

Sec. 4.004. On the other hand, why does the Constitution distinguish between parties intending to marry and spouses? *See Fanning v. Fanning*, 828 S.W.2d 135 (Tex. App.—Waco 1992) aff'd in part, and reversed in part on other grounds, 847 S.W.2d 225 (Tex. 1993); *Dokmanovic v. Schwarz*, 880 S.W.2d 272 (Tex. App.—Houston [14th] 1994, no writ).

E. Wages, Salaries, Personal Earnings

Ever since the passage of the 1980 amendment practitioners have questioned whether the parties to a premarital agreement should be able to agree that wages and salaries and other personal earnings will be the acquiring spouse's separate property. For example, Professor Sampson noted:

> It remains to be seen whether revising the type of agreement entered into here to contemplate a present partition of future earnings will suffice to take the parties completely out of the community property system. Generally, I hope not, although I also tend to believe that folks ought to be able to do what they want with their property. On the other hand, an agreement such as this between a doctor and his to be housewife seems clearly abusive and overreaching. Editor's note, Family Law, State Bar Section Report, Vol. 87-6, Fall 1987, pp. 35-36.

Professor Sampson's comments followed a discussion of *Bradley v. Bradley*, 725 S.W.2d 503 (Tex. App.—Corpus Christi 1987, no writ), where the court held that a premarital agreement did not effectively partition the parties' future earnings.

F. Partition and Exchange

It is this author's opinion that the *Bradley* agreement itself was not drafted to accomplish a direct partition of future earnings but was an agreement to partition future earnings once the earnings came into existence. Further, the author believes Art. XVI, Sec. 15 of the Texas Constitution clearly authorizes the partition of and exchange of any and all community property not yet in existence, including, but not limited to, personal earnings, retirement benefits, I.R.A.s, trust income, income from separate property, and property acquired on credit; so does the legislature. *See* Sec. 4.001(2), of the Family Code. The cases of *Fanning v. Fanning, supra* and *Winger v. Pianka*, 831 S.W.2d 853 (Tex. App.— Austin 1992, writ denied) have confirmed this viewpoint.

G. Community Free Marriage

It is, therefore, the "partition and exchange" agreement which can be effectively used to create the "community free marriage." This type of agreement also allows the couple to address some otherwise troubling issues.

1. REIMBURSEMENT/ECONOMIC CONTRIBUTION

In view of the emergence of the community claim for reimbursement during the 1980s, and the creation of statutory claims for economic contribution in 2001, it would be advisable to address specifically any such potential claim in the premarital agreement if either spouse owns significant separate property. For example, perhaps the nonowner spouse could agree to waive the claim for reimbursement. Although there are no definitive cases on point, it is arguable that such a waiver would be valid. However, it may be advisable for the couple to partition the claim in a manner which would at least limit the exposure the owner spouse would have by reason of the community claim for reimbursement or economic contribution.

2. QUASI-COMMUNITY PROPERTY

Separate property acquired by a couple while residing in a common law state that would have been community had they been residing in Texas can be divided by a Texas divorce court on a just and right basis. Tex. Fam. Code Sec. 7.002. The Family Code does not convert such asset into community property but allows for it to be treated as such in a divorce proceeding. This concept is not applicable in probate. *See Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987). Since such property is merely quasi-community and not actually community property, can it be subject to a partition and exchange agreement as authorized by the constitution and the statutes? Is this a right that the nonowner spouse can waive in a premarital agreement? There does not appear to be a good answer to this question, but it is an issue that should be addressed specifically in this agreement, if relevant.

3. QUASI-SEPARATE PROPERTY

A 2003 amendment to Sec. 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. 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. Since such property is merely quasi-separate and not actually separate property, this category of community property should be subject to a partition and exchange agreement.

4. PROFESSIONAL DEGREES, LICENSES

In view of the national trend to treat professional degrees and licenses as property and therefore capable of division by the divorce court and possible partition by the probate court, the possibility of such a result in Texas should be anticipated although the only case in Texas to date on point has held to the contrary. *See O'Brien v. O'Brien*, 489 N.E.2d 712 (N.Y. 1985) and *Frausto v. Frausto*, 611 S.W.2d 656 (Tex. App.—San Antonio 1980, writ dism'd w.o.j.). If professional degrees and licenses are eventually found to be property in Texas and consequently community property, if acquired during marriage, they should be treated as such in the agreement and could be subjected to a partition and exchange, if the parties so agree.

5. CERTAIN PERSONAL INJURY RECOVERIES

Personal injury recoveries for loss of earning capacity during marriage are defined as community property. Tex. Fam. Code Sec. 3.001(a)(3). Notwithstanding this statutory provision and *Graham v. Franco, supra*, 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 couple 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, the 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. In view of current law possibly creating such an inequitable result, possible personal injury recoveries could be addressed in a partition and exchange agreement.

6. PERSONAL SERVICE CONTRACTS

Wages and salaries earned during the marriage are clearly community property, but the characterization of money earned during the marriage pursuant to a contract signed before marriage, or money received after the marriage pursuant to a deferred compensation agreement signed during the marriage, is uncertain. Even if wages and salaries generally are not going to be partitioned, these other issues could be addressed in the premarital agreement to avoid future confusion and litigation.

H. Division of Property upon Divorce

The parties should be able to agree as to a certain division of their community and separate properties in the event of divorce instead of awaiting an "equitable division" of the community by the divorce court. Of course, such an agreed to division cannot affect a parent's child support obligations. Such an agreement may also affect the determination of whether an agreement is unconscionable or not.

I. Contracts Concerning Succession

The parties to a premarital agreement may also agree that they will not assert inheritance rights upon the first spouse's death or that one spouse is to leave to the other spouse certain assets in the event the marriage terminates by reason of the obligor's death. Sec. 59A of the Texas Probate Code was amended in 2003 in order to confirm that a contract to make a will or devise can be established by either (i) provisions in a will stating that the contract exists and the material provisions of the contract, or (ii) *the provisions of a written agreement that is binding and enforceable.* Even without the addition of the latter provision, this author is of the opinion that Sec. 59A was never intended to apply to an agreement whereby a spouse is required to leave property to the other spouse pursuant to a premarital agreement. This situation is not one where there are reciprocal testamentary promises but one where there is current consideration in exchange for a testamentary promise.

J. Homestead, Exempt Personal Property and Widow Allowance

In *Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978), the Texas Supreme Court approved the provisions of a premarital agreement whereby one party waived his right following the first spouse's death to occupy the other party's separate property home, to utilize the exempt personal property and to claim a family allowance.

1. SELECTION AND ABANDONMENT

The premarital agreement presents the opportunity for a couple to agree which of their homes will be the homestead and what process should be followed to abandon and select a new one.

2. SALE OR ENCUMBRANCE

The *Williams* case involved the surviving spouse's rights following the owner's death. Sec. 5.001 of the Texas Family Code prohibits the owner of the homestead from selling or encumbering it during the marriage without the joinder of the non-owner spouse. Can this right of the non-owner be waived in a premarital agreement? Sec. 4.003(a)(2) appears to authorize it.

3. LIABILITY

So long as the owner is alive, the homestead and certain items of personal property continue to be exempt from the claims of most creditors. Tex. Prop. Code Secs. 41.001 and 42.002. However, if the non-owner has waived the right of occupancy and possession upon the death of the owner, will such property continue to be exempt from most creditors following the owner's death? Presumably yes, if the owner also was survived by a minor child or unmarried adult child remaining at home, but if the only constituent family member surviving the owner is the spouse who previously waived these rights, the answer is not so clear.

K. Retroactive Application

The Texas Supreme Court has retroactively applied the 1980 amendment to validate a 1977 premarital agreement stipulating that income from separate property will be separate property. *Beck v. Beck*, 814 S.W.2d 745 (Tex. 1991). Although the author is of the opinion that a premarital agreement or marital agreement should be governed by the law in effect at the time the agreement becomes effective, the ramifications of *Beck* are significant. Income which for years was believed to have been community due to an invalid pre-1980 agreement may now be deemed separate.

L. The Universal Community

Can the parties to a premarital agreement agree that the property they are bringing into the marriage and/or the property to be acquired during marriage by gift, devise or descent are to be community property? In other words, can those intending to marry agree to an "all community" marriage? Notwithstanding the 1999 amendment, such an agreement would still appear to violate the Texas Constitution which does not expressly offer a procedure for parties intending to marry to accomplish the result. *Tittle v. Tittle*, 148 Tex. 102, 220 S.W.2d 637 (1949). Of course, once married, one spouse may give the other spouse one-half of the donor's separate property, thereby making them tenants in common, and spouses over a period of time can allow their separate estates to become commingled and, therefore, community property. In addition, since January 1, 2000, spouses can enter into transmutation agreements. *See* VIII., *infra*. Perhaps in the premarital agreement they can agree to enter into a transmutation agreement once they are married. Or, is a premarital agreement really a marital agreement? *See* VII, D. *supra*.

VIII. AGREEMENTS DURING MARRIAGE

During marriage, spouses can generally accomplish the same results that could have been generated in a premarital agreement. They can partition or exchange among themselves their existing community property or their community property to be acquired in the future. Tex. Fam. Code Sec. 4.102. Spouses may also agree that income from a spouse's separate property will be separate property. Tex. Fam. Code Sec. 4.103. Accordingly, spouses, like persons intending to marry, have the legal ability to create a "community free marriage."

A. 2003 and 2005 Legislation

Section 4.102 was amended in 2003 to provide that, if community property is partitioned, the income the partitioned property thereafter generates is also partitioned into separate property unless the parties agree such income will be community property. HB 885 (2003). However, due to concerns that the 2003 amendment may have been unconstitutional, HB 202 (2005) amended Sec. 4.102 again to negate the presumption that future earnings and income would be separate property so that now Sec. 4.102 only authorizes such an agreement.

Accordingly, the parties to a partition and exchange agreement now have the express statutory authority to partition and exchange the future earnings and income from the property they had agreed to partition, a right already granted to them by the 1980 amendment to Art. XVI, Sec. 15 of the Texas Constitution and Sec. 4.102 as originally enacted.

1. <u>PRE-2005 PARTITIONS</u>

Unfortunately, it can be anticipated that someone will argue and perhaps even convince a court that Texas spouses did not have until the effective date of the 2005 amendment the right to partition the future earnings and income of the community property being partitioned, thereby casting doubt on the effectiveness of any such agreements entered into prior to that time. Hopefully, the courts will rule that spouses have had the constitutional right to enter into these types of agreements since November 4, 1980, and that the Legislature was not even trying to take this right away in later legislation. Nevertheless, there also remains the question of the effectiveness of partition and exchange agreements entered into between the effective dates of the 2003 and 2005 amendments that do not expressly divide the future earnings and income of the property being partitioned.

2. <u>PARTITIONS WITHOUT CONSIDERATION</u>

HB 202 (2005) also amended Sec. 4.104 by adding a sentence that provides: "Either agreement (referring to both Sec. 4.103 and Sec. 4.102 agreements) is enforceable without consideration." This sentence makes sense as applied to Sec. 4.103 agreements but may be unconstitutional as to Sec. 4.102 partition and exchange agreements. A partition and exchange agreement contemplated by Art. XVI, Sec. 15 requires some type of consideration being received by both parties to the agreement, otherwise the agreement is, in reality, a gift if one party receives 100% of the property being partitioned.

The court in *Byrnes v. Byrnes*, 19 S.W.3d 556, 559 (Tex.App.—Ft. Worth, *no writ*), stated the obvious:

> The term "partition" as used in this section contemplates a division of property among the parties, not a complete forfeiture or assignment. *See McBride v. McBride*, 797 S.W.2d 689, 692 (Tex.App.—Houston [14thDist.] 1990, writ denied). Absent a specific reference to a partition or language indicating that such a division was intended, Texas courts have refused to uphold transactions between spouses as partitions. *See Maple v. Nimitz*, 615 S.W.2d 690, 695 (Tex. 1981); *Collins v. Collins*, 752 S.W.2d

636, 637 (Tex.App.—Ft. Worth 1988, writ ref'd).

Of course, a gift by one spouse to the other of presently existing community property is permissible under Art. XVI, Sec. 15; however, Art. XVI, Sec. 15 may not allow such a gift of *any and all community property to be acquired in the future*. Other than income from separate property, other future community acquisitions (e.g., future personal earnings) can only be partitioned under Art. XVI, Sec. 15. Of course, a gift of presently existing community property by one spouse to the other is presumed to include any future income generated by the gift. Tex. Fam. Code Sec. 3.005, as authorized by Art. XVI, Sec. 15.

3. FORM OVER SUBSTANCE

This 2005 amendment implies that spouses could "partition" an item of community property so that it becomes one spouse's separate property. Accordingly, without an express partition of the future income, the future income the partitioned property generates would be community property. However, if one spouse gives to the other spouse an item of community property, the property is the donee spouse's separate property, and the future income it generates will also be separate property, unless the donor spouse expressly retains a community income interest. Form over substance should not prevail; if a "partition" results in one spouse receiving 100% of the property being "partitioned," it's not a partition, but rather it is a gift. Why create confusion by enacting a statute that says a partition does not need consideration?

B. Formalities

The formalities required and the rules of enforcement for marital agreements are essentially the same as for premarital agreements. Tex. Fam. Code Secs. 4.104 and 4.105. On the other hand, these agreements would appear to be particularly susceptible to charges of involuntariness and unconscionability. Further, any such agreement cannot prejudice the rights of preexisting creditors. Tex. Fam. Code Sec. 4.106. An agreement in order to settle property rights incident to a divorce requires the approval of the divorce court. Tex. Fam. Code Sec. 7.006. In other words, it appears that a divorce settlement cannot be disguised as a marital agreement to avoid court involvement in property division at divorce.

C. Transmutation

Prior to January 1, 2000, it was unconstitutional for a married couple to convert by agreement separate property to community property. Many believed that couples should have that flexibility since they had the ability to convert community into separate by agreement. They already had the ability to allow their separate assets to become commingled and therefore community property. They could also exchange a separate asset for a community asset. So why not allow conversion of separate into community by an agreement? Perhaps, a couple would like to take advantage of the "step up in basis" community property enjoys upon the death of one spouse. Perhaps they wish to rescind an earlier agreement to convert community into separate so that property which was community is community again. There are any number of legitimate reasons why a couple should have the ability to change the character of their marital assets from community to separate, or separate to community.

1. CHANGE IN LAW

Accordingly, the 1999 Legislature approved both HB 734 and HJR 36. HB 734 (1999) described a procedure whereby spouses could by agreement change separate property into community property. *See* Tex. Fam. Code Sec. 4.202. Their ability to utilize this procedure depended on a constitutional amendment to Art. XVI, Sec. 15 (HJR 36) being approved by the voters in November 1999. It was approved by the voters on November 2, 1999, and became effective January 1, 2000.

2. FORMALITIES

An agreement to convert separate property into community property must be in writing and: (a) be signed by the spouses; (b) identify the property being converted; and © specify that the property is being converted into the spouses' community property. Fam. Code Sec. 4.203.

3. MANAGEMENT

An agreement to convert a spouse's separate property into community does not necessarily mean that the newly created asset is subject to joint management. Management still depends on record title or possession. Tex. Fam. Code Sec. 4.204.

4. ENFORCEABILITY

The agreement is not enforceable if the spouse against whom enforcement is sought proves that the spouse did not: (a) execute the agreement voluntarily; or (b) receive a fair and reasonable disclosure of the legal effect of converting the property into community property. Tex. Fam. Code Sec. 4.205.

5. PRESUMPTION OF FAIR DISCLOSURE

An agreement that contains the following statement, or substantially similar words, prominently displayed in bold-faced type, capital letters, or underlined, is rebuttably presumed to provide a fair and reasonable disclosure of the legal effect of converting property to community property:

This instrument changes separate property to community property. This may have adverse consequences during marriage and on termination of the marriage by death or divorce. For example:

> *Exposure to creditors. If you sign this agreement, all or part of the separate property*

> *being converted to community property may become subject to the liabilities of your spouse. If you do not sign this agreement, your separate property is generally not subject to the liabilities of your spouse unless you are personally liable under another rule of law.*
>
> *Loss of management rights. If you sign this agreement, all or part of the separate property being converted to community property may become subject to either the joint management, control, and disposition of you and your spouse or the sole management, control and disposition of your spouse alone. In that event, you will lose your management rights over the property. If you do not sign this agreement, you will generally retain those rights.*
>
> *Loss of property ownership. If you sign this agreement and your marriage is subsequently terminated by the death of either spouse or by divorce, all or part of the separate property being converted to community property may become the sole property of your spouse or your spouse's heirs. If you do not sign this agreement, you generally cannot be deprived of ownership of your separate property on termination of your marriage, whether by death or divorce.*

See Tex. Fam. Code Sec. 4.205(b).

6. PREEXISTING CREDITORS

A conversion of separate property to community property does not affect the rights of a preexisting creditor of the spouse whose separate property is being converted. Tex. Fam. Code Sec. 4.206. After all, a transmutation agreement is a "transfer" of property from one spouse to the other.

IX. EFFECTIVENESS OF THE AGREEMENT

Assuming a valid, enforceable agreement has been executed in order to create a "community free marriage," have the goals of insulating each spouse's separate estate from the claims of the other spouse and the other spouse's creditors been accomplished? The answer: "Maybe!" For one thing, since everything is his or her separate property, each spouse is free generally to manage his or her property without interference from the other spouse. (Note: Absent an effective waiver, the homestead rules will still prohibit a transfer of the home without the joinder of the other spouse). Further, the separate assets of one spouse are generally exempt from the creditors of the other spouse. In the event of divorce there is no community property to divide on a just and right basis; and upon the death of a spouse, the decedent's estate passes to the decedent's heirs and devisees, and the surviving spouse retains his or her estate untainted by the claims of the decedent's spouse. However, the situation is not as perfect as it may appear.

A. Necessaries

Generally, each spouse still has the legal duty to support the other spouse and their children for so long as the children are minors and thereafter until they graduate from high school. Tex. Fam. Code Secs. 2.501 and 154.001. Therefore, both spouse's separate properties are liable for such necessaries. Tex. Fam. Code Sec. 3.201.

B. Child Support

As would be expected, an agreement between spouses to limit either's child support obligations would be against public policy. This concept has been codified in Sec. 4.003 of the Texas Family Code.

C. Tax Liability

For any tax year that the spouses file joint income tax returns, each spouse remains jointly and severally liable for any tax liability arising from that year's tax.

D. Spousal Torts

Will public policy prevent the anticipatory waiver of spousal tort claims in a premarital agreement? Should there be a different rule for negligence and intentional torts? In general, *see* "Releases: An Added Measure of Protection from Liability," 39 Baylor Law Review. 487 (1987).

E. Joint Ventures

A spouse remains personally liable for the acts of the other spouse if the other spouse is an agent of the otherwise innocent spouse. Tex. Fam. Code Sec. 3.201. Although the marital relationship itself does not create a principal/agency relationship among the married couple, their being engaged together in a business venture or other joint action can create vicarious liability and expose each spouse's separate property to any liability arising therefrom.

F. Preexisting Creditors

Section 4.106 of the Family Code says that a partition and exchange agreement is void with respect to the rights of preexisting creditors whose rights are intended to be defrauded therein. It is interesting to note that it is not clear whether this provision applies to premarital partition and exchange agreements. Also, such provision does not by its own terms apply to spousal income agreements under Sec. 4.102.

G. U.F.T.A. and the Bankruptcy Code

Creditors may avoid and recover fraudulent transfers. The trustee in bankruptcy can avoid transfers deemed fraudulent under the Texas version of the Texas Uniform Fraudulent Transfer Act. This means that certain prepetition transfers of community property by a filing spouse to a nonfiling spouse, by way of gift or partition, can be avoided because the transfer acted to deprive creditors of property that would otherwise be available to creditors as part of the bankruptcy estate. Each type of transfer must be analyzed under the fraudulent transfer theory to determine if assets otherwise within the reach of a creditor have been pulled beyond the creditor's reach by virtue of the challenged transfer. For example, a spouse might impermissibly transfer his own interest in existing community property by way of a partition. Yet the same spouse could probably renounce, by way of a premarital partition, an interest in community property to be acquired in the future since the parties to the partition had no vested interest in the future community property absent the partition. Of course, these sections of the U.F.T.A. and the Bankruptcy Code also invalidate transfers involving actual or constructive fraud.

H. Federal Preemption

ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan. . . ." 29 U.S.C.A. Sec. 1144. Further, ERISA requires for many qualified retirement plans that the participant's spouse receive a mandatory death benefit upon the death of the participant or a joint and survivor annuity upon the retirement of the participant, regardless of the marital property character of the participant's interest in the plan. Of course, the spouse may waive these statutory rights in a consent procedure prescribed by statute. 29 U.S.C.A. Sec. 1055©.

Several cases have held that these ERISA granted rights of the participant's spouse cannot be waived in a premarital agreement. In *Manning v. Hayes*, 212 F.3d 866 (5th Cir. (Tex.) 2000), cert. denied, 121 S.Ct. 1401 (2001), language in a premarital agreement was not sufficiently explicit to result in a waiver of an ex-wife's beneficiary status under an ERISA plan. In *Hurwitz v. Sher*, 789 F. Supp. 134 (S.D. N.Y. 1992), aff'd 982 F.2d 778 (2nd Cir. 1992) cert denied 508 U.S. 912 (1995), the decedent and his spouse executed a premarital agreement waiving any rights with respect to the other's separate property and the court held that the wife had not waived her rights to the plan benefits to which she was entitled because only a spouse, not a fiancé, can waive such rights under federal law. A similar result was reached in *Nellis v. Boeing Co.*, 1992 WL 122773, 15 Employee Benefits Cas. 1651 (D. Kan. 1992); further the court noted that language in the agreement stating that the agreement was to take effect upon marriage did not save the agreement. In *Zinn v. Donaldson Co.*, 799 F. Supp. 69 (D. Minn. 1992), the court even held that a constructive trust could not be imposed on the surviving spouse to equitably enforce the premarital agreement. A similar result was affirmed by the Sixth Circuit in *Howard v. Branham & Baker Coal Co.*, No. 91-5913, 968 F.2d 1214 (table), (6th Cir. 1992) (text in Westlaw).

I. Trap for the Unwary

Accordingly, a properly prepared premarital or marital agreement under Texas law may ensure that the employee's interest in the retirement plan is separate property, but such a result, in and to itself, does not negate whatever rights the spouse may have under ERISA at the time of the employee's retirement or death absent an effective ERISA waiver of those rights.

J. Maintenance

The Family Code does not expressly address whether "maintenance" under Tex. Fam. Code Sec. 8.001 can be waived in a premarital or marital agreement although Sec. 4.003 does refer to the waiver of spousal support in premarital agreements. However, since "maintenance" was enacted as part of a welfare reform package, such a waiver may be against public policy.

K. Future Legislative Changes

The potential impact of future state and federal legislation (e.g., amending ERISA or adopting the concepts of quasi-community property at death, or a statutory share system, or even permanent alimony) should be considered and addressed in the agreement. Of course, these potential rights could be expressly waived in the premarital agreement, but is the waiver of a right that is not yet in existence enforceable? Generally, to be enforceable a waiver of statutory rights must be clear, specific and unequivocal and given by a party who has full knowledge of its consequences. In any event, the issues should be addressed and identified as specifically as possible.

L. Income Tax Basis

To the extent property is held as community property, both halves receive a new income tax basis upon the death of the first spouse under Sec. 1014(b)(6) of the Internal Revenue Code. This tax advantage is lost if community property has been partitioned into separate property.

X. COMMUNITY PROPERTY WITH RIGHTS OF SURVIVORSHIP

The 1987 amendment to Art. XVI, Sec. 15 of the Texas Constitution permitted spouses to agree in writing that all or any part of their community property shall belong to the surviving spouse without going through probate upon the death of the first spouse.

A. Legal Effect of the Amendment

Prior to Nov. 3, 1987, in order to create a right of survivorship of their community property for the surviving spouse, the married couple had to first partition their community property into separate property and then enter into the survivorship arrangement. *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961). Now, married couples can create survivorship rights without first partitioning the community. All that is required is a written agreement;

there is no specific signature requirement in the Constitution.

B. Amendments to the Texas Probate Code

The 1987 legislature amended Sec. 46 of the Texas Probate Code in anticipation that the amendment would pass. Amended Sec. 46 provided that spouses may agree in writing "that all or any part of their community property which is titled or held with indicia of title becomes the property of the surviving spouse on the death of a spouse." The highlighted language presented possible conflicts with the Constitution, most of which conflicts may have become moot because in 1989 Sec. 46 was amended again to state that Sec. 46 does not apply to any agreements between spouses regarding their community property which are now to be governed by new Part 3 of Chapter XI of the Probate Code, which was added to the Probate Code in 1989.

C. Part 3, Chapter 11 of the Texas Probate Code

This part of the Texas Probate Code purports to provide a comprehensive approach to community property with survivorship rights.

1. FORMALITIES

Sec. 452 requires that the survivorship agreement be in writing and signed by both parties and includes nonexclusive "safe harbor" language for the proper manifestation of intent. It should be noted that neither the Constitution nor old Sec. 46 required a signature. Can the legislature require the signature of both parties when the Constitution does not? Can an agent sign on behalf of a party, or is this a nondelegable privilege?

2. OWNERSHIP AND MANAGEMENT

Sec. 453 provides that the property subject to the valid survivorship agreement will remain community property during the remainder of the marriage. It also provides that such an agreement in and of itself does not alter the rights of management. In other words, special community property does not automatically become joint community property, which would appear to mean the managing spouse can make a valid inter vivos disposition of the same. If so, are the proceeds subject to the survivorship agreement?

3. DEATH OF FIRST SPOUSE

In the event of divorce, the rights of the parties will not be affected by the survivorship agreement, but upon the death of the first spouse, the community property subject to the survivorship agreement becomes the property of the surviving spouse through a non-probate means. (It can be assumed that Sec. 47(d) will require the surviving spouse live for 120 hours.) If the spouses have not recorded their survivorship agreement and/or have not titled their property to reflect the survivorship agreement, the survivor will need to prove his/her ownership of the property, which will still appear on record to have been partitioned upon the death of the first spouse like any other community property asset. Accordingly, Sec. 456 creates a new judicial process whereby the survivor can establish the validity of the survivorship agreement. Accordingly, upon application, citation and proof, the survivor can avoid probate.

D. Creditor's Claims

Will the property still be liable for the deceased spouse's debts since the property passes nonprobate to the survivor? Common law joint tenancies, like life insurance, avoid probate and the claims of creditors, but joint bank accounts per Tex. Prob. Code Sec. 442 have second tier liability. Now Sec. 461 provides that spousal multi-party bank accounts shall be governed by Sec. 436 and that other community assets subject to survivorship rights will continue to be liable for debts as if the survivorship agreement was not in effect.

E. Estate Taxes

The deceased spouse's one-half interest in the community property subject to survivorship rights will be included in the deceased spouse's gross estate but will qualify for the marital deduction so that such assets are not taxed upon the death of the first spouse. Will both halves receive a step up in income tax basis under Sec. 1014(b)(6) of the Internal Revenue Code? Presumably so, *see* I.R.S. Rev. Rul. 87-98 1987-39 I.R.B. 15. However, to the extent that such assets are not consumed or otherwise removed from the tax base of the surviving spouse, such assets will be included in the surviving gross estate at the survivor's death. This result can disrupt sound marital estate planning, waste the first spouse's exemption equivalent and cause the family to pay additional death taxes.

F. Substantive Questions

Notwithstanding a comprehensive set of statutes, there are issues related to survivorship agreements that cause many to question its advisability in many situations.

1. REVOCABILITY

Can one spouse unilaterally rescind the agreement? Prior to the 1989 legislation, commentators argued the negative in that the property was probably joint community which required joint action of the spouses; in addition, the spouses were perhaps bound by a contract. Perhaps the survivorship arrangement itself is revocable, and breach of contract is the remedy. On the other hand, perhaps all that has been created is a non-testamentary transfer, revocable by either spouse. Added in 1989, Sec. 455 provides that one spouse may revoke by a written instrument signed by the revoking spouse and delivered to the other spouse. But, could there still be a breach of contract action?

2. PROPERTY SUBJECT TO SURVIVORSHIP

Assuming a married couple desires survivorship rights for all of their community property, can they execute an agreement simply referring to "all of their community property in existence at the time of the agreement"? Can they agree to survivorship rights as to community property not yet in existence? The answer may depend in part on the proper interpretation of Art. XVI, Sec. 15 and the constitutionality and the interpretation of Sec. 46 of the Texas Probate Code prior to the effective date of the 1989 legislation, but Sec. 451 appears to contemplate an "any and all property agreement."

3. RETROACTIVITY

Assume a married couple entered into a community survivorship agreement prior to Nov. 3, 1987, and the first spouse dies after Nov. 3, 1987, will the survivorship rights be effective? This is a particularly troublesome question as it relates, for example, to a community property joint bank account with survivorship rights which the couple signed years ago without an understanding of the legal significance of their agreement. If the first spouse died prior to Nov. 3, 1987, the spouse's one-half interest then would have passed to his heirs and devisees; now, does it pass to the surviving spouse? Sec. 3 of SB 1643 provides that the amendments made by SB 1643 apply to all community property survivorship agreements entered into on or after November 3, 1987, and to any earlier agreements, if both spouses were living on that date and the agreement complies with Part 3 of Chapter XI of the Texas Probate Code. *See Estate of Stripling v. Stripling*, 812 S.W.2d 397 (Tex. App.—Eastland 1991, no writ).

4. FURTHER APPLICATION

Does new Part 3 of Chapter XI of the Texas Probate Code apply to every non-probate disposition of community assets between spouses or only those where the agreement is for the property to pass to whomever is the surviving spouse? It is the author's opinion that Part 3 applies only to those transactions previously voided by the *Hilley* rule.

G. *Free v. Bland*

In *Free v. Bland,* 369 U.S. 663, 82 S.Ct. 1089, 8 L.Ed 2d 180 (1962), a husband and wife purchased United States savings bonds with community funds. The wife died, and Texas law directed that the wife's one-half interest passed to her heirs; however, a federal treasury regulation provided that when one co-owner died, the other would become the "sole and absolute owner." Following the wife's death, her heirs sued the surviving husband for an accounting and obtained a judgment for one-half the value of the bonds. The United States Supreme Court held that the federal regulations preempted Texas community property law. *Further, the Supreme Court held that the heirs could not circumvent preemption by obtaining a judgment for one-half the value of the bonds rather than title to one-half interest in the bonds themselves.*

H. The Power of Preemption

In an attempt to avoid the consequence of preemption, state law awarded full title to the husband but required him to account for half of the value of the bonds to the decedent's estate. The Court in *Free v. Bland* noted: "Viewed realistically, the State has rendered the award of title [by the federal regulations] meaningless.... If the State can frustrate the parties' attempt to use the bonds' survivorship provision through the simple expedient of requiring the survivor to reimburse the estate of the deceased co-owner as a matter of law, the State has interfered directly with a legitimate exercise of the power of the Federal Government to borrow money."

XI. MULTIPLE-PARTY ACCOUNTS

The most common forms of marital agreements and non-probate dispositions are multiple-party accounts that are frequently opened by spouses during a marriage. The marital property character of multiple-party accounts are determined in part by the form of account used by the depositing spouse. The form of the account will also dictate the disposition of the funds on dissolution.

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 Sec. 436 (1) and (3).

Note: The question remains as to whether the multiple-party account rules apply to all joint-type accounts at brokerage firms (i.e., securities held in street name) or only those which are, effectively, checking or savings accounts.

A. Multiple-Party Accounts

Subject to the 900 lb. Gorilla rule (*see* X1, C2, *infra*) Chapter XI of the Texas Probate Code now authorizes five different multiple-party accounts. Chapter XI does not use the term "joint tenancy" account or "joint tenancy with right of survivorship" account. Sec. 46 governs joint tenancies; Chapter XI governs multiple-party accounts.

1. JOINT ACCOUNTS

Such accounts belong, during the joint lifetimes of the parties, to the parties in proportion to their "net contributions" to the account, and at the death of a party, the surviving party and the heirs or devisees of the deceased party continue to own the account in proportion to their "net contributions." There is no right of survivorship. Tex. Prob. Code Secs. 438(a) and 438A.

2. CONVENIENCE ACCOUNTS

Such accounts are established by the depositer and are owned by the depositer, even if additional funds are added to the account. A "co-signer" may withdraw funds from the account "for the convenience" of the owner of the account but does not acquire ownership of the account during the owner's lifetime or at the owner's death. In other words, there is no right of survivorship. Tex. Prob. Code Sec. 438A.

3. SURVIVORSHIP ACCOUNTS

A "joint account with survivorship rights" belongs to the parties during their joint lifetimes in the same manner as the previously described joint account. However, at one party's death, the entire account belongs to the surviving party. Tex. Prob. Code Sec. 439(a).

4. P.O.D. ACCOUNTS

A "P.O.D. account" belongs to the depositor during the depositor's lifetime but passes to the "P.O.D. payee" upon the depositor's death, provided such payee survives the depositor. Tex. Prob. Code Secs. 438(b) and 439(b).

5. TRUST ACCOUNTS

A "trust account" belongs to the depositing "trustee" during the trustee's lifetime and passes to the beneficiary of the account at the trustee's death, provided the beneficiary survives the trustee. The existence of such an account depends on the nonexistence of an express trust. A trust account under Chapter XI is not a private express trust. Tex. Prob. Code Secs. 438© and 439©.

6. DEPOSITOR INTENT

Sec. 439(a) of the Probate Code was amended to provide that an agreement is sufficient to confer survivorship in a joint account if the account states substantially that all funds or deposits of one party shall vest in and become the property of the surviving party. The question of what is necessary to "make an account survive" is still being litigated and is a subject beyond the scope of this outline. *See*, however, Glenn Karisch's excellent outline, "Multi-Party Accounts in Texas," (2000), accessible to view at www.texasprobate.com/articles/accounts.htm.

B. Marital Property Problems

The deposit of community property into a multiple-party account raises several substantive issues in the estate practice, the resolution of which will depend in part on the form of account used by the depositing spouse.

1. 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; provided that, 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. Could *Land v. Marshall's* illusory transfer argument apply? Arguably, see III, G, *supra*.

c. Upon the death of the non-depositing spouse, the account is a 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.

2. JOINT ACCOUNTS/CONVENIENCE ACCOUNTS

Community property is deposited into such an account of the spouses.

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.

3. JOINT ACCOUNTS WITH SURVIVORSHIP RIGHTS

Community property is deposited into a "joint account with 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 determined as provided in XI, B.2, a, *supra*, unless the account is a "46b special account" - an account which partitioned the account into the spouses' separate properties. *See* XI, C.4, *infra.*

b. Upon the death of either spouse prior to the 1987 amendment, the community account was 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 Nov. 3, 1987. Does the same result occur if the account was opened prior to the 1987 amendment. Yes, *see* X, F.3, *supra* for further comment.

4. JOINT ACCOUNTS AND THIRD PARTIES

Special community funds of a spouse are 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. See III, E, *supra.*

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 survivorship agreement.

c. If there is a survivorship agreement, upon the death of the depositing spouse, the account belongs to the third party but subject to the imposition of a constructive trust to remedy a possible fraud on the community property rights of the non-depositing spouse. Could *Land v. Marshall's* illusory transfer argument apply? Arguably, see III, G, *supra.*

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. See XIII, B, *infra.*

e. The death of the third party prior to the death of either spouse would not affect the ownership of the account since, 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. *See* III, I, *supra.*

C. Conclusions and Observations

1. IMPORTANCE OF SIGNATURE CARDS

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 funds from those funds deposited into multiple-party accounts.

2. 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 11 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.

3. IMPACT AT DIVORCE

The marital character of bank accounts and assets purchased with funds out of the accounts will be of vital importance in the event of divorce since the divorce court cannot award one spouse's separate property to the other spouse. *See Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977) and *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982).

4. IMPACT AT DEATH

The marital property character of joint accounts is not as important today as it was in the past in determining the effectiveness of non-testamentary transfers at death since *Hilley* has been overruled by constitutional amendment. In other words, the 1987 amendment dismissed the need for partitioned bank accounts.

5. 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 which contained both partition and survivorship language per Sec. 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 since 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.

XII. MARITAL PROPERTY IN PROBATE

When a married resident of Texas dies, the marriage terminates and community property ceases to exist. Death works a legal partition of the community probate assets; the deceased spouse's undivided one-half interest passes to his heirs and/or devisees, and the surviving spouse retains an undivided one-half interest therein. There is not a "just and right" division of the community as in the divorce court; neither is the concept of quasi-community recognized. *See* V.A., *supra* and *Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987).

Note: 2007 legislation introduced a new procedure to facilitate a post-death challenge to the validity of a marriage based on the mental capacity of a spouse at the time of the marriage. The challenge must be brought within one year of the party's death, and only a marriage commencing within three years of the death can be challenged. Marriages that occurred more than three years earlier cannot be challenged unless there was a family court or a guardianship proceeding pending at the time of death. Tex. Prob. Code Sec. 47A

A. Administration of Community Property

In addition to collecting the assets of the estate, paying the decedent's debts and distributing the remaining assets to the Decedent's heirs and/or devisees, the administration of a married decedent's estate includes the actual partition of the community probate property. While death may work a legal partition of the community probate assets, it is often necessary to open an administration to effectively handle the claims of creditors and/or divide the community probate property among the surviving spouse and the decedent's heirs and/or devisees. Absent the opening of a formal administration, the surviving spouse administers the community and can discharge the "community obligations." *See* Tex. Prob. Code Sec. 160. See XIII, *infra.*

Note: If the deceased spouse died intestate and the surviving spouse is the sole heir, there is no need for any type of formal administration. Tex. Prob. Code Sec. 155.

B. Probate v. Non-Probate

The estate of a decedent must initially be divided into two separate and distinct categories. Certain assets fall within the probate class and others are placed in the non-probate classification.

1. NON-PROBATE

An asset is non-probate if during the decedent's lifetime, the decedent entered into an inter vivos transaction, as opposed to a testamentary transaction, that controls the disposition of the asset at death. Many non-probate dispositions are contractual arrangements with third parties or the intended beneficiaries, and the terms of the contracts control the dispositions. Common examples of these types of contractual arrangements include three of the multiple-party bank accounts discussed in Chapter XI of the Texas Probate Code, most life insurance policies and certain employee benefits. Tex. Prob. Code Sec. 450. In other non-probate dispositions, the ownership of a future interest in the property is transferred to the intended beneficiary during the owner's lifetime, and the future interest becomes possessory upon the death of the owner. Revocable trusts and springing executory interests are examples of these types of non-probate dispositions. Of course, an inter vivos gift of the ownership and possession of an asset prior to the owner's death can be considered a non-probate disposition. As to the legal consequences of community assets being made non-probate, *see* III, D and E, *supra*.

2. PROBATE

Probate assets are those assets which are not controlled by an inter vivos arrangement and pass at the owner's death through probate administration and on to the owner's heirs or devisees. A married individual's probate estate consists of the decedent's separate probate assets and his or her one-half of the community assets which are not subject to an inter vivos or non-probate arrangement. The surviving spouse retains, not inherits, his or her one-half interest in the community probate assets.

C. Intestate Death

1. COMMUNITY PROBATE PROPERTY

If a spouse dies intestate, the surviving spouse continues to own (not inherits) an undivided one-half interest in the community probate assets. If there are not any descendants of the deceased spouse surviving, or all surviving descendants are also descendants of the surviving spouse, the decedent's one-half interest passes to the surviving spouse, who would then own the entire community probate estate. If there are any descendants surviving who are not descendants of the surviving spouse, the decedent's one-half interest in the community probate assets passes to the decedent's descendants per capita with right of representation. Tex. Prob. Code Secs. 43, 45. Prior to September 1, 1993, the surviving spouse inherited the deceased spouse's one-half of the community only if no descendants of the deceased spouse were then surviving. Tex. Prob. Code Sec. 45. The rules relating to "representation" were modified to be effective September 1, 1991. Tex. Prob Code Sec. 43.

2. SEPARATE PROBATE PROPERTY

If a spouse dies intestate, the decedent's separate probate assets are divided in the following manner: (i) one-third of the personal property passes to the surviving spouse and two-thirds thereof to the decedent's descendants and (ii) the surviving spouse receives a life estate in one-third of the separate real property and the descendants of the decedent receive the balance of the separate real property. If there are no descendants, the surviving spouse receives all of the personal property and one-half of the real property. The other one-half of the real property passes in accordance with the rules of intestate succession. Tex. Prob. Code Sec. 38.

D. Testate Death

Every person who is or has been married has received a broad grant of authority from the legislature to dispose of his or her probate property. There is no forced heirship in Texas. Tex. Prob. Code Secs. 57 and 58. This broad grant of testamentary authority is, however, effectively limited to the testator's separate probate property and his or her one-half interest in the community probate property. *Avery v. Johnson*, 108 Tex. 294, 192 S.W. 542 (1917). Not even the divorce court can enjoin a spouse from exercising the spouse's testamentary power. *See* Tex. Prob. Code Sec. 69A.

E. Texas "Widow's" Election

It is fundamental that the deceased spouse has testamentary power over only one-half of the community probate assets, whether the community assets are held in the husband's name, the wife's name, or both of their names. An attempt to dispose of both halves of the community is ineffective unless the attempt triggers the application of "equitable election." In Texas, this doctrine has been termed the "widow's election" whether the survivor is a widow or widower.

1. EQUITABLE ELECTION

Whenever any devisee is entitled to a benefit under a will and asked to suffer a detriment under the will, the devisee cannot accept the benefit without suffering the detriment. The choice is left to the devisee who can elect to accept under the will or elect against the will. The most common example of an election is when the testator attempts to dispose of property which the testator does not own while at the same time devising other property to the actual owner. *See Wright v. Wright*, 154 Tex. 138, 274 S.W.2d 670 (1955). *Dunn v. Vinyard*, 251 S.W. 1043 (Tex. Com. App. 1923, opinion adopted).

2. COMMUNITY PROPERTY ELECTION

It is common for one spouse to attempt to leave a community asset to a third party while leaving the surviving spouse another asset. Such a disposition would put the surviving spouse to an election. The surviving spouse is also put to an election when the decedent gives the surviving spouse a life estate in the entire community estate while expecting the survivor to allow her or his one-half of the community to pass under the decedent's will. *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *Vardell's Est. v. Comm.*, 307 F.2d 688 (5th Cir. 1962). Compare with the "illusory" inter vivos transfer concept. *See* III, E., *supra*.

3. THE TEXAS RULE

In *Wright v. Wright, supra*, the Texas Supreme Court explained the Texas rule. First, the will must dispose of property owned by the surviving spouse while at the same time granting some benefits to the surviving spouse. Second, the surviving spouse must elect to allow all or part of his or her property to pass as provided in the will before accepting the benefits conferred. Third, the will must clearly put the survivor to an election.

4. PROCEDURE

The surviving spouse may be put to either an express or an implied election. In other words, the language of the will may specifically and expressly set forth the intent to require an election. *Calvert v. Ft. Worth Nat. Bank*, 348 S.W.2d 19 (Tex. Civ. App.—Austin, 1961), affirmed 163 Tex. 405, 356 S.W.2d 918 (Tex. 1962). In other situations, the election is implied from the language of the will. The question of whether the survivor is put to an election is one of law for the court. *Wright, supra*. The question of whether the survivor has made an election is one of fact. Generally, two factors are involved. First, the survivor must have been aware of the choice. Second, the survivor must intend to so elect; however, the totality of the circumstances are considered in making this determination. *Dunn v. Vinyard, supra*. Mere acceptance of benefits may be deemed an election to take under the will. *See* Dougherty, "*Election*", Texas Estate Administration Secs. 8.1, 8.2.

5. TAX CONSEQUENCES

The decision to elect or not can have significant transfer and income tax consequences which are beyond the scope of this article. For a discussion of these matters and an in depth study of the Texas widow's election, *see* Kinnebrew and Morgan, "*Community Property Division at Death,*" 39 Baylor Law Review 1037, 1072-1079 (1987).

6. SUPER ELECTION

Traditionally, the doctrine of election has required the electing spouse's benefit and detriment to be found in the same disposition (e.g., the deceased spouse's will or revocable trust). Perhaps it is time to consider the "super election" in view of the prevalent use of probate and non-probate dispositions as part of a comprehensive estate plan. For example, a husband designates his wife as beneficiary of a $1 million life insurance policy, but purports to specifically devise in his will both halves of a certain $100,000 community asset to his kids by a prior marriage, without naming his wife as a beneficiary in the will. Should she be able to accept the $1 million and also assert her rights to one-half of the community asset specifically devised to the kids? Or, if she accepts a significant benefit in the comprehensive plan, shouldn't she be deemed to have accepted the detriment in another part of the plan?

F. Protection for Surviving Spouse

Despite the very broad general grant of testamentary power given a married testator and the limited rights of inheritance given the surviving spouse when the decedent dies intestate, there exists certain constitutional and statutory provisions which protect the surviving spouse, whether the decedent died testate or intestate.

1. HOMESTEAD

The Texas Constitution still exempts the homestead from the claims of some of the decedent's creditors. Tex. Const. Art. XVI, Sec. 50. In addition, notwithstanding the provisions of the decedent's will or the rules of intestate succession, the surviving spouse is given an exclusive right of occupancy of the homestead so long as he or she elects to occupy it as his or her home. Tex. Const. Art. XVI, Sec. 52. This right of occupancy exists whether the home is separate property of the deceased spouse or the couple's community property. In the event there is not a family home, the probate court is required to set aside an allowance in lieu of a homestead. Tex. Prob. Code Sec. 273.

2. EXEMPT PERSONAL PROPERTY

Certain items of tangible personal property are exempt from creditors of the decedent if the decedent is survived by a spouse. Tex. Prob. Code Secs. 271 and 281. These items are described in the Texas Property Code and generally include the household furnishings, personal effects and automobiles in an amount that does not exceed $60,000. Tex. Prop. Code Sec. 42.002. In addition, during administration, the surviving spouse can retain possession of these items and will receive ownership of these items if the decedent's estate proves to be insolvent; otherwise the decedent's interest in these items passes to his or her heirs and/or devisees when the administration terminates. Tex. Prob. Code Sec. 278. There is also an allowance in lieu of exempt personal property. Tex. Prob. Code Sec. 273.

3. FAMILY ALLOWANCE

In addition to the allowances in lieu of homestead and exempt personal property, an allowance for one year's maintenance of the surviving spouse and minor children may be established by the probate court. Tex. Prob. Code Secs. 286 and 287. The allowance is paid out of the decedent's property subject to administration. *Ward v. Braun*, 417 S.W.2d 888 (Tex. Civ. App.—Corpus Christi, 1967, no writ). The amount is determined in the court's discretion and is not to be allowed if the surviving spouse has a sufficient separate estate. Tex. Prob. Code Sec. 288; *Noble v. Noble*, 636 S.W.2d 551 (Tex. App.—San Antonio 1982, no writ).

XIII. ADMINISTRATION OF COMMUNITY PROPERTY

The purposes of a decedent's estate administration are to collect the assets of the estate, to pay the decedent's debts and to distribute the remaining assets to the decedent's heirs and/or devisees. In addition, the administration of a married decedent's estate includes the actual partition of the community probate property. As discussed previously, death works a legal partition of the community probate assets, but it is often necessary to open an administration to effectively set aside the homestead, exempt property and family allowance, handle the claims of creditors and/or divide the community probate property among the surviving spouse and the decedent's heirs and/or devisees.

A. Types of Administration

1. FORMAL AND INFORMAL ADMINISTRATION

Whether the decedent died testate or intestate, it is possible in Texas for the decedent's surviving spouse and distributees to informally administer the decedent's estate. In other words, the assets can be collected, the debts paid and the balance properly distributed without a court appointed personal representative. It may be necessary to admit the decedent's will to probate as muniment of title, or to have a judicial determination of heirship and order of no administration entered by the probate court, in order to establish the distributees' title. Tex. Prob. Code Sec. 89 and Tex. Prob. Code Secs. 48-56. Other situations will require the appointment of a personal representative to formally administer the estate. The personal representative can either be (i) an administrator or executor or (ii) an independent administrator or independent executor. In any event, it is the personal representative's function to accomplish the purposes of estate administration.

2. NECESSITY OF ADMINISTRATION

In order to open a formal administration, the need for an administration must be established to the satisfaction of the probate court. A necessity is deemed to exist if two or more debts against the estate exist, or it is desired that the probate court partition the estate among the distributees. These two statutory provisions are not exclusive. Tex. Prob. Code Sec. 178. The decedent's designation of an executor in his or her will is sufficient cause for the opening of a formal administration.

3. PRIORITIES

If there is a need for formal administration, the persons named as executors in the will are given priority in the selection process of the personal representative. If the named executors are not able to qualify, the surviving spouse, then others, are given priority. If the decedent dies intestate, letters of administration are first granted to the surviving spouse, then others. Tex. Prob. Code Sec. 77.

4. DEPENDENT AND INDEPENDENT ADMINISTRATIONS

The personal representative appointed by the court will be designated either (i) the independent administrator or independent executor or (ii) the executor or administrator. An independent administration is created by will or pursuant to certain specified procedures and allows the independent personal representative to administer the estate free of routine supervision by the probate court. Tex. Prob. Code Secs. 145-154A. If the court fails to grant an independent administration, the personal representative's actions are supervised on a routine basis, and the personal representative must seek the court's authority prior to entering into many transactions. Sec. 145® permits an independent executor named in the will who refuses to so act or resigns to qualify as a dependent personal representative.

5. ACCOUNTABILITY

During a dependent administration, the personal representative must file (i) an inventory and list of claims, (ii) annual accountings and (iii) final accountings. These documents must be approved by the probate court. An independent personal representative must file and have approved his inventory and list of claims but has no other formal accounting requirements; however, the representative is accountable to the distributees as is any fiduciary.

6. THE INVENTORY

While there is disagreement among the commentators, it is this author's opinion that the inventory and list of claims should list the assets of the estate which are subject to administration by the personal representative, identifying which assets were community. Since both halves of the certain community probate assets are subject to administration, the inventory and list of claims should account for both halves of the community probate assets, as well as the decedent's separate probate assets. *Cain v. Church*, 131 S.W.2d 400 (Tex. Civ. App. 1939, no writ). It may be appropriate to identify the decedent's one-half interest in the survivor's special community as a claim. The decedent's nonprobate assets and the surviving spouse's separate property are not subject to administration and do not belong on the inventory. Tex. Prob. Code Sec. 250. *See* Ikard and Golden, Administration of Community Property, 1996 Adv. Est. Planning and Probate Course (State Bar of Texas).

B. Distribution of Powers Among Personal Representative And Surviving Spouse

During formal administration, the personal representative is entitled to possession of not only the deceased spouse's separate property but also the couple's joint community property and the decedent's special community property. The surviving spouse may retain possession of the survivor's special community property during administration or waive this right and allow the personal representative to administer the entire community probate estate. Tex. Prob. Code Sec. 177. The authority of the personal representative over the survivor's one-half of the community should be limited to what is necessary to satisfy the debts of the deceased spouse properly payable out of such community assets even if the decedent's will grants to the representative more extensive powers over the decedent's separate assets and one-half interest in the community. However, if there is a will and the surviving spouse is a beneficiary of the will, the surviving spouse who accepts any benefits under the will may have elected to allow the executor to exercise more extensive powers over his or her share of the community assets during administration. *See* XI, *supra*.

1. COMPARISON WITH FAMILY CODE PROVISIONS

This division of authority dovetails with the contractual management and liability rules of the Texas Family Code and facilitates the personal representative's or ability to step into the decedent's shoes and satisfy his or her debts. Tex. Fam. Code Secs. 3.102 and 3.202. Of course, both the personal representative and surviving spouse should eventually account for both halves of the community in order to settle the estate. If the community assets in possession of the personal representative and available to satisfy the deceased spouse's creditors are insufficient for that purpose, Tex. Prob. Code Sec. 156 indicates that the deceased spouse's one-half interest in the surviving spouse's special community property can be reached to satisfy the deceased spouse's creditors; these assets were generally exempt from the claims of the deceased spouse's non-tortious creditors during the marriage. Both halves of those community assets are liable for any tortious debts of the deceased spouse.

2. AUTHORITY OF SURVIVING SPOUSE – NO PERSONAL REPRESENTATIVE

When there is no personal representative for the estate of the deceased spouse, Sec. 160(a) enables the surviving spouse to sue in order to recover community property, to sell or otherwise dispose of community property to pay debts payable out of the community estate, and to collect claims owing to the community estate. The survivor may be sued by a third party in a matter relating to the community estate. That section also grants to the surviving spouse the authority needed under the circumstances to exercise such other powers as are necessary to preserve the community estate, to discharge obligations payable out of community property and to generally "wind up community affairs."

The survivor is entitled to a "reasonable commission" for administering the community and can incur reasonable expenses in the management of the estate. Like any other fiduciary, the surviving spouse is accountable to the deceased spouse's heirs and/or devisees who are entitled to their share of the remaining community assets after the debts properly payable out of the community assets have been paid. *See* Tex. Prob. Code Secs. 156 & 168 and *Grebe v. First State Bank*, 150 S.W. 2d 64 (Tex. 1941).

Note: In 2007, the legislature repealed the provisions of the Probate Code relating to the creation, administration and closing of an administration by a "qualified community administrator." Repealed Sec. 169 directed the community administrator to pay debts within the time, and according to the classification, and in the order prescribed for the payment of debts as in other administrations. Section 160(a) simply directs the surviving spouse to "preserve the community property, discharge community obligations and wind up community affairs."

3. AUTHORITY OF THE SURVIVING SPOUSE – PERSONAL REPRESENTATIVE

When a personal representative is administering the estate of the deceased spouse, including the surviving spouse's one-half of the decedent's special community and the couple's joint community, the surviving spouse's fiduciary authority over the survivor's special community property enables the survivor to exercise all the powers granted to the surviving spouse where there is no administration pending. Tex. Prob. Code Sec. 177. This statutory language suggests that the survivor can deduct from the special community being administered "necessary and reasonable expenses" and a "reasonable commission." The survivor shall keep a distinct account of all community debts allowed or paid. *See* Tex. Prob. Code Sec. 156.

C. Allocation of Liabilities After Death

1. PROBATE ASSETS

As pointed out previously, the Texas Probate Code's division of authority tracks the contractual management and liability rules of the Texas Family Code and facilitates the personal representative's ability to step into the decedent's shoes and satisfy primarily the deceased spouse's contractual debts, but it does not resolve all the issues related to which assets are liable for which debts.

2. NON-PROBATE ASSETS

In the past, practitioners could follow a general "rule of thumb": probate assets pass subject to the decedent's debts whereas non-probate assets pass to their designated beneficiaries, free of the decedent's debts. Today, there is a growing body of statutory rules and common law which negates the application of this old "rule of thumb."

3. GENERAL POWER THEORY

Even if the Uniform Fraudulent Transfer Act is not violated, the Texas definition of a general power of appointment would seem broad enough to capture most non-probate dispositions, including joint tenancies and revocable trusts, within its coverage and, thereby, subject the property in question to the liabilities of the donee of the power, either during the donee's lifetime or at death, unless there is a specific statutory exemption.

4. ABATEMENT

Despite the growing need for a comprehensive statute which would complement Sec. 450(b) of the Texas Probate Code and define the rights of creditors in and to the probate and non-probate assets of a deceased debtor, the legislature has only codified the order in which property in the probate estate would be liable for debts and expenses properly chargeable to the probate estate. Sec. 322B of the Texas Probate Code does not apply to death taxes.

5. ABATEMENT AMONG COMMUNITY AND SEPARATE ASSETS

Sec. 322B also failed to give direction to the personal representative who has both non-exempt separate and community assets in its possession and control in order to satisfy the decedent's debts. The potential conflict of interest is obvious; the expenditure of separate funds to satisfy the debt will inure to the benefit of the surviving spouse while using community funds would accrue to the benefit of the decedent's estate. Presumably Sec. 3.203 of the Texas Family Code would be relevant, and the facts and circumstances surrounding the source of the debt should be considered. For example, is it a purchase money indebtedness? Is it tortious or contractual in nature? The author is not aware of any definitive cases on point that offer the personal representative any clear guidance. Accordingly, the personal representative should pay certain claims out of the decedent's separate property or the decedent's one-half of community assets. These claims would include funeral expenses, separate property's purchase money indebtedness, and tort claims against the decreased spouse. Other debts, like credit cards, utilities, and community property purchase money indebtedness, and should be paid out of the community funds being administered by the personal representative.

D. Closing the Estate

Upon the death of the first spouse and while record legal title still 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.

Assuming that the decedent's one-half community interest has been left to someone other than the surviving spouse, the respective ownership interests of the survivor and the decedent's distributees are subject to the possessory rights of either a court appointed personal representative or the surviving spouse for administration purposes. When administration is completed, the survivor and the distributees are entitled to their respective one-half interests in each and every community probate asset.

1. NON PRO RATA DIVISION

Accordingly, can the survivor and the personal representative (or the decedent's distributees) agree to make a non pro rata division of the community estate so that the surviving spouse receives 100% of some of the assets and the distributees receive 100% of other community assets? The answer is an obvious yes. The authority of an executor to enter into such a transaction should depend on the powers granted to the executor in the decedent's will. Of course, even if the will purports to enable the executor to make a non pro rata division of the community, the surviving spouse's agreement is still required. However, the surviving spouse may have already agreed by accepting benefits under the will through either an express or equitable election. *See* XI, E, *supra*. The real issue is whether any such agreement will be considered a taxable exchange, subjecting the parties to capital gain exposure to the extent the assets have appreciated in value since the decedent's date of death.

2. I.R.S. POSITION

Three private letter rulings suggest that such an exchange is not taxable. In one, PLR 8037124, 1980 WL 134564, a husband and wife proposed to divide into two equal, but non-pro rata shares, certain community assets in order to create liquidity for one to pay estate taxes upon an anticipated death; relying in part on Rev. Rul 76-85, 1976-L C.B. 215, 1976-WL 36350, the memorandum concludes that such a partition would not result in a taxable event.

In the second, PLR 8016050, 1980 WL 132102, where a husband and the executor of his wife's estate proposed an equal, but non-pro rata division, again the Service ruled the exchange was not a taxable event. In California, the ruling noted, the right of partition is to the entire community estate and not merely to some specific part, relying in part on the legal principle that the marital property interest of each spouse is an interest in the property as an entity. The legal entity principle relied on in the memorandum is, however, only mentioned in the context of Rev. Rul. 76-83, 1976-1 C.B. 213, 1976 W.L. 36350. Rev Rule. 76-83 ruled that a divorce non prorata division of community transaction was a non-taxable transaction with no gain or loss being recognized. This author has not found any definitive reference in the ruling to the community being an entity under California law. The main point of the ruling was, while a division of the community in a divorce settlement may result in a taxable event, such a division is not considered taxable when there is an equal division of the value with some assets going to the wife and other assets going to the husband. In Texas, for most purposes, community property principles do not create an entity. Community property is a form of co-ownership among a husband and wife that ceases to exist when the marriage terminates.

Note: The 1980 private letter rulings were issue prior to the enactment of 26 U.S.C.A. Sec. 1041, which provides that no gain or loss is recognized on a transfer between spouses incident to a divorce.

In the third, PLR 9422052, 1994 WL 237304 community assets had been placed in a revocable trust arrangement prior to the first spouse's death, and the trust agreement authorized the trustee to make non pro rata distributions following the first spouse's death among the survivor's trust and the deceased spouse's marital deduction and bypass trusts.

3. THE LAW

Do these three rulings really support the legal conclusion that a non pro rata division of assets in Texas among the surviving spouse and the heirs and/or devisees of the deceased spouse is not a taxable event, or is Texas substantive law different enough to generate a different tax result? However, as discussed below, California law may not be as different as PLR 8016050 suggested.

Perhaps PLR 9422052 suggests a possible planning advantage a revocable trust may have over a traditional testamentary plan. In a traditional testamentary plan, a safe harbor approach may be for the personal representative with appropriate authority granted in the will to enter into a partition and exchange agreement with the surviving spouse shortly after the first spouse's death and prior to any significant appreciation in value to the community assets. Care should then be taken to track the income from the partitioned assets so that the income is properly reported on the income tax returns of the survivor and the estate (or its successors).

Note: Even if the will of the deceased spouse authorized the executor to make non pro rata distributions, it is doubtful such mandate is binding on the surviving spouse whose agreement to the division will be necessary to complete the exchange.

E. The California Approach

Notwithstanding the comfort that the above described rulings would appear to give California couples, on Jan. 1, 1999, California amended its Probate Code. Section 100 now provides:

> (a) Upon the death of a married person, one-half of the community property belongs to the surviving spouse and the other half belongs to the decedent.
> (b) Notwithstanding subdivision (a), a husband and wife may agree in writing to divide their community property on the basis of a non pro rata division of the aggregate value of the community property or on the basis of a division of each individual item or asset of community property, or partly on each basis. Nothing in this subdivision shall be construed to require this written agreement in order to permit or recognize a non pro rata division of community property.

Thus, it appears that, absent an agreement of the couple, California law is similar to Texas law; at death, the surviving spouse retains an undivided one-half (½) interest in each and every community asset, and the deceased spouse's undivided one-half (½) interest passes to his or her heirs/devises. California law differs because of the statute that expressly authorizes the couple to agree to a non pro rata division of the aggregate value of the community property. Further, Cal. Prob Code Sec. 104.5, which became effective on Jan. 1 2000, permits Sec 100b agreements to be incorporated into revocable trusts.

F. The Texas Response

Since Texas does not have a statute expressly authorizing such an agreement, the question is whether Texas couples can enter into such an agreement. Would such an agreement be valid under existing Texas statutes and Art. XVI, Sec. 15 of the Texas Constitution? Arguably, such an agreement is valid under existing Texas law. Both Tex. Fam. Code Sec. 4.102 and Art. XVI, Sec. 15 of the Texas Constitution authorize spouses to partition between themselves all or part of their community property, then existing or to be acquired, as they may desire. It is not too much of a stretch to imagine this statutory language includes an agreement to divide the community property on the basis of a non pro rata division upon the death of the first spouse.

On the other hand, a strict construction of the constitutional and statutory language suggests that only spouses, *during the marriage*, can partition, then existing community property, or community property to be acquired in the future. The California type agreement seems to contemplate an agreement during the marriage to partition in a certain way after the marriage terminates. Thus, such an agreement may violate Art. XVI, Sec. 15.

In *Hilley v. Hilley*, a case decided prior to 1980 amendment to Art. XVI, Sec. 15 that liberalized the spousal partition rules, the Texas Supreme Court held it was unconstitutional for a couple to enter into an agreement during marriage that would avoid a pro rata partition of the community upon the first spouse's death. The couple in that case tried to attach "survivorship" rights to certain community assets. *Hilley v. Hilley*, 342 S.W.2d 565 (Tex. 1961). Of course, survivorship rights were later authorized by the 1987 amendment to Art. XVI, Sec. 15. See X, *infra*.

Lending support to the argument that the agreement may not violate Art. XVI, Sec. 15 is the old case of *Gorman v. Gause* 56 S.W.2855 (Tex. Comm. Of Appeals 1933) where the court, in the context of a pre-marital agreement, stated that ". . . it might be agreed by such parties that...a certain portion of the community estate, when acquired, would be conveyed by him to the wife and made her separate property. . . . Such an agreement would not violate either the Texas Constitution or statutes of this state. . ." Accordingly, perhaps an agreement of the spouses to partition community in a certain way following the first spouse's death would not violate existing Texas law.

XIV. REIMBURSEMENT AND ECONOMIC CONTRIBUTION

The last twenty years have seen several important cases which have specifically added to the evolvement of the equitable concept of reimbursement between the marital estates that usually arises when one spouse's separate property is improved through the expenditure of community funds or community time, talent and labor. The increased importance of this concept 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.

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 would apply 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 found to exist, the Texas courts have not been very precise in determining the measure of reimbursement. Over the years three distinctive means of measurement evolved.

1. "COST OF THE IMPROVEMENT"

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

2. "ENHANCED VALUE OF THE IMPROVEMENT"

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. "LESSER OF COST OR ENHANCED VALUE"

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 putting the surviving spouse to an equitable election (i) to accept the benefits conferred in the will and waive the claim, or (ii) to assert the claim and waive the 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. VALLONE

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. COOK

In *Cook v. Cook*, 665 S.W.2d 161 (Tex. Civ. App.—Ft. 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 (Tex. 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 for 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 secure 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.—Ft. 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 owns separately 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* Weekley, "*Reimbursement Between Separate and Community Estates*," 39 Baylor Law Review 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 Sec. 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 Sec. 3.006(b) (1999). Compare, however, the language in Sec. 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 Sec. 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 Sec. 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 Sec. 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 Sec. 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 Sec. 3.401 (1999) financial contribution? Did Sec. 3.401(b) (1999) or Sec. 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) contains a major overhaul to subchapter E. For example, statutory reimbursement is no longer referred to as an "equitable interest." It is more accurately referred to as a "claim for economic contribution."

a. *Intent*

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

b. *Economic Contribution Defined*

Economic contributions arise 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 Sec. 3.402(a). Economic contribution does 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 Sec. 3.402(b).

c. *New Formula*

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

Note: The new formula allows the claim to participate in the benefitted property's appreciation or depreciation. Discussion among some family law experts suggests that the application of the new formula may render the formula unconstitutional as a conversion of separate property into community property by a means not authorized by Art. XVI, Sec. 15.

d. *Use and Enjoyment*

The use and enjoyment of the property during marriage does not create a claim of an offsetting benefit. Tex. Fam. Code Sec. 3.403(e). Obviously, the couple's occupancy of the separate property home of the husband that was improved with community funds is not an offset. However, if the property is income producing, or generating tax benefits, shouldn't that benefit to the community offset the claim for economic contribution?

Note: The statute uses the language "use and enjoyment," not "use and benefit."

e. *Surviving Spouse's Election*

If the owner spouse devises the benefitted separate property to the other spouse, the other spouse should not be able to accept the devise and also assert a claim for economic contribution. The correct analysis may be to explain that the surviving spouse is put to an election. Even if the benefitted 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 economic contribution. *See* XII, E *supra*.

f. *Equitable Lien*

In divorce situations, an equitable lien is imposed to secure payment of the claim. In death situations, a party of interest must request the imposition of the equitable lien. Tex. Fam. Code 3.406.

Note: The equitable lien can be imposed on any assets of the owner of the benefitted property; the court is not limited to the benefitted property itself.

g. *Claims for Reimbursement*

The claim for economic contribution does not eliminate from Texas law the traditional claim for reimbursement except in those fact situations that are statutorily defined claims for economic contributions. Tex. Fam. Code Sec.3.408(a). In fact, the statute gives examples of the more traditional claim for reimbursement—payment of unsecured liabilities and *Jensen* type claims. Tex. Fam Code Sec. 3.408(b). Claims for reimbursement are to be resolved using equitable principles, including "use and enjoyment" offsets. Tex. Fam. Code Sec.Sec. 3.408© and (d). A 2007 amendment to the section places the burden of proof on the party seeking the offset. Tex. Fam. Code Sec. 3.408(e). The statute does describe 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 Sec. 3.409. Despite some apparent confusion on the part of some courts (*see Lewis v. Lewis*, 1999 Tex. LEXIS 4920 Houston [1st, no petition], "waste of community assets" should be considered as a type of fraud on the community, not a claim for reimbursement. *See* V. B, *supra*.

h. *Marital Property Agreement*

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

G. Death of Non-Owner Spouse

Upon the death of the non-owner spouse, the non-owner spouse's one-half interest in the community claim for reimbursement or economic contribution would pass to that spouse's heirs or devisees.

1. DUTY OF PERSONAL REPRESENTATIVE

If the sole heir or devisee is not the owner spouse or if the estate is insolvent, the personal representative would appear to be under a duty to pursue the claim against the owner 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 would be included in the deceased spouse's gross estate for death 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. Death of Owner Spouse

Upon the death of the owner spouse, the asset which is the subject of the community claim for reimbursement or economic contribution will remain the owner's separate property and pass under the owner's will or by intestate succession; however, the claim continues to exist.

1. CONFLICT OF INTERESTS

Such a situation can create a conflict of interest (i) between the surviving spouse and the decedent's heirs or devisees where the surviving spouse is not the sole heir or devisee 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

As explained in *Dakan*, 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 receives 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.

I. Gift Tax Consequences

Failure to assert a claim for reimbursement or economic contribution by the non-owner spouse, or heirs and devisees of a deceased non-owner spouse, may be considered to be a taxable gift to the heirs and devisees of the owner spouse, or the owner spouse.

J. Rights of Creditors

Is the community claim for reimbursement or economic contribution a community asset that could be attached by one spouse's creditor in order to indirectly reach the separate property of the other spouse? The author is not aware of any Texas authority on point but believes it is a distinct possibility. Further, upon death or divorce, the non-owner spouse (or such spouse's heirs or devisees) may become the owner's largest creditor due to the community claim for reimbursement.

K. Separate Property Claims

A claim for reimbursement or economic contribution can also exist in favor of a spouse's separate estate where separate funds are used to enhance the community estate. One unique application of the separate claim for reimbursement is found in *Horlock v. Horlock*, 533 S.W.2d 52 (Tex. App.—Houston [14th Dist.] 1975, writ dism'd w.o.j.), where separate property brought into the marriage was reimbursed out of the community for the separate estate lost due to the husband's inability to overcome the community presumption and trace his separate property when the marriage terminated.

L. Post-Mortem Opportunities

In the right family situation, the existence of the community claim for reimbursement or economic contribution may also present an opportunity for creative post-mortem tax planning.

1. OWNER'S DEATH

If the owner spouse dies first with a will that does not provide for optimal marital deduction planning, the claim can be used to reduce the decedent's taxable estate by the amount owed to the surviving spouse, thereby shifting value from the first spouse's estate to the surviving spouse's estate and deferring death taxes until the survivor's death.

2. NON-OWNER'S DEATH

If the non-owner spouse dies first with a will that does not leave the residuary estate to the owner spouse in a manner which qualifies for the marital deduction, the claim creates the opportunity to shift value from the surviving spouse's presumably more valuable estate through the non-owner's probate estate to the spouses' children with less overall transfer taxes.

M. Planning During the Marriage

In a situation where a spouse having a claim for reimbursement or economic contribution does not intend to enforce the claim, the couple should consider attempting to resolve the claim issue before the death of either spouse in order to avoid complications when the marriage terminates at the first spouse's death. One possible solution is for the claimant spouse to make an inter vivos gift to the other spouse of the claim that has accrued as of the date of the gift and waive and/or partition any claim that might accrue in the future.

1. NEED FOR PARTITION AGREEMENT

A partition and exchange agreement should be considered due to the uncertain effectiveness of an anticipatory waiver of the claim. While the Texas Supreme Court in *Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978) approved provisions in premarital agreements that waive significant marital property rights such as the homestead right of occupancy, a simple waiver of a claim for economic contribution or reimbursement without tangible consideration may not be enforceable. However, Art. XVI, Sec. 15 of the Texas Constitution and Tex. Fam. Code Sec. 4.102 expressly authorize spouses to partition and exchange community property to be acquired in the future, and a community claim for reimbursement or economic contribution should be considered to be a community asset for this purpose, as well as other purposes. The partition and exchange agreement approach would be especially attractive where both spouses own separate property and have reciprocal community claims for reimbursement or economic contribution. The partition and exchange agreement could also be used by persons intending to marry who are bringing separate property into the marriage. In both the premarital and marital context, partition agreements require that each spouse receive some type of consideration for giving up a valuable property right. *See* VII, D, and VIII, *supra*.

2. MARITAL DEDUCTION CONSIDERATIONS

Any transfer or waiver for less than full fair market value among the spouses during the marriage should qualify for the marital deduction, thereby eliminating any transfer tax consequences of the agreement. A waiver or gift by the claimant spouse after the other spouse's death may be a taxable gift to the decedent's heirs or devisees and not qualify for the marital deduction.

3. DEVISE TO OWNER

Another possible solution is for each claimant spouse to devise the claim for reimbursement or economic contribution to the other spouse upon the claimant's death – a technique used frequently in other situations. For example, many lawyers have their married clients, when appropriate, devise to the surviving spouse the deceased spouse's interest, if any, in the surviving spouse's retirement plans and IRAs, as well as any insurance policies on the surviving spouse's life in order to avoid complications and controversy at the first spouse's death. Such a devise will likely eliminate any administration controversy between the claimant's estate and the surviving spouse, as well as eliminate any transfer tax consequences due to the marital deduction. In other words, in the right situation this technique is another safe harbor approach. Otherwise, the decedent's claim may pass as part of the residuary estate to, or for the benefit of, beneficiaries other than the surviving spouse and consequently place the executor and/or trustee in the awkward fiduciary position of pursuing a claim against the surviving spouse.

N. Election Planning

If the surviving spouse has a claim for reimbursement or economic contribution against the estate of the deceased spouse, can the surviving spouse assert that claim and still accept the benefits devised to the surviving spouse in the deceased spouse's will (including perhaps the devise to the surviving spouse of the deceased spouse's claim against the survivor)? In other words, is the surviving spouse put to an election to either elect against the will and assert the survivor's community property rights or elect to accept the benefits under the will and forego asserting any such community property rights? Absent language in the will expressly putting the surviving spouse to such an election, the parties will likely argue over whether there is an implied election that prevents the surviving spouse from accepting under the will and asserting community property rights inconsistent with the intent expressed in the will. *See* XI, E, *supra*.

1. EXAMPLES

For example, if the separate asset of the deceased spouse generating the claim is devised outright to the surviving spouse, it would appear that the surviving spouse's acceptance of the devise should estop the surviving spouse from asserting the claim against the decedent's estate. However, if the asset is not left outright to the survivor but is left to another beneficiary and the survivor is left other assets, or if the asset is devised to a QTIP trust or a bypass trust for the benefit of the surviving spouse, the parties will likely argue over the possibility of there being an implied election for the surviving spouse. This situation may be similar to the one where the separate property homestead of the deceased spouse is left to his or her children by the previous marriage and the surviving spouse is left other assets. Can he or she accept the benefits and assert his or her homestead right to occupy the separate homestead?

2. EXPRESS ELECTION

To avoid the uncertainty, controversy and possible litigation that such a claim could create, the first spouse to die could devise his or her claim to the surviving spouse expressly conditioned on the surviving spouse effectively either (i) waiving the claim against the decedent's estate or (ii) assigning the claim to the devisees of the asset that generated the claim. If the spouses' respective claims are not roughly equivalent in value, or if the decedent's claim does not exceed the surviving spouse's claim, other devises in the will in favor of the surviving spouse could be conditioned on the survivor effectively foregoing his or her claim against the estate.

3. MARITAL DEDUCTION PROBLEM

This express election approach avoids the uncertainty of whether the surviving spouse is put to an implied election, but it does not avoid the negative effect a condition attached to a devise to the decedent's surviving spouse can have on the marital deduction. Such a condition may cause the devise to the surviving spouse to be treated as a nondeductable terminable interest.

4. PRESERVING THE MARITAL DEDUCTION

Accordingly, if preserving the marital deduction is important to the planning, the debt payment clause in the deceased spouse's will could direct that all claims for economic contribution or reimbursement of the surviving spouse be charged against any assets passing to the surviving spouse, or if no assets are passing outright to the surviving spouse, charged against the assets passing into any trust created for the benefit of the surviving spouse. Under this approach, any marital deduction lost on the estate tax return should be made up by the deductible claim for reimbursement or economic contribution.

5. EFFECTIVE CONDITIONS

Alternatively, conditions could be attached to devises to, or for the benefit of, the surviving spouse which would not affect the marital deduction. For example, if the surviving spouse asserts such a claim, the standard for distributions of income and/or principal from the bypass trust could be made more restricted, or possibly distributions of principal from the QTIP trust could be eliminated.

6. REVOCABLE TRUST PLANS

The planning ideas discussed above could also be incorporated into a revocable trust plan.

O. Avoiding the Problem

If a person intending to marry owns property that is likely to generate a claim for reimbursement or economic contribution during the marriage, the best plan is to avoid creating situations during the marriage that would give rise to the claim, if possible. A sale or gift of the property subject to any such claim does not cause the claim to be extinguished. The other spouse's claim will still exist when the marriage terminates.

1. CLOSELY HELD BUSINESSES

The owner of a separately owned business should be paid adequate compensation for the value of services rendered. The amount and adequacy of the compensation, whether in the form of salary or fringe benefits, should be documented in order to be in the position to defend the other spouse's *Jensen* claim for reimbursement when the marriage terminates. Any infusion of community cash during the marriage should be documented as a loan with adequate interest, and the loan should be repaid. An owner of a "flow through" entity, like a Subchapter S corporation or a partnership, should pay out of separate funds any resulting income tax liabilities generated and retained by the entity and reported on the owner's individual income tax returns. The owner should avoid personal liability for any debts of the entity whenever possible. If required, the owner should try to negotiate with the lender for the lender to agree to look only to the owner's separate property for repayment. In any event, any debts of the entity should be repaid with entity funds or the separate funds of the owner, if possible.

2. REAL ESTATE

The use of community funds to reduce the principal amount of any indebtedness secured by separate real property or to make an improvement to separate real property creates a claim for economic contribution which is not "offset" by the use and enjoyment of the property during the marriage. Sec. 3.403(e) of the Texas Family Code may not even allow community rental income to "offset" economic contribution claims. The use of community funds to make interest payments, to pay ad valorem taxes, to pay ordinary repairs, or to pay casualty insurance premiums may create a reimbursement claim, if the benefits enjoyed by the "community estate" do not "offset" the costs to the "community estate." Accordingly, separate funds should be used whenever possible to pay for any capital improvements or to pay the principal of any such indebtedness. Separate funds should also be expended to pay any expenses that may generate a claim for reimbursement if the benefits the community enjoys does not exceed the cost to the community. The client should also be made to realize that the expenditure of uncompensated "time, talent and labor" to improve separate property may give rise to a *Jensen* type reimbursement claim when the marriage terminates.

3. UNSECURED DEBTS AND LIFE INSURANCE

Premiums for separately owned life insurance policies should be paid with clearly traceable separate funds. Any unsecured loans incurred prior to marriage should be paid with separate funds. Any such payments should be documented and the documentation retained in order to meet the burden of proof required of the owner of separate property.

4. OTHER SITUATIONS

Tangible personal property, like automobiles, boats, and planes, can give rise to an economic contribution or reimbursement claims that are also not extinguished by the transfer of the asset to a third party. Payments of community funds to reduce the principal of a debt secured by tangible personal property also creates a claim for economic contribution with no offset for any benefits the "community estate" derived from its use during the marriage. Whenever possible separate funds should be used to pay the debt and make any improvements. Casualty insurance premiums and costs of ordinary maintenance and repair can be "offset" by the benefits the "community estate" derives through the property's use.

XV. INCAPACITY OF A SPOUSE

The Texas Probate Code describes the procedure which can allow one spouse to manage the entire community estate upon the incapacity of the other, absent any pre-need planning. This procedure offers the opportunity to avoid the opening of a guardianship when the estate consists entirely of community property. HB 1132 (2001) made significant changes to this area of the law. It repealed the provisions in the Texas Family Code which prior to September 1, 2001, offered an alternative procedure in the event of one spouse's incapacity. It defines the spouse who assumes managerial authority over the community as the "community administrator." It allocates authority between the incapacitated spouse's guardian and the community administrator and also more clearly defines the rights of the incapacitated spouse.

A. Texas Probate Code

Sec. 883 provides that when a spouse has been declared incapacitated by the probate court, the other spouse is presumed to be a suitable community administrator, thereby assuming the full authority to manage, control and dispose of the entire community estate, including the incapacitated spouse's sole management community property and the couple's joint management community property. Accordingly, a guardianship is not necessary for the community estate if the managing spouse is not disqualified. Unlike prior law where there may or may not have been a need for a guardianship of the incapacitated spouse's separate property, Sec. 883(a)(2) appears to require the appointment of a guardian for the separate property. However, the other spouse may be appointed the guardian for the incapacitated spouse's separate property.

B. Disqualified Spouse

If the competent spouse is found to be disqualified or otherwise unsuitable to serve as community administrator, the court is required to appoint a third party guardian. In that event, the court (after considering relevant factors) may order the competent spouse to deliver to the guardian up to one-half of the joint management community property. Tex Prob. 883(c)(2). Accordingly, the guardian will be entitled to administer (a) the incapacitated spouse's separate property, (b) that portion of the joint community to be managed by the guardian by order of the court, © the sole management community property of the incapacitated spouse and (d) any income earned by these assets. Of course, depending on the court's allocation of authority, the competent spouse may retain management over that spouse's separate property and sole management community assets and only one-half of the joint community assets.

C. Other 2001 Changes

Sec. 883C describes the grounds for removing the community administrator. Sec. 883B provides for the community administrator to provide an inventory and accounting under certain circumstances. Sec. 883D provides for the appointment of an attorney ad litem for the incapacitated spouse. Sec. 884A requires the community administrator to inform the court of a pending divorce or other action filed by the competent spouse where the incapacitated spouse is a defendant.

D. Conflicting Authority-Spouse Agent

If one spouse while still competent executes a durable power of attorney naming the other spouse as his or her agent, does the qualification of another party (e.g., as an adult child by a previous marriage) as guardian of the principal spouse's estate also terminate the agent spouse's authority over the community estate? Apparently, Sec. 485 states that the powers of the attorney in fact or agent terminate on the qualification of a permanent guardian of the estate or may be suspended if a temporary guardian is appointed.

A finding of incapacity by the probate court in order to open a permanent guardianship would also appear to trigger the other spouse's managerial authority under Sec. 883, but Sec. 485 directs the agent under the durable power of attorney to deliver all of the ward's assets to the guardian. Section 884 then directs the guardian to deliver the community property to the other spouse, if the competent spouse has become the community administrator under Sec. 883. Of course, if the third party has been appointed the guardian because the other spouse had been disqualified under Sec. 681 (thereby presumably disqualifying such spouse under Sec. 883), the community assets would be managed as described in XV, A and B, *supra*.

E. Conflicting Authority-Third Party Agent

If a third party had been originally designated as agent under the durable power of attorney and the principal is later declared incapacitated by the court and a guardian qualifies, the authority of the agent terminates. The agent is then required to deliver the principal's assets to the guardian. The competent spouse would then appear to have the opportunity to become community administrator and assume authority to demand possession of the community assets unless such spouse would be disqualified to serve as guardian as described in XI A and B, *supra*. Accordingly, a spouse who does not wish the other spouse to assume authority over his or her assets, either as guardian or as community administrator in the event of incapacity, needs to execute a "pre-need" guardianship designation pursuant to Sec. 679. This designation could expressly disqualify the other spouse as guardian under Sec. 681(9) and as community administrator under Sec. 883.

F. Fiduciary Issues

Under Sec. 883, the community administrator may assume the sole power to manage, control and dispose of the entire community estate, or a part thereof, until the marriage terminates or the other spouse regains capacity. Obviously, the managing spouse assumes the role of a fiduciary in the management of the community on behalf of the other spouse. However, Sec. 883(e) states that the duties and obligations between spouses, including the duty of support, are not affected by the manner in which the community is being administered. The real question is, however, whether the fiduciary duty so owing should be the same as is required of the managing spouse under Tex. Fam. Code Sec. 3.102 (i.e., not to commit a "fraud on the community") or is the duty a greater one (similar to the ones owing by the trustee of an express trust) in view of the other spouse's incapacity and the entry of the court's order.

XVI. 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 Sec. 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." Scott, Trusts 3, 4 (3rd Ed. 1967).

1. DEFINITION

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 Trust (Third) Sec. 2. (2003)

2. CREATION

According to Sec. 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 which 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. Sec. 112.051. *See* Restatement (Second) Trusts, Sec. 330; Bogert, Law of Trusts and Trustees, Sec. 998 (1983).

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 Sec. 101.002 and Tex. Trust Code Sec. 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 can 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.

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 which 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 or appointment over the entire trust estate, creditors can reach the entire trust estate. See Bank of Dallas v. Republic Nat. Bank, 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*, 1992 WL 297338 (Tex. App. Dallas 1992). The inclusion of a spendthrift provision will not insulate the settlor's retained interest from the settlor's creditors. *See* Tex. Trust Code Sec. 112.035 and *Glass v. Carpenter*, 330 S.W.2d 530 (Tex. Civ. App.—San Antonio 1959, writ ref'd n.r.e.).

1. MARITAL PROPERTY ISSUES

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.—Ft. Worth 1996, writ denied) and *In re Marriage of Burns*, 573 S.W.2d 555 (Tex. App.—Texarkana 1978, writ dism'd w.o.j.). Some older cases support that same result. *See Shepflin v. Small*, 23 S.W. 432 (Tex. Civ. App., no writ 1893 no writ) and *Monday v. Vance*, 32 S.W. 559 (Tex. Civ. App. 1895 no writ).

2. OTHER FACTORS

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* III, G, *infra.* 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. Civ. 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 In re Marriage of Long*, 542 S.W.2d 712 (Tex. App.—Texarkana 1976, no writ), and *Wilmington Trust Company v. United States*, 753 F.2d 1055 (5th Cir. 1985).

4. UNDISTRIBUTED INCOME

Undistributed income is normally neither separate nor community property. *See In re Burns, supra; Buckler v. Buckler*, 424 S.W.2d 514 (Tex. App.—Ft. 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. But, *see* XV,E,3. *supra.*

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 Sec. 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* XV,E, *supra.*

4. <u>NON-GENERAL POWERS</u>

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?

XVII. COMMUNITY PROPERTY IN THE REVOCABLE TRUST

If a married individual or couple places community property into a revocable trust, the relative marital property rights of the husband and wife could be adversely affected. For example, separate and community could be commingled; community property subject to a spouse's sole management and control could become subject to the couple's joint control. Community property may be deemed partitioned.

A. Professional Responsibility

It is obvious, therefore, that the practitioner advising the couple should be alert for possible conflicts of interests and to make sure the couple understands the effect revocable trust planning could have on their marital property rights during the remainder of the marriage and on its dissolution either by death or divorce.

B. Creation and Funding

Generally, when marital property is to be placed into a revocable trust, steps should be taken to insure that the planning:

1. Is not deemed fraudulent or even "illusory" under *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968). In this

case, the husband placed his sole management community property into a revocable trust; upon his death, the wife disrupted the plan by pulling her one-half interest out of the trust under the "illusory" transfer doctrine.

2. Is not deemed void because one spouse unilaterally attempted to transfer community property subject to joint control into the trust.

3. Does not amount to a "mixing" of the different types of community property so that special community assets become joint community property.

4. Does not work a commingling of community and separate funds as to risk losing the separate character of the separate property.

5. Does not amount to, nor was it intended to be, a partition of community property into their respective separate estates. In other words, precautions should generally be taken in the drafting and funding of the trust to document that the retained equitable interest in community assets placed in the trust remain community during the balance of the marriage, and if an asset was a spouse's special community property, that it maintains that character as well unless a different result is intended after due consideration of the consequences. Of course, a spouse's retained interest in any separate property should remain separate in most situations.

C. Power of Revocation

When a husband and wife fund a revocable trust with community property, should the power of revocation be exercised jointly or severally? If the document directs that either spouse can revoke the trust unilaterally, should the power extend to the whole community asset being withdrawn from the trust or only to the revoking spouse's undivided one-half interest therein?

1. <u>JOINTLY REVOCABLE</u>

If the power to revoke is retained jointly by the couple, the couple's equitable interest in the trust would appear to be their joint community property even though some of the community assets in the trust were a spouse's special community property prior to funding. Converting special community property into joint community property affects the relative marital property rights of the husband and wife. For example, an asset which would have been exempt from certain debts of a particular spouse would become liable. *See Brooks v. Sherry Lane National Bank*, 788 S.W. 2d 874 (Tex. App.—Dallas 1990, no writ.) *See* IV, A, *supra.*

2. <u>UNILATERAL PARTITION</u>

To avoid converting special community property into joint community property, the document could be drafted to permit either spouse to withdraw from the trust that spouse's community one-half interest in any community asset placed in the trust. Such a power would, in effect, permit either spouse to unilaterally partition the couple's community property interests, a result which does not appear to be authorized by Art. XVI, Sec. 15 of the Texas Constitution. Only jointly can spouses partition community property into their respective separate estates. Even an agreement by the spouses to authorize such a unilateral partition would appear to violate the "mere agreement" rule of marital property. *See Kellet v. Trice* 95 Tex. 160, 66 S.W. 51 (1902); *King v. Bruce*, 145 Tex. 647, 201 S.W.2d 803 (1947); *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961).

3. <u>JOINT AND SEVERAL REVOCATION</u>

Accordingly, the safe harbor approach would be for the couple to retain the power of revocation (i) jointly for some assets of the trust, (the joint community property assets) and (ii) severally as to other assets in the trust (special community property and separate property) after giving notice to the other spouse. If the power of revocation is exercised as to a special community asset, the withdrawn asset would remain the couple's community property but still subject to the withdrawing spouse's sole management and control. If the couple so agrees, allowing either spouse to revoke as to a joint community asset would not appear to have any adverse consequences from a constitutional, liability or tax perspective so long as the asset in its entirety is revested as community property.

D. Incapacity of a Settlor

As with any revocable trust, the trust document should address the effect the possible incapacity of a settlor will have on the power of revocation. Can an agent under a durable power of attorney revoke on behalf of the settlor/principal? Can a guardian revoke the ward's revocable trust? Or, is the power of revocation a non-delegable power? *See Weatherly v. Byrd*, 566 S.W.2d 292 (Tex. 1978). The questions evolve even further if the settlor is married and the trust is funded with the incapacitated spouse's special community property or joint community property. Does Sec. 883 of the Texas Probate Code permit the other spouse to revoke the trust on behalf of the incapacitated spouse? There appear to be no clear cut answers to these questions, but these issues should be addressed in the document.

E. Rights of Creditors

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 creditors. If (i) the trust is irrevocable, (ii) the settlor has not retained an equitable interest in the trust estate and (iii) the transfer of assets into the trust was not in fraud of creditors, the assets of the trust belong to the beneficiaries and are not generally liable for the debts of the settlor. If the transfer of assets in order to fund the trust is found to have been in fraud of creditors, creditors can reach the assets in trust like any other assets transferred free of trust.

1. REVOCABLE TRUSTS

Most of the assets transferred by the settlor to the trustee of a Texas revocable trust will in all probability continue to be liable for the settlor's debts both during the settlor's lifetime and following the settlor's death. There is, however, authority to the contrary. *Jones v. Clifton*, 101 U.S. 225 (1980); 92 A.L.R. 282 (1934); Scott, Sec. 330.12; Bogert, Sec. 41. But the modern trend appears to adopt the premise: *if one can claim the assets at any time, they should be available to one's creditors. See State Street Bank v. Reiser*, 389 N.E.2d 768 (Mass. 1979).

2. TEXAS AUTHORITY

In Texas, the provisions of the Uniform Fraudulent Transfer Act give creditors theories whereby assets placed in the revocable trust can be reached to satisfy the settlor's debts. *See* Tex. Bus. & Comm. Code Secs. 24.001 through 24.013. Even if the Uniform Fraudulent Transfer Act is not violated, the Texas definition of a "general power of appointment" would seem broad enough to capture revocable trust assets within its coverage and thereby subject the property in question to the liabilities of the settlor/donee of the power, either during the settlor's lifetime or at the settlor's death. A general power includes "the authority to...alter, amend or revoke an instrument under which an estate or trust is created or held, and to terminate a right or interest under an estate or trust...." Tex. Prop. Code Sec. 181.001(2). The Restatement provides that appointive assets covered by a general power can be subjected to the claims of the donee or claims against the donee's estate. Restatement (Second) Property Sec. 13.1(1984). In *Bank of Dallas v. Republic National Bank*, 540 S.W.2d 499 (Tex. Civ. App. Waco 1976, writ ref'd n.r.e.), the court, after adopting the general restatement approach, stated: "If the settlor reserves for his own benefit not only a life estate but also a general power...his creditors can reach the principal." In addition, the fact that the trust is a spendthrift trust would not afford any protection from the settlor's creditors. Tex. Prop. Code Sec. 112.035(d). However, Texas courts have not specifically addressed whether the settlor's creditors can reach the assets of the settlor's revocable trust after the settlor's death. See *FCLT Loans, L.P. v. Estate of Bracher*, 93 S.W.3d 469 (Tex.App.—Houston [14th Dist.] 2002, no pet.). However, as explained above, Texas law does define a general power of appointment to include a power of revocation, and it's this author's opinion that non-exempt assets placed in the revocable trust should remain liable for the settlor's debts before and after the settlor's death.

F. Effect of Divorce

Community assets and quasi-community property held in trust where one, or both, of the spouses hold a power of revocation should be part of the "estate of the parties" subject to division by the divorce court in a just and right manner pursuant to Sec. 7.001 of the Texas Family Code.

1. POWERS OF APPOINTMENT

A power of revocation is defined in the Texas Property Code as a general power of appointment, giving the holder thereof the equivalence of ownership over the assets subject to the power. *See* Tex. Prop. Code, Sec. 181.001.

2. VOID AND VOIDABLE TRANSFERS

If only one spouse is the settlor of a trust funded with the settlor spouse's special community property, the transfer of such community assets into the trust is deemed "illusory" as to the other spouse. *See Land v. Marshall, supra.* If the sole settlor spouse attempted to transfer into the trust joint community assets without the joinder of the other spouse, the transfer should be found to be void as to the other spouse. *See* III,F, *supra.*

3. SEPARATE TRUST ESTATE

If the settlor spouse transfers separate property into a revocable trust arrangement, (a) the original trust estate and its traceable mutations should retain the separate character of the separate property contributed to the trust, (b) trust income distributed to the settlor is community property and (c) any undistributed income and its mutations should be deemed to be community due to the settlor's power of revocation.

4. TRANSFERS TO THIRD PARTIES

Any trust income, or any other community assets held in the trust, distributed by the trustee to a third party, such as a child of the settlor from the settlor's prior marriage, is usually deemed to be a completed gift by the settlor to the third party for tax purposes (unless the distribution satisfied the settlor's legal obligation of the support) and is subject to attack by the other spouse as being a transfer in fraud of the other spouse's community property rights.

5. REVOCABLE TRUSTS BECOMING IRREVOCABLE

If during the marriage, a revocable trust becomes irrevocable due to a modification by the settlor, or due to the trusts own terms (e.g., the trust provides that it becomes irrevocable upon the settlor's incapacity or death), (a) the interests of the non-settlor beneficiaries may become fixed, vested and/or ascertainable, (b) the settlor may be deemed to have made a completed gift for tax purposes and (c) the now completed transfers to the non-settlor beneficiaries are subject to scrutiny as being transfers in fraud of the other spouse's community property rights.

6. INCOME TAXES

The income generated by the assets of a revocable trust is taxable to the settlor whether or not the income is distributed to the settlor, retained in the trust or distributed to another beneficiary of the trust. Since the income either retained in the trust or distributed to a third party is still reported on the settlor's individual income tax return (typically a joint return with the settlor's spouse), the payment of the consequential income tax liability with community funds could adversely affect the rights of the other spouse.

G. Death of First Spouse

Upon the death of the first spouse, the decedent's separate property and one-half interest in the community assets are normally placed in a continuing decedent's trust or are distributed in accordance with the provisions of the trust document. However, the surviving spouse's separate property and one-half interest in the community property generally should be delivered to the surviving spouse or segregated into a "survivor's trust" that continues to be revocable by the surviving spouse unless a different result is desired after considering the consequences of it becoming irrevocable. In addition to the substantive advantages for the surviving spouse, continuing revocability prevents an unintended taxable gift on the part of the surviving spouse. If the surviving spouse is not a settlor of the trust (or did not otherwise agree to the terms of the trust) and does not receive the survivor's one-half interest in the community property, the settlor spouse can use the "illusory trust" argument to reclaim the survivor's one-half interests in the community trust assets. *See Land v. Marshall, supra.*

H. Planning Considerations

When drafting the trust document, separate trusts may be desirable for the husband's separate property, the wife's separate property and their community property. In fact it may be advisable to segregate the community property further into three separate sub-trusts, one for the husband's sole management community property, one for the wife's sole management community property, and one for their joint community property in order to maintain their relative marital property rights, to facilitate the management rules of Sections 3.101 and 3.102 of the Family Code and to continue the liability exemption rules of Section 3.202 of the Family Code. Otherwise the couple's relative rights are affected and the attorney is placed in a conflict of interest by trying to represent both spouses in the planning.

I. Community Property Basis

Since the decedent's interest in the revocable trust assets is included in the gross estate, such assets will receive a new income tax basis; however, if a married couple is creating the revocable trust and plan on placing community property in the trust, care should be taken in the drafting of the trust agreement and the other transfer documents to make sure that the funding of the trust with community property does not amount to a partition of the community property so that both halves of the community can receive a step up in income tax basis upon the death of the first spouse. *See* Rev. Rul. 66-283, 1966-2 C.B. 297.

J. Settlor's Homestead Protection

A homestead exemption from the owner's general creditors can only exist in a possessory interest in land. *See Capitol Aggregates v. Walker*, 448 S.W.2d 830 (Tex. Civ. App.—Austin 1969, writ ref'd n.r.e.); *Texas Commerce Bank v. McCreary*, 677 S.W.2d 643 (Tex. App.—Dallas 1984, no writ). In revocable trust planning, where legal title in the home is transferred to the trustee, the settlor usually retains the equitable title at least for the remainder of the settlor's lifetime. In addition, there is authority for the proposition that an "equitable interest" will support a homestead claim. *See Rose v. Carney's Lumber Co.*, 565 S.W.2d 571 (Tex. Civ. App.—Tyler 1978, no writ); *White v. Edzards*, 399 S.W.2d 935 (Tex. Civ. App.—Texarkana 1966, writ ref'd n.r.e.). In fact, one early case held that the property retained its homestead character during the settlor's lifetime notwithstanding the fact it had been conveyed to a trustee where the settlor had continued to occupy the property and the purpose of that trust was to prevent the premises from being taken by creditors. *See Archenhold v. B.C. Evans Co.*, 32 S.W. 795 (Tex. Civ. App. Ft. Worth 1895, no writ). Thus, it appears as if the homestead continues to be exempt from most creditors so long as the settlor is alive. Tex. Prop. Code Sec. 41.001. The same would appear to be true for exempt personal property. Tex. Prop. Code Sec. 42.001.

K. Protection of Family

However, upon the settlor's death, the transfer of assets to the revocable trust may result in the loss of certain probate provisions which protect the surviving members of the family from the settlor's creditors (i.e., the probate homestead, exempt personal property, widow's allowance and the claims procedures followed in probate administration) following a decedent's death.

1. <u>PROBATE HOMESTEAD</u>

The Texas Constitution provides that on the death of a homestead owner, the homestead is to descend and vest in like manner as other real property of the deceased but that it shall not be partitioned among the heirs of the deceased during the lifetime of the surviving spouse for so long as the survivor elects to use or occupy the same as a homestead, or so long as the guardian of the minor children of the deceased may be permitted, under the order of the proper court having the jurisdiction, to use and occupy the same. Tex. Const. Art. XVI. Sec. 52 (1987). The effect of this constitutional mandate is to vest a life estate in the surviving spouse until abandonment, or a right to receive an estate until majority for minor children. *Thompson v. Thompson*, 236 S.W.2d 779 (Tex. 1951). In addition, the Texas Probate Code provides that following the owner's death, if the owner is survived by a spouse, minor children or unmarried child remaining at home, the homestead will not be liable for any debts, except for the purchase money thereof, the taxes due thereon, or work and material used in constructing improvements thereon. Tex. Prob. Code Sec. 270. Further, the probate code directs the probate court to set apart for the use and benefit of the surviving spouse and minor children all such property of the estate as is exempt from execution or forced sale by the constitution and laws of the state.

2. RIGHT OF OCCUPANCY

Will the surviving spouse have a right to occupy the home following the death of the owner when it had been placed in a revocable trust prior to its owner's death? While there are no definitive cases on point, it appears that the surviving spouse may not have such a right unless the trust document so provides. First, whether the home was community property or not, if the home was placed in the revocable trust during marriage, both spouses would have had to join in the transaction or the conveyance would have been void. Tex. Fam. Code Sec. 5.81. Second, the Texas Supreme Court has approved provisions in premarital agreements that allow one to waive his/her homestead right of occupancy . However, it has also been held that such waivers must be clear and unambiguous and with full disclosure. *See Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978) and *Hunter v. Clark*, 687 S.W.2d 811 (Tex. App.—San Antonio 1985, no writ). Consideration should be given to the effect of Sec. 113.022 of the Texas Trust Code which states that a trustee may permit real estate held in trust to be occupied by a current beneficiary of the trust.

In addition, if the home had been placed into the revocable trust by its owner before the marriage, or if the owner places it in trust during the marriage but before it is used as the home, the survivor's right of occupancy may never have even come into existence since the right can attach only to the actual property interest owned by the owner, which in the revocable trust situation is an equitable life estate that terminates upon the settlor's death. This same rationale may even defeat the possession rights of the owner's minor children. On the other hand, perhaps public policy in favor of the surviving spouse and minor children will lead the courts to extend the "illusory transfer" concept to such a situation to protect the rights of the surviving spouse and minor children to occupy the home like it did to protect the surviving spouse's community one-half interest unilaterally placed in a revocable trust in *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968).

This probable loss of the right of occupancy is consistent with the constitutional and statutory homestead provisions since both contemplate the homestead being a probate asset upon the death of the owner. If the home has been placed into a revocable trust, the settlor's life estate terminates and the remainderman's interest becomes possessory upon the death of the settlor instead of going through probate.

3. CREDITOR'S ARGUMENTS

Assuming the settlor is survived by a constituent family member, will the home placed in a revocable trust continue to be exempt from most creditors of the settlor upon the settlor's death? Again, there are no definitive cases and the likely result is not very clear. First, a creditor could argue that if the constituent family members have lost their right of occupancy, the purpose in exempting the property is frustrated and, therefore, the creditors should be able to reach the asset like any other revocable trust asset. Second, the creditors will point out that the exemption from creditors is found in the probate code and is directed at probate assets; since the owner elected to take the home out of probate, its exemption is lost. On the other hand, the basic theory that supports the creditor's position, in effect, ignores the existence of the trust, thereby revesting the settlor with the property and returning it to his probate estate where it would have been exempt from the claims of the creditors in the first place. In other words, the creditors have essentially forced the settlor to revoke the trust thereby making the home probate property again and, therefore, entitled to probate protection.

4. EXEMPT PERSONAL PROPERTY

Normally, certain items of tangible personal property are exempt from most of the decedent's creditors if the decedent is survived by a constituent family member. Tex. Prob. Code Sec.Sec. 271 and 281. These items are described in the Texas Property Code and generally include the household furnishings, personal effects and automobiles in an amount that does not exceed $60,000. Tex. Prop. Code Sec. 42.002. In addition, during administration, the family members can retain possession of these items and will receive ownership of these items if the decedent's estate proves to be insolvent; otherwise the decedent's interest in these items passes to his heirs and/or devisees when the administration terminates. Tex. Prob. Code Sec. 278. The arguments "pro" and "con" as to whether these rights exist if these items of property which would otherwise be exempt are placed in a revocable trust would seem to parallel the above homestead discussion.

5. ALLOWANCES

In addition to the allowances in lieu of homestead and exempt personal property, an allowance for one year's maintenance of the surviving spouse and minor children may be established by the probate court. Tex. Prob. Code Secs. 286 and 287. The allowance is paid out of the decedent's property subject to administration. *Ward v. Braun*, 417 S.W.2d 888 (Tex. Civ. App.—Corpus Christi, 1967, no writ). Thus, it appears that the family allowance would be lost if all of the decedent's assets have been placed in a revocable trust.

6. CLAIMS PROCEDURES

The probate code also describes a very elaborate statutory scheme for the handling of secured and unsecured claims against a probate estate. These procedures afford protection and guidance to the persons charged with administering the decedent's estate and assure the creditors of fair treatment. It does not appear that these procedures would apply to a trust administration.

XVIII. FAMILY BUSINESS PLANNING

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 client intending to marry can also take advantage of this planning opportunity to preserve the assets contributed to the family limited partnership for the client and the children of a prior marriage. The client's partnership interest 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 be partnership assets, not the marital assets of the owner and the owner's spouse.

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 partnership interest 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* Art. 6132b–2.01 of the Texas Revised Partnership Act and *see also Harris v. Harris*, 765 S.W.2d 798 (Tex. App.—Houston [14th] 1989, writ denied). Caution should be taken in the day to day management of the partnership to avoid claims for economic contribution and reimbursement. *See* XIV, *supra*. *See also* III, B, *supra*, Marital Opportunity Theory.

B. Distributed Profits

When the partnership distributes its 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 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).

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. Non-liquidating distributions by the entity to the owners take on a community character like ordinary cash dividends distributed by a corporation to its shareholders. Accordingly, established corporate law concepts, like the alter ego theory of *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. App.—Ft. Worth 1968, writ dism'd w.o.j.) and reimbursement for the expenditure of community time, talent and labor like in *Jensen* and *Vallone,* should apply to these new entities as well.

D. Convert Sole Proprietorships

Even if the client is not willing to share a business enterprise with other members of the family, a sole proprietorship should be 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. *See* XI, E, *infra*. 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. Caution should be taken in the day to day management of the corporation to avoid claims for economic contribution and reimbursement.

E. Reverse Veil Piercing

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. See *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex.App.—Ft. 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.App.—Ft. 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 veil piercing is an equitable doctrine that can be used to prevent an unfair or 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 damaged the community estate beyond that which could be remedied by a claim for 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.

XIX. OTHER SPOUSE'S INTEREST IN THE EMPLOYEE'S RETIREMENT PLAN

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 theory" gives the non-employee spouse an increasingly 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.—Ft. 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, Sec. 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

It has been this author's opinion that the 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 1977, 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. Sec. 3.007

A 2005 addition to the Texas Family Code resolves many of these issues. A spouse, who is a participant in a defined benefit retirement plan, now has 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 is 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 Sec. 3.007(a) and (b).

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 Sec. 3.007©.

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 Sec. 3.007(d), (e) and (f).

D. Divorce

Upon a divorce of the spouses, the community portion, and presumably "quasi-community" portion, of the employee's interest in the plan, just like any other community property asset, are subject to a "just and right" equitable division by the divorce court. However, the separate or "quasi-separate" portion is not divisible. *See* V, *supra*. Any separate property lost due to the employee's inability to trace may result in a separate claim for reimbursement. *See* XIV,K, *supra*.

XX. Effect of Death on Retirement Plans

As explained in XIX, *supra*, unlike most marital assets, the separate or community character of an interest in a retirement plan is determined using the "apportionment theory" 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." *See* III,A, *supra*.

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, before 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 non-probate 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 so 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 know 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 Sec. 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 Art. XVI, Sec. 15 of the Texas Constitution. *Kunin v. Feofanov*, 69 F.3d 59 (5th Cir. 1995). No Texas cases discussing that section of the Government Code were found.

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 benefit 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. *See* IRC Secs. 401(a) and 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 Sec. 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 Sec. 401(a)(11)(B)(iii) or are considered to be a "transfer plan" under Reg. 1.401(a)-20, Q & A 5. *See* IRM 4.72.9(3-1-02), I.R.S.

Caveat: The "ERISA rights" of the participant's spouse are governed by not only ERISA (USCA Title 29) but also the Internal Revenue Code (USCA Title 26), as well as 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, and 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 USCS Sec. 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 which is the actuarial equivalent of a single annuity for the life of the participant. *See* 29 USCS Sec. 1055(d) and (e).

F. IRAs and SEPs

Individual retirement accounts ("IRAs") and simplified employee pensions ("SEPs") are not subject to the QJSA and QPSA requirements. 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. Sec. 1056(d). Sec. 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*, 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 USC Sec.1056(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 died 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 and 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 that 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. NON-PARTICIPANT'S DEATH

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. The non-participant's one-half interest in the ESOP stock should pass to her heirs or devisees, absent some non-probate contractual arrangement. Likewise, her one-half of the IRA should pass to her heirs or devisees, absent some non-probate 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. PARTICIPANT'S DEATH

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 non-probate 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. *See* III, E, *supra.*

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 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.

TMF/3/Articles/T&E Guide to Texas Marital Property-San Antonio

APPENDICES

"Trouble on the South Spoon"

J.R. and Sue Ellen Ewing were married in 1975 and immediately moved to his parent's ranch, the South Spoon, just outside of Waco. At the time of their marriage, J.R. owned the clothes on his back, a sports car and shares of Exxon common stock (stock's f/m/v then of $50,000). Sue Ellen owned at that time her clothes, a car and 40 acres of land that her father gave her when she graduated from college (land's f/m/v then of $40,000).

In 1976, J.R.'s father, Jock, died and devised South Spoon to J.R.'s mother, Miss Ellie, and all of the outstanding common stock of Jock's corporation, Ewing Gas, Inc., to J.R. Both South Spoon and Ewing Gas, Inc. were Jock's separate property. At that time Ewing Gas, Inc. was appraised for $1,000,000.

Today, the significant assets of J.R. and/or Sue Ellen consist of:

(1) The same "40 acres" (f/m/v of land $800,000).

(2) The "weekend home" paid for with $50,000 borrowed from a local bank by Sue Ellen and built on the 40 acres in 1985. The note was paid off with J.R.'s salary. (f/m/v of house is $75,000).

(3) Shares of the "ExxonMobile stock" (f/m/v $100,000).

(4) The same shares of "Ewing Gas, Inc." (f/m/v $30,000,000).

(5) "J.R.'s investments," various stocks and bonds purchased by J.R. in his name with Exxon or ExxonMobile dividends. (f/m/v $500,000)

(6) "Sue Ellen's investments," various stocks and bonds acquired by Sue Ellen in her name with (I) $100,000 given to her in 1982 by J.R. and (ii) the dividends and interest generated by the original investments and the profits from sales of the same. (f/m/v $200,000).

(7) The "joint bank account" in the names of J.R. and Sue Ellen where J.R. deposits his salary from Ewing Gas, Inc. (balance $100,000, living expenses paid from here).

(8) The "$500,000 life insurance policy" on J.R.'s life given to Sue Ellen by J.R. in 1976. It has a cash surrender value of $50,000. Premiums have been paid out of the joint account by Sue Ellen.

(9) "Sue Ellen's savings account," balance of $50,000, including $10,000 of accumulated interest, an account where she has deposited royalty receipts of $40,000 for the oil produced on the 40 acres; there have been no withdrawals.

(10) "J.R.'s savings account," balance of $100,000, including deposits of $90,000 which J.R. received as distributions from a trust set up by Miss Ellie for his benefit and $10,000 of accumulated interest. There have been no withdrawals.

(11) "The beach house," in 1974, Jock and Miss Ellie gave J.R. $100,000, and J.R. used the $100,000 as the down payment on a beach house in Galveston in 1974; the balance of the purchase price ($300,000) was a promissory note signed by J.R. and secured by a deed of trust on the beach house. J.R. has made all note payments out of his salary. The note was paid off in 1984 and the lien has been released. (f/m/v now of $800,000).

(12) "The new ranch," in 1990, Miss Ellie gave J.R. $100,000 in cash and J.R. used that $100,000 in 1990 as the down payment for a new ranch; the balance of the purchase price was a $300,000 promissory note signed by J.R. and secured by a deed of trust to the new ranch. J.R. has made all the note payments out of his salary. The note was paid off in 2000 and the lien has been released. (f/m/v now of $1,000,000).

(13) "J.R.'s retirement plan," prior to his marriage to Sue Ellen, Ewing Gas had contributed $500,000 to J.R.'s qualified retirement plan; during their marriage, Ewing Gas has contributed another $1,000,000. (f/m/v today of the plan is $3,000,000).

"He Really Left it to Beaver"

After 30 years the marriage of Ward and June Cleaver has just come to an end by reason of Ward's death last month. Ward and June had two children of the marriage, Walter and Theodore (the Beaver), both adults. Ward's valid will has been duly probated as a muniment of title.

Ward's will, dated 1990, leaves all of his property to Beaver.

Among the significant community property assets of June and Ward on hand at Ward's death are items 1-13:

1. Household furnishings, jewelry and personal effects – "personalty."

2. Auto in Ward's name and another auto in June's name – "the autos."

3. Home in names of June and Ward acquired in 1985 (the deed does contain survivorship language) – "home."

4. Cash in joint account of Ward and June (the signature card does not contain survivorship language) – "checking account."

5. 1,000 shares of IBM, Inc., common stock in Ward's name – "Ward's stock."

6. Cash in the form of a certificate of deposit in Ward's name payable on death to June, balance $100,000 – "$100,000 C.D."

7. Cash in a savings account in Ward's name as trustee for April Cleaver (Ward's sister) – "the savings account."

8. The $200,000 insurance policy on Ward's life, which is held in Ward's name and made payable at Ward's death to Ward's mother, if she survives Ward, if not to Ward's estate – cash surrender value of $10,000, face value $100,000 – "the $100,000 policy."

9. $300,000 in a qualified retirement plan due to Ward's employment and made payable at Ward's death in a lump sum to the Beav – "Ward's retirement plan."

10. Cash in the form of a certificate of deposit in June's name as trustee for Ward, balance $200,000 – "$200,000 C.D."

11. 1,000 shares of General Motors common stock held in June's name – "June's stock."

12. $400,000 policy on June's life, which is held in June's name and made payable at June's death to Ward, cash surrender value $10,000, face value $400,000 – "the $400,000 policy."

13. $600,000 in June's qualified retirement plan at work; in the event of June's death, the death benefits are payable to Ward – "June's retirement plan."

Keeping Your Cool ($$$)

Arthur Fonzerelli ("The Fonz") and LaVern DeFazio were married a year ago and now reside in Lacy-Lakeview, Texas. Prior to the marriage, LaVerne lived in Wisconsin; the Fonz moved to Texas in 1983 following the cancellation of his T.V. show. Due to his success as an actor the Fonz accumulated a very large estate consisting of real and personal property located now in Texas. He now works as a high priced model for a leather jacket manufacturer at the Dallas Trade Mart.

LaVerne gave up her job as a "bottle capper" at a brewery in Wisconsin to marry the Fonz; she brought to Texas only her clothing and a few personal effects. She is not working outside the home and enjoys accompanying Fonz on his trips.

Prior to the wedding, Fonz asked LaVerne to sign an agreement that Fonz's Texas Lawyer had prepared. Fonz had explained that "anyone who marries me does it for my 'cool,' not my money." LaVerne then moved to Texas, signed the agreement and married Fonz in less than a week's time.

The agreement provides that:

1. The property owned by Fonz prior to marriage shall remain his separate property.

2. The property owned by LaVerne prior to marriage shall remain her separate property.

3. All property acquired by either spouse by gift or inheritance will be the acquiring spouse's separate property.

4. The income from a spouse's separate property shall remain the owner's separate property.

5. Fonz's personal earnings and salary will be his separate property and LaVerne's personal earnings and salary shall be her separate property.

6. Each waives any claims for reimbursement, any right to a probate homestead, a family allowance and exempt personal property.

7. In the event of divorce, neither spouse will assert a claim against, or an interest in, the other spouse's separate property.

8. In the event of death, the surviving spouse will not assert any claim to, or an interest in, the deceased spouse's separate property; and the personal representative and heirs and devisees of the deceased spouse will not assert any claims to, or interest in, the surviving spouse's separate property.