# MARITAL PROPERTY AND ESTATE PLANNING ISSUES: CHARACTERIZATION AND ATTACKING TRUSTS, FAMILY LIMITED PARTNERSHIPS (FLPs), ETC.


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Family Law Practice Manual Committee of the State Bar of Texas - 1993-1994
Dallas Association of Young Lawyers - Chair of CLE Committee - 1995-1997
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Speaker - "1993 Legislative Update" - Plano Bar Association, 1993
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Speaker -"Working as an Expert Witness" - 5th Annual Dallas Chapter TSCPA Divorce Conference - 1996
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Speaker - "Trying a Property Case on a Shoestring" - State Bar of Texas Marriage Dissolution Institute - 1997
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Speaker - "Stock Options and Pension Plans", 6th Annual Dallas Chapter TSCPA Divorce Conference - Dallas Chapter TSCPA - 1997
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Speaker - "Pre-Nuptial Agreements", Advanced Drafting: Estate Planning and Probate Course, State Bar of Texas - 1997
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# MARITAL PROPERTY AND ESTATE PLANNING ISSUES: CHARACTERIZATION AND ATTACKING TRUSTS, FAMILY LIMITED PARTNERSHIPS (FLPS), ETC.

## I. SCOPE OF ARTICLE

This paper is an attempt to familiarize the family law practitioner with the concepts of trusts and family limited partnerships and how to deal with the issues they present on divorce. There is a general discussion regarding the characterization of property under the Texas community property system. It includes an analysis of the community property system, a review of the Texas constitutional provisions, a discussion of the importance of characterization and the methodologies used in determining the characterization of property. The concepts of characterization discussed in this paper are themselves the subject of lengthy articles. Therefore, this article should be viewed as a starting point with respect to more detailed research. This article is not a "how to" guide or "how to draft" a trust or partnership agreement. Other than brief references to tax implications, there is no in depth discussion of the Internal Revenue Code ("IRC") or its effect on marital estates. Finally, there is a brief discussion regarding offshore trusts.

## II. INTRODUCTION

Estate planners and financial consultants have historically been advising their clients to utilize living trusts, testamentary trusts and family limited partnerships (FLPS) as an effective means of planning for the future. The primary motive for the creation of trusts and FLPS is to allow the parties to take advantage of income and estate tax savings and to insulate the donor(s) property from liability from third party creditors. However, dealing with trusts and FLPS at the time of divorce presents an extremely difficult situation. Even though their creation and existence are susceptible to attack on divorce, a successful challenge may result in such negative tax implications to the client that other alternatives must be explored. An ethical issue is also raised in the drafting of such instruments. Whenever a document will alter the respective rights of either spouse, each spouse should have his or her own independent counsel to advise them on the potential adverse effects. Failure to do so may result in alleged breach of fiduciary duty by the attorney, and possibly by the spouse initiating the formation of such a trust or partnership.

## III. THE COMMUNITY PROPERTY SYSTEM

### A. In General.

Texas utilizes the community property system to determine the property rights of a husband and wife. Marital property is separate, community or mixed. All property of whatever kind acquired by the husband and wife, or either of them, during the marriage is community property of the two spouses, except for property meeting the definition of separate property.

The character of property is determined by operation of law according to the time and circumstances of acquisition. Property acquired before marriage by any method, or during marriage by gift, devise, or descent, is separate property. Recovery for personal injuries is separate property, subject to narrow exceptions. Property purchased with separate funds is separate property. Property correctly specified as separate property in an enforceable premarital agreement and community property partitioned in the manner provided by statute constitutes separate property. All other property, whether acquired by the husband or the wife or by their joint efforts, is community property.

Finally, separate property that is converted to community property pursuant to the Texas Family Code ("TFC")[1] will also be community property subject to division by the Court.

1. Community Property.

Texas law does not define community property any more specifically than all property acquired by either the husband or wife during marriage, except that property which is the separate property of either the husband or the wife. The Supreme Court has held that no other definition is necessary. Lee v. Lee, 247 S.W. 828 (Tex. 1923). The principle foundation of the community property system is that whatever is acquired by the efforts of either the husband or wife shall be their common property. This is true, even though one spouse contributed nothing to the acquisitions, and the acquisitions of properties were wholly attributable to the other spouse's industry. Graham v. Franco, 488 S.W.2d 390 (Tex. 1972).

2. Texas Constitution.

No specific definition of community property is contained in Article XVI, § 15 of the Texas Constitution. Rather, the Texas Constitution merely states the following:

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[1] Texas Family Code Ann. (Vernon 1998) (as amended) [hereinafter "TFC"].

> **. . .** laws shall be passed more clearly defining the rights of the spouse in relation to separate and community property **. . .**

3. Texas Family Code.
   TFC § 3.002 defines community property as follows:

> Community property consists of the property, other than separate property, acquired by either spouse during marriage.

Id.

Quite simply, all marital property, not specifically within the scope of the statutory and constitutional definition of separate property, is by implication excluded, and therefore is community property regardless of how it was acquired. Hilley v. Hilley, 342 S.W.2d 565 (Tex. 1961); Arnold v. Leonard, 273 S.W. 799 (Tex. 1925). Property acquired by the joint efforts of the spouses, was regarded as acquired by "onerous title" and belonged to the community. Graham, 488 S.W.2d at 393. The rule is the same regardless of whether the new acquisition is the result of the husband or wife's individual labor, skill, or profession. Norris v. Vaughan, 260 S.W.2d 676 (Tex. 1953).

**B. Separate property**

1. Texas Constitution.
   Art. XVI, § 15 defines separate property as:

> All property, both real and personal, a spouse owned or claimed before marriage, and that acquired afterwards by gift, devise, or descent, shall be the separate property of that spouse.

The 1980 amendment to § 15 revised that part of the constitutional provision (added in 1948) to allow an agreement to partition community property to include partition of property existing or to be acquired, and to include income from separate property:

Art. XVI, § 15 now includes the following:

> **. . .** provided that persons about to marry and spouses, without the intention to defraud pre-existing 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 othercommunity 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 also may 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; 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.

Id. (*emphasis added*.)

Marital property agreements can significantly alter Texas marital property law. In 1999, the final phrase was added to Article XVI, § 15 of the Constitution to permit spouses to agree that their separate property would become community property. The enabling legislation is contained within §§ 4.201-.206 of TFC.

2. Texas Family Code.
   TFC §3.001 defines the separate property of a spouse:

> A spouse's separate property consists of:
>
> a. the property owned or claimed by the spouse before marriage;
> b. the property acquired by the spouse during the marriage by gift, devise, or descent; and
> c. the recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage.

Although Texas courts have held that the legislature is without power to enlarge or to diminish the scope of the constitutional definition of separate property, the language of the statute providing for recovery for personal injuries to the body of a spouse, including disfigurement and physical pain and suffering, as being separate property is within the scope of the constitutional provision and therefore valid. Graham, 488 S.W.2d at 395; Schwirm v. Bluebonnet Express. Inc., 489 S.W.2d 279 (Tex. 1973).

TFC §4.102 provides that:

> At any time, the spouses may partition or exchange between themselves any part of their community property, then existing or to be acquired, as the spouses may desire. Property or a property interest transferred to a spouse by a partition or exchange agreement becomes that spouse's separate property. (*emphasis added)*

Id.

TFC §4.103 provides that:

> At any time, the spouses may agree that the income or property arising from the separate property that is then owned by one of them, or that may thereafter be acquired, shall be the separate property of the owner. (*emphasis added)*

Id.

3. Separate Property Summary.

In summary, separate property consists of:

a. Property owned or claimed by a spouse before marriage;
b. Property acquired during marriage by gift;
c. Property acquired during marriage by devise or descent;
d. Future community property that persons about to marry have agreed in writing, in a premarital agreement, will be separate property;
e. Current or future community property that spouses have agreed in writing in a partition or exchange agreement will be separate property;
f. Income or property derived from a spouse's existing or future separate property that spouses have agreed will be separate property pursuant to a partition or exchange agreement;
g. All income or property arising from a gift of property from one spouse to the other spouse;
h. Pursuant to a survivorship agreement, any part of the community property that the spouses have agreed in writing shall become the property of the surviving spouse on the death of the other spouse; and
i. Property received as recovery for personal injuries sustained by a spouse during marriage, except any recovery for loss of earning capacity.

4. Community Property Summary.

a. All income and property acquired by either spouse during marriage, other than separate property; and
b. Current separate property of either or both spouses that the spouses have agreed in writing to convert to community property.

5. The Importance of Characterization.

The community property concept is treated in detail in Chapter 3 of the TFC. Characterization of property is necessary for the proper determination of the rights of each spouse upon divorce. §7.001 of the TFC provides for division of property in a suit for dissolution of marriage by divorce or annulment, and states that:

> In a decree of divorce or annulment, the court shall order a division of the estate of the parties in a manner that the court deems just and right, having due regard for the rights of each party and any children of the marriage.

Id.

The starting point in a contested property case is establishing the nature of the property to be divided as separate or community. Muns v. Muns, 567 S.W.2d 563 (Tex. Civ. App. - Dallas 1978, no writ); Cooper v. Cooper, 513 S.W.2d 229 (Tex. Civ. App. -Houston [1st Dist.] 1974, no writ). The trial court, pursuant to the mandate of §7.001 to divide the estate of the parties having due regard for the rights of each party, must determine the character of the marital property, in light of the definition provided by the constitution and the statutes.

While the trial court has broad latitude in the division of the community estate, it does not have the discretion to award separate real or personal property of one spouse to the other spouse. Eggemeyer v. Eggemeyer, 554 S.W.2d 137 (Tex. 1977) (real property); Cameron v. Cameron, 641 S.W.2d 216 (Tex. 1982)(personal property). Additionally, the trial court has no authority to divest an interest in separate property, even though the interest is small, and to require the spouses to maintain a tenancy-in-common. *See* Whorrall v. Whorrall, 691 S.W.2d 32 (Tex. Civ. App. - Austin 1985, writ dism'd) (husband owned a separate 9/10 of 1% interest in house as his separate property).

Ability to characterize marital property as separate or as community is essential if the lawyer is to properly discharge his or her professional responsibility to the client. *See* Cearley v. Cearley, 544 S.W.2d 661 (Tex. 1976); Busby v. Busby, 457 S.W.2d 551 (Tex. 1970).

## IV. ESTABLISHING THE CHARACTER OF PROPERTY

The basic rules of characterization are: (1) property acquired before marriage or brought into marriage is separate property; (2) property acquired during the marriage is presumed to be community property, but this presumption may be overcome by showing (a) acquisition by gift or inheritance, (b) mutation of separate property demonstrated by tracing, or (c) the existence and validity of a premarital agreement or partition or exchange agreement.

### A. Doctrine of Inception-of-Title.

The character of property as separate or community is determined at the time and under the circumstances of its acquisition. Bradley v. Bradley, 540 S.W.2d 504 (Tex. Civ. App. - Fort Worth 1976, no writ). Hilley, 342 S.W.2d 565.

Property is characterized as separate or community at the time of "inception of the title". Saldana v. Saldana, 791 S.W.2d 316 (Tex. App. - Corpus Christi 1990, no writ). Under the inception of title doctrine, the character of property, whether separate or community, is fixed at the time of acquisition. Henry S. Miller Co. v. Evans, 452 S.W.2d 426 (Tex. 1970); Colden v. Alexander, 171 S.W.2d 328 (Tex. 1943); Villarreal v. Villarreal, 618 S.W.2d 99 (Tex. Civ. App. - Corpus Christi 1981, no writ).

The terms “owned and claimed” as used in the Constitution and the TFC mean that if the right to acquire the property accrued before the marriage, the property is separate, even though the legal title or evidence of the title is not obtained until after marriage. Inception of title occurs when a party first has a right of claim to the property by virtue of which title is finally vested. Jensen v. Jensen, 665 S.W.2d 107 (Tex. 1984); Welder v. Lambert, 44 S.W. 281 (Tex. 1898). The existence or non-existence of the marriage at the time of incipiency of the right by which title eventually vests determines whether property is community or separate. Jensen, 665 S.W.2d 107. The word “acquired” as used in the Constitution and TFC refers to the inception of the right, rather than the completion or ripening thereof. Where a contract to purchase was entered into before marriage, although the title is not finally obtained until after marriage, the property becomes the separate property of the purchaser-spouse. The watershed case of Welder v. Lambert establishes the rule that title and ownership refer back to the time of making the contract. 44 S.W. at 287.

1. Property Acquired Before Marriage.

Once character as separate property has attached, it is immaterial that part of the unpaid purchase price is thereafter paid from community funds, since the status of property as being either separate or community is determined at the time of acquisition and such status is fixed by the facts of the acquisition. Villarreal, 618 S.W.2d 99; Hilley, 342 S.W.2d 565; Lindsay v. Clayman, 254 S.W.2d 777 (Tex. 1952); Grost v. Grost, 561 S.W.2d 223 (Tex. Civ. App. - Tyler 1977, writ dism'd). In such a case, the community estate is entitled only to a claim from the separate estate. Colden v. Alexander, 171 S.W.2d 328 (Tex. 1943); Bishop v. Williams, 223 S.W. 512 (Tex. Civ. App. - Austin 1920, writ ref'd).

2. Property Acquired During Marriage.

Property with respect to which inception of title occurs during marriage is community property unless it is acquired in one of the following manners, in which event it is the separate property of the acquiring spouse:

- by gift;
- by devise or descent;
- by a partition or exchange agreement or premarital agreement specifying that the asset is separate;
- as income or property from separate property made separate by a partition or exchange agreement entered into by the spouses;
- by survivorship;
- in exchange for other separate property; or
- as recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage.

A problem sometimes arises as to just what step in the purchase of property marks the acquisition of ownership, or inception of title. Is the ownership of land acquired, for example, when an earnest money contract is signed or does it occur at closing?

It is well established that a claim to real property can arise before the legal title or evidence of title has been attained. The Supreme Court in Welder, 44 S.W.2d 281, established the rule that title and ownership refer back to the time of making the contract. In Welder, a contract right giving the husband the right to acquire land was obtained before marriage, but the conditions of the contract were not met until after marriage, at which time title vested. The court held that the property was the husband's separate property because his claim to the property was acquired before marriage. Id.

In Wierzchula, 623 S.W.2d 730, the husband entered into an earnest money contract to purchase a home before marriage. He applied as a single man for a home loan and was issued a certificate of loan commitment as a single man. Thereafter, the parties were married and the husband received a deed conveying the property to him after marriage. The court held the house to be the separate property of the husband:

> In our case, the appellee acquired a claim to the property at the time the purchase money contract was entered into. The earnest money date being prior to the marriage of the parties, the appellee's right of claim to the property preceded the marriage, and the character of the property as separate property was established and the community property presumption was rebutted. (*emphasis added)*

Id. at 732-733.

When even a parol contract for purchase of land is made before marriage, and title to the land is received by the spouse after marriage, the parol contract constitutes such an equitable right to purchase prior to marriage as to establish the character as separate. Evans v. Ingram, 288 S.W. 494 (Tex. Civ. App. -Waco 1926, no writ).

However, in Duke v. Duke, 605 S.W.2d 408 (Tex. Civ. App. - El Paso 1980, writ dism'd), the earnest money contract for purchase of realty had been entered into by the husband prior to marriage, was signed only by the husband, and the husband paid $500 earnest money listed as part of the consideration. The earnest money contract provided that the property would be conveyed to both the husband and the wife and the property was conveyed to both the husband and the wife as grantees by warranty deed after marriage. Id. at 410. The court held:

> Title to the property was by the deed and, being in both of their names and acquired during marriage, prima facie establishes that the property is community property. Title is from the deed, and the contract of sale is merged in it . . . . It is a rule of general application that in the absence of fraud, accident or mistake, all prior agreements entered into between the parties are considered merged in the deed.

Id. at 410.

In Carter v. Carter, 736 S.W.2d 775 (Tex. App. - Houston [14th Dist.] 1987, no writ) husband signed an earnest money contract for a house on October 29, 1974, prior to the December 7, 1974, marriage. The closing took place on January 15, 1975, and both husband and wife signed the note and deed of trust. The wife claimed that there was insufficient "clear and convincing evidence" that husband had acquired the right to title in the property prior to marriage, basing her argument on the fact that the earnest money contract was not offered into evidence and on the lack of evidence to indicate when the contract was accepted by the seller. Id. at 779. The court held:

> Ownership of real property is governed by the rule that the character of title to property as separate or community depends upon the existence or nonexistence of the marriage at the time of the incipience of the right in virtue of which the title is finally extended and that the title, when extended, relates back to that time. Appellee acquired a right to title to the property when he entered into the earnest money contract. As the date of execution of the earnest money contract was prior to the marriage, appellee's right to title preceded the marriage and the separate character of the property was thereby established . . . . The date of acceptance by the seller is not relevant. (*emphasis added)*

Id. at 779.

In Carter the wife also contended that the earnest money contract merged into the deed; therefore, the right to acquire the property ripened after marriage. The wife cited Duke, 605 S.W.2d 408, to support her proposition. The court stated:

> However, though the earnest money contract in Duke had been entered into prior to marriage, it provided that the property would be conveyed to "James H. Duke and wife, Barbara J. Duke . . . . " In this case there is no evidence that both spouses were named in the earnest money contract. Therefore, Duke is not applicable . . . . "

Id. 736 S.W.2d at 780.

**B. Presumption of community property**.

1. In General.

An evaluation of the legal rights of divorcing parties begins with the community property presumption. TFC §3.003(a), provides:

> Property possessed by either spouse during or on dissolution of marriage is presumed to be community property.

Id. TFC §3.003(b) states that:

> The degree of proof necessary to establish that property is separate property is clear and convincing evidence.

Id.

The statute creates a rebuttable presumption that all property possessed by husband and wife upon divorce is community property and imposes the burden upon one asserting otherwise to prove the contrary by clear and convincing evidence. Tarver v. Tarver, 394 S.W.2d 780 (Tex. 1965); Schreiner v. Schreiner, 502 S.W.2d 840 (Tex. Civ. App. - San Antonio 1973, writ dism'd). The statutory presumption of §3.003(a) makes no distinction between property acquired before marriage and that acquired after the marriage; it refers to property "possessed" by either spouse.

Since property possessed by either husband or wife during or on dissolution of marriage is presumed to be community property, it makes no difference whether the conveyance is in form to the husband, to the wife, or to both. McGee v. McGee, 537 S.W.2d 94 (Tex. Civ. App. - Amarillo 1976, no writ); Hilley, 342 S.W.2d 565.

2. Rebuttal of Presumption.

The statutory presumption that property possessed by either spouse upon dissolution of the marriage is community is a rebuttable presumption and is overcome by evidence that a specific item of property is the separate property of one spouse or the other. Jackson v. Jackson, 524 S.W.2d 308 (Tex. Civ. App. - Austin 1975, no writ). Because the presumption is rebuttable, the general rule is that to discharge the burden imposed by the statute, a spouse, or one claiming through a spouse, must trace and clearly identify property claimed as separate property. McKinley v. McKinley, 496 S.W.2d 540 (Tex. 1973). The Supreme Court has clearly held that the statute creates only a rebuttable presumption. In Tarver, Chief Justice Calvert wrote:

> The plain wording of the statute creates a rebuttable presumption that all property possessed by a husband and wife when their marriage is dissolved is their community property and imposes the burden upon one asserting otherwise to prove the contrary by satisfactory evidence.

Id. at 783.

**C. What constitutes separate property**.

1. Property Owned or Claimed Before Marriage.

Any property owned or claimed by a spouse before marriage remains the separate property of that spouse after marriage. Tex. Const. Art. XVI, §15; TFC §3.001. *See* Tarver, 394 S.W.2d 780, (evidence showed husband received conveyance of specific land before marriage, land was his separate property); Norris, 260 S.W.2d 676, (husband's interest in partnership acquired before marriage is separate property, although salary and profits from partnership during marriage were community property).

2. Property Acquired by Gift

a. In General.

Property acquired by a spouse by gift, whether before or during the marriage, is separate property. Tex. Const. Art. XVI, §15; TFC §3.001.

If one spouse makes a gift of property to the other, the gift is presumed to include all the income and property which may arise from that property. Tex. Const. Art. XVI, §15; TFC §3.005.

A "gift" is a voluntary transfer of property to another made gratuitously and without consideration. Hilley, 342 S.W.2d 565; Bradley, 540 S.W.2d 504. There are three elements necessary to establish the existence of a gift: (1) intent to make a gift; (2) delivery of the property, and (3) acceptance of the property. Harrington v. Bailey, 351 S.W.2d 946 (Tex. Civ. App. - Waco 1961, no writ); Sumaruk v. Todd, 560 S.W.2d 141 (Tex. Civ. App. - Tyler 1977, no writ); Pankhurst v. Weitinger & Tucker, 850 S.W.2d 726 (Tex. App. - Corpus Christi 1993, writ denied). Generally, one who is claiming the gift has the burden of proof. Grimsley v. Grimsley, 632 S.W.2d 174 (Tex. App. - Corpus Christi 1982, no writ).

Harmon v. Schmitz, 39 S.W.2d 587 (Tex. Comm'n App. - 1931, holding approved) is one of the early discussions of an effective gift. The court said:

> To constitute a valid gift inter vivos the purpose of the donor to make the gift must be clearly and satisfactorily established and the gift must

> be complete by actual, constructive, or symbolic delivery without power of revocation.

Id. *See also* Akin v. Akin, 649 S.W.2d 700 (Tex. App. - Fort Worth 1983, writ ref'd n.r.e.); Kennedy v. Beasley, 606 S.W.2d 1 (Tex. Civ. App. - Houston [1st Dist.] 1980, writ ref'd n.r.e.).

The promise to give property in the future is generally not a gift, being unenforceable without consideration. Woodworth v. Cortez, 660 S.W.2d 561, 564 (Tex. App. - San Antonio 1983, writ ref'd n.r.e.). Our courts have held that the crucial point of inquiry is the intent of the asserted donor. The controlling factor in establishing a gift is the donative intent of the grantor at the time of the conveyance. Ellebracht v. Ellebracht, 735 S.W.2d 659 (Tex. App. - Austin 1987, no writ). If a fair inference exists that a gift was intended, then there remains the question of did the donor intend for it to be effective at that time or in the future? An effective means of determining if an immediate gift were intended is to inquire if the possession were delivered to the donee. Hester v. Hester, 205 S.W.2d 115 (Tex. Civ. App. - Fort Worth 1947, no writ).

Delivery of the property should be such that all dominion and control over the property is released by the owner. *See* Harmon v. Schmitz, 39 S.W.2d 587 (Tex. Comm'n App. 1931, Judgment adopted). Actual delivery is not always necessary; rather, where the circumstances make actual delivery impractical, delivery may be symbolic or constructive. Bridges v. Mosebrook, 662 S.W.2d 116 (Tex. App. - Fort Worth 1983, writ ref'd n.r.e.); Mortenson v. Trammell, 604 S.W.2d 269 (Tex. Civ. App. -Corpus Christi 1980, writ ref'd n.r.e.).

b. Property Acquired by Devise or Descent.

Whether by devise or decent, legal title vests in beneficiaries upon the death of the decedent. Texas Probate Code §37. Johnson v. McLanglin, 840 S.W.2d. 668 (Tex. App. - Austin 1992, no writ). Any interest devised to a spouse, whether a fee or a lesser interest will belong to that spouse as separate property. Sullivan v. Skinner, 66 S.W. 680 (Tex. Civ. App. 1902, writ ref'd). In Sullivan, the wife was willed property "for the term of her natural life, with full power to receive for her sole and separate use, and no other, the rents and profits of the same, and on her death the same to belong to any child or children of the wife." The rents and profits were held to be her separate property. Id.

An expectancy has been held to be a present existing right. Barre v. Daggett, 153 S.W. 120 (Tex. 1913); Martin v. Martin, 222 S.W. 291 (Tex. Civ. App. - Texarkana 1920, writ ref'd). Property received in consideration of the assignment and release of the heir's expectancy is in the nature of property acquired by descent and is therefore the separate property of the spouse receiving it. In Barre, 153 S.W. 120, the court stated:

> The status of the expectancy, as a separate or community right and interest, would be determined, we think, by the character of the right in which it had its origin. Without question the expectancy here, if and when it shall fall into possession, would follow, under the laws of descent and distribution, from the fact that Mrs. Barre was in the relation of child. So, in measuring the legal rights of Mrs. Barre, the expectancy, or contingent interest, in controversy, should be, it is not doubted, treated and regarded as a separate, and not community, right and interest of Mrs. Barre, and controlled as to ownership and sale, by the laws governing in such respects.

Id.

c. Recovery for Personal Injuries.

The recovery for personal injuries sustained by a spouse during marriage, except for recovery for loss of earning capacity during marriage, is the separate property of the injured spouse. TFC §3.001(3).

d. Attempted Gifts to the Community.

An attempted gift to the community estate by a spouse has been held to be entirely ineffective. Tittle v. Tittle, 220 S.W.2d 637 (Tex. 1949), (deed from husband to wife and husband reciting purpose of converting separate property into community property ineffective). In Higgins, 458 S.W.2d 498, the court held as a matter of law that there was not, nor could there be, a gift to the community. The court quoted an earlier opinion: "There is no warrant in law or logic for the proposition that the separate property of either spouse may be the subject of a gift to the community estate . . . . " Id.

Under this analysis, if a third person attempts to make a gift to the community estate, each spouse will acquire an undivided one-half interest as separate property, and not as a community property. Kamel v. Kamel, 721 S.W.2d 450 (Tex. App. - Tyler 1986, no writ); McLemore v. McLemore, 641 S.W.2d 395 (Tex. App. -Tyler 1982, no writ).

**D. Presumption of separate property**.

1. When Presumption Arises.

Generally property possessed by either husband or wife during, or on, dissolution of marriage is presumed to be community property, and it makes no difference whether the conveyance is in form to the husband, to the wife, or to both. However, a presumption of separate property arises when (1) one spouse is grantor and the other spouse is grantee; (2) one spouse furnishes separate property consideration and title is taken in the name of the other spouse; or (3) the instrument of conveyance contains a "separate property recital" or a "significant recital."

2. Separate Property Recital Defined.

A recital in the instrument of conveyance is considered to be a "separate property recital" if it states that the consideration is paid from the separate funds of a spouse.

3. Significant Recital Defined.

A recital in the instrument of conveyance is considered to contain a "significant recital" if it states that the property is conveyed to a spouse as his or her separate property.

4. Conveyance Containing No Separate Property Recital.

a. Third Party Grantor - Normal Community Property Presumption.

When the deed is from a third party as grantor to either spouse, or to both of the spouses, as grantee, and the conveyance does not contain a separate property recital, the normal community property presumption can be rebutted by parol evidence that the consideration was paid from the separate funds of one of the spouses. Cooper, 513 S.W.2d 200; *see also* Binford v. Snyder, 189 S.W.2d 471 (Tex. 1945) (trespass to try title suit where deed from grantor to grantee recited $100 consideration, grantee was allowed to show by parol evidence no money was paid and purpose was to reinvest grantee with title held by grantor as Trustee.)

b. Wife as Grantee.

Van v. Webb, 215 S.W.2d 151 (Tex. 1948); Patterson v. Metzing, 424 S.W.2d 255 (Tex. Civ. App. - Corpus Christi 1967, no writ); Skinner v. Vaughan, 150 S.W.2d 260 (Tex. Civ. App. - El Paso 1941, writ dism'd jdgmt. cor.).

c. Husband as Grantee.

Alexander v. Alexander, 373 S.W.2d 800 (Tex. Civ. App. - Corpus Christi 1963, no writ); Bridges, 662 S.W.2d 116.

d. Both Spouses Named as Grantees.

Where it is shown that the conveyance was a gift and both husband and wife are named as grantees, the gift of the property vests in each spouse an undivided one-half interest as separate property. White, 179 S.W.2d 503; Von Hutchins v. Pope, 351 S.W.2d 642 (Tex. Civ. App. -Houston 1961, writ ref'd n.r.e.); Connor v. Boyd, 176 S.W.2d 212 (Tex. Civ. App. - Waco 1943, writ dism'd w.o.m.).

5. Spouse as Grantor - Presumption of Gift.

When the conveyance is from the husband to the wife as grantee, and contains no separate property recital, the normal community property presumption is replaced by the presumption that the husband is making a gift to the wife, in the absence of parol evidence to rebut the presumption of gift. Dalton v. Pruett, 483 S.W.2d 926 (Tex. Civ. App. -Texarkana 1972, no writ); Babb v. McGee, 507 S.W.2d 821 (Tex. Civ. App. - Dallas 1974, writ ref'd n.r.e.); Carriere v. Bodungen, 500 S.W.2d 692 (Tex. Civ. App. -Corpus Christi 1973, no writ).

*See* Powell v. Jackson, 320 S.W.2d 20 (Tex. Civ. App. - Amarillo 1958, writ ref'd n.r.e.), presumption of gift arises when one spouse conveys separate property to the other spouse. *See also* Purser, 604 S.W.2d 411; Whorrall, 691 S.W.2d 32.

6. Spouse Furnishes Separate Property Consideration – Presumption of Gift.

Where one spouse uses separate property consideration to pay for property, acquired during the marriage and takes title to the property in the name of the other spouse or both spouses jointly, the presumption is that a gift is intended. Cockerham, 527 S.W.2d 162; Peterson v. Peterson, 595 S.W.2d 889( Tex. Civ. App. - Austin, writ dism'd); Hampshire, 485 S.W.2d 314; Carriere, 500 S.W.2d 692; Van Zandt v. Van Zandt, 451 S.W.2d 322 (Tex. Civ. App. -Houston [1st Dist.] 1970, writ dism'd).

In Peterson, the court held that, when a husband uses his separate property to pay for land acquired during the marriage and takes title to the land in the name of husband and wife, it is presumed he intended the interest placed in the wife to be a gift; however, the presumption is rebuttable and parol evidence is admissible to show that a gift was not intended. Peterson, supra.

7. Conveyance Containing Separate Property Recital or Significant Recital.

The presumption in favor of the community as to land acquired in the name of either spouse during the marriage is replaced by a presumption in favor of the separate estate of a spouse where the deed of acquisition recites either that the land is conveyed to the spouse as his or her separate property, or that the consideration is from his or her separate estate, or includes both types of recitation. Henry S. Miller Co., 452 S.W.2d 99. *See also* Magee v. Young, 198 S.W.2d 883 (Tex. 1946); Little v. Linder, 651 S.W.2d 895 (Tex. App. - Tyler 1983, writ ref'd n.r.e.). Under these circumstances the party contesting the separate character must produce evidence rebutting the separate property presumption. Trawick v. Trawick, 671 S.W.2d 105 (Tex. App. - El Paso 1984, no writ).

Where the deed recites that the consideration paid, and to be paid shall be out of the separate property or funds or estate of a spouse, it is immaterial that a promissory note is executed for a portion of the purchase price. The property is separate in character. Smith v. Buss, 144 S.W.2d 529 (Tex. 1940).

8. When Separate Property Presumption is Rebuttable.

Generally a presumption created by the form of conveyance is rebuttable. In some cases, the intentions of the parties are controlling, and intentions may be judged by the facts surrounding the case.

In Carter, 736 S.W.2d 775, the husband signed an earnest money contract and paid the earnest money prior to marriage. The closing took place after marriage, and the deed was made to both spouses. Husband testified that he did not intend to make a gift of a one-half interest in the house to wife and that he did not request that both names be placed on the deed. Rather, he merely accepted and signed the papers prepared by the savings and loan company, and he had recently moved to Texas from Michigan and was unfamiliar with Texas community property laws. The court held there was no evidence of a gift and any such presumption was rebutted by the evidence. Id.

In Peterson, 595 S.W.2d 889, the husband purchased a house with separate property funds 28 days after marriage. On the day he was notified the sale was ready to close, he phoned wife to advise her of the closing. Husband testified that it was at that point that he learned that his wife would not move into the house with him unless her name appeared on the deed, and testified that:

> . . . I was real shocked. I didn't know what to do. I had just been married. I really didn't want to stir up any trouble at that early [stage] of a marriage . . . so I called . . . and asked . . . if we could get her name added to the deed right away . . . .

Id.

The wife's name was subsequently added to the deed and the sale was consummated. Husband testified that he did not intend to make a gift to wife of any interest in the house, but that he added her name to make her happy and to assure her that "she had a place to live the rest of her life," and "then at her death, it would be passed on to my children." The court found that the presumption of gift created by the taking of title in the name of husband and wife was rebutted by evidence establishing no intent to make a gift. Id.

9. When Presumption is Irrebuttable.

When offered by a party to the transaction, or by one in privity with a party, parol evidence is not admissible to rebut a separate property recital in the absence of allegations entitling the party to equitable relief. Messer v. Johnson, 422 S.W.2d 908 (Tex. 1968); Lindsay, 254 S.W.2d 777; Hodge v. Ellis, 277 S.W.2d 900 (Tex. 1955); Kahn, 58 S.W. 825.

In Loeb v. Wilhite, 224 S.W.2d 343 (Tex. Civ. App. - Dallas 1949, writ ref'd n.r.e.), the husband caused a deed to be made to his wife conveying certain property to her for consideration recited to have been paid out of her separate funds and her assumption of an outstanding indebtedness. The deed conveyed the property to the wife as her separate property. It was sought to show that the property was paid for by community funds, and that a resulting trust arose in favor of plaintiff, a daughter by a former marriage, to an undivided one half interest. Evidence was introduced, over the objection of the surviving widow (who had since married Loeb) as to a prior agreement between husband and wife that she should take the property in her own name and as her separate estate for the protection of the community. In reversing and rendering the case in favor of the wife, the court of appeals held such evidence inadmissible in the absence of any allegations of fraud, accident or mistake. (emphasis added) Id.

In Letcher v. Letcher, 421 S.W.2d 162 (Tex. Civ. App. - San Antonio 1967, writ dism'd), the husband conveyed community property to wife by deed which noted $10.00 and other valuable consideration paid by wife "out of her own property and estate", and "to her sole and separate use and benefit" all of the husband's undivided right, title, and interest in the property. Upon divorce, husband attempted to introduce evidence that he made in the conveyance in an effort to protect the property from judgment creditors. The court held:

> As a matter of law, the [husband] is precluded from showing any agreement, understanding, or interest contrary to the unequivocal language in the deed.

Id.

In Lindsay v. Clayman, supra, husband joined with wife in an installment sale contract for certain lots "for and in consideration of the sum of $950 to be paid by Mrs. Frances M. Lindsay out of her separate funds . . . as her separate property and for her own separate use and estate". Id. The contract further provided that upon payment of the purchase price "to promptly execute and deliver to the said Frances M. Lindsay a general warranty deed conveying such property to her as separate property . . . ." Subsequently, the seller executed and delivered the deed which recited payment out of wife's separate funds and conveyed to wife "as her separate property and for her own separate use and estate." Husband was not a party to the deed. The court held:

> [w]here the evidence shows the third party seeking to introduce evidence to vary the recitals in the deeds is in privity with the parties to the deed, the parole evidence rule also applies to him. [Husband] was a party to the contract and in privity with the parties to the deed conveying the lots to his wife. Since the deed states the nature of the estate conferred upon the wife and the consideration being contractual, parole evidence is not admissible to contradict or vary the deed in the absence of allegation of fraud, accident or mistake.

Id.

In Little v. Linder, 651 S.W.2d 895 (Tex.Civ.App.-Tyler 1983, writ ref'd n.r.e.), the wife was the named grantee in the deed, the deed recited the consideration paid out of her money, her husband participated in the transaction in withdrawing the funds for the payment and "saw to their being mailed." The court concluded that the property was wife's separate property. The court also noted that, after receipt of the deed to wife as her separate property, "the husband with full knowledge of its contents acquiesced in conveyance to his wife without seeking a correction (if he deemed same to be incorrect) and that he joined with the wife in various instruments (deeds, mineral leases, and easements) relating to the property, all without asserting a community interest in the property." Id.

Finally, a spouse is deemed to be a party to the transaction even if he is merely present when the deed recitals are drafted. Long v. Knox, 291 S.W.2d 292 (Tex. 1956).

## V. TRUSTS

### A. Generally

Trusts are a traditional and popular tool in estate plans. Trusts are being used more and more by families as a way to protect assets and to lessen the estate tax their heirs will face. Trusts are also popular because they allow heirs to receive income from the trust assets while allowing a (presumably) more responsible person to manage the principal or corpus of the trust.

As indicated, the transfer of assets to a trust can significantly reduce the donor's taxable estate, which ultimately reduces the amount of estate tax that would be due on the death of the donor. Furthermore, placing assets into a trust can protect these assets from the trust beneficiary's creditors. Finally, a trust may also allow the donor to maintain direct or indirect control of the trust assets, while still accomplishing the above objectives.

The family law practitioner will generally encounter trusts in one of two scenarios. First, in the situation where a spouse is the beneficiary of a trust created by a third party. Second, where a spouse or spouses have created a trust, contributing community and/or separate assets, for the benefit of themselves and their children.

Under each scenario, the issues faced by the family law practitioner and the methodologies available to solve the issues presented can be and are often, quite distinct and different.

### B. What is a trust?

Pursuant to the Texas Trust Code ("TTC") § 111.003, a trust is an express trust and does not include a resulting trust, a constructive trust, a business trust or a security instrument such as a deed of trust, mortgages, or security interest as defined by the Business and Commerce Code. *(emphasis added)*

1. The Express Trust.

An express trust comes into existence by the execution of an intention to create it by one having legal and equitable dominion over the property made subject to the trust. Mills v. Gray, 147 Tex. 33, 210 S.W.2d 985, 987-88 (1948).

It has been said that when it is not qualified by the word "charitable", "resulting" or "constructive", a trust 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, arising as a result of a manifestation of the intention to create the relationship. Restatement Trust (Second) §2.

2. The Resulting Trust.

A resulting trust arises by operation of law when title is conveyed to one party while consideration is provided by another. Cohrs v. Scott, 338 S.W.2d 127, 130 (Tex. 1960). A resulting trust can arise only when title passes, not at a later time. Id. at 130. This rule, however, does not apply between spouses. Between spouses, the inception of title doctrine controls so that a resulting trust can arise only at the inception of title, even if title passes at a later time. A resulting trust also arises when a conveyance is made to a trustee pursuant to an express trust, which fails for any reason. Nolana Development Ass 'n v. Corsi, 682 S.W.2d 246, 250 (Tex. 1984). Ordinarily, the proponent of a resulting trust has the burden of overcoming the presumption of ownership arising from title by "clear, satisfactory and convincing" proof of the facts giving rise to the resulting trust, Stone v. Parker, 446 S.W.2d 734, 736 (Tex. Civ. App.--Houston [14th Dist.] 1969, writ ref'd n.r.e.). However, when marital property is in issue, the presumption of community prevails over the presumption of ownership arising from title, so proof that property is possessed by a spouse during marriage is sufficient to establish, prima facie, a resulting trust in favor of the community even where title is held in the name of one spouse alone. *See* TFC § 3.003.

3. The Constructive Trust.

A "constructive trust" is not really a trust; it is an equitable remedy. The court imposes a "constructive trust" when an equitable title or interest ought to be, as a matter of equity, recognized in someone other than the taker or holder of legal title. The Supreme Court described the doctrine as follows:

> A constructive trust does not, like an express trust, arise because of a manifestation of intention to create it. It is imposed by law because the person holding the title to property would profit by a wrong or would be unjustly enriched if he were permitted to keep the property.

Omohundro v. Matthews, 341 S.W.2d 401, 405 (Tex. 1960). *Accord*, Mills v. Gray, 147 Tex. 33, 210 S.W.2d 985, (1948).

### C. How to create an express trust.

According to §112.00 of the TTC, 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.

1. Intent to Create.

It must be clear from the instrument that the settlor manifested an intention to create the trust. TTC §112.002.

2. Consideration Not Necessary.

No consideration is necessary to create a valid express trust. However, a promise to create a trust in the future is valid only if it meets the requirements of an enforceable contract. TTC §112.003.

3. Necessity of Written Instrument.

It is mandatory that the terms of the express trust in real or personal property be in writing and be signed by the settlor, or his authorized agent. TTC §112.004. A trust consisting of personal property is only enforceable if: 1) the trust property is transferred to a trustee who is neither the settlor or beneficiary, if the transferor expresses simultaneously with, or prior to the transfer the intention to create a trust; 2) there is a written declaration by the owner that the owner holds the property for another, or for the owner and another person as beneficiary. TTC §112.004.

4. Trust Property Must Be in Existence.

A trust cannot be created unless there is trust property. TTC §112.005. One dollar has been held as sufficient to create a valid trust. In Re the Estate of Canales, 837 S.W.2d 662 (Tex. App. -San Antonio 1992, no writ).

5. Settlor's Capacity.

The capacity to create a trust is determined in the same manner as that of any other person to transfer, will or appoint free of trust. TTC §112.007. This would also encompass the authority of the settlor to transfer or will community property.

6. Capacity of Trustee.

The trustee must have the legal capacity to take, hold and transfer the trust property. If a corporate trustee, it must have powers to act under state law. Additionally, the settlor of a trust may be the trustee of the trust. TTC §112.008.

7. Acceptance by Trustee.

The signature of the person named as trustee on the writing evidencing the trust or on a separate written acceptance is conclusive evidence that the person accepted the trust. A person named as trustee who exercises power or performs duties under the trust is presumed to have accepted the trust. However, a person named as trustee who does not accept the trust incurs no liability with respect to the trust. TTC § 112.009.

8. Trust Purposes.

A trust may be created for any purpose that is not illegal. Additionally, the terms of the trust may not require the trustee to commit a criminal or tortuous act or an act that is contrary to public policy. TTC § 112.031.

9. Merger of Legal and Beneficial Title = NO TRUST.

When both the legal and beneficial title to property is transferred to the same person, no trust is created and the transferee holds the property as his own. If the equitable and legal title merge in the grantor, he then holds the property free of trust. TTC §112.034.

10. Revocation. Modification and Amendment.

Unless made irrevocable by the expressed terms of the trust or amendment, a grantor retains the right to modify the terms of a trust. However, the duties may not be enlarged without the consent of the trustee. If the trust was created by written instrument, the revocation, modification, or amendment must also be in writing. TTC §112.051.

11. Judicial Modification or Termination.

A trustee or beneficiary may petition a court to modify the terms of the trust, enlarge or restrict the trustee's power, or request that the trust be terminated. However, the court's authority to modify or terminate a trust is limited. A request to terminate or modify a trust can only be granted if: 1) the purposes of the trust have been fulfilled; 2) the purposes of the trust have become illegal or impossible to fulfill, or 3) because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the purposes of the trust. TTC §112.054.

Query: What authority does the divorce court have to modify the terms of the trust allegedly improperly created without consent of one of the spouses? What about trust property that is under the sole management and control of one of the spouses?

**D. Categories of trusts.**

Trusts can be broken down into two categories: (1) testamentary trusts, which are trusts created by a will, and (2) inter vivos, or living trusts, which are created by a person or persons who are still alive. 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. On the other hand, an irrevocable trust is one that cannot be amended or terminated by the settlor for some period of time. Again, in Texas, all trusts are revocable unless the trust document expressly states otherwise.

**E. Types of trusts.**

Below is a brief discussion of the five common trusts the family law practitioner may encounter: (1) the Life Insurance Trust; (2) the Inter Vivos or Living Trust, (3) the Q-Tip Trust, (4) the Qualified Residential Property Trust; and (5) the §2503(C) Trust.

1. Life Insurance Trust.

Irrevocable life insurance trusts have been extensively used to remove death benefits from an insured decedent's estate for estate tax purposes, allowing death benefits to be paid to beneficiaries free of income and estate tax. An irrevocable trust that owns a life insurance policy insuring the life of a decedent successfully removes the proceeds of the policy from his or her estate if: 1) the trust has an independent trustee; 2) the premiums are paid by the trust; 3) the decedent has none of the incidents of ownership of the policy; and 4) if the proceeds are payable to the trust.

In Texas, estate planners should advise a client who is setting up a life insurance trust that the gifts to the trust are to be made from the separate property cash of the insured. This can frequently be accomplished by the Husband and Wife executing annual partition and exchange agreements, which have the effect of partitioning cash, which would in turn create separate property cash for the insured to make the required gift. On the other hand, if community cash were used to make the gift, a portion of the life insurance proceeds would be included in the estate of the insured spouse under §2036 of the Internal Revenue Code.

2. Inter Vivos or Living Trust.

The Inter Vivos or Living Trust is a type of trust that says how you want property you put into the trust to be managed and distributed. This type of trust can be revocable or irrevocable. If the trust is revocable, it can be changed or revoked.

The living trust can be a means of avoiding probate and keeping the family wealth a private matter. It can also be an effective means of avoiding an ancillary probate when out-of-state realty is involved, even if it is funded only with the out-of-state realty. Furthermore, the Inter Vivos or Living Trust may also be an effective tool in planning for the incapacity of a spouse. However, the use of a this type of trust for some or all of these purposes may affect either or both spouses' marital property rights in the assets used to fund the trust during their lifetime.

3. Q-Tip Trust.

The Q-Tip Trust is an exception to the terminable interest rule because on a certain event the property will pass to someone other than the surviving spouse. The Q-Tip Trust is nothing more than an interest in property which passes from the decedent and in which the surviving spouse has a "qualifying income interest" for life and for which a qualifying election is made. See, IRC §205.6(b)7B.

An example of the language used for a Q-Tip Trust would be as follows:

> "The trustee shall pay all the income to my spouse in at least annual installments. On the death of my wife, assets of this trust shall pass to my children."

4. Qualified Residential Property Trusts.

A personal residence, such as a principal residence or a vacation home, may be transferred to a Qualified Personal Residence Trust. ("QPRT"). If this is done, the property can continue to be used by the transferor during his or her life or for a term of years such as ten or twenty years. At the end of the term the trust terminates, and the residence or vacation home passes to the remaindermen of the trust at a transfer tax cost based on its current value reduced by the value of the taxpayer's right to occupy the residence or vacation home for the term of the trust, i.e. the value of the remainder, not the full fair market value of the residence. The longer the term of a QPRT, the less the current value of the gifted remainder interest. All the income and expenses of the residence or vacation home flow through to the taxpayer's personal income tax return. If the grantor is the trustee, no trust income tax return need be filed. If the grantor survives the term of the QRPT, there is no interest passing to his or her children at the end of the term; they were previously given the residence subject to a term of years that has now expired. At the end of the life estate or term of years, the children have the entire residence together with all increases and appreciation from the date the property was originally placed in trust. If the trustor dies during the term, the residence goes to the trustor's estate or revocable inter-vivos trust, and the residence is included in the taxpayer's gross estate for estate tax purposes. I.R.C. § 2036.

Query: If the trust is funded with a residence that consists of community property, what happens in the event of a divorce? The initial reaction might be to allocate the residence held in trust to one spouse in exchange for that spouse's interest in another asset. However, the sale of the residence by the trust, directly or indirectly, to the grantor or grantor's spouse is specifically prohibited as is the sale to another grantor trust of the grantor or grantor's spouse. Treas. Reg. § 25.2702-5(c)(9).

Query: Would the exchange of a residence held in trust to one spouse in exchange for that spouse's interest in another asset constitute a sale since the division of property at the time of divorce constitutes a non-taxable transaction?

5. §2503(C) Trust.

A 2503(c) Trust receives assets that are to vest in the beneficiary at the age of 21. The Trustee may distribute income and/or principal to the beneficiary prior to the time the beneficiary reaches the age of 21. Gifts to this type of trust qualify for the annual gift tax exclusion (presently $11,000 per donor). The trust instrument may provide the beneficiary with withdrawal right(s) when the beneficiary attains the age of 21. However, in the event that right is waived, the trust continues. Although the trust assets are considered to be the separate estate of the beneficiary, income earned on the trust assets (such as dividends, interest, and rents) during marriage are community property, even if they are retained in the trust after the 21st birthday. The family law practitioner should investigate relevant dates and birthdates in a situation involving a trust of this type in order to determine if tracing is necessary to prove up the portion of trust assets claimed as separate property.

## F. Characterization and division of trusts and trust assets on divorce.

1. Characterization of Trust Interest.

A lot has been written about the characterization of trusts for purposes of property division upon divorce. However, there are still some unanswered questions.

Nevertheless, when addressing the characterization of a trust interest, it is important to understand that a trust beneficiary does not actually hold legal title to trust property. Instead, the beneficiary owns an equitable interest in the trust property. If a married beneficiary's interest in trust property is acquired before marriage or during marriage by gift, devise, or descent the interest may very well be treated as separate property.

In Hardin v. Hardin, the court characterized a husband's interest in a trust as a separate property gift. 681 S.W.2d 241, 242 (Tex. App.–San Antonio, 1984, no writ). The husband's beneficial interest in the trust was created by a former employer, after Mr. Hardin had retired, in appreciation for his service. Id. The court held that this interest was acquired by gift and was properly characterized as his separate property, "(s)ince the employer was under no obligation to establish the trust or to make any payments to the husband at the time of his retirement. Id. at 242-243. See also In the Matter of the Marriage of Burns, 573 S.W.2d 555, 557 (Tex.Civ.App.-Texarkana 1978, writ dism'd) where it was undisputed that a testamentary trust interest created by the husband's parents was his separate property.

2. Characterization of Trust Income.

The question which usually arises upon divorce, as it relates to the spouse/beneficiary of a trust, is that of the characterization of trust income. This includes both distributed income as well as accumulated and/or undistributed income. As with all marital property characterization issues, the practitioner must start with the statutory presumptions. In other words, "community property" is all property acquired by either spouse during marriage other than separate property. TFC §3.002. Separate property on the other hand is that property which was owned before marriage or property that was acquired during marriage by gift, descent, or devise. Tex. Const. Art. XVI, §15. Finally, income from separate property is community property. Maben v. Maben, 574 S.W.2d229, 232 (Tex. Civ. App. - Fort Worth 1978, no writ).

For assets to be community property, they have to be marital property of the spouses. Ostensibly, assets owned by a trust, and not by a spouse, are not marital property. But Texas law has recognized that trust assets, although not owned by a spouse (other than "beneficially," as the trust beneficiary) may be considered and treated as marital property, for purposes of division of the marital estate upon divorce of the beneficiary/spouse. Of particular importance, accumulated trust income may be considered, under the proper circumstances, to be community property. However, an important issue that must be considered is the amount of control the beneficiary/spouse has over the trust assets.

Generally, the characterization of the trust income, at the time of divorce, becomes important if one spouse (1) is the beneficiary of a trust holding undistributed income; (2) has saved distributed income in a separate property account; or (3) has purchased property with distributed trust income.

a. Characterization of Undistributed Income.

Texas cases addressing the character of trust income have generally emphasized two issues: first, the beneficiary's "constructive acquisition" of or failure to acquire a property interest in the trust income or corpus; and second, the method by which the property interest was acquired (i.e. gift, inheritance, etc.).

b. Trusts created by third parties.

In trusts created by persons other than the parties to the marriage, undistributed income generated during marriage has been characterized as the separate property of the beneficiary. This is true in both discretionary pay trusts and mandatory pay trusts. Cleaver v. Cleaver, 935 S.W.2d 491 (Tex. App.-Tyler [12th Dist.] 1996, no writ); In the Matter of the Marriage of Burns, 573 S.W.2d 555 (Tex.Civ.App.-Texarkana 1978, writ dism'd); Currie v. Currie, 518 S.W.2d 386 (Tex.Civ. App.-San Antonio [4th Dist.] 1975 writ dism'd); Buckler v. Buckler, 424 S.W.2d 514 (Tex.Civ.App.-Fort Worth [2nd Dist.] 1967, writ dism'd).

Additionally, trust income that a married beneficiary does not receive, and to which he has no claim other than an expectancy interest in the corpus, has been held to constitute separate property. Cleaver v. George Staton Co., Inc., 908 S.W.2d 468, 470 (Tex. App--Tyler 1995, writ denied), Ridgell v. Ridgell, 960 S.W.2d 144 (Tex.App. -Corpus Christi 1997, no writ). Currie v. Currie, 518 S.W.2d 386 (Tex.Civ.App. -San Antonio 1974, writ dism'd), holds that undistributed trust income is not community property in a case where trust income was added to the corpus and all distributions were made according to the trustee's "uncontrolled discretion." Id.

In Re Marriage of Long, 542 S.W.2d 712 (Tex.Civ.App.-Texarkana 1976, no writ), dealt with a trust, which provided that the income of the trust was to be either distributed or accumulated at the discretion of the trustee until the beneficiary (husband) reached twenty-five, at which time fifty percent of the trust corpus was to be distributed to him. When husband reached thirty, the balance of the trust was to be distributed to him. Husband and his wife separated before husband reached twenty-five, but the divorce proceeding was not commenced until a later time. When husband reached twenty-five, he "decided to leave his half interest in the trust though he was entitled to withdraw approximately $85,000." The court held that the income accumulated by the trustee prior to the time husband reached twenty-five was husband's separate property and the income accumulated in the portion of the trust not distributed until husband reached thirty was his separate property. Only the income earned on that portion of the trust corpus that husband was entitled to receive upon reaching twenty-five, but chose not to, constituted community property and, therefore, was subject to distribution in the divorce proceeding. Id. The court stated:

> Unlike the situation in Currie, supra, the beneficiary in the case before us was entitled to a present possessory interest in one-half of the trust corpus and the income from that one-half. In the Mercantile Bank, supra, case, undistributed income was in the hands of the trustees but the beneficiary had a present possessory interest in the funds. In the Mercantile Bank case we concluded that the income on the trust corpus should have been labeled community property.

See also Ridgell, supra, which held that income received by a married beneficiary on trust corpus to which the beneficiary is entitled or becomes entitled is community property.

Burns, Currie and Buckler involved "discretionary pay" trusts. The courts' reasoning emphasized the beneficiary's inability to compel a distribution of income. The courts noted that the undistributed income was the property of the trust estate, rather than property of the beneficiary. In other words, the court recognized the beneficiary's lack of "constructive acquisition" of any property right in the undistributed trust income.

Wilmington Trust Co. v. United States, 573 F.2d, 1055 (1985), on the other hand, involved a "mandatory pay" trust. The court analyzed Texas law, and in doing so, it emphasized that the beneficiary had no interest in the trust corpus. As a result, income generated by the trust corpus was *not* income generated by the separate property of the beneficiary. It also recognized that the beneficiary's right to receive income from the trust was a gift, and therefore the separate property of the beneficiary. The Court stated:

> It is concluded that, under the law of Texas, as developed and expounded by the Texas courts, the income derived during the marriage of [the spouses] from the seven trusts that are involved in the present case constituted the separate property of [the wife], and was not community property of [the spouses]. [The wife] never "acquired"--and she will never acquire--the corpus of any of these trusts. The corpus of each trust is to be held and controlled by the trustee or trustees during [the wife's] lifetime, and, upon [the wife's] death, the corpus will pass to her issue. Accordingly, the corpus of each trust was not [the wife's] separate property, and the trust income was not from [the wife's] separate property.
>
> What [the wife] "acquired"--and what she used to purchase the stocks and establish the bank accounts that are involved in the litigation--was the income from the trust property. As the income resulted from the gifts made to trustees for [the wife's] benefit, the income necessarily constituted her separate property under § 15 of article XVI of the Texas Constitution.

Although the rationale of no "constructive acquisition" of a property right with respect to undistributed trust income is consistent with the principles stated in a number of cases when addressing undistributed trust income in a "discretionary pay" trust, it appears to be of no relevance when addressing the characterization of undistributed income in a "mandatory pay" trust. This is because, unlike a discretionary pay trust, the beneficiary of a mandatory pay trust does have the right to compel distribution of income. Therefore, the right to receive income is a property right of the beneficiary, which means the recognition of the manner in which the property was acquired, discussed in Wilmington Trust Company, supra, is essential.

It seems clear that the common thread in the cases cited is the method of acquisition, i.e. gift or devise. Since property acquired by gift or devise is separate property, undistributed trust income derived from a corpus received by gift or devise is separate property, as well.

c. Self Settled or Grantor Trusts.

Although undistributed income generated by trusts created by third parties has been characterized as separate on the basis that the income becomes the property of the beneficiary by virtue of a testamentary or inter-vivos gift, the same cannot be said of income generated by "grantor trusts". Nevertheless, in the cases of In the Matter of the Marriage of Burns, supra, and Lemke v. Lemke, 929 S.W. 2d 622 (Tex.Civ.App. - Fort Worth 1996, writ denied) both Courts held that the income generated by a "grantor trust" is the separate property of the beneficiary. Both cases reached the conclusion that undistributed trust income was not community because the income had not been distributed to the beneficiary, and the beneficiary had no present or past right to compel distribution. Therefore, the income was considered to be the property of the trust estate, not the property of the beneficiary. As a result, the community had no interest in the undistributed income.

In Re Marriage of Burns, supra, involved the wife's claim that undistributed trust income held for the husband's benefit was community property. The husband was the beneficiary of six trusts, three of which had been established by his parents and grandparents. The husband had established the other three trusts. Five of the trusts came into existence prior to the marriage. The husband established the sixth trust after the marriage with separate property. The three trusts established by husband's ancestors were spendthrift trusts. Five of the six trusts were discretionary pay trusts in which "the trustee or trustees could either withhold or distribute the income and/or corpus at their sole discretion." Id. The remaining trust required that its income be accumulated until May 28, 1982, when the entire corpus and accumulated income was to be distributed to husband.

The Burns court held that the undistributed trust income in each of the trusts was neither separate nor community property. The court relied on (then) § 5.01(b) of the Tex.Fam.Code, which provides that "(c)community property consists of the property, other than separate property, acquired by either spouse during marriage". Id. The court concluded that husband had not "acquired" the trust income during marriage as required by the statute inasmuch as it had not been distributed and he did not "have a present or past right to require its distribution so as to compel a finding that there was a constructive acquisition". Id. (emphasis added)

In Lemke v. Lemke, supra, Mr. Lemke as settlor, prior to marriage, created an irrevocable spendthrift trust with proceeds he had received from a personal injury settlement. He was the sole beneficiary and a third party was named as trustee. Upon divorce wife argued that the undistributed income of the trust was community. Id. at 663. In rejecting her claim the court, citing Burns, held that there being no evidence that the trust was created in fraud of wife or evidence that husband had neither actually or constructively, acquired the undistributed income, the community estate had no interest. Id. at 664. The court followed the rationale in Burns by stating that the undistributed income remained a part of the trust and was not community. Id. It should be noted that the court emphasized the presence of the spendthrift provision, but never really explains the importance of such term as it relates to their decision.

A more recent case which discussed this issue is Lipsey v. Lipsey, 983 S.W.2d 345 (Tex.App.–Fort Worth 1998, n. pet.h.). In Lipsey v. Lipsey, the husband, prior to his marriage, had rolled over his retirement plan into a 401(k) plan. Under the terms of the plan, the husband could not demand distributions until he was 70 years of age. The trial court found the plan to be separate, but the increase in the plan value to be community. The husband appealed the characterization of that increase in value as community property, as well as the undistributed trust income. The Court of Appeals reversed, stating that, absent fraud, a spouse may create a trust from separate property as long as the income remains undistributed during marriage. Furthermore, because the beneficiary/spouse did not have the right to compel distribution, the income was not acquired during marriage, was not community property and remained property of the trust. Id at 351.

Query: Would there be a different result if husband had begun receiving distributions?

However, in Mercantile National Bank v. Wilson, 279 S.W.2d 650 (Tex.Civ.App. - Dallas 1955, writ ref'd n.r.e.), the wife created a trust prior to her marriage, naming her father as trustee and her mother as successor trustee. The trust was irrevocable and the trust instrument gave the trustee discretion either to accumulate the trust income or to expend it for the wife's use and benefit. The trust continued throughout the marriage and existed at the time of the husband's death. The court was called upon to determine whether undistributed income held in the trust at the time of the husband's death was community property. The court in Wilson held that it was:

> The first and preliminary material question, in our opinion, is whether or not the undistributed profits or income from the trust in the hands of the trustee is community property. We must answer that the income on the trust corpus was community property from the date of the marriage of appellee [wife] to George O. Wilson [husband], now deceased, until the time of the death of George O. Wilson.

297 S.W.2d at 653-654

Burns, Lemke and Lipsey appear to be in conflict with the ruling in Mercantile National Bank at Dallas v. Wilson, supra. Given the difference in treatment of income from "discretionary pay" and "mandatory pay" trusts, it would be expected that the conflict arises there, since Burns, Lemke, and Lipsey involve "discretionary pay" trusts which held undistributed income. Unfortunately, the Mercantile National Bank at Dallas opinion does not clearly describe the trust in question as "mandatory pay" or "discretionary pay", although it appears that the court construed the trust in Mercantile National Bank at Dallas to be a "discretionary pay" trust.

One might argue that the statement in Mercantile National Bank at Dallas that "...the income on the trust corpus was community property from the date of the marriage..." is dicta because the characterization of the income was not dispositive of the issue on appeal. If that statement is dicta, then Burns, Lemke and Lipsey are controlling.

Regardless, the consequence of Burns, Lemke and Lipsey is that a person about to marry may thwart the community property laws of Texas by placing separate property in a "discretionary pay" trust for his or her benefit and thereby maintain the separate character of income generated by the trust (formerly the separate property of the settlor) because the income generated by the trust corpus and held by the trust is not community property of the beneficiary. In such a situation, the non-beneficiary spouse's only claim may be one for fraud against the community, if the non-beneficiary spouse can show the action was motivated solely to defraud the community.

Burns, Lemke and Lipsey leave open the question of the characterization of the income if it is actually distributed to the beneficiary during marriage. Clearly, the income is not the result of a gift or inheritance. What, then, is the characterization of income paid to the beneficiary of the trust? It seems that the income paid to the beneficiary from a "grantor trust" would not fall within the definition of separate property and is therefore community property. Arnold, supra. Otherwise, a spouse could "launder" income from his separate property through a self-settled trust and thereby change the character of that income from community property to something else.

In summary, based upon the holdings in Burns, Lemke and Lipsey, it appears that if the income distribution is discretionary as opposed to mandatory, the undistributed income will likely remain separate.

\ Where the beneficiary of a trust became entitled, during the marriage, to receipt of one-half (1/2) of the trust corpus and chose to leave the vested interest in the control of the trustee, income generated by the one-half (1/2) vested portion of the trust corpus was held to be community property. In the Matter of the Marriage of Long, supra. The court held that the beneficiary's vested one-half (1/2) interest in the trust corpus was separate property, but the income generated thereon was community, even though held by the trust.

Similarly, "income on income" retained by the trustee beyond the date when the income generated by trust corpus should have been distributed to the income beneficiary, has been held to be community property. Cleaver, supra.

3. Characterization of Distributed Income.

As in characterization cases involving undistributed income, claims by the community estate to income distributions made during the marriage have been based upon the theory that the distribution is income on the beneficiary's separate property and is community property.

a. Trusts Created by Third Parties.

Income distributed, and the property purchased with that income, has consistently been characterized as the separate property of the beneficiary. This is true for both discretionary pay trusts and mandatory pay trusts. Taylor v. Taylor, 680 S.W.2d 645 (Tex. App.–Beaumont [9th Dist.] 1984, writ ref'd n.r.e.); Hardin v. Hardin, supra; Wilmington Trust Company, supra.

Although not stated in the Taylor opinion, the rationale for this characterization was clearly that the income was a gift. Hardin, supra.

b. Grantor Trusts.

As noted earlier, the characterization of income actually distributed from a grantor trust has not been directly addressed. Burns, Lemke, Lipsey and Mercantile National Bank of Dallas address only undistributed income. Again, it would seen that income of a grantor trust, when distributed would be community property since it does not fall within the constitutional definition of separate property.

4. Income on Wrongfully Retained Income or Corpus.

As previously noted, this income has been consistently characterized as community property. In the Matter of the Marriage of Long, supra; Cleaver, supra.

5. Characterization of Assets Distributed From Trust to a Spouse.

a. Grantor/Self Settled Trusts.

In Mercantile National Bank at Dallas v. Wilson, supra, the court held that the undistributed income of a trust created by wife for her own benefit, prior to marriage, is community property. *See* In re Marriage of

Burns, supra, (income on separate property corpus of trust created by spouse for his own benefit was community property to the extent it was received by husband). In Ridgell v. Ridgell, supra, the appellate court stated that the income a spouse receives from a trust is community property. The court also said that if the spouse does not receive income from the trust and has no more than an expectancy interest in the corpus, the income remains separate property. Id. at 148. In Ridgell some of the trusts were funded by gift or devise and one was funded by the spouse prior to marriage. The court also recognized that separate property corpus distributed out of the self-settled trust was received by the spouse as separate property. Id. at 150.

b. Trust Funded by Gift or Devise.

There are a number of cases which say that income from a trust which was created in a separate property manner (i.e., by will or by gift) is received by the spouse/beneficiary as separate property. These cases do not address the question of whether a trust created by a spouse for his own benefit, using separate property, gives rise to separate or community income.

Notwithstanding the opinions referred to above relating to undistributed income, there is case authority which supports the proposition that income from a third party settlor trust remains separate. The leading case which supports this theory is McClelland v. McClelland, 37 SW. 350 (Tex. Civ. App. 1896, writ ref'd). Husband's father created a testamentary trust for him which required mandatory distributions of income, as well as, discretionary income pay outs. The court determined that the intent of the settlor was to make a gift to his son of not only the corpus, but all income flowing therefrom. It should be noted that the settlor specifically stated in the trust that it was to be "enjoyed by him (his son) [sic] only in futuro..." Id. at 354. Hence, the wife's claim that the income was community was denied. A similar reasoning was used in the case of In the Matter of the Marriage of Thurmond, 888 S.W.2d 269, 272-275 (Tex. App.-Amarillo 1994, no writ). Without expressing its rationale the court held that the trust distributions, both income and corpus, were entirely the separate property of the beneficiary. Id. at 275. In Taylor v. Taylor, supra, the husband contested the trial court's finding that assets purchased during the marriage with income distributions from a trust created by wife's father were her separate property. The appellate court affirmed the trial court's finding that the distributions were separate, and not community, the primary reason being that the trust asset which generated the earnings was a retail store. The settlor specifically stated in the trust that "in order to continue the growth and expansion of the business, management is authorized to create the necessary reserves and make proper additions to capital from earnings before distribution of earnings". Id. at 649 [emphasis added]. The court found that because of the nature of the settlor's intent, the profits and earnings became a part of the corpus, and the distribution of the corpus was not considered to be community income. *See* Sullivan v. Skinner, 66 S.W. 680 (Tex.Civ.App. 1902, writ ref'd) (where wife received a life estate in land under her father's will, which provided that she was to receive the income for her sole and separate use, the rentals from the land were wife's separate property).

6. Commingling Inside Trust.

In McFaddin V. Commissioner, 148 E2d 570 (5th Cir. 1945), a tax case, a trust was created by the mother and father of the McFaddin children. The parents conveyed two large cattle ranches into trust, subject to the debts secured by the properties and further subject to an annual payment to the mother of $30,000 per year, payable from income or, if insufficient, from the corpus.

The Tax Court ruled that children who are beneficiaries of a trust, which is created by gift of their parents, hold that interest as separate property. The Tax Court further found that the rights of the beneficiaries did not attach to the gross income, but rather to the distributable net income, of the trust, and that the gross income of the trust used by the trustees to purchase additional property could not be community income of the beneficiaries. The Tax Court further held that the fact that the property was conveyed into trust subject to debts and liens did not convert what was otherwise a gift into a transfer for onerous consideration. And oil royalties and bonuses distributed by the trustee remained the beneficiaries' separate property.

The Fifth Circuit agreed that the res of the trust was a gift, and thus separate property. Id. at 572. Therefore, the oil royalties, bonuses and profits from the sale of the land "came to" the McFaddin children as separate property, taxable as separate income.

Nonetheless, the court held that property acquired by the trust during the beneficiaries marriages was community because separate and community funds had been commingled within the trust. The court stated:

> The theory of the Tax Court that none of the commingled property with which the after acquired property was purchased was community property because, under the terms of the trust instrument, gross income was treated as corpus, the rights of the beneficiaries

> did not attach to gross income but only to the distributable net income, and the gross income used by the trustees was, therefore, not community property, will not at all do. The taxpayers were the beneficial owners of the trust properties, and every part and parcel of them, including income from them, belonged beneficially to them, either as separate or as community property, in the same way that it would have belonged to them had the property been deeded to the taxpayers and operated by themselves. The greater part of the normal income from the property during the years preceding the tax years in question was community income. When it was commingled in a common bank account with other funds of the trust so that the constituents had lost their identity, the whole fund became community; and when it was used by the trustees to purchase additional properties, those properties, taking the character of the funds which bought them, were community property. [footnotes omitted]

Id. at 573.

The Fifth Circuit Court of Appeals also rejected the Commissioner of Internal Revenue's argument that because the trusts were spendthrift trusts, they were in effect conveyances of income to the separate use of the beneficiaries. Id. at 574.

In sum, it would appear that the McFaddin case stands for proposition that income received by a trust is community or separate by the same rules as would apply had the income been received outside of trust. And if those funds are commingled, then the separate corpus of the trust can be lost to the community, upon subsequent distributions to the beneficiaries.

This rule was applied to the gross income of the trust, not just to the distributable net income. Since the gross income was commingled in trust bank accounts with separate property receipts, the whole fund became community property, and the subsequently-acquired property was community in nature, and the oil income therefrom was similarly community.

7. Trusts Created During Marriage.

When confronted with the characterization issue of corpus and income of a trust created during marriage it is advisable for the practitioner to understand the holding in Land v. Marshall, 426 S.W.2d 841 (Tex. 1968). The character of the corpus will be determined by the inception of title doctrine. As a general rule, if separate property of a spouse is used to create the trust, the corpus will remain separate, and the income will be community. If community property is used, the resulting character will be dependant of whether the other spouse has consented to the creation of the trust.

a. The "Illusory" Trust - One Spouse Has Not Consented.

A spouse cannot create a trust with community property without the consent or joinder of the other spouse. Land v. Marshall at 846. In Marshall, husband created a trust funding it with stock which was clearly community property. He also retained the right to manage and the power of revocation. The party's daughter was the beneficiary and trustee. After husband died, wife sued to set aside the purported trust on the basis that she never consented or agreed to the establishment of same and her interest in the stock could not be transferred without her joinder. The trustee argued, unsuccessfully, that husband possessed the power to create the trust because of his "managerial" powers over the community. Id. The attempt by husband to create the trust without consent of his spouse resulted in an 'illusory trust", or no valid trust at all. He retained the same power and control over the property as he had before the creation of the trust. Where one of the spouses undertakes to devise community property belonging to both, the survivor has an election to take under the will or to take the community share. Land v. Marshall at 844.

b. Where Both Spouses Consent.

When there has been consent by both spouses to create a trust, it will be difficult to defeat the trust, absent a finding of fraud. See, Knox v. Long, 291 S.W.2d 292, 296 (Tex. 1956). (Absent fraud pleadings and proof, if a spouse participates in transaction with other spouse, consent will be inferred as a matter of law). Depending upon the terms of the trust, specifically whether it is revocable or irrevocable, the trial court may not have the ability to divide the assets within the trust. If the trust is an inter vivos revocable trust and one of the spouses is the trustee, the trial court should have the absolute authority to divide the trust assets. The court should also have the ability to order the spouse trustee to do whatever may be necessary to effectuate a transfer of any of the assets to the other spouse. However, prior to embarking on a division of any trust assets the practitioner should consult a estate planner or a qualified tax expert to determine whether there will be any adverse tax ramifications to either spouse if the trust is dissolved and the remaining income and corpus are distributed.

c. Source of Trust Corpus.

The property initially used to create the trust may well lose its identity by the time of death of one of the parties or at the time of divorce. As an example, if the husband funds an irrevocable trust with separate property in an effort to protect his assets from creditors, and the wife is a beneficiary of the trust, it may be determined upon divorce that he intended to make a gift of those assets and income therefrom (via the trust) to the beneficiary. On the other hand, if the husband/settlor transfers separate property into a revocable trust, and is able to trace the assets and mutations upon divorce, the remaining "traceable" corpus would be separate, but the undistributed income would most likely be deemed community due to the settlor's retention of the power of revocation. See, In the Matter of the Marriage of Long, supra.

## VI. FAMILY LIMITED PARTNERSHIPS

Another common estate planning tool which has been utilized by many estate planners is the Family Limited Partnership (FLP). However, the general opinion of family law attorneys is, although the formation of this type of entity may save taxes and insulate the limited partners from some liability, they are extremely difficult to deal with upon divorce. The specifics of all of the advantages of a FLP is beyond the scope of this paper. However, if structured properly, a FLP insulates the partners from potential liability, reduces income taxes, and provides an avenue to distribute wealth while reducing federal estate taxes. All of these benefits may exist with the added bonus of retaining the right to maintain control of the assets.

### A. Partnerships in general.

The Texas Uniform Partnership Act ("TUPA") ("Uniform Act") became effective January 1, 1962, and was codified in Art. 6132b, Tex. Rev. Civ. Stat. Ann. (Vernon 1970). In 1993, the Texas Revised Partnership Act, Tex. Rev. Civ. Stat. Ann., Art. 6132b, (Vernon Supp. 1998) ("TRPA") ("Revised Act") came into effect and governed all new partnerships created after January 1, 1994, while the Uniform Act continued to govern those partnerships created prior to 1994 (unless otherwise agreed by the partnership). The Uniform Act expired on January 1, 1999, and now, all partnerships, regardless of when formed, are governed by the Revised Act.

1. Partnership Defined.

A partnership is an association of two or more people carrying on a business for profit. Once formed, a partnership is a legal entity distinct from its partners.

2. Creation.

It is preferable to set out the agreements of the partners in writing. The following factors suggest the existence of a partnership:

- Right to receive a share of the profits;
- Expression of the intent to be business partners;
- Right to participate in the control of the business;
- Sharing or agreeing to share in business losses and liabilities; and
- Contributing cash or other property to the business.

See TRPA §2.03.

3. Partner Rights.

A partner has the following rights in a partnership.

a. Personal Property.

A partnership interest is personal property. See TRPA §5.02 and TRLPA §7.01.

b. Interest in Partnership v. Interest in Partnership Assets.

Under the Revised Act, a partner has an ownership interest in the partnership entity itself, not the partnership's specific assets. See TRPA §§2.04 & 5.01.

4. Limited Partnerships.

In 1987, the Texas Revised Limited Partnership Act, Tex.Rev.Civ.Stat.Ann. art 6132a-1 (Vernon Supp. 1998) ("TRLPA") was enacted. Since September 1, 1992, TRLPA has been applicable to all domestic and foreign limited partnerships doing business in Texas. See TRLPA § 13.02(b).

5. General Versus Limited Partnerships.

A limited partnership is a partnership having one or more general partners and one or more limited partners. General partners in limited partnerships (like their counterparts in general partnerships) have the right to participate in the management and control of the business and, as a result, they have unlimited liability with regard to partnership debts and obligations. Limited partners, on the other hand, have limited management and control rights. In return, limited partners have limited liability for partnership obligations.

6. Statutory Requirements.

"To form a limited partnership, the partners must enter into a partnership agreement and one or more partners, including all of the general partners, must execute a certificate of limited partnership." TRLPA §2.01(a). "A limited partnership is formed at the time of the filing of the initial certificate." TRLPA §2.01(b). Thus, if the partners "enter into a partnership agreement" but never file a certificate, the resulting partnership is a general partnership and not a limited partnership.

7. Applicability of the Uniform Act and the Revised Act.

TRLPA is silent on many fundamental partnership issues, focusing primarily on the issues specific to limited partnerships. Under TRLPA §13.03, "the applicable statute governing partnerships that are not limited partnerships..." apply in any case not provided for by TRLPA. Thus, the Revised Act governs numerous aspects of limited partnerships. A substantial portion of all marital property issues in limited partnerships are now governed by the Revised Act, not TRLPA.

Under the Revised Act, as previously stated, the legal concept of a partnership is that of an entity rather than that of a status or aggregate theory. (§ 2.01) Under the Uniform Act, it provided the extent of community property rights of a partner's spouse in § 28-A as follows:

a. A partner's rights in specific partnership property are not community property;
b. A partner's interest in the partnership may be community property; and
c. A partner's right to participate in the management is not community property.

The Revised Act provides essentially the same concepts. Under the Uniform Act, the partners were treated as "tenants in partnership". The Revised Act specifically states that the partners are not co-owners of the partnership property. Section 2.04 of the Revised Act states, "Partnership property is not property of the partners. Neither the partner nor a partner's spouse has an interest in partnership property." Id. § 5.01 of the Revised Act provides as follows: "A partner is not a co-owner of partnership property and does not have an interest that can be transferred, either voluntarily or involuntarily, in partnership property." Id. The comments to § 5.01 of the Revised Act state that "a corollary of this section is that a partner's spouse has no community property right in partnership property, the same as in the Uniform Act §28A(l)."

§7.01 of TRLPA specifically states: "A partner has no interest in specific limited partnership assets."

Additionally, §5.02(a) of the Revised Act, states, "A partner's partnership interest is personal property for all purposes. A partner's partnership interest may be community property under applicable law." The comments to this section clarify that a partner's right to management of the partnership is not community property.

Therefore, with 1993's adoption of the Revised Act, the entity theory clearly became the application rule. The Revised Act has clearer wording as to partner interests in partnerships, eliminating the "tenants in partnership" wording, and specifically states that "[a] partnership is an entity distinct from its partners," Revised Act §2.01, and that "partnership property is not property of the partners," Revised Act §2.04.

In summary, the Revised Act clearly treats interests in partnership property and interests in the partnership differently. Neither a partner nor his spouse has any interest in the property of the partnership. However, the interest in the partnership can be community or separate. The interest in the partnership is related to specific property of the partnership entity in roughly the same way stock in a corporation is related to specific property of the corporate entity. Under the entity theory, partnership property is owned by the partnership entity, not the individual partners. Partnership property is, therefore, neither separate nor community in character. See Marshall v. Marshall, 735 S.W.2d 587, 594 (Tex. App. - Dallas 1987, writ ref'd. n.r.e.) which held that the partnership property cannot be characterized as either separate or community. However, "a partner's partnership interest is personal property for all purposes. A partner's partnership interest may be community property under applicable law." §5.02(a). However, a court does not have the right to award specific partnership property to one of the spouses. Roach v. Roach, 672 S.W.2d 524 (Tex. App. - Amarillo 1984, no writ).

8. Creating and Funding the Partnership.

As a result of the entity theory, the creation and funding of a partnership is a very significant act. By contributing assets to the partnership, the new partners give up ownership of these assets in exchange for ownership of a totally new and distinct asset: partnership interests. They no more "own" the assets of the partnership than a shareholder in General Motors "owns" a Buick assembly plant in Michigan.

a. During Marriage.

A partner's management rights, if any, are not community property. See TRPA §4.01(d). The partner spouse has the right to participate in the management and control over the partnership according to the terms of the partnership agreement. The non-partner spouse does not have a comparable right even though the partnership interest may be community property.

b. Death or Divorce.

Upon the death or divorce, the non-partner spouse will be deemed a transferee of any interest partitioned or acquired by the non-partner spouse. See TRPA §5.04. As such, his or her sole right is to receive distributions if and when made. See TRPA §5.03(b).

Neither the Uniform Act nor the Revised Act attempts to define the extent to which the partner's "interest in the partnership" is community or separate property. Under appropriate circumstances it can be community property. These matters are left to determination: (1) by reference to the basic entity nature of partnerships under the Revised Act and (2) to the characterization and tracing concepts under Texas law.

(1) Partnership Interest.

The only partnership property right the partner has which is subject to a community or separate property characterization is his interest in the partnership, that is, his right to receive his share of the partnership profits and surplus. Harris v. Harris, 765 S.W.2d 798 (Tex. App. - Houston [14th Dist] 1989, writ denied); Marshall v. Marshall, 735 S.W.2d 587 (Tex. App.- Dallas 1987, writ ref'd n.r.e.).

Where the "interest in the partnership" is acquired before marriage, the interest is separate property. The same is true where the interest is acquired by gift or by inheritance. This is simply the application of the doctrine of inception of title. Harris v. Harris, 765 S.W.2d 798 (Tex.App–Houston [$14^{th}$ Dist] 1989, writ denied).

In Harris, the same husband and wife were twice married and twice divorced. Husband was awarded the partnership interest in his law partnership in the first divorce. However, during the second marriage of the parties, the partners changed and a second partnership agreement was executed. Subsequently, husband sold his interest in the partnership under a buy-out agreement entered into among the partners of husband's law partnership. The court held:

> The second agreement, *which was* executed during their marriage, altered and controlled the terms of appellee's withdrawal from the firm. However, appellee's partner status in Andrews and Kurth was established when that association of attorneys, then known as Andrews, Kurth, Campbell and Jones, first executed their partnership agreement in 1972. He remained a partner at all relevant times thereafter. The partnership itself was never dissolved. Appellee's partnership interest upon his withdrawal from the firm was, therefore, the same partnership interest that he possessed in 1972 and which was adjudged his separate property in a prior divorce.
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> There was no evidence presented to show that a "new" or "additional" interest had been acquired during the parties' marriage. Furthermore, while it may be possible in some cases to show that an increase in the value of a separate property asset was based on some community property factor, such was not shown by any evidence in this case. No such reimbursement theory was developed at trial.
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> Apparently, appellant believes that if the system of valuation of appellee's partnership interest changed during the marriage, by virtue of the amendments to the original partnership agreement, any increase in the sum due to him at buy-out would presumptively be community property. We do not agree with this reasoning.
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> While the value of appellee's separate property interest may have fluctuated from time to time, there was no evidence that any "additional" interest was acquired during the parties' marriage. As in the case of stock splits and increases, analogous to this situation involving "units" of a partnership, mutations and increases in separate property remain separate property.

Harris, 765 S.W.2d at 803.

During the second marriage, the husband in Harris executed a new "Reserve Capital Agreement", an agreement providing for the distribution of proceeds from a 30% contingent fee agreement with the maternal heirs of Howard Hughes (entered into between marriages). The court held:

> Whether the contingent fee contract was the property of a separate partnership among the partners alleged to have been created specifically for the management of the Hughes case or not, the parties to the contract-were the

> Hughes heirs and the Andrews and Kurth partnership. There is no evidence in the record that the fee contract was owned by the several partners individually. Under the entity theory of partnership, the undivided interest owned by individual partners in specific partnership property is not community property. Only the partner's interest in the partnership may be characterized as community property. Therefore, as partnership property, the fee contract is not subject to classification as either community or separate in nature.

Id. at 803-804.

The court in Harris then considered the question of any increase in the amounts due to husband as a result of his work on the Hughes case:

> In keeping with the principles applicable to stock splits, an increase in the value, of a separate property interest resulting from fortuitous circumstances and unrelated to any expenditure of community effort will not entitle the community estate to reimbursement. Note, Community Property Rights and the Business Partnership, 57 TEX.L.REV. 1018,1035-1036. However, a significant line of decisions holds that the community is entitled to reimbursement for time, toil and talent spent by one spouse for the benefit and enhancement of his or her separate property interests. Jensen v. Jensen, 665 S.W.2d 107, 109 (Tex. 1984); Vallone v. Vallone, 644 S.W.2d 455 (Tex. 1982). While the law contemplates that a spouse may expend a reasonable amount of talent or labor in the management and preservation of his separate property without impressing a community character upon it, a showing that appellee's energy was spent in such a way that increased his future right to share in the separate fee without adequate compensation to the community, may have entitled the community to reimbursement for that expenditure of community time. Vallone at 459. The burden of pleading and proof at trial is on the party asserting a right to reimbursement. Id. In the instant case, the only evidence introduced relevant to this reimbursement issue was appellee's testimony that his income from the Hughes fee was unrelated to the amount or extent of his work on the case.

Id. at 805.

(2) Profits Distributed.

Distributions of the partner's share of profits and surplus (income) received during marriage are community property even if the partner's interest in the partnership is separate property. Harris, 765 S.W.2d 798; Marshall, supra. Such income simply falls into the classic category of "rents, revenues, and income" from separate property.

Marshall, supra, deals with the characterization of distributions from a separate property partnership. Marshall is of particular significance because the distributions were related to income received by the partnership from oil and gas interests, which otherwise would have been clearly the separate property of the husband. The wife claimed that $542,000 distributed to the husband during marriage was salary and profits, and therefore community property because they were "acquired" during the marriage. The husband claimed the distributions were only partly salary, but mostly consisted of return of capital from his separate property investment. Id. The court carefully reviewed the effect of the Uniform Act, and stated:

> With the passage of the Uniform Partnership Act in 1961, Texas discarded the aggregate theory and adopted the entity theory of partnership. Under the UPA, partnership property is owned by the partnership itself and not by the individual partners. In the absence of fraud, such property is neither community nor separate property of the individual partners. A partner's partnership interest, the right to receive his share of the profits and surpluses from the business, is the only property right a partner has that is subject to a community or separate property characterization. Further, if the partner receives his share of profits during marriage, those profits are community property, regardless of whether the partner's interest in the partnership is separate or community in nature.
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> [A] withdrawal from a partnership capital account is not a return of capital in the sense that it may be characterized as a mutation of a partner's separate property contribution to the partnership and thereby remain separate. Such characterization is contrary to the UPA and implies that the partner retains an ownership interest in his capital contribution. He does not;

> the partnership entity becomes the owner, and the partner's contributions become property which cannot be characterized as either separate or community property of the individual partners. Tex. Rev. Civ. Stat. Ann., art. 6121b, secs. 8, 25 & 28-A(l) (Vernon 1970); Thus, there can be no mutation of a partner's separate contribution; that rule is inapplicable in determining the characterization of a partnership distribution from a partner's capital account.
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> In this case, all monies disbursed by the partnership were made from current income. The partnership agreement provides that "any and all distributions . . . of any kind or character over and above the salary here provided . . . shall be charged against any such distributee's share of the profits of the business." Under these facts, we hold that all of the partnership distributions that Woody received were either salary under the partnership agreement or distributions of profits of the partnership.

Id. at 593-595.

However, under the TRLPA, § 1.02(1), "Capital Account" is defined to mean "unless otherwise provided in a written partnership agreement, the amount of a partner's original contribution to a limited partnership, which consists of cash and the agreed value of any other contribution to the partnership, increased by the amount of additional contributions made by that partner and allocations to that partner of partnership profits and decreased by the amount of distributions to that partner and allocations to that partner of partnership losses."

Additionally, under TRLPA, §102(13), Return of Capital has been defined to mean, unless otherwise provided in a written partnership agreement, any distribution to a partner to the extent that the partner's capital account immediately after the distribution is less than the amount of that partner's contribution to the partnership as reduced by prior distributions that were a return of capital."

(3) Undistributed Profit.

When profits have been earned by the partnership but retained for the reasonable needs of the business, present or reasonably anticipated, the profits remain a part of the "partnership property" (whether in the form of cash in the bank, increased inventory, or otherwise). Jones v. Jones, 699 S.W.2d 583 (Tex. App. - Texarkana 1985, no writ); McKnight v. McKnight, 543 S.W.2d 863 (Tex. 1976).

Where profits are not distributed and are accumulated by the partnership beyond the reasonable needs of the business and in fraud of the non-partner spouse or community or is transferred to the partnership in fraud of the non-partner spouse, it is suggested that the non-partner spouse may have the same rights and remedies as if the partnership were a corporation, trust, or third person.

In Marriage of Higley, 575 S.W.2d 432 (Tex. Civ. App. - Amarillo 1978, no writ), deals with the characterization of "gross income receipts". In Higley, the wife claimed reimbursement for her "community share" of the gross income receipts in a partnership (in which husband owned an interest as separate property before marriage), during the periods of marriage, which were used to pay partnership indebtedness of $219,005.21. The court of appeals held that gross income receipts do not automatically become community property. Id. The court went on to say that the wife failed to show the indebtedness was paid by the partnership from any (net) profits or surplus accumulated by the partnership during marriage. Id.

(4) Community Reimbursement.

Some questions may arise in situations where the partner-spouse devotes 100% of his time, toil, and talent to the partnership business, but receives only modest distributions and the bulk of the profits are accumulated in the partnership entity. In such cases the same rules of reimbursement should arguably apply as with the corporate entity, and the community estate's right to claim reimbursement for the time, toil and efforts expended to enhance the separate estate, other than that reasonably necessary to manage and preserve the separate estate for which the community did not receive adequate compensation. *See* Harris, 765 S.W.2d at 805; *see generally* Jensen v. Jensen, 665 S.W.2d 107 (Tex. 1984).

(5) Alter Ego.

The alter ego rules for piercing the corporate veil should apply to the partnership entity in the same manner as they apply to the corporate entity with respect to the shareholder spouse's conduct. *See generally,* Bell v. Bell, 513 S.W.2d 20 (Tex. 1974); Spruill v. Spruill, 624 S.W.2d 694 (Tex. App. - El Paso 1981, writ dism'd).

**B. Family limited partnerships**.

A FLP is simply a limited partnership formed among family members. In the last decade, families have used FLPs with increasing frequency to provide additional asset protection and as an estate planning vehicle. The business of the FLP may be nothing more than managing the real and personal property of members of the older generation or of the entire family. Often, an older generation member will create a FLP with his or her assets, such as an ongoing business, stock, real property, etc. The younger generations may contribute additional property to the FLP or they may obtain their interests in the FLP by gift. Members of the older generation are usually the general partners, so they can retain control, and members of the younger generation are typically limited partners (although a younger generation member sometimes serves as a general partner in order to provide asset management for the older generation). The limited partners cannot compel a distribution but are entitled to a share of any partnership distribution if and when made. In addition, FLP agreements will frequently contain significant restrictions on the transfer or assignment of a partnership interest in order to keep the business "in the family." The combined effect of these restrictions is to significantly influence the value of partnership interests both during a partner's life and at death and protect the partnership from a partner's creditors by making the asset less desirable.

1. FLP Marital Property Considerations in General.

a. Partnership Interests.

As previously indicated, a partnership interest is characterized as separate or community property under the same general rules of any other interest acquired during the marriage. Thus, it is necessary to determine whether the partnership interest is acquired before marriage, after marriage, as a result of a gift, devise, or decent, or whether it can be traced to separate property. See In re Marriage of Higley, 575 S.W.2d 432 (Tex.Civ.App.--Amarillo 1978, no writ) (partnership interest acquired by husband prior to marriage was separate property). Partnership interest acquired during marriage or which does not fit within the statutory definition of separate property is presumed to be community property. See York v. York, 678 S.W.2d 110 (Tex.App.--El Paso 1984, writ ref'd n.r.e.) (partnership interest acquired during marriage is community property). If separate funds are used to fund the partnership, then the interest in the partnership remains separate. If the funds used are community the resulting interest is community. Harris v. Harris, 765 S.W.2d 798, 802 (Tex. App. - Houston [l4th Dist.] 1989, writ denied).

b. Marital Property v. Partnership Property.

Again, property transferred to and acquired by a partnership becomes an asset of the partnership rather than of any individual partner. Once specific property is transferred into the partnership, that property is no longer capable of being either community or separate inasmuch as it becomes partnership property and is no longer property owned by the spouse or the spouses. See Marshall, *supra*. Further, property acquired with partnership funds is presumed to be partnership property unless a contrary intent exists. See TRPA §2.05(c).

2. Formation of the Family Limited Partnership.

a. Reasons to Create a FLP.

At the time most spouses contemplate the formation of a FLP, a divorce is not even a remote possibility. The suggestion to consider creating a FLP usually comes from the party's CPA or estate planner. If the family lawyer is approached by a client to assist in forming a FLP, the best advice is to refer the client to someone who is qualified in the area of estate planning and taxation. The client should also be advised that each spouse should have their own independent counsel prior to its formation.

A FLP should have good reasons to exist, particularly if it is to withstand a challenge by the IRS. Some commentators assert that all of these reasons should be specifically set forth in the partnership agreement, while others believe the reasons should be excluded. Nevertheless, the following constitutes a partial list of reasons for the creation of a FLP:

- Resolve disputes that arise among family members, thereby helping to preserve harmony and avoid the expense and problems of litigation.
- Maintain control of family assets.
- Promote efficient and economic management of the assets and properties under one entity.
- Consolidate fractional interests in family assets.
- Increase family wealth.
- Make annual gifts without fractionalizing the underlying family assets.
- Restrict the right of non-family members to acquire interests in the family assets.
- Protect family assets from claims of future creditors.
- Prevent the transfer of a family member's interests as a result of a failed marriage.
- Provide flexibility in business planning not available through trusts, corporations, or other business entities.
- Facilitate the administration and reduce the cost associated with the disability or probate of the estate of family members.

- Promote the family's knowledge of communication about family assets.

b. What Goes In May Not Always Come Out.

Because of the nature of partnerships, and the property owned by the partnership, the property used by the spouses to fund the partnership may be very different when the partners divorce. As previously stated, the specific property is converted into a partnership interest. So the spouse who funds with stock, does not get the interest in the stock back, only an undivided interest in the partnership. Even if the assets are the separate property of one of the spouses, after years of partnership activity, the ability to trace out the percentage of that separate interest may be impossible.

c. To Partition or Not to Partition.

It is not unusual for estate planners to advise clients to enter into a partition or exchange agreement prior to the creation of a FLP. Again, while this may make the funding interests easier to deal with, each spouse should have independent counsel to advise them of the possible adverse effects of relinquishing their respective community property rights. TFC §4.102.

d. Affects of Formation.

Below is a flow chart which portrays a common FLP setup. This is provided for ILLUSTRATIVE PURPOSES ONLY, as there are an enumerable ways FLPs can be structured.

**PROPERTY**

**JONES FLP**

Many times the spouses execute a partition agreement

**H & W - 49 ½% EACH**

**GENERAL PARTNER - 1% INT.**

No Personal Liability

Total Control

No Control/Management

Personal Liability

No Assignment of Int.

No Removal w/o 70% Int. Consent

Can't Dissolve w/o Consent of all Partners

**THE SPOUSES THEN**

**H Transfers % Interest to Children**

**W Transfers % Interest to Children**

**10% to Child 1**

**10% to Child 2**

**10% to Child 1**

**10% to Child 2**

Excluded from Parent's Estate

Passes Tax Free

Generates Income

Once the FLP has been formed, what has been accomplished for income and estate tax purposes:

- Income earned on the gifted partnership interests is removed from the spouse's estate;
- The appreciation of rental properties, if any, is removed from spouse's estate for estate tax purposes;
- The value of the partnership to the children pass to them gift tax free. Gift tax will be based not on the value of the property transferred, but on the value of the "gift" of the partnership interest. With the children getting a minority interest, in all likelihood the value will be heavily discounted because of lack of marketability of the interest transferred.
- The control of the assets are maintained by the person(s) capable of managing the assets;
- If a creditor were to go after any of the partners, they don't get the assets, they only get an minority interest in the partnership that they can do little or nothing with to satisfy their debt;
- Creditors who seize the interest have no right to vote on partnership affairs;
- A creditor would only be entitled to the pro rata distribution, if and when made;
- Maximizes the possibility that a judgment creditor would be willing to sell the assignee interest at a substantial discount;
- If judgment was result of a tort, the judgment creditor can't touch the other spouse's interest, because the separate property of one spouse is not liable for the torts of the other spouse;
- Probably would make no difference if the partnership assets were a stock portfolio or real estate

3. Problems With Limited Partnerships on Divorce.

The mere structure of the FLP is inherent with practical problems on divorce. If a FLP is setup like the example above, the non-controlling spouse may not reap much from a monetary standpoint, absent a finding of fraud. Who wants to buy into a partnership where there is no control and no guaranty of return on the investment?

a. Valuation.

The value of the limited partner's interest is susceptible to valuation in the same manner as that of the IRS. There will be major discounts because of the lack of marketability and restrictions on transferability.

The IRS has routinely upheld discounts for minority interests and lack-of-marketability at fairly substantial rates. Limited partnership interests will often be discounted at 30-40%, leaving it worth much less than a general interest.

Factors that will weigh heavily into the evaluator's determination are the restrictions placed on the limited partners' interests (i.e. possible non-transferability, lack of management and control, inability to withdraw during the term of years, etc.). Goodwill may well prove to be a relevant as well.

In Crowell v. Crowell, 2000 Tenn. App. Lexis 370 (decided May 30, 2000), the Tennessee trial court considered, in determining an award of alimony, the value of the wife's inherited separate property interest. The wife had inherited a 48.5% limited partnership interest in an FLP which held over $1,000,000 in assets, including a farm. She argued that her limited interest was of very little value to her because it was not liquid. She did admit, however, that the partnership property could produce income, but that she did not intend to draw income from it, as it would be against the wishes of her mother, brother and herself. The trial court, factored the wife's interest "heavily" against her, despite her valuation arguments and the appellate court upheld its decision.

b. Inability to Force Distributions.

Depending upon how the management powers are allocated, the non-controlling spouse is faced with the reality that the ability to force distributions other than stated in the FLP will not be possible. In Cleaver v. Cleaver, supra, wife was one of the beneficiaries under her father's testamentary trust. Part of the trust corpus was a 8.33% undivided interest in a partnership which was managed by the wife's uncle Joe, who also owned a *75%* interest. The trust provided that Joe had the total discretion on how to invest the earnings in the partnership business. He could distribute the earning to the trust, or reinvest in the business. Joe chose to reinvest the earnings in the business, as opposed to distributing them to the beneficiaries. Citing Heilbron v. Stubblefield, 203 S.W.2d 986, 989 (Tex. Civ. App. - El Paso 1947, writ ref d. n.r.e.) the court held that partnership management had the right to withhold earnings and determine the amount of earnings to be distributed, if any. Once the earnings were reinvested in the partnership, they became part of the "entity". Since the earnings were never actually distributed to the trust, but instead reinvested directly into the partnership, there was no valid claim by husband to "community" income from the trust.

c. Destroying Family Harmony.

In addition to the lack of value and inability to manage the partnership, the non-controlling spouse is faced with the difficult decision of whether to join the FLP as a party to the divorce. In a true business setting this is somewhat of a no brainer decision. However, if the spouse's children are also limited partners in the FLP there exists the distinct possibility that, if successful in defeating the FLP, the children will obviously be affected financially. As a result, the only thing the family law attorney can do is properly advise the client of the financial risks involved and the client must be the one who assesses the emotional risk at stake.

d. Setting Aside the Partition Agreement.

If there was a partition or exchange agreement executed prior to the formation of the FLP, the complaining spouse must set aside that marital agreement first, before attacking the FLP, in order to get to the characterization issue of the partnership interest. The statutory requirements and burden of proof mandated by the statute could make this approach an extremely difficult and risky endeavor. TFC §4.105. See also, Marsh v. Marsh, *949* S.W.2d 734, 738 (Tex. App. - Houston [14th Dist. 1997, no writ). If the attack fails, the contesting spouse could be liable for costs and attorney fees for breach of the marital contract. See, Tex. Civ. Prac. & Rem. Code Ann. §38.001. Even if the complaining spouse is successful in setting aside the marital agreement, the issue of fraud as it relates to the formation of the FLP is still left to be decided.

e. Tax Effects of Getting What You Ask For.

The adage, "be careful what you ask for because you may get it", is especially true when contemplating invalidating a FLP. A detailed explanation of every tax trap is beyond the scope of this paper. However, if successful, the adverse tax impact may greatly outweigh the benefits to be gained by setting aside the FLP. Counsel should consult with a tax expert before embarking on this path so the client can be fully advised as to the possible tax implications if successful.

## VII. ATTACKING TRUSTS AND FLPs ON DIVORCE.

If there exist no reasonable possibility of an amicable resolution, an all out attack on the Trust or FLP may be the only alternative. If so, listed below are some general suggestions in formulating a strategy to be used when attacking the Trust or FLP.

### A. READ and understand the operative documents.

It is crucial to obtain, read, and understand the terms of the trust or FLP in question. Retain an expert and have him/her analyze each and every term of the instrument. This can be extremely important in determining, not only the validity of the trust or FLP, but also whether there has been compliance with its terms. One should look closely at the stated business purpose of the FLP. Many FLPs state that the general purpose is to make a profit, provide a means of increasing family wealth, etc. If some of the purposes have not been followed it may provide some incentive to resolve the matter on more favorable terms to the non-controlling spouse. Even if the chances of invalidating the entire FLP are slim, there may be a way to force the proponent to the settlement table if there has not been strict compliance or glaring inconsistencies in the manner in which the FLP was administered. Although the trust or partnership agreement can determine the standards of the duty of care and obligation of good faith of a partner, such obligation cannot be eliminated. TRPA §4.03(c-d).

### B. Examine the books and records.

In the case of trusts, a beneficiary always retains the right to an accounting once every 12 months. TTC §113.151. A partner, whether general or limited, cannot be unreasonably restricted from access to the books and records of the partnership. TRPA §4.03(b). Even if the other spouse is the sole beneficiary of a third party grantor trust, the books and records of the trust should be discoverable for the purpose of determining the character of the income generated from the trust.

### C. Fraud and alter ego claims.

An element of fraud will always be present at the time of divorce mainly because one of the spouses always feels that they have been cheated or somehow treated unfairly by the other spouse during the marriage. While the practitioner may be inclined to immediately plead some form of fraud when confronted with one of these situations, he or she needs to have a clear understanding of what the limits are as applied to trusts and FLPs. As discussed below, alter ego has also been advanced as a theory if the controlling spouse uses the trust or FLP as a mere conduit to do what he or she desires without regard to the necessary formalities imposed by law. However, there are no reported cases which apply the alter ego theory to either trusts or FLPs.

1. Fraud.

For purposes of this article the comments will be confined to what family lawyers know as "fraud on the community" or "fraud on the spouse doctrine". See, Jackson v. Smith, 703 S.W.2d 791, 795 (Tex. App. - Dallas 1985, no writ). Jackson defines constructive fraud as the breach of a legal or equitable duty which violates a fiduciary relationship which exists between spouses. Id.

The opinion reiterates that the presumption of constructive fraud arises where one of the spouses disposes of the other spouse's one half interest in community property without the other's knowledge or consent. Id. Take, for example, the man who, shortly prior to marriage, conveys all of his income-producing property into trust, and then, either as trustee or through control over the trustee, uses undistributed trust income to acquire assets such as the car which he drives, the house in which he lives, etc. --items which would have been community property had the income been received by him free of trust. This activity might not constitute a constructively fraudulent conveyance of community property; however, would it constitute use of an express trust in a constructively fraudulent manner? If the principles which apply to use of a corporation to perpetrate a fraud can be adapted to express trusts, perhaps equity will allow the court in a divorce to disregard the trust "fiction." Although fraud in this context may be easy to detect, the real question is whether it stands as a separate cause of action in a divorce suit.

a. Fraud in Divorce - A Separate Cause of Action?

Whether the alleged fraud relates to a trust or a FLP, Texas law indicates that fraud, as a independent cause of action, cannot be maintained in a divorce suit. In the Matter of the Marriage of Moore, 890 S.W.2d 812 (Tex. App. - Amarillo 1994, no writ) husband was the manager of the community assets. On divorce, wife sought reimbursement and alleged a separate cause of action claiming husband breached his fiduciary duty to the community. Id. at 825. She sought both actual and exemplary damages. The appellate court held that the two claims were basically the same. Id. at 827. In reversing the award of damages to Mrs. Moore the court held that no independent cause of action existed for fraud on the community. Id. at 829. As opposed to a separate award of damages, the Moore court sees the equalizing recovery as a recoupment to the community for the fraudulent acts of the other spouse. Four years following the *Moore* case, the Texas Supreme Court confirmed that position in Schlueter v. Schlueter, 975 S.W.2d 584 (Tex. 1998). Mrs. Schlueter sued both husband and his father in a third party action alleging fraud, breach of fiduciary duty, and conspiracy. Husband had attempted to transfer community funds to his father. Had he been successful, those funds would not have been available for the trial court to divide upon divorce. The trial court found for wife and awarded actual and exemplary damages. The court of appeals affirmed the trial court's judgment. Schlueter v. Schlueter, 929 S.W.2d 94, 100 (Tex. App. - Austin 1996), rev'd, 975 S.W.2d 584 (Tex. 1998). In a 6-3 decision, the supreme court held that a separate and independent tort cause of action for actual fraud and exemplary damages against one spouse does not exist in the context of a deprivation of community funds by the intentional fraudulent acts of the other spouse directed against the assets of the community. Id. at 585. The holding in Schlueter was followed by the El Paso Court of Appeals in Sprick v. Sprick, 25 S.W.3d 7, 16 (Tex. App. - El Paso 1999, pet. denied). Citing Schlueter, the court held that where the economic tort depletes the community estate so as to leave insufficient property available to the wronged spouse, the court may impose a monetary judgment in order to achieve an equitable division . 975 S.W.2d at 588. Because the amount of any such judgment is directly referable to a specific value of lost community property, it will never exceed the total value of the community. (emphasis added)

Query: What if there are insufficient assets to satisfy the judgment? What happens to the monetary judgment if the guilty spouse discharges the equalizing judgment in bankruptcy?

b. Spouse Versus Partner.

Based on the rationale stated in Moore, Schlueter, and Sprick it is clear that if the tort is between spouses there is really little or no relief for the offended spouse. Does this preclude the spouse who is also a partner from bringing an independent fraud action against the other spouse in his/her partnership capacity, or against the partnership? Probably not. The wronged spouse may bring an independent suit. However, the recovery may be limited to the partner's interest in the partnership. If successful, what exactly has the defrauded spouse won? The control of the entity may not be affected and the spouse will not be able to get to specific partnership property. The plaintiff may still not be able to force dissolution.

2. Alter Ego.

Alter ego (also referred to as piercing the corporate veil) has been recognized for many years when an individual had used the corporate entity for his/her on personal benefit, thereby perpetrating a fraud on others. Castleberry v. Branscum, 721 S.W.2d 270 (Tex. 1986). Its application has been confined to closely held corporations. Zisblatt v. Zisblatt, 693 S.W.2d 944 (Tex. App. - Fort Worth 1985, writ dism'd.); Parker v. Parker, 897 S.W.2d 918 (Tex. App. - Fort Worth 1995, writ denied). There are no reported cases where an alter ego claim has been made against a trust or FLP. Closely following the decision in Castleberry v. Branscum was an amendment to the Business Corporation Act which codified, and in effect, narrowed the use of the alter ego theory. It requires an obligee of corporate debt to prove that the person caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual, rather than merely constructive, fraud on the obligee for the direct personal benefit of the shareholder, owner or subscriber. Comment, Tex. Bus. Corp. Act, Art. 2.21 (West Supp. 2001). Even though this cause of action historically has been restricted to corporations, it may well be applicable to other types of entities.

3. Parties to Suit To Contest Trust or FLP.

Generally speaking, if the trust is revocable and husband and wife, or one of them is the settlor, and they are also the sole beneficiaries, there should be no need to join the controlling spouse as trustee. However, if the trust is irrevocable it may be necessary to join the trustee and the other beneficiaries in the suit. Starcrest Trust v. Berry, 926 S.W.2d 343, 355 (Tex. App. - Austin 1996, no writ). There should be a careful examination of the trust document to determine whether the trust requires joinder. Additionally, if you are going to attack or attempt to set aside a FLP, a great deal of thought should be given on whether the FLP and/or its general partner and limited partners should be, or are, necessary parties to the litigation.

## VIII. SPECIFIC CHALLENGES TO TRUSTS AND FLPS.

Listed below are some specific areas to be investigated when dealing with trusts and FLPs on divorce.

### A. Trusts.

1. Defects in Formation.

If one of the spouses is the settlor of the trust before marriage, the contesting spouse should make sure that the required elements of the creation of the trust have been met. This can include the basic requirements such as proper signature, express intent, and the actual funding of the trust. Remember, an express trust can come into existence only by the execution of an intention to create it by the one having legal and equitable dominion over the property made subject to it. Mills v. Gray, 147 Tex. 33, 210 S.W.2d 985, 987 (1948). Title to the property must immediately pass to the trustee, and beneficial or equitable title to the beneficiaries, Cutrer v. Cutrer, 334 S.W.2d 599, 605 (Tex. Civ. App. - San Antonio 1960), *aff'd.* 163 Tex. 166, 345 S.W.2d 513 (1961).

2. Challenging Intent to Create the Trust.

Before there can be a trust, the settlor must intend the creation of the trust. See TTC §112.002. ("A trust is created only if the settlor manifests an intention to create a trust"); Gonzalez v. Gonzalez, 457 S.W.2d 440 (Tex. Civ. App.--Corpus Christi 1970, writ ref'd n.r.e.); Tolle v. Sawtelle, 246 S.W.2d 916, 918 (Tex. Civ. App.--Eastland 1952, writ ref'd).

Some trust arrangements, such as funds deposited in a bank account with a signature card reading "in trust," or securities held "as trustee" for another, are so informal that a clear intention to create a trust is not readily ascertainable from the documentation.

Thus, intent of the settlor to create the trust is the first thing to check when considering an assault on an express trust.

a. Extrinsic Evidence of Intent.

Generally, the parol evidence rule normally prohibits the use of extrinsic evidence to add to or vary the terms of a written document, absent allegations of ambiguity, fraud, duress or mistake. Guardian Trust Co. v. Bavereisen, 132 Tex. 396, 121 S.W.2d 579, 583 (1938). However, the court may consider parol evidence as to the circumstances surrounding the creation of the document, for the purpose of applying the document to the subject with which it deals, and for the purpose of ascertaining the real intention of the parties. Id. at 583. *See* McClung, A Primer on the Admissibility of Extrinsic Evidence of Contract Meaning, 49 Tex. Bar. J. 703 (1986).

On the other hand, some courts have taken a more restricted approach to parol evidence. In the case of Otto v. Klement, 656 S.W.2d 678 (Tex. App.--Amarillo 1983, writ ref'd n.r.e.), the court refused to consider parol evidence on intent where the proof was offered to vary a survivorship provision contained on a bank signature card. In Isabell v. Williams, 705 S.W.2d 252 (Tex. App. --Texarkana 1986, writ ref'd n.r.e.), parol evidence was admitted only because a conflict between printed language and writing on an account signature card created an ambiguity.

b. Intent to Create a Trust.

There is specific authority that parol evidence may be considered in determining whether a person intended to create a trust in a particular circumstance. As stated by the Texas Commission of Appeals in connection with funds deposited in an account "in trust" for another:

> The ultimate controlling fact to be determined is the intention of the donor. Such a transaction does or does not create a trust according as the

> donor intended. Since in this case no one but Mrs. Baldwin knew or could have known what were her real intentions in these transactions, that fact must be arrived at by a consideration of her relevant acts and declarations, prior to, at the time of, and subsequent to the various transactions. As stated in the application for writ of error:
>
> "The intention referred to is to be ascertained, not by the application of barren concepts to a single fact, but 'by rational deductions' based upon all the facts."

Fleck v. Baldwin, 141 Tex. 340, 172 S.W.2d 975, 978-79 (1943).

3. Failure in Mechanics of Creation.

The TTC has certain requirements for express trusts that must be observed. When these conditions are not met, an express trust cannot be recognized in a court proceeding.

a. Must be in Writing.

The TTC provides that an express trust containing real or personal property is unenforceable unless it is created by a written instrument, signed by the settlor, containing the terms of the trust. TTC § 112.004. The mere designation of a party as "trustee" on an instrument does not alone create a trust. Nolana Development Ass'n v. Corsi, 682 S.W.2d 246, 249 (Tex. 1985).

b. Exception for Personalty.

There are two exceptions to this rule, for trusts which involve only personalty.

(1) Personalty Transferred to Another With Intent Expressed.

Where the trust includes only personalty, the trust is enforceable if the personalty is transferred to a trustee who is not a beneficiary or settlor, and the settlor expresses the intention to create a trust, either before or at the time of the transfer. TTC § 112.004. In such a situation, written evidence of the trust is not required.

(2) Personalty Retained by Settlor With Writing Reflecting Trust.

A trust of personalty is also enforceable where an owner of personalty states *in writing* that certain personalty is held by that person as trustee for another, as beneficiary, or for himself and another, as beneficiaries. TTC §112.004. This exception would apply to funds which the party has deposited in a financial institution, where the account reflects the party as "trustee" for another. *See* Jameson v. Bain, 693 S.W.2d 676 (Tex. App. --San Antonio 1985, no writ). This exception would also apply to stocks, bonds, CD's, etc. carried in the name of the party "as trustee" for another. *See* Citizens Nat. Bank of Breckenridge v. Allen, 575 S.W.2d 654, 658 (Tex. Civ. App. --Eastland 1979, writ ref'd n.r.e.).

c. No Exception for Realty.

No exception to the requirement of a writing exists for realty. Thus, where one person holds title to real estate as "trustee," and no written trust agreement exists, the relationship is not an express trust. It may, however, be a resulting trust. The TTC, however, specifically states that it does not apply to resulting or constructive trusts. TTC § 111.003.

d. A Transfer is Necessary.

There must be a present transfer of legal title of property from the settlor to the trustee for the trust to be valid. Cutrer v. Cutrer, 334 S.W.2d 599, 605 (Tex. Civ. App.--San Antonio 1960), *aff'd*, 162 Tex. 166, 345 S.W.2d 513 (1961). However, the settlor may "transfer" legal title to the property to himself as trustee as long as his words or acts clearly reflect his intent to relinquish individual ownership in favor of holding the property merely as trustee for the beneficiary. Westerfield v. Huckaby, 474 S.W.2d 189 (Tex. 1972). *Accord*, TTC § 112.004(2). The settlor may retain rights in the property, or may be the initial trustee, and may retain the right to revoke the trust, without violating this rule. Westerfield, supra at 193.

4. Non-Consenting Spouse's Property Used to Fund Trust.

As previously indicated, the illusory trust doctrine is a species of constructive fraud. This doctrine is limited to those situations in which a non-consenting spouse's property is used to fund the trust. Westerfield v. Huckaby, 474 S.W.2d 189 (Tex. 1971). It should be noted that the entire trust in Land v. Marshall was invalidated by the court, while in Westerfield, only that portion of the trust attributable to wife's property was void.

5. Participation by Spouse Will Defeat Claim.

Absent a finding of fraud, a claim asserted by a spouse who has consented to the formation of the trust or to the funding of the trust with his or her separate, or community interest property, will fail. See, Marsh v. Marsh, supra, at 742. The length of time between the funding and the attack will be an important factor for the court to consider in addressing this type of claim. If the complaining spouse knew of the questioned transfers, has enjoyed the benefits from the transaction, and a substantial amount of time has passed, the court may be less likely to sustain the attack. Where both spouses participate in transferring property to another to avoid creditors, that property will not be included in the community estate. Jones v. Jones, 804 S.W.2d 623 (Tex. App.-Texarkana 1991, no writ). The Joneses (H & W) transferred property to husband's son from a prior marriage in anticipation of a potential judgment being rendered against them. Id. at 624, The fraud perpetrated in Jones was not directed toward the community, but toward third party creditors. Id. at 625. The trial court ordered the son to reconvey the property to the parties. Reversing the trial court, the appellate court held where a person conveys land in fraud of his creditors, though the land is only to be held in trust, neither he nor his heirs can enforce the trust against the grantee. *Id.*

6. Failure to Distribute Pursuant to Terms of Trust.

An indirect attack on the validity of a trust will include those of failure of the trustee to comply with the terms of the trust to distribute the income and/or corpus. This will occur when the beneficiary/spouse, though entitled to a distribution, has not received the property according to the terms of the trust. If the trustee is someone other than the spouse, they should be joined as party in the divorce. This would apply to both express trusts and questionable transfers where the imposition of constructive trust may be appropriate. Failure to join the proper person or entity may result in collateral estoppel if the harmed spouse attempts to bring a separate action after the conclusion of the divorce.

7. Dry Trust

The Texas Supreme Court has said that "[w]hen a trustee has no duties to perform, the purposes of the trust having been accomplished, it becomes a simple, passive or dry trust, as it is termed in the law, and the cestui que trust is entitled to have the full legal title and control of the property, because no other person has an interest in the property." Lanius v. Fletcher, 100 Tex. *550*, 101 S.W.2d 1076, 1078 (1907). Under these circumstances, the beneficiary is entitled to possession of the contents of the trust. Hall v. Rawls, 188 S.W.2d 807, 815 (Tex. Civ. App. --Beaumont 1945, writ ref d). Similarly, if the trustee is not given affirmative powers and duties in the trust instrument, the trust is passive or dry, and legal title is vested in the beneficiaries, not the trustee. Nolana Development Assn v. Corsi, 682 S.W.2d 246, 249 (Tex. 1984). Consider, however, the effect of § 112.004 of the TTC, which recognizes the enforceability of a trust of personalty in certain situations, even though the terms of the trust are not specified.

The doctrine of "dry trust" was explored in the case of Zahn v. National Bank of Commerce, 328 S.W.2d 783 (Tex. Civ. App.--Dallas 1959, writ ref'd n. r. e.). The settlor' s will provided that land was to be held for two years after her death and if at that time, oil or minerals were not found, the land was to be sold and the oil and mineral rights reserved and placed in trust for the benefit of five cousins. The trustee asked for a construction of the will to determine if this trust was valid. The Court of Civil Appeals determined that it was permissible for the trust to remain dry" or unfunded for the two-year period. If the oil or mineral rights were found within that period, the beneficiaries would receive title in fee simple. If not, the trust would be funded (with the oil and mineral rights as the *res)* for administration on behalf of the beneficiaries.

8. Illusory Trust

An express trust can be challenged on the ground that it is an "illusory trust." The leading Texas case on illusory trusts is Land v. Marshall, supra. In Land v. Marshall, the husband had created an inter vivos trust using almost all of the community property. He retained, however, the power to revoke the trust, the right to consume the principal, to control the trustee, and other beneficial interests during his lifetime. Upon his death, the trust passed title in the community property to the parties' daughter. In a challenge brought by the wife after the husband's death, the entire trust was held by the Supreme Court to be invalid. The test announced by the Supreme Court for an "illusory trust" was:

> Did the decedent, by his conveyance in his lifetime, retain such a large interest in the property that, at least as to his wife, his inter vivos trust was illusory? Id. at 848.

If so, then the trust was "illusory," and failed as to the wife's one-half community property interest. This happened in Land v. Marshall. However, in Land v. Marshall, the court also nullified the trust as to the husband's one-half of the property, because the removal of the wife's one-half interest in the property was seen as defeating the husband's testamentary intent. Id. at 849.

Therefore, the Illusory Trust doctrine was adopted in Land v. Marshall, because the husband sought to make a testamentary disposition of his wife's community interest in property through the use of an inter vivos trust. Texas law prohibited the husband from bequeathing his wife's community interest in the property. The Texas Supreme

Court concluded that, where the conveyance into trust was illusory, the trust failed as to the wife's one-half community interest.

A similar concept was described in Hunter v. Clark, 687 S.W.2d 811, 814 (Tex. App.--San Antonio 1985, no writ), in that a spouse could not defeat the other spouse's survivor's homestead right by conveying the homestead during lifetime.

a. Only When Non-Consenting Spouse's Property is Used to Fund a Trust.

The illusory trust doctrine "is limited to instances in which a non-consenting spouse's property is used to fund a trust." Westerfield v. Huckaby, 474 S.W.2d 189 (Tex. 1971). Consequently, the remedy is available only to the extent that the complaining spouse's separate property, or share of the community property, is used without her consent. As explained in Westerfield, the trust in Land v. Marshall was an illusory trust only as to the wife's interest in the property. Westerfield, 474 S.W.2d at 191. However, the entire trust failed, even as to the husband's interest in the property, because the loss of half of the trust corpus was deemed to defeat the husband's plan of distribution. Id. at 849.

b. Excessive Control Not Sole Basis of "Illusory Trust" Attack.

In Westerfield, the administratrix of a decedent sought to set aside inter vivos trusts created by the decedent, on the grounds that the decedent had retained too much control and the trusts were "illusory." The administratrix's attack was rejected by a majority of the Supreme Court which felt that the decedent could create valid trusts even though she reserved in herself broad beneficial rights, as well as the right to revoke the trusts and the right to control or manage the trustees. Id. at 192. [There was no problem of community property in Westerfield, because the decedent was a single woman (femme sole).]

c. Spouse's Participation Forecloses Attack.

An illusory trust attack cannot be raised by a spouse who participated in the original conveyance into trust. United States v. Gordon, 406 E2d 332, 343 (5th Cir. 1969).

9. Alter Ego.

Family lawyers know that the independence or separateness of a corporation or other business entity can be attacked under the "alter ego" doctrine. The doctrine might be available to contest whether certain property is actually "held in trust." The Court of Civil Appeals, in In re Marriage of Burns, 573 S.W.2d *555*, *557* (Tex. Civ. App. --Texarkana 1978, writ dism'd), acknowledged this potential attack, when it pointedly observed that the wife in that case had not challenged the husband's trust as being the alter ego of the husband.

The necessary legal standards to establish a trust as an alter ego can be adapted from cases where a spouse has sought to pierce the corporate veil. *See* Spruill v. Spruill, 624 S.W.2d 694 (Tex. Civ. App. --El Paso 1981, writ dism'd); Duke v. Duke, *605* S.W.2d 408 (Tex. Civ. App.--El Paso 1980, writ dism'd); Humphrey v. Humphrey, 593 S.W.2d 824 (Tex. Civ. App. --Houston [14th Dist.] 1980, writ dism'd); Goetz v. Goetz, *567* S.W.2d 892 (Tex. Civ. App.--Dallas 1978, no writ). Martin v. Martin, 628 S.W.2d 534 (Tex. App.--Fort Worth 1982, no writ). *See generally* Tex. Prop. Code Ann. § 112.008(c) (Vernon 1995) (settlor and beneficiary may be trustee, except where merger would occur). It should be noted that a trust may be operated as an alter ego of the settlor, or of the beneficiary, or of the trustee.

The Texas Supreme Court examined the contours of the alter ego theory as to corporations, in great detail, in Castleberry v. Branscum, 721 S.W.2d 270 (Tex. 1986). There the Court discussed seven recognized grounds for disregarding the corporate fiction: (i) alter ego; (ii) because "the corporate form has been used as part of a basically unfair device to achieve an inequitable result; (iii) fraudulent conveyance; (iv) the trust fund doctrine; (v) breach of fiduciary duties; (vi) the denuding theory; and (vii) inadequate capitalization. Id. at 271-73. As to the alter ego theory the Court said:

> Alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice. First Nat. Bank in Canyon v. Gamble, 132 S.W.2d 100, 103 (Tex. 1939). It is shown from the total dealings of the corporation and the individual, including the degree to which corporate formalities have been followed and corporate and individual property have been kept separately, the amount of financial interest, ownership and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes. [Citations omitted.] Alter ego's rationale is: "if the shareholders themselves disregard the separation of the corporate enterprise, the law will also disregard it so far as necessary to protect individual and corporate creditors."

Id. at 272.

The policy reasons which support disregarding the corporate fiction may well also apply to situations where a trust relationship to property is conducted in a manner that makes the trustee an alter ego of the settlor, the beneficiary, or the person who is acting as trustee. If the facts warrant it, plead the cause of action.

10. Colorable Trust vs. Alter Ego.

While some might wonder at the usefulness of drawing distinctions between two trust doctrines, neither of which has as yet become established law in this state, one can draw certain distinctions between a “colorable” trust and a trust relationship which is conducted so as to make the trustee the “alter ego” of the settlor, the beneficiary or the trustee. To prove that a trust is colorable, the proponent must show an agreement between the settlor and the trustee such that the settlor retains ownership of the rest of the trust, notwithstanding the apparently completed conveyance to the trustee. To establish that a trust is being operated as an alter ego, the proponent would presumably have to show that the settlor, or trustee, or beneficiary, as the case may be, dealt with the trust property as if it was not subject to the fiduciary obligations deriving from the trust instrument. Thus, even if the attempt to prove an *agreement* between the trustee and the settlor is unsuccessful, and the colorable trust attack fails, success may be available on alter ego grounds, because of the way the trust property is handled.

11. Rescission, Cancellation and Reformation for Fraud, Duress, Mistake, Etc.

Conveyances into trust, like every other transaction, are subject to rescission, cancellation or reformation on the grounds of fraud, accident, mistake, undue influence, duress, failure of consideration, etc. See 72 Tex. Jur. 3d Trusts § 154 (1990).

a. Fraud in the Inducement as Basis for Rescission.

In order to rescind a conveyance for fraud in the inducement, it must be shown that: (1) a false representation was made by the defendant; (2) the victim detrimentally relied upon the false representation; and (3) injury resulted to the victim. Citizens Standard Life Ins Co. v. Muncy, 518 S.W.2d 391, 194 (Tex. Civ. App.--Amarillo 1974, no writ). The misrepresentation must relate to a material fact. Runfield v. Runfield, 324 S.W.2d 304, 406 (Tex. Civ. App.--Amarillo 1959, writ ref’d n.r.e.). The speaker need not know the falsity of the representation. Citizens Standard Life Ins. Co. v. Muncy, 518 S.W.2d 391, 195 (Tex. Civ. App.--Amarillo 1974, no writ). The failure to disclose a material fact will not support rescission, unless the wrongdoer had a duty to disclose arising from the nature of the relationship between the wrongdoer and the victim. Anderson v. Anderson, 620 S. W 2d 815, 819 (Tex. Civ. App.--Tyler 1981, no writ). A promise regarding future behavior will not support rescission unless the wrongdoer had no intent to carry out the promise at the time it was made. Bassett v. Bassett, 590 S.W.2d 531, 533 (Tex. Civ. App.--Houston [1st Dist.] 1979, writ dism’d). Where the victim has knowledge of the falsity, rescission will not lie. Shaw Equipment Co. v. Hoople Jordan Const. Co., 428 S.W.2d 835, 839 (Tex. Civ. App.--Dallas 1968, no writ).

In the context of a trust, it can be imagined that the settlor, or someone claiming through him, might assert fraud in the inducement as a ground to rescind the conveyance into trust. Consider, this example: Assume that the wife is induced by her husband to join in a conveyance of their community property into trust, with the income from the trust to be paid in equal portions to husband and wife, for their lives, and then to the survivor, for life, and with the remainder to go to the spouses’ children. Shortly after the conveyance, the husband files for divorce, and moves in with his girlfriend. The wife’s lawyer wants to rescind the conveyance into trust. Given the fiduciary relationship which arguably exists between spouses, and the husband’s failure to disclose the existence of a girlfriend or his intent to seek a divorce, the evidence should support rescission of the conveyance into trust, for fraud in the inducement. Proof of actual fraud eliminates the need to show a fiduciary relationship. Meadows v. Bierschwale, 516 S.W.2d 125 (Tex. 1974).

(1) Accident.

The Texas Supreme Court has discussed what constitutes an accident sufficient to rescind or cancel a transaction. In Henry S. Miller Co. v. Evans, 452 S.W.2d 426, 432 (Tex. 1970), the court described such an accident as:

> ..an unforeseen and unexpected event, occurring externally to the party affected by it, *and of which his own agency is not the proximate cause,* whereby, contrary to his own intention and wish, he loses some legal right or becomes subject to some legal liability and another acquires a corresponding legal right, which it would be a violation of good conscience for the latter person, under the circumstances, to retain . . . . If the party’s own agent is the proximate

cause of the event, it is mistake rather than an accident.

(2) Mistake.

Equity recognizes "mistake" as a ground for reformation, rescission or cancellation of a transaction. It should be noted that if rescission or cancellation is not available, the settlor could alternatively reform the trust agreement to make it revocable, and then later exercise his power to revoke the trust.

(3) Mistake as Basis for Reformation.

Reformation is an equitable proceeding in which a document which is erroneously written is caused to conform to the true agreement between the parties. Continental Oil Co. v. Doornbos, 402 S.W.2d 879, 883 (Tex. 1966). Ordinarily, the mistake in the document must be mutual, and not unilateral, in order to support reformation. To warrant reformation, the proponent must prove the true agreement of the parties, and that the written memorandum deviates from the true agreement as a result of mutual mistake. Brown v. Havard, 593 S.W.2d 939, 942 (Tex. 1980). However, unilateral mistake by one party will support reformation where it is accompanied by fraud or inequitable conduct by the other party. Ace Drug Marts, Inc. v. Sterling, 502 S.W.2d 935, 939 (Tex. Civ. App.--Corpus Christi 1974, writ ref'd n.r.e.). For example, where the other party knows of the mistake but fails to mention it, inequitable conduct exists to support reformation based upon unilateral mistake. Cambridge Companies, Inc. v. Williams, 602 S.W.2d 306, 308 (Tex. Civ. App. --Texarkana 1980), *aff'd*, 615 S.W.2d 172 (Tex. 1981).

(4) Mistake as Basis for Rescission and Cancellation.

To rescind or cancel an agreement for mistake, the mistake generally must be mutual. Hanover Ins. Co. v. Hoch, 469 S.W.2d 717, 722 (Tex. Civ. App.--Corpus Christi 1971, writ ref'd n.r.e.). The mistake must relate to a material and essential issue, not an incidental one. Simpson v. Simpson, 387 S.W.2d 717, 719 (Tex. Civ. App.--Eastland 1965, no writ). The mistake cannot have resulted from the negligence of the party seeking to negate the transaction. Plains Cotton Cooperative Assn. v. Wolf, 553 S.W.2d 800, 803 (Tex. Civ. App. --Amarillo 1977, writ ref d n. r. e.). Generally, an error in predicting the future will not support rescission or cancellation. City of Austin v. Cotten, 509 S.W.2d 554, 557 (Tex. 1974). A mistake as to a party's existing legal rights can support rescission. Plains Cotton Cooperative Assn. v. Wolf, *553* S.W.2d 800, 803 (Tex. Civ. App.--Amarillo 1977, writ ref'd n.r.e.). Unilateral mistake, which is not known to or induced by the other party, will not support rescission or cancellation of an agreement. Johnson v. Snell, 504 S.W.2d 397, 399 (Tex. 1973). However, unilateral mistake can support rescission where the mistake is of such a magnitude that to enforce the contract would be unconscionable; the mistake involves a material feature of the agreement; the mistake was made despite the exercise of ordinary care; and the parties can be returned to the status quo after rescission. James T Taylor, Etc. v. Arlington Ind. School Dist., 335 S.W.2d 371, 373 (Tex. 1960).

(5) Cancellation of Trust Agreements.

American Law Reports, Second Edition, contains an annotation on the subject of when an irrevocable inter vivos trust can be cancelled on the ground of mistake or misunderstanding. Annot., 59 A.L.R.2d 1229 (1958).

One federal judge concluded that under Texas law, a settlor may reform a trust agreement to insert a power of revocation where that power was omitted from the trust agreement by mistake. *See* DuPont v. Southern Nat. Bank of Houston, Texas, *575* F. Supp. 849, 859 (S.D. Tex. 1983), *aff'd in part, rev'd part on other grounds*, 771 E2d 874 (5th Cir. 1985). The court also dealt with rescission of a trust on the grounds of mistake as to tax consequences, and suggested that Texas law would require the following showing before rescinding the trust: (1) that the trust was created solely for tax considerations; (2) that these tax considerations had been definitely changed or frustrated by an actual assessment of tax liability or by a change in law that would lead an expert to conclude that a transfer tax liability would more likely than not accrue on the transaction; (3) that the changed tax circumstance amounts to a material mistake; (4) that the settlor proves that but for the mistake he would not have entered into the transaction; and (5) that when plaintiff knew or should have known of the mistake he acted immediately to remedy the situation. Id. at 861.

(6) Undue Influence.

Undue influence can support rescission or cancellation of a transaction. It is a form of legal fraud. Bounds v. Bounds, 382 S.W.2d 947, 951 (Tex. Civ. App. - Amarillo 1964, writ ref'd n. r. e.). In the area of will contests, where undue influence arises, the term is defined as such an influence as would subvert or overpower the mind at the time of the transfer in question, and without which influence the transfer would not have been made. Bohn v. Bohn, 455 S.W.2d 401, 409 (Tex. Civ. App.--Houston [1st Dist.] 1970, writ dism'd). *See* In Re Estate of Willenbrock, 603 S.W.2d 348, 350 (Tex. Civ. App.--Eastland 1980, writ ref'd n.r.e.). The same definition was applied to a suit to rescind a real estate conveyance, in Edwards v. Edwards, 291 S.W.2d 783, 786 (Tex. Civ. App.-Eastland 1956, no writ), wherein a daughter sought to rescind a conveyance of real estate by her mother to her half-brother. Where the conveyance is made in the context of a confidential or fiduciary relationship, and the fiduciary thereby profits, a different burden of proof may apply. Mason v. Mason, 366 S.W.2d *552* (Tex. 1963), is an example of a testamentary trust that was invalidated when the will creating it was held invalid for undue influence.

(7) Duress.

Duress may be used as a basis to cancel instruments. Duress exists when: (1) there is a threat to do some act which the party threatening has no legal right to do; (2) there is some illegal exaction or fraud or deception; and (3) the restraint is imminent and such as to destroy free agency without present means of protection. Housing Authority of City of Dallas v. Hubbell, 325 S.W.2d 880 (Tex. Civ. App.--Dallas 1959, writ ref'd, n.r.e.). Hailey v. Fenner & Beane, 246 S.W. 412, 412 (Tex. Civ. App.--Dallas 1923, no writ).

12. Uniform Fraudulent Transfer Act.

Chapter 24 of the Texas Business and Commerce Code sets out the Uniform Fraudulent Transfer Act ("UFTA"). By using this Act, a spouse can perhaps undo a conveyance into trust.

The provisions of Chapter 24 apply to "transfers," including every mode of or parting with an interest in an asset. UFTA. A spouse is a "creditor" who can invoke the provisions of the statute. UFTA § 24.002(4).

a. Transfers Made with Intent to Defraud.

§ 24.005(a)(1) of UFTA voids transfers made with the intent to hinder, delay or defraud creditors. Transferred property cannot be recovered from a "bfp" who gave a reasonably equivalent value for the transfer. UFTA § 24.009(a). Cases involving spouses under earlier law include: Lott v. Kaiser, 61 Tex. 665 (1884) (for transfer made during divorce in which wife sought alimony); Goodwin v. Goodwin, 451 S.W.2d 532 (Tex. Civ. App.--Amarillo), *rev'd on other grounds*, 456 S.W.2d 885 (Tex. 1970) (regarding transfer by husband occurring between date of rendition and date of signing of decree of divorce awarding wife judgment against husband); Spence v. Spence, *455* S.W.2d 365 (Tex. Civ. App.--Houston [14th Dist.] 1970, writ ref'd n.r.e.) (regarding transfer by husband between the date the decree of divorce was signed and the date it became final, where wife received an unsecured money judgment against husband); Rilling v. Schultze, *95* Tex. 352, 67 S.W.2d 401 (1902) (regarding transfer by ex-husband after entry of divorce decree ordering him to pay child support to ex-wife.

b. Debtor's Transfer Not for Value.

§ 24.005 of the UFTA states that a transfer made by a debtor without receiving a reasonably equivalent value is void with respect to an existing creditor if: (1) the debtor was about to engage in a transaction for which his/her assets were unreasonably small; (2) the debtor believed that he/she would incur debts beyond the debtor's ability to pay as they come due. UFTA § 24.005(a)(2). Intent by the debtor to defraud a creditor or interested person is not an issue under this provision. *See* First State Bank of Mobeetie v. Goodner, 168 S.W.2d 941, 944 (Tex. Civ. App.-- Amarillo 1943, no writ). The burden of proving insolvency is on the creditor. Wester v. Strickland, 87 S.W.2d 765, 767 (Tex. Civ. App.-- Amarillo 1935), *aff'd* 112 S.W.2d 1047 (Tex. 1938).

13. Conveyances During Divorce.

§ 6.707 TFC provides that a transfer of community property, or the incurring of debt, that subjects the other spouse or the community property to liability by a spouse while a divorce is pending is void as against the other spouse, if done with the intent to injure the rights of the other spouse. The statute further provides, however, that the transfer or debt is not void as to the transferee or lender who had no notice of the intent to injure. The complaining spouse has the burden to prove such notice. However, the mere pendency of the divorce is not constructive notice to third parties of fraudulent intent. First Southern Properties, Inc. v. Gregory, 538 S.W.2d 454, 458 (Tex. Civ. App.--Houston [1st Dist.] 1976, no writ).

14. Fraud-on-the-Spouse Doctrine.

a. Actual Fraud.

No Texas cases were found where a conveyance into trust was attacked as constituting actual fraud upon a spouse. However, the issue was examined in Martin v. Martin, 282 Ky. 411, 138 S.W.2d 509 (1940). In that case, the issue was whether a man who was about to marry could transfer his property to a third party with the intent to deprive his intended spouse of a distributive share of his estate, upon his death. The high court of Kentucky made the following statement of the law:

> [A] man may not make a voluntary transfer of either his real or personal estate with the intent to prevent his wife, *or intended wife,* from

> sharing in such property at his death and that the wife, on the husband's death, may assert her marital rights in such property in the hands of the donee. [Emphasis added.]

Id. at 515. The Texas Pattern Jury Charges PJC 206-2A (2002) gives the following instruction regarding actual fraud of a spouse's interest in community property:

> A spouse commits fraud if *that spouse transfers community property or expends community funds for the primary purpose of depriving the other spouse of the use and enjoyment of the assets involved in the transaction.* Such fraud involves dishonesty of purpose or intent to deceive. [Italicized language is subject to substitution of different language, depending on facts of case]

b. Constructive Fraud.

Authorities agree that, even without proof of actual intent to defraud the spouse, the court will rescind a transaction whereby one spouse unfairly gives away the other spouse's one-half interest in community property. The doctrine of constructive fraud is one method that can be used to undo one spouse's conveyance *of* the other spouse's share of community property into a trust. *See* Stephens County Museum, Inc. v. Swenson, 517 S.W.2d 257 (Tex. 1975) (a non-marital case remanded to trial court for determination of constructive fraud issue regarding transfer into trust).

The Texas Pattern Jury Charges PJC 206-4A (2002) gives the following instruction regarding constructive fraud as to a spouse's interest in community property:

> *A spouse may make moderate gifts, transfers, or expenditures of community property for just causes to a third party. However, a gift, transfer, or expenditure of community property that is capricious, excessive, or arbitrary is unfair to the other spouse. Factors to be considered in determining the fairness of a gift, transfer, or expenditure are—*
>
> 1. *the relationship between the spouse making the gift, transfer, or expenditure and the recipient;*
> 2. *whether there were any special circumstances tending to justify the gift, transfer, or expenditure; and*
> 3. *whether the community funds used for the gift, transfer, or expenditure were reasonable in proportion to the community estate remaining.* [Italicized language is subject to substitution of different language, depending on facts of case]

(1) In Conveyances During Lifetime.

The following cases, among others, have addressed the issue of constructive fraud-on-a-spouse in inter vivos conveyances to third parties: Carnes v. Meador, 533 S.W.2d 365 (Tex. Civ. App.--Dallas 1976, writ ref'd n.r.e.) (widow sued to negate gifts of community property from deceased husband to his children from prior marriage); Horlock v. Horlock, 533 S.W.2d 52 (Tex. Civ. App.--Houston [14th Dist.] 1975, writ dism'd) (wife sought to recover from husband in divorce proceeding for gifts of community property he made to his children from a prior marriage); Logan v. Barge, *568* S.W.2d 863 (Tex. Civ. App.--Beaumont 1978, writ ref'd n.r.e.) (widow sued stepchildren to recover one-half of gifts of community property made to them by her deceased husband).

(2) In Conveyances Effective Upon Death.

The following cases have addressed the issue of constructive fraud-on-a-spouse in conveyances taking effect upon death: Givens v. Girard Life Ins. Co. of America, 480 S.W.2d 421 (Tex. Civ. App.--Dallas 1972, writ ref'd n.r.e.) (widow sued deceased husband's girlfriend to recover proceeds from community property life insurance policy on life of deceased husband); Murphy v. Metropolitan Life Ins. Co., 498 S.W.2d 278 (Tex. Civ. App.--Houston [14th Dist.] 1973, writ ref'd n.r.e.) (decedent's mother sued insurance company and decedent's wife for proceeds of community property life insurance policy on decedent's life).

15. Merger of Title.

The doctrine of merger is expressly set out in TTC § 112.034. The TTC provides:

> [I]f a settlor transfers both the legal title and all equitable interests in property to the same person or retains both the legal title and all equitable interests in property in himself as both the sole trustee and the sole beneficiary, a trust is not created and the transferee holds the property as his own . . . . Except as provided by subsection (c) of this section, a trust terminates if the legal title to the trust property and all equitable interests in the trust become united in one person.

Therefore, a trust ceases to exist when there is a merger of the legal and equitable title in the trustee or beneficiary. Whenever legal title and equitable title to trust property are joined in the same person, the two interests merge, and the property no longer in trust. Cisnerios v. San Miguel, 640 S.W.2d 327, 330 (Tex. App. - San Antonio 1982, writ ref' d. n.r.e.). As a result, even if the trust was valid when created, but by its terms has terminated (merger of title), and though not yet distributed, there would be no trust. Hence, the property would rest in fee with the beneficiary. Depending on the character of the property, both corpus and income, an aggrieved spouse may be able to assert a claim. See, In the Matter of the Marriage of Long, supra. Discretionary versus mandatory disbursements from the trust will also impact the success of the merger argument. When faced with the question of merger of title, the practitioner must be able to demonstrate that real control of the trust lies in the spouse seeking to uphold the trust.

Merger can also occur at the outset of the trust, as a result of a design defect in the trust instrument, or it can result from a subsequent act of the beneficiary. For example, when the beneficiary of an express trust conveys equitable title to the trustee, so that legal title and equitable title are merged in the trustee, the trust is terminated and the trustee has an unrestricted right to the property. Becknal v. Atwood, 518 S.W.2d 593 (Tex. Civ. App.- Amarillo 1975, no writ). In Becknal, where the father conveyed real property to his wife as trustee for their children, and the children later conveyed their remainder interest back to their mother, for her use and enjoyment during her lifetime, and then to the trustor-father, for his use during his lifetime, legal and equitable title merged and the property in question exited the trust. However, other trust property not involved in the re-conveyance continued to remain in trust.

Note that the merger provision of the TTC speaks of merger of legal and equitable title in *one* person. Also, note the TTC's use of the words "sole trustee" and "sole beneficiary." There is a general view that, where there are multiple trustees and multiple beneficiaries, a unification of legal and equitable title in the trustees and beneficiaries collectively does not constitute a merger. *See* Annot., 7 A.L.R.4th 621 (1981). However, this argument did not avoid a finding of merger in the Becknal case, where there were two trustees.

In sum, whenever the legal and equitable titles to property held in trust are combined, the possibility of merger arises.

16. Internal Revenue Code Standards.

The IRC addresses issues analogous to the "illusory trust," "colorable trust," and alter ego doctrines in connection with taxation of trust income and the inclusion of trust property in the estate of a decedent. While there is a well-recognized distinction between the validity of a transaction under state property law and the validity of the transaction for tax purposes, the parallels are inescapable.

a. Income Tax Considerations.

The IRC recognizes a trust as a separate taxable entity only when there is a genuine relinquishment of the settlor' s control over his wealth. If the settlor retains too much control over the trust, the income of the trust will be taxed to the settlor. The IRC also taxes trust income to the settlor if the income is used to make payments which the settlor is obligated to make, such as child support. I.R.C. 674(b)(1), 677(b); Regs. § 1.674; 1.677. While recognition of a trust as a taxable entity under the IRC is different from recognition of a trust under state property law, in most instances the IRC standards relate to the true "separateness" of the trust from the settlor. Also, the failure to meet IRC requirements makes the trust's income taxable to its grantor, creating a liability for the community estate, and perhaps bolstering the claim that if income is taxable to the community, then the conveyance into trust should be declared to be ineffective.

Query: If the trust is nonetheless valid under state property law, would a right of reimbursement arise for community property used to pay taxes on the income of the trust? For a discussion of the specific questions addressed by the IRC, see 33 Am. Jur.2d Federal Taxation § 3000-3038 (1996).

b. Estate Tax Considerations.

The IRC also contains provisions which cause property conveyed into a trust to be included in the decedent's estate, for estate tax purposes. The rules are similar to those discussed above in connection with income taxation. See 34A Am. Jur.2d Federal Taxation § 143,179 (1996).

c. Apparent Authority by the Beneficiary.

In most cases, the beneficiary of the conventional estate planning trust will not be the nominal grantor of the trust. Rather, the nominal grantor will be an ancestor of the beneficiary (or, perhaps, the beneficiary's deceased spouse). However, the analysis should not end there. For marital property purposes, the important issue is not who is the nominal grantor of the trust, but rather who is the actual grantor of the trust; that is, who is the person responsible for the transfer of wealth to the trust. In contemporary estate planning trusts, there are a number of ways in which the beneficiary can (and, in certain planning situations, is expected to) actually or constructively transfer wealth to a trust nominally created by another person. Set forth below are some suggestions, given the particular situation, that may cause the beneficiary of a trust to become or be deemed to be the grantor of the trust. If any of these situations occur, it may put the beneficiary's spouse in a position to claim a community property interest in both accumulated and distributed trust income.

d. Lapse of Crummey powers.

A "Crummey" power is one of several conventional, widely used withdrawal rights granted to trust beneficiaries in estate planning. These provisions are included in trusts for lawful tax planning purposes and they have been part of conventional estate planning and trust drafting for decades.

The gift tax laws include an annual exclusion, allowing taxpayers to avoid gift tax on what would otherwise be a "taxable gift." IRC § 2503. To qualify for the annual exclusion, the gift must provide the recipient with a "present interest" in the gifted property. In other words, the recipient must have the ability to possess and enjoy the gift. When a gift is made to a trust, the transfer usually does not create a present interest, since the assets go to the trust and not to the beneficiary. Estate planners devised a technique to address that problem: Give the trust beneficiary a limited right (e.g., one lasting for thirty days) to withdraw the assets placed in the trust, up to the annual exclusion amount. If such a withdrawal power is included in the trust instrument, a transfer of assets to the trust would create a "present interest" because the beneficiary would have the right (although limited) to take the trust assets as a result of the transfer. The gift to the trust would therefore qualify for the annual gift tax exclusion.

The IRS initially did not approve of this strategy. However, the courts gave the withdrawal right its intended tax effect, and over the years the IRS finally conceded the tax issue. The first case to test the tax effect of such a withdrawal right was Crummey v. Commissioner, 397 F.2d 82 (1968), and that case gave this type of withdrawal right its name. Clauses granting Crummey withdrawal rights are now routinely included in trusts whenever the grantor wants to insure that his gift to the trust will qualify for the annual gift tax exclusion.

A Crummey clause creates a withdrawal right that is real, but that is also ethereal. In practice, the beneficiary almost never exercises his withdrawal right, and this, of course, is why the IRS fought against its tax recognition for so many years (and still does wherever the Crummey clause is carelessly drafted or administered). If the beneficiary did take the trust assets, he would defeat the grantor's plan to have the assets administered in trust rather than taken by the beneficiary (after all, the grantor did not transfer those assets to the beneficiary, but to the trust). The beneficiary who disappointed the grantor and actually withdrew the assets could expect that the grantor would not make further gifts to the trust, which would work against the interests of the beneficiary. The beneficiary might also contemplate that the grantor might revise his will, insofar as it provided for the beneficiary who had taken the trust assets against his wishes.

As a result, most Crummey withdrawal rights "lapse"—that is, they expire without being exercised—and the trust assets that were subject to withdrawal by the beneficiary remain in the trust. One can argue, for marital property purposes, that the lapse of a withdrawal right constitutes a constructive transfer by the beneficiary to the trust of the assets that were available for withdrawal. This would render the trust self-settled by the beneficiary (i.e., the beneficiary becomes the grantor) to the extent of the property subject to the lapsed withdrawal right, giving rise to possible claims by the marital property estate.

As Crummey powers are conventionally used in estate tax planning, this result could have considerable impact; the Crummey powers may extend to a substantial part of the wealth that is transferred into the trust by the beneficiary's ancestor. A very common example of this in estate planning occurs with irrevocable life insurance trusts ("ILITs"), which have been widely used tax vehicles for decades. The ancestor, the nominal grantor, might create an ILIT that is designed to hold millions of dollars of life insurance on his life. He will transfer to the ILIT each year only assets adequate to pay insurance premiums, which may be a very small amount in relation to the death benefit of the life insurance policy owned by the ILIT. It is not unusual for the entire annual transfer to be subject to withdrawal by one or more trust beneficiaries, through Crummey powers. It is possible, therefore, when the ancestor/grantor dies, and the ILIT owns millions of dollars of insurance proceeds, that one or more trust beneficiaries will have grantor status as to the entire trust.

The critical question is whether, for Texas marital property law purposes, the trust beneficiary who allows a Crummey power to lapse is considered to become the grantor of the trust, to the extent of the property subject to the lapsed withdrawal right. There does not appear to be a clear answer to this under Texas law; that is, there are no Texas cases which address the issue.

Federal tax law treatment of a Crummey power can be helpful in assessing how Texas, for marital property law purposes, would treat a lapse of such a power; that is, would the State dignify it as converting the Crummey beneficiary into the trust grantor? There are a number of situations when federal tax law, which is designed to accomplish objectives that are obviously distinct from state law, diverge from how state law operates, specifically in the area of trusts.

In general, the lapse of a right to withdraw property from a trust is treated as a transfer of that property to the trust by the beneficiary for estate and gift tax purposes. I.R.C. §§ 204l(a)(2), 2514(b). This tax result is changed, statutorily, to the extent the value of the property subject to the withdrawal right does not exceed, in any calendar year, the greater of $5,000 or 5% of the value of the trust property. I.R.C. § 204l(b)(2), 2514(b), (e) (see discussion of "five and five" powers below). However, the "five and five" rule is only a statutory exception to the general rule that the lapse of a withdrawal right is equivalent to a transfer of the subject assets by the beneficiary, to the trust, for estate and gift tax purposes.

Similarly, a trust beneficiary who allows a withdrawal right to lapse is generally treated as a grantor of the trust for federal income tax purposes. I.R.C. § 678. Under the income tax laws, there are some statutory exceptions to when the Crummey beneficiary will be treated as the grantor (which are different than the statutory exceptions under the estate and gift tax laws). I.R.C. 678 (b) and (c). However, the general rule remains that a Crummey beneficiary is treated as the grantor of the trust for federal income tax purposes.

A second area of investigation, in an effort to understand how Texas would treat a Crummey power for marital property law purposes, is whether the lapse of a Crummey right is considered to be a transfer of property by the beneficiary for creditors' rights purposes. It is not impossible that Texas law would treat a Crummey power one way for creditors' rights purposes and differently for marital property law purposes, just as certain assets are exempt under Texas law for creditors' rights purposes but subject to division in divorce proceedings as a matter of marital property law. But it may be instructive, still, to see whether such powers are treated as making the Crummey beneficiary a grantor of the trust under Texas creditors' rights law.

In 1997, the Texas legislature expressly addressed this issue. A "spendthrift clause" in a trust, which restrains involuntary alienation of the beneficiary's interest by creditors, normally does not prevent a beneficiary's creditors from reaching the beneficiary's interest in a trust where the beneficiary is also the grantor. TTC § 112.035(d). However, the TTC provides that, for this purpose, a beneficiary will not be considered to be the grantor of a trust merely because he has allowed a withdrawal right to lapse, so long as the amount that could have been withdrawn in any calendar year does not exceed the greater of (i) the "five and five" amount, or (ii) the annual gift tax exclusion under I.R.C. § 2503(b) (currently $11,000). TTC § 112.035(e). It is important to note that the effective date of this provision is September 1, 1997, the date §112.035(e) was added to the TTC.

It is not clear whether this provision of the TTC is (i) an exception to a more general rule that a lapse of a withdrawal right is equivalent to a transfer by the beneficiary for creditors' rights purposes, as it is for tax purposes, or (ii) illustrative of a more general rule that a lapse of a withdrawal right is not equivalent to a transfer by the beneficiary for creditors' rights purposes. The fact that the legislature chose to add § 112.035(e) in 1997 suggests a belief, absent this provision, that a lapse would be treated as a transfer by the beneficiary, and that interpretation (i) is therefore correct. The legislative history of §112.035(e) indicates that the Texas Legislature was unsure of the current state of Texas law on this issue, rather than that the Legislature was codifying its understanding of existing Texas law.

However, substantial authority exists for the proposition that creditors of the holder of a withdrawal right cannot reach the assets subject to that withdrawal right (except if it is actually exercised by the beneficiary). This suggests that interpretation (ii) is correct. See University National Bank v. Rhoadarmer, 827 P.2d 561 (Cola. App. 1991); Irwin Union Bank and Trust Company v. Long, 312 N.E.2d 908 (MD. App. 1974); Smith v. Smith, 253 N.W.2d 143 (Minn. 1977); In re Pearson, 212 B.R. 128 (Bankr. E.D. Va. 1997); G. Bogert, The Law of Trusts and Trustees § 233 (rev. 2d ed. 1992); A. Scott, The Law of Trusts § 147.3 (4th ed. 1987); Restatement (Second) of Property § 13.2 and cmt. a (1986). Cf. First Bank & Trust v. Goss, 533 S.W.2d 93 (Tex. Civ. App. - Houston [1st Dist. 1976, no writ); Arnold v. Southern Pine Lumber Company, 123 S.W. 1162, 1166-1167 (Tex. Civ. App. 1909).

On the other hand, Professor Featherston has expressed the contrary view. Thomas M. Featherston, Jr., Marital Property Characterization of Interests in Trusts, Including Distributed and Undistributed Income, State Bar of Texas Advanced Estate Planning and Probate Course (June 2, 1999), at G-6,7 and 12,13. Texas law, he writes, does not follow the older rule of law. His view is that a beneficiary's power of appointment over trust assets (of which a Crummey power is but one example) will subject such assets to his creditors. It would seem to follow, then, that the lapse of such a right will not defeat the rights of the beneficiary's creditors; the Crummey beneficiary will be treated as the grantor of the trust under Texas law, for creditors' rights purposes, except as limited by § 112.035(e) (which is effective only from the date of its enactment).

Of course, the IRC and TTC provisions discussed above apply only to tax and creditors' rights issues. There is no similar statutory provision that expressly applies in the marital property context and that governs whether, or to what extent, a lapse of a withdrawal right will make the beneficiary a grantor of the trust for purposes of determining the marital property character of trust income. The IRC provisions invite the beneficiary's spouse to argue by analogy that the lapse of a Crummey withdrawal right constitutes a transfer to the trust for marital property purposes, just as it does in general for estate, gift and income tax purposes, but with no "five and five" exception such as that which applies in the estate and gift tax context. The TTC provisions may allow the beneficiary's spouse to make the same argument by analogy, depending upon whether § 112.035(e) is ultimately held to be an exception to the general rule or a special case of the general rule.

If these arguments are successful, then the trust beneficiary who allows a Crummey withdrawal right to lapse may inadvertently become a grantor of the trust. Arguments for characterizing trust income as community property based on the existence of a self-settled trust would then be applicable.

e. Lapse of "Five and Five" Powers.

Frequently, a trust will grant its beneficiary a "five and five" power, *i.e.* the power to withdraw annually the greater of $5,000 or 5% of the value of the trust property. The five and five power is similar to the Crummey power, in that it allows the beneficiary to withdraw part of the trust property and vest it in himself. However, the five and five power is also different from the conventional Crummey power in a number of respects. Whereas the Crummey power is designed merely to allow a gift to a trust to qualify for the annual gift tax exclusion, the five and five power is intended to give the beneficiary the flexibility to draw down trust assets by making discretionary withdrawals in excess of whatever distributions the trustee is allowed or required to make under the trust instrument. Also, the Crummey power frequently expires if it is not exercised within a relatively short period (for example, thirty days); the five and five power normally will recur automatically, each year. The difference is a result of the very different functions the two powers serve.

As noted above, federal estate and gift tax law specifically provides a "safe harbor" for five and five powers. A beneficiary who allows a five and five power to lapse will not be treated as having transferred any property back to the trust for estate and gift tax purposes. I.R.C. § 204l(b)(2), 2514(b), (e). As noted above, the TTC also provides a similar safe harbor for five and five powers in the creditors' rights context: the lapse of such a power will not render the beneficiary a grantor of the trust for purposes of determining the validity of a spendthrift clause insofar as it applies to the beneficiary's interest in the trust. TTC § 112.035(e). (Again, this legislative protection is effective only as of the effective date of § 112.035(e).) Still, the question remains whether a beneficiary who allows a five and five power to lapse will be treated as the grantor of a trust for marital property purposes.

The issues here are primarily the same as those discussed above with regard to Crummey powers. A beneficiary who allows a five and five power to lapse may inadvertently become a grantor of the trust for marital property purposes, even if he is not a grantor for tax or creditors' rights purposes. The beneficiary's status as a grantor deems the trust self-settled, which may give the accumulated trust income community property character.

f. "HEMS" Powers.

Federal estate and gift tax law provides another "safe harbor" for trust beneficiaries. A beneficiary may be allowed, by the terms of the trust, to withdraw trust assets in an amount necessary to provide for the beneficiary's health, education, maintenance and support. This is sometimes referred to as a "HEMS" power or an "ascertainable standard." Often, a HEMS power is found when the beneficiary is also the trustee of the trust, and has the power to make distributions to himself for his health, education, maintenance, and support. If the beneficiary does not take trust assets in the full amount that he could under the HEMS power, then the IRC provides that the lapse of the power will not cause the beneficiary to be treated, for tax purposes, as having transferred the subject assets to the trust. Instead, the power is ignored for gift and estate tax purposes. I.R.C. §§ 204l(b)(l)(a), 2514(c)(l).

But, just as with Crummey and five and five powers, the failure of a beneficiary to withdraw trust assets to which the beneficiary is entitled under a HEMS power could be deemed a constructive transfer of those assets to the trust by the beneficiary. This is particularly the case where the trust agreement does not require that the beneficiary's other resources be taken into account in determining what the beneficiary needs from the trust for his health, education, maintenance, and support. If the beneficiary has other resources sufficient to meet his needs and the trust agreement does not require that those other resources be counted, then this is equivalent to giving the beneficiary a simple right to withdraw trust assets equal to the amount of his needs, even though his needs are being met from other assets. The failure to exercise that right could be characterized as a constructive transfer of wealth to the trust and could make the beneficiary an inadvertent grantor of the trust.

g. Disclaimers.

Federal and state law provide a vehicle through which the intended recipient of a gift or inheritance may "disclaim" the property he is entitled to receive. A disclaimer is simply a refusal to accept the gift or inheritance, with the result that the property passes to someone else. If the intended recipient is the spouse of the donor or decedent, the alternate taker may be a trust of which the intended recipient is the beneficiary.

A common estate planning technique is for one spouse to devise property to the other, while at the same time providing that if the surviving spouse disclaims the property it will pass into a trust for the benefit of the surviving spouse. This allows the surviving spouse to evaluate, at the deceased spouse's death, whether the creation of a trust will produce estate tax benefits that would be lost if the surviving spouse took the property free of trust. A disclaimant has up to nine months after the transfer is made to decide whether to accept or disclaim the subject assets.

Federal estate and gift tax law also provides a "safe harbor" for disclaimers. Section 2518 of the IRC provides that, if a person makes a qualified disclaimer, the disclaimant will not be treated as having transferred the disclaimed property for federal transfer tax purposes. The same is true under Texas law for creditors' rights purposes. The disclaimant is treated as never having received the disclaimed property, and that property is therefore not subject to the claims of his creditors. Tex. Prob. Code Ann. § 37A; TTC § 112.010(d).

The consequences of a disclaimer for marital property purposes are, however, unclear. Suppose a surviving spouse disclaims a devise of property, with the result that the property passes into a trust for the benefit of the surviving spouse. Is the surviving spouse the grantor of the trust for marital property purposes, so that a second spouse may raise a community property claim to trust income? The issues here may well be the same as those discussed above regarding withdrawal rights, and the use of a disclaimer to fund a trust for the disclaimant may make the disclaimant an inadvertent grantor of the trust for marital property purposes.

h. Commercial Transactions Between the Beneficiary and the Trust.

In some situations, the beneficiary will deem it advantageous, for estate tax purposes, to attempt to increase the value of the assets of the trust. The rationale is that the trust may be exempt from estate taxes and/or generation-skipping transfer taxes; increasing the value of trust assets, rather than allowing wealth to be created so that it is owned by the beneficiary individually, free of trust, will allow that wealth to be sheltered from such taxes. In those cases, the beneficiary may engage in a variety of business transactions with the trust which are designed to enhance the value of trust assets. Some of those transactions may aggressively favor the trust. In engaging in this strategy, the beneficiary may be counseled to follow rules that have proven effective, for federal transfer tax law planning purposes, in not causing the beneficiary to be treated as the grantor of the trust. But those rules, developed for narrow federal tax law purposes, need not be consistent with how Texas law would analyze whether the beneficiary is a grantor of the trust for state marital property law purposes. (And in some cases, beneficiaries have been known to engage in aggressive transactions that are not sanctioned by tax law; with the expectation that the taxing authorities will not discover the activity.)

For example, the beneficiary may make bargain sales of assets to the trust, transferring valuable assets to the trust for less than full and adequate consideration. Sometimes these transfers are made in such a way that they are invisible to the taxing authorities, and the beneficiary, as seller, may use aggressively low prices on the assets being sold to the trust. Nonetheless, for state law purposes, the beneficiary would seem clearly to be a grantor of the trust to the extent of the bargain element in any such sale.

The beneficiary may also loan funds to the trust on less than commercially reasonable terms. Commercially reasonable terms would take into account the net asset value of the trust, collateral, prevailing interest rates, and the level of risk posed by the trust's activities with the borrowed funds. If the beneficiary loaned funds to the trust on terms that a commercial lender would not have accepted, this would constitute the transfer of a valuable asset (i.e., credit) to the trust. The value of this asset may be measured by the difference between the interest rate charged by the beneficiary on his loans to the trust and the rate that would have been charged by a commercial lender.

The beneficiary may also guarantee loans made by others to the trust and pledge his property to support his guarantees. There is real economic value to the use of one person's credit and assets to guarantee another person's obligations, and in a commercial context a substantial fee would be charged for providing this benefit and assuming the risks to the guarantor that went with it. If the beneficiary did not charge the trust for this service, the value of his guarantees may be measured by the amount a third party would have charged the trust to guarantee its loans.

Each of these transactions results in the transfer of value to the trust by the beneficiary, without consideration. Arguably, each type of transaction makes the beneficiary a constructive grantor of the trust, and should trigger the marital property consequences that attach to self-settled trusts.

i. Waiver of trustee fees.

Frequently, the beneficiary of a trust will also be appointed as the trustee of that trust. The beneficiary may be entitled to compensation for serving as trustee, either under the terms of the trust instrument or under the TTC § 114.061. If the beneficiary declines to take compensation for serving as trustee, the beneficiary may be treated as having constructively transferred the amount of the forgone compensation to the trust. The beneficiary may therefore be treated as the grantor of the trust to that extent. A trustee may voluntarily waive trustee fees, but an effective waiver may require formalities, prior to such fees being earned, that are often not followed.

Whether trustee fees are waived or taken, there may be an issue as to the adequacy of such fees, given the actual services rendered by the trustee/beneficiary to the trust. If the trustee is managing a portfolio of financial assets, that may call for one level of compensation; if the trustee is engaging in active, entrepreneurial activity on behalf of the trust, that may justify another level of trustee compensation.

Additionally, if a spouse does not pay himself a trustee fee for services provided, his deemed contribution of this amount back to the trust is a contribution of community property (absent any marital property agreement by which the spouses agree that earnings are separate property). Hence, the non-beneficiary spouse can have a community property interest not only in the income earned by the trust principal, but in the trust principal itself.

j. Foregone distributions.

As discussed above, a beneficiary of a trust which is sheltered from estate or generation-skipping transfer tax may aggressively look to grow the assets of the trust. While there is no trust law authority to do so, the beneficiary may, knowingly, simply not receive the full amount of distributions from such a trust to which he is entitled. (This may be facilitated by the beneficiary being the trustee of the trust.)

It would seem apparent that a beneficiary who does this is in effect the grantor of the trust to that extent. What is less apparent is when such situations have arisen. For example, consider a beneficiary who is entitled to all trust income. There are many circumstances, depending upon the nature of the trust's investments and management, that are not clear under principles of fiduciary accounting. Questions arise whether certain receipts should be allocated to income or principal. Even more thorny questions may arise as to whether expenditures should properly be paid by income or principal. Often such close decisions are not examined for years during a trust administration. In a divorce context, this may require substantial trust accounting analysis to diagnose and remedy errors in distributions.

Such fiduciary accounting issues can arise even where there is no attempt at gamesmanship by the beneficiary; it's simply an area of trust law with many questions and subtleties.

k. Examining the Nature of Control and Enjoyment of Retained Trust Assets.

It has been discussed above that, where a beneficiary is also the grantor of a trust, it may be considerably more likely that trust assets will be considered to be marital property, and trust income community property, as compared to the beneficiary not also being the grantor. Texas law does not seem to have grappled with this issue sufficiently to have developed clear, cogent lines of distinction. But it appears that the level of control over the trust retained by the grantor/beneficiary, and the level of beneficial enjoyment available to the grantor/ beneficiary in his status as beneficiary may be important variables. The more retained control over and enjoyment of trust assets, the more likely that trust assets will be considered marital property, where the beneficiary spouse was also the trust's grantor.

Sometimes the level of control and enjoyment retained over trust assets by a beneficiary is not altogether apparent. The following discussion concerns certain of these situations which are not uncommon in conventional trusts used in estate planning.

l. Ability to "Withdraw" Trust Assets if Spendthrift Provision is Ineffective.

Most conventional estate planning trusts include a "spendthrift" provision. This prevents the trust beneficiary's creditors from attaching the beneficiary's interest in the trust. Texas law enforces spendthrift clauses. TTC § 112.035 (a).

There is an important exception, however, to the enforceability of spendthrift clauses under Texas law. If the beneficiary is also the grantor of the trust, the spendthrift clause is ineffective, and the beneficiary's interest in the trust is available to his creditors, as with any asset of the beneficiary that is not exempt from creditors. TTC § 112.035 (d). Under Texas law, which is typical of the rule in most states, a person may not create a trust for himself, retain rights in the trust as a beneficiary, and prevent his creditors from gaining access to the retained beneficial interest.

Where a beneficiary is also the grantor of the trust, the beneficiary's creditors may demand that the trust pay for the beneficiary's obligations. The creditors may demand that the trustee distribute to them the maximum amount that the trustee could have distributed to the beneficiary. The trustee is forced to exercise his discretion so as to maximize the distribution. Bank of Dallas v. Republic National Bank, 540 S.W. 2d 499, 501-502 (Tex. Civ. App. Waco, 1976, writ ref'd n.r.e.).

Let's assume that a spouse/beneficiary is also the grantor of the trust. The more obvious result is that the beneficiary's creditors can attach all of his beneficial interest in the trust. The less obvious result is that this vastly enhances the beneficiary's effective level of control over and enjoyment of trust assets, as compared with his nominal rights in the trust. As an example, consider a trust with assets of $3 million, as to which the beneficiary may be considered the grantor. The trust document provides that someone other than the beneficiary serves as trustee. The beneficiary's right is to receive distributions for "health, education, maintenance and support" in his accustomed manner of living, and the trustee need not consider whether the beneficiary has other assets adequate for these needs. The beneficiary has a robust lifestyle, and that distributional standard could justify distributions of $250,000 per year for these needs of the beneficiary.

The beneficiary could, theoretically and perhaps practically (depending upon various circumstances) gain immediate access, in effect, to the full $3 million of trust assets. The beneficiary could borrow $3 million from a third party, which could be a family member or family business, or an outside commercial lender. Or the beneficiary could buy $3 million of assets on credit. In either case, the beneficiary could direct his creditors to the trust for repayment. The creditors could attach the beneficiary's right to receive a stream of annual payments for health, education, maintenance and support, and they could force the trustee to distribute that amount each year (i.e., the maximum amount the trustee could have justified distributing under the terms of the trust document): $250,000 per year, for as many years as are required to pay the debt, principal and interest.

As a result, in effect the beneficiary may have the power to convert all of the trust's assets to his own possession and enjoyment. Such a power may justify the determination that all trust income should be considered community property, whether distributed to the beneficiary or accumulated in the trust. The fact that trust assets are available to the beneficiary's creditors greatly augments his control and enjoyment of the trust assets.

As discussed above, in 1997, the Texas legislature added § 112.035(e) to the TTC ["Subsection (e)"]. This provision creates an important statutory exception to the rule that a spendthrift clause is not effective where the beneficiary is also the grantor of the trust. Subsection (e) provides that the lapse of a typical Crummy power or a typical 'five and five" power will not cause the beneficiary who held such a power to be considered the grantor of the trust, thereby destroying the spendthrift protection that would otherwise be available to the beneficiary. In other words, the spendthrift protection will be available to a beneficiary who is the grantor solely through the lapse of a typical Crummey power or a five and five power.

Subsection (e) cures the problem discussed in the preceding paragraphs: a beneficiary's creditors have access to his beneficial trust interest; therefore the beneficiary has by implication great power over and enjoyment of the trust assets, beyond his nominal rights as beneficiary as articulated in the trust document. Subsection (e) limits the implied, expanded power over trust property that results in a self-settled trust if the trust is deemed self-settled only because of the beneficiary's limited withdrawal rights. But Subsection (e) itself has limits:

1. It only applies to lapses after its effective date, September 1, 1997, and such trusts and trust powers have been in widespread use for decades preceding that date.
2. It only applies to typical Crummey powers and five and five powers. All of the other ways in which a beneficiary may become the grantor of a trust are not affected by Subsection (e). For example, if a beneficiary becomes the grantor of the trust by contributing trustee fees, or by

lending money to the trust at commercially unreasonably low interest, the beneficiary's creditors can access his beneficial interest in the trust.

3. It only allows the Crummey or five and five beneficiary to avoid being a grantor of the trust for creditors' rights purposes. It does not speak to marital property law and the rights of the beneficiary's spouse. For those important purposes, the beneficiary is not precluded by Subsection (e) from being considered the grantor, as a function of the lapse of these powers.)

m. The apparently ascertainable distributional standard.

A beneficiary may have the right, as trustee, to distribute to himself under a HEMS standard. Initially, this may be considered a narrow, limited power, ascertainable in its scope. If the need is there, there will be a distribution to the beneficiary. One might argue about the marital property character of the actual distribution, but that argument should not extend to the assets that remain in trust. If they were not distributed, it may first be thought, it's because the beneficiary, as trustee, had no right to do so under the HEMS power; if he had no right to do so, how can the trust assets be considered marital property?

Often, however, a HEMS power is drafted to be ascertainable in part, and not ascertainable in part. The trust document may provide that the trustee has discretion to determine whether to take into account the beneficiary's other assets, apart from the trust, in measuring the need to make a distribution for HEMS. This is a very important, if somewhat subtle provision. It tells the beneficiary, as trustee, that each year he can choose to take wealth out of the trust or not to, in his unfettered discretion. There's an outside limit to how much wealth can be taken: it can't exceed the amount required to provide for the beneficiary's HEMS needs (again, often in accordance with the beneficiary's accustomed standard of living). Let's assume that the trustee could distribute up to $250,000 per year for such needs. (This could include housing, clothing, automobile, reasonable recreation, food, medical, certain insurance, etc.) The beneficiary, as trustee, has total discretion, each year, to determine whether to distribute to himself $1 or $250,000, or any amount in between. And that has nothing to do with the beneficiary's actual needs, given other assets available to him. The beneficiary's needs only set the outside limit to distributions.

n. Is the trust administered according to its terms, or are the rules of trust administration disregarded?

It may be that the grantor/beneficiary's retained rights in the trust are limitless; or at least that they are not limited by the terms of the trust document. The way the trust is administered in fact may show that the beneficiary regards the trust as a sham, an alter ego for the beneficiary.

As discussed above, Texas law recognizes the alter ego concept for marital property purposes in a divorce. The fact that assets are owned by an entity does not mean that they are not marital property. If the entity is the alter ego of one spouse, the assets will be considered marital property of that spouse under Texas law. In the case of a trust which is the alter ego of one spouse, the other spouse, even though not a beneficiary of the trust, would still have enforceable marital property rights in the trust assets.

A corporation may be an alter ego of a spouse, with the result that corporate assets are marital property. For many years, Texas courts have recognized the "alter ego" doctrine as a method of piercing the corporate veil and subjecting shareholders to personal liability for corporate obligations. However, Texas courts also employ the alter ego doctrine as a method of "reverse piercing" in domestic relations cases. That is, the alter ego doctrine is a recognized method of treating corporate assets as shareholder assets that are subject to division on divorce. Dillingham v. Dillingham, 434 S.W.2d 459 (Tex. Civ. App. — Fort Worth 1968, writ dism'd); Uranga v. Uranga, 527 S.W.2d 761 (Tex. Civ. App. — San Antonio 1975, writ dism'd); and Zisblatt v. Zisblatt, 693 S.W.2d 944 (Tex. App.— Fort Worth 1985, writ dism'd).

Similarly, "trust assets" can be marital property. Texas marital property rules apply only to property that is owned by the spouses. Where, however, a spouse has sufficient "ownership" of trust assets, the assets will be treated as marital property, even if legal title to such assets is in the trust, not the spouse. In re Marriage of Long, supra. Where a trust has been used as an alter ego for marital property law purposes, a divorce court will likely also apply the alter ego analysis to the trust, with the result that trust assets are marital property, as in Long.

The actual operation of the trust by the trustee and beneficiary (whether or not the same person) may indicate that the trust was the beneficiary's alter ego. To the beneficiary, the distinction between trust assets and personal assets may be blurred; he may not have behaved as if the two were different. This occurs with some frequency among family trusts where there is no professional trustee serving, as is often the case. The following conduct may be indicative of alter ego status:

1. Moving assets into and outside of the trust to meet the convenience of the beneficiary or the trust, through distributions to the beneficiary, contributions to the trust, loans, bargain sales, etc.
2. Distributions to the beneficiary which are clearly not justified under the terms of the trust agreement, especially if the beneficiary is also the trustee.
3. Provisions in the trust document that relieve the beneficiary, as trustee, of the need to account to any beneficiary other than himself.

17. Joinder of Beneficiaries.

As a general rule, both the trustees and the beneficiaries should be made parties to suits involving trust property. Starcrest Trust v. Berry, 926 S.W.2d 343, 355 (Tex. App.--Austin 1996, no writ). However, beneficiaries need not be joined in the action if the dispute does not involve a conflict between the trustee and beneficiaries, or between the beneficiaries themselves. *Id.* at 355. Also, the beneficiaries need not be joined if the trust instrument places the power to litigate exclusively on the trustee. Hedley Feedlot, Inc. v. Weatherly Trust, 855 S.W.2d 826, 833 (Tex. App. --Amarillo 1993, writ denied). The terms of the trust instrument and the purpose of this suit must be examined to determine whether a suit may be prosecuted with the trustee without joining the beneficiaries. Id. at 833.

B. FLPs.

A spouse may have the same or similar complaints to the validity of a FLP as they would to a trust. The following are examples of the some of the more basic approaches which may be tried.

1. Examine the Purposes for Forming and Maintaining the FLP.

A thorough examination of the purposes behind the formation of, and the maintaining of, the FLP should be very instructive when attempting to formulate your client's attack on the FLP. The following are some recommendations:

(1) Do the obvious - be sure that the partnership documents comply with state law requirements.
(2) If the partnership agreement sets forth the reasons for the formation of the FLP, have those reasons and/or purposes been followed or carried out?
(3) Does the FLP attempt to limit the fiduciary liability of the general partner? This may be especially important if the parent who contributes most of the property to the partnership is a general partner.
(4) Does the FLP give any extraordinary powers to the general partner? Some commentators believe these should be avoided.
(5) Has the general partner made any reports to the other partners? Some believe the general partner should over-report to the other partners.
(6) Have periodic distributions been made to all partners?
(7) Have there been any adjustments of percentages of ownership as a result of disproportionate distributions to partners and disproportionate additional contributions of capital?
(8) Has the general partner ever consulted with family partners?
(9) Has there been a contribution of personal-use property (a home, a time-share in Florida, a yacht) to the partnership?
(10) Has all property identified as partnership property actually been transferred to the partnership?
(11) Avoid the contribution of voting stock in a family owned and controlled corporation if the person who makes the contribution is the general partner.
(12) Were gifts of partnership units to the next generation beneficiaries made prior to the time the partnership was recorded and fully funded?
(13) Were gifts of partnership units supported by a good business appraisal?
(14) If other family members contributed property to the partnership, was a market appraisal of all assets performed in order to precisely allocate initial percentages of ownership?
(15) Does the FLP provide for compensation to a general partner?
(16) Some commentators believe that caution should be observed when funding or contributing mortgaged property to the FLP, particularly if the mortgage has a "due on sale" clause.
(17) Has the FLP been funded with marketable securities? If so, there are special rules which may apply.

2. Defects in Formation and Operation.

As with trusts, the spouse attacking a FLP should first be sure that the formalities necessary to create the FLP have been followed. This scrutiny should also extend to the proper maintaining of books and records, TRLPA §1.07. While singular deficits in attempted formation and operation may not be sufficient to invalidate a FLP, if enough inconsistencies exist, it may make room for fruitful negotiations.

3. Failure to Distribute in Accordance With FLP Terms.

Failure of the general partner to distribute income in accordance with the terms of the trust can possibly lead to favorable results for the betrayed spouse. This could include the removal of the general partner, forced dissolution (if authorized by the partnership agreement), an independent suit against the general partner for damages, or all of the above. All of these complaints should be addressed in the divorce proceeding when the FLP is an integral part of the marital estate. Therefore, as with a trust, the partnership should be joined as a party to avoid a later estoppel defense.

4. Uniform Fraudulent Transfer Act.

As with trusts, a defrauded spouse may find the UFTA beneficial when attempting to attach a FLP. Although limited in application, it could apply in divorce actions given the right set of facts.

a. Transfers Which Can Be Set Aside.

Under the UFTA, the transfer or creation of a debt must be shown to have been done with the actual intent to defraud a creditor or without receiving reasonable consideration in exchange, and if: (1) the debtor was engaged or was about to engage in a business or a transaction which would leave the remaining assets of the debtor unreasonably small in relation to the business or transaction; or (2) the debtor intended, knew, or should have known that he would not be able to pay the debt when due. UFTA §24.005. A spouse can surely be considered a creditor of the community estate, at least to that spouse's share of the community.

b. Must Be a Present Creditor.

The transfer is considered fraudulent if the creditor's claim arose before the transfer was made, or the obligation was incurred if the debtor made the transfer without value and the debtor was insolvent, or, the transfer was to an insider and the insider knew of the insolvency. UFTA §24.006. Assuming insider would include close relatives of the transferring spouse, this part of the act may be applicable in a divorce action.

c. Remedies Under UFTA.

The aggrieved creditor can request the court to: void the transfer; attach the property transferred; grant injunctive relief against further disposition; appoint a receiver to take possession of the property; or, other appropriate relief UFTA §24.008. The question still remains of whether the damages, if any, come from the community estate. As discussed above, Moore, Schlueter, and Sprick indicate that the award cannot exceed the total value of the community estate.

d. Bona Fide Purchasers Excluded.

If the transfer was made to a bona fide purchaser for value, the transaction is not voidable. UFTA §24.009.

5. Claims for Economic Contribution and Reimbursement.

a. Economic Contribution.

Provided that the requirements necessary to establish an economic contribution claim are present, there would be no reason why the contributing estate could not make a claim against the benefitted estate because it is a trust or FLP. TFC §3.401-3.402. A common example that family lawyers frequently encounter involves separate property trust funds being used to reduce the secured debt of the party's community property homestead. Once one has grasped the concepts and rules related to an economic contribution claim, the type of entity of the benefitted, or contributing estate, as the case may be, should make no difference. However, if the benefitted estate was a spendthrift trust, it may be doubtful whether the court could impose a forecloseable lien on the trust, or any of its assets. In the case of a FLP as the benefitted estate, the contributing estate would only be able to enforce any such judgment against the partnership interest. As discussed above, has the contributing estate really gained anything?

b. Reimbursement.

The same rationale would be applied to reimbursements claims of a contributing estate. Payment by the community estate of income tax liability on a separate property entity such as a trust or FLP would be a good example of such a claim. A more difficult question to be resolved would be that of a spouse who is a limited partner in a separate property FLP. Assuming that spouse devotes a significant amount of time to increasing the value of his partnership interest, would the community estate have a claim? TFC §3.408. If that spouse was only a limited partner, with no management or right of control, is the contributing estate precluded from asserting a reimbursement claim, because the "business entity" IS NOT under the control and direction of that spouse? A strong argument could be made that no reimbursement should be allowed because of the lack of control. As cases are reported interpreting economic contribution and reimbursement statutes, the picture may be easier to see whether these types of claims will truly be applicable to trust and FLPs.

## IX. CHECKLIST FOR FORMULATING A CONTEST OF TRUSTS AND FLPS.

In addition to what has previously been discussed above, the following represent some preliminary questions which should be answered in evaluating any of the claims discussed in this article.

- Were both parties represented by the same lawyer, or did each have independent counsel?
- Was a partition or exchange agreement executed prior to the formation of the trust or FLP?
- What was the timing of the formation of the entity as it relates to the first sign of marital problems?
- How long has the FLP or trust has been in existence?
- What reasons were initially given, and by whom, as to why this entity should be formed?
- Have both spouses benefitted from the entities created, or just one of the spouses?
- How were the discounted values of the property used to fund the FLP determined? [25% discounts are very common. Some estate planners may be much more aggressive]
- How savvy is each spouse in business matters and/or trust and FLPs?
- How active was each in the preparation of documents, financials, etc. prior to the formation?
- Were all required tax returns, reports, etc. properly and timely filed?
- Has the entity been operated and administered in accordance with agreement?
- Can one of the spouses force a revocation or dissolution of the entity?
- Does the agreement provide for any type of court intervention regarding modification, amendment, or dissolution?
- Has the IRS questioned any information supplied to them, or threatened any action against the entities, or its principals?
- Does one spouse have superior control of the entity, to the exclusion of the other spouse?
- Does the spouse in control have the exclusive right to set compensation, or discretion as to when and how much the distributions will be?
- What, if any, would be the adverse tax ramifications if an attack was successful, and the trust or FLP was set aside?
- What impact, financially or otherwise, would a successful challenge have on the party's children as beneficiaries?

## X. OFFSHORE TRUSTS

Two of the more complicated types of trusts is the Offshore and Asset Protection Trusts. The family law practitioner usually has to know through their client or a third party that such a trust exists, as obtaining information on the trust through normal discovery means is almost impossible. Since offshore trusts are set up by account numbers, if you do not have the account number and password, you cannot obtain any information on the trust. Jurisdictions that party's often set up offshore trusts in, such as the Cook Islands or the Cayman Islands, do not recognize United States judgments. Therefore, it is extraordinarily expensive to pursue an offshore trust. In order to attack the trust, a party would have to hire local counsel in the particular jurisdiction, and there is an extremely high burden, set out below, to attack an offshore trust. The following information about offshore and asset protection trusts sets out some of the hurdles the family law practitioner has to clear, as well as some of the obstacles that need to be overcome in dealing with offshore trusts.

### A. Definition of asset protection trusts.

An Asset Protection Trust is an offshore trust structure used to protect an individual's assets from claims of potential future creditors. Basically, an APT is a trust that designates the law of a debtor-friendly jurisdiction (rather than a law of the settlor's domicile) as controlling the trust's governance and effect in order to benefit from that jurisdiction's abolition of the so-called self-settled spendthrift trust rule. Gideon Rothschild, Daniel S. Rubin, *Asset Protection After Anderson: Much Ado About Nothing?*, 26 Est.Plan. 466,467.

Jurisdictions that have repealed the self-established spendthrift trust rule (such as the Cook Islands) allow a trust established for the settlor's own benefit to be protected from future (but not current) creditors. Gideon Rothschild, *Establishing and Drafting Offshore Asset Protection Trusts*, 23 ETPL 65 (Feb 1996). Shielding assets from future creditors is often a major concern for individuals who are at high risk for various types of liability. APTs that allow conscientious professionals future protection against egregious malpractice claims also have the effect of leaving "involuntary" creditors with no recourse of clear remedy at law and facilitate the intentional avoidance of "current" debt owed by judgment debtors. Randall J. Gingiss, *Putting A Stop To 'Asset Protection' Trusts*, 51 Baylor L. Rev. 987, 988 (Gingiss). Placing assets in trust in a jurisdiction which will not recognize a United States judgment is a time-honored strategy to avoid the claim of creditors. Gingiss at 995.

**B. Recognition and enforcement of foreign judgments**.

Assets held by a foreign trustee in a "tax haven" jurisdiction are virtually impossible to seize. In order for a creditor to enforce a foreign judgment and claim assets in an offshore APT, a recognition (the first step in an attempt to enforce a foreign judgment) and enforcement action must be brought in the local courts of the foreign jurisdiction where the creditor's lawyer is not licensed to practice law, not afforded the opportunity to come before the local court pro hac vice, and is rarely (only when extremely lucky, stars are perfectly aligned and the moon is as close as it has been in 400 years) allowed to sit at counsel's table. The creditor is further disadvantaged by differences in language, customs and public policy, as well as, conflicting and unfamiliar laws. Finding competent local counsel is often a formidable challenge to the creditor, as is paying the staggering legal fees seemingly imposed to thwart success of the case. Quickly becoming cost prohibitive, claims are usually dropped. Moreover, bank secrecy codes serve to shield trusts from discovery attempts, frustrating effort to obtain financial records that would otherwise divulge what assets were being held from whom, where and in what amounts.

**C. Barriers to recovery**.

Although basic comity principles are well established and generally agreed upon, application becomes frustrated when limitations are imposed by conflicting laws and public policies. Some jurisdictions maintain a reciprocity requirement, while others whose 1989 trust statute was co-authorized by Barry S. Engel, an asset protection lawyer in Englewood, Colorado (see "*Island Castaways*," October 1998 ABA Journal, page 54), for example, does not recognize court judgments from the rest of the world. See William C. Smith, Offshore Trust Busting: A Contempt Ruling May Mean Trouble in Debtors' Paradise, 85-NOV A.B.A. J. 32 (Smith). Thus, a U.S. judgment creditor seeking assets from a Cook Island trust must relitigate the claim in the capital city of Rarotonga, located some 2,800 miles south of Honolulu. Id.; See also, Federal Trade Commission v. Affordable Media, 179 F. 3d 1228 (Anderson) [The FTC was forced to bring suit against the Anderson Trust before the Cook Islands' courts and have to date been unsuccessful).

Finding local counsel is only the first of many barriers facing creditors in the Cook Islands. Smith at 32. To set aside a fraudulent conveyance, the claim must be brought within one year of the transfer, and fraudulent intent must be established beyond a reasonable doubt. Id. Further, a transfer is presumptively non-fraudulent if it did not leave insolvent the settlor who created it. Id. Even if a creditor manages to prove a fraudulent conveyance, the recovery is limited to the amount of the tainted transfers rather than the entire trust fund. Id.

Legislation in the Cayman Islands [Special Trusts (Alternative Regime) Law (1997) (Cayman Islands)] shows a bold attempt to accommodate settlors by setting up a category of "special trusts," eliminating the requirement that trust from rights of the beneficiaries, and provides for "enforcers" who may be named in the trust instrument and are responsible for all enforcement of all enforceable rights of the beneficiaries. Gingiss at 1004.

**D. Fraudulent conveyance law**.

The most powerful weapon a creditor has to attack an APT is the ability to claim that "the settlor's conveyance or transfer into the trust was fraudulent." Jahd, 26 Est.Plan. At 411. A fraudulent conveyance or transfer may generally be defined as a transaction by means of which the owner of real or personal property has sought to place such property beyond the reach of existing creditor demands. Id., citing 37 Am. Jur. 2d Fraudulent Conveyances §21.

**E. Requisites for a present creditor** .

If the party contesting the transfer has the status of a present creditor, he must generally first establish that the transfer of assets into the trust was made without the transferor receiving a reasonably equivalent value in exchange. Since transfers into an APT are generally made voluntary and without consideration, this normally does not present a problem for a present creditor. Jahde at 411,412. The determination of whether adequate consideration was received is a question of fact. Id. At 412. In addition to showing that the transfer was made for less than reasonably equivalent value, a present creditor must prove that the Debtor was insolvent at the time of the transfer or that the debtor became insolvent as a result of the transfer. Id. The distinction between a present and a future creditor is crucial. If a creditor does not have the status of a present creditor, a more challenging subjective standard must be met before the conveyance into the trust will be set aside. The creditor, whether present or future, can meet the standard by showing that the debtor made the transfer with the actual intent to hinder, dely or defraud any creditors of the debtor. UFTA §4.

**F. Creditor's burden to prove fraudulent conveyance**.

Beneficiaries of APTS are commonly family members, clearly insiders under the UFTA and, as with gifts, rarely does the debtor receive adequate consideration for the transfer. Id. At 413. However, other factors may be significantly harder to prove depending on certain variables such as the settlor's post-transfer actions, the settlor's UFTA solvency status, existence of the creditor's cause of action and the creditor's timing in bringing the cause of action. Id. If the evidence shows the debtor's concealment, insolvency, and claims of creditors to exist on the date of the transfer of assets or that the trust was established in anticipation of liability, insolvency or fraud, then the creditor should be able to convince the Court the transfer was fraudulent. Id. Courts have found requisite fraudulent intent in literally thousands of cases in which the creditor's claim or cause of action existed on the date of transfer (Zahra Spiritual Trust v. United States, 910 F. 2d 240 (5th Cir., 1990); In re: Janz, 432 NW2d 13 (Nev., 1988), but very few relating to claims of creditors whose claim or cause of action arose after the transfer, i.e., a future creditor. *But cf*. Alperin, Conveyance as Fraudulent Where Made in Contemplation of Possible Liability for Future Tort, 38 ALR 3d 597; See also Mandolini Co. V. Chicago Produce Suppliers, 540 NE 2d 505 (III. App. 1st Dist., 1989).

The remedy afforded a creditor who is able to establish that the debtor's transfer into the APT was fraudulent is the ability to void the transfer to the extent necessary to satisfy the creditor's claim. Jahde at 413. However, a creditor has a problem if the creditor is unable to obtain jurisdiction over the APR as transferee, or its assets, or if the creditor's claim of fraudulent conveyance is time-barred under the governing law of another country and that county's law is determined to be the governing law. Id.

**G. Statute of limitations**.

In all common law jurisdictions, a suit to set aside a fraudulent conveyance must be instituted within the applicable statute of limitations, depending on which jurisdiction's law will apply. In this regard, the situs of an APT is critical, the impending question being, "whose law applies?" If the law of the debtor's residence applies, the statute of limitation is generally four years from the date of the transfer or one year from the date of the creditor's notice of the transfer. Id at 414. If the law of the offshore jurisdiction applies, limitations will be much shorter. Additionally, many countries with asset protection legislation have statutes that bar claims of creditors whose claims did not exist on the date of the statute. Id.

Foreign jurisdictions that are "debtor-friendly" generally have significantly shorter limitations periods in which creditors are permitted to challenge transfers as being fraudulent. For example, with respect to either present or future creditors, the UFTA has an alternative limitations period of the grantor of (1) four years from the date of the transfer, or (2) one year from the date the creditor discovered the transfer or should have discovered the transfer. Id. In contrast, the Cook Islands limitations period is *immediate* as to future creditors and generally two years as to present creditors, and the Cook Islands statute does not include a known or should have known definition. Id.

**H. Burden of proof**.

Differences between the laws of the various asset protection jurisdictions and the laws of a given state are numerous and dramatic. For example, the Cook Islands state requires that a fraudulent transfer be proven by a creditor beyond a reasonable doubt, a much higher burden of proof for the creditor to meet than the preponderance of the evidence or even a clear and convincing standard typically found in the United States. Id.

Where a trust consists of personal property, it is usually construed by the jurisdiction designated as the "governing law" in the trust instrument and according to that jurisdiction's rules of construction. Therefore, in situations when it is not possible to determine the intent of the settlor by reference to the trust instrument, a role of law of the jurisdiction specified in the trust instrument will be applied to fill in the gap. Restatement (Second) of Conflict of Laws §224. Similarly, matters regarding administration of the trust, such as the authority of the trustee to make certain investments and to take specific action with respect to the trust assets, will also be based on the law of the jurisdiction specified in the trust instrument. Id. §§268 and 271.

As one can see, it can be difficult to locate an offshore trust and even if one is located, there are many barriers to easily recovering assets in an offshore trust. The family law practitioner may want to ask that the court order the other party to do a specific act (i.e., transfer funds to a joint account in the United States) and if the person fails to do so, the lawyer can initiate contempt proceedings, rather than jump into the murky waters of attacking an offshore trust.

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