MARITAL PROPERTY OBSTACLES/ OPPORTUNITIES IN TESTAMENTARY PLANNING

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I. INTRODUCTION

When a married resident of Texas dies, the marriage terminates, and their community property ceases to exist because it can only exist between spouses. Nonprobate assets pass to the designated beneficiaries. Tex. Prob. Code § 450. Death effectively partitions community probate assets, and the deceased spouse's undivided one-half interest passes to his/her heirs and/or devisees. Tex. Prob. Code § 37. A spouse's testamentary power is generally limited to that spouse's separate property and undivided one-half interest in the community property. *Avery v. Johnson*, 108 Tex. 294, 192 S.W. 542 (1917).

II. TESTAMENTARY POWER

As a general rule, the deceased spouse's testamentary power is limited to the decedent's undivided one-half interest in each and every probate asset that was community property prior to the deceased spouse's death because the surviving spouse retains (not inherits) an undivided one-half interest in each such asset, whether the assets were held in his or her name or their names prior to the first spouse's death.

A. The Spouses' Respective Interests

While there has been some academic discussion concerning the nature of the surviving spouse's interest in what had been community property prior to the first spouse's death, the rule in most of the community property states is that the surviving spouse continues to own an undivided one-half interest in each and every former community asset upon the first spouse's death – the "item approach." It is not merely a claim to 50% of the value of the community estate as it existed when the first spouse died – the "entity approach" or "aggregate approach." *See* Jesse Dukeminier, Stanley Johanson, James Lindgren and Robert Sitkoff, *Wills, Trusts and Estates* (Aspen 2005).

"*Wright* (*Wright v. Wright*, 154 Texas 138, 274 S.W.2d 670 (1955)) and other cases . . . establish that at dissolution of the community by death, Texas employs the item theory of community ownership." Joseph McKnight and William Reppy, Jr., *Texas Matrimonial Property Law*, p. 288 (The Michie Company, 1983). *See*, also, J. Thomas Oldham, *Texas Marital Property Rights*, p. 480 (Carolina Press 2011). Accordingly, the decedent's undivided one-half interest in each community is what passes under the deceased spouse's will or by intestate succession. However, the deceased spouse can attempt to incorporate the "entity approach" into the post-death administration by putting the surviving spouse to a "widow's election" in the deceased spouse's will.

B. The Election Will

The doctrine of election (equitable or express) can require the surviving spouse to select between (i) retaining his/her undivided one-half interest in each community asset and asserting other marital or statutory rights (e.g., reimbursement, homestead) or (ii) accepting whatever benefits are conferred by the decedent's will and whatever detriments are mandated by the will. Accordingly, notwithstanding the limitations imposed by *Avery v. Johnson, supra,* the deceased spouse can effectively dispose of any community asset and not just the decedent's one-half interest therein, if the surviving spouse elects to take under the election will.

III. NON-PRORATA DIVISION

A frequently asked question during the administration of the deceased spouse's estate is whether the surviving spouse (or the personal representative) and the decedent's distributees can agree to a non-pro rata division of the community estate so that the surviving spouse receives 100% of some of the assets and the distributees receive 100% of other community assets? The answer is an obvious "yes." Obviously, such a "swap" between the surviving spouse and the decedent's heirs/devisees would be treated as a taxable exchange subject to the non-recognition provisions, such as "like-kind exchange." Further, if one "gives up" more in value than received, the donor may also have made a taxable gift.

A. Election Planning

In an election will, the deceased spouse can require the surviving spouse to accept a non-pro rata distribution of their former community assets, if the surviving spouse elects to accept the benefits conferred by the will. The decision to elect or not can also have significant transfer and income tax consequences.

Note: *For a discussion of these matters and an in depth study of the Texas widow's election, see Kinnebrew and Morgan, "Community Property Division at Death," 39 Baylor Law Review 1037, 1072-1079 (1987).*

B. Executor's Authority/Spouse's Consent

Absent an election situation, the authority of an executor (even an independent executor) to enter into such a transaction should depend on the powers granted to the executor in the decedent's will. Of course, even if the will purports to enable an executor to make a non-pro rata division of the community, the surviving spouse's agreement is still required. The more difficult issue is whether any such agreement will be considered a taxable exchange, subjecting the parties to taxable gain exposure to the extent the assets have appreciated in value since the decedent's date of death. Again, if the surviving spouse "gives up" more in value than received, a taxable gift may have also occurred.

Note: *In a traditional testamentary plan, a safe harbor approach may be for the independent executor with appropriate authority granted in the will to enter into a partition and exchange agreement with the surviving spouse shortly after the first spouse's death and prior to any significant appreciation in value to the community assets. Care should then be taken to track the income from the partitioned assets so that the income is properly reported on the income tax returns of the survivor and the estate (or its successors).*

C. Possible Tax Avoidance

Two private letter rulings suggest that when such an exchange may not be taxable. In one, PLR 8037124, 1980 WL 134564, a couple in an unnamed community property state had entered into an agreement to divide into two equal, but non pro rata shares, certain community assets in order to create liquidity for one to pay estate taxes upon an anticipated death; relying in part on Rev. Rule 76-85, 1976-L C.B. 215, 1976-WL 36350, the memorandum concludes that such a partition would not result in a taxable event.

In the second, PLR 8016050, 1980 WL 132102, where a husband and the executor of his wife's estate in California proposed an equal, but non-pro rata, division following the wife's death, again the Service ruled the exchange was not a taxable event. In California, the ruling noted, the right of partition is to the entire community estate and not merely to some specific part, relying in part on the legal principle that the marital property interest of each spouse is an interest in the property as an entity. The legal entity principle relied on in the memorandum is, however, only mentioned in the context of Rev. Rul. 76-83, 1976-1 C.B. 213, 1976 W.L. 36350. Rev Rule. 76-83 ruled that a divorce non-pro rata division of community transaction was a non-taxable transaction with no gain or loss being recognized. The main point of the ruling was, while a division of the community in a divorce settlement may result in a taxable event, such a division is not considered taxable when there is an equal division of the value with some assets going to the wife and other assets going to the husband.

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

D. Relevant State Law

Do these rulings really support the legal conclusion that a post-death, non-pro rata division of assets in Texas would not be a taxable event, or is Texas substantive law different enough to generate a different tax result? In other words, would the agreement described in the first ruling be valid in Texas? Perhaps! But since Texas is an "item" state, would the second ruling be helpful in a Texas administration? In the author's opinion, the second ruling is not good precedent in Texas. However, as discussed below, California law may not be as different as PLR 8016050 suggested.

E. Current California Law

After the rulings were issued, on Jan. 1, 1999, California amended its Probate Code, Section 100, to provide: (a) upon the death of a married person, one-half of the community property belongs to the surviving spouse and the other half belongs to the decedent, (b) notwithstanding subdivision (a), a husband and wife may agree in writing to divide their community property on the basis of a non pro rata division of the aggregate value of the community property or on the basis of a division of each individual item or asset of community property, or partly on each basis. Nothing in this subdivision shall be construed to require this written agreement in order to permit or recognize a non-pro rata division of community property.

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

F. Compare Texas Law

So, can a Texas couple enter into the agreement described in the first ruling? First, Texas does not have a statute expressly authorizing such an agreement. Accordingly, would such an agreement be valid under existing Texas statutes and Art. XVI, Sec. 15 of the Texas Constitution?

Arguably, such an agreement is valid under existing Texas law. Both Tex. Fam. Code § 4.102 and Art. XVI, § 15 of the Texas Constitution authorize spouses to partition between themselves all or part of their community property, then existing or to be acquired, as they may desire. It is not too much of a stretch to imagine this statutory language could be interpreted to include an agreement to divide the community property on the basis of a non-pro rata division upon the death of the first spouse.

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

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

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

What's the bottom line? Perhaps an agreement of the spouses during the marriage to partition community in a certain way following the first spouse's death would not violate existing Texas law.

G. The Revocable Trust Advantage

Until the issue raised in III, F, is resolved, another ruling suggests a possible planning advantage a revocable trust may have over a traditional testamentary plan. In PLR 9422052, 1994 WL 237304 community assets had been placed in a revocable trust arrangement prior to the first spouse's death, and the trust agreement authorized the trustee to make non pro rata distributions following the first spouse's death among the survivor's trust and the deceased spouse's marital deduction and bypass trusts. It is interesting to note that the California Probate Code was amended to expressly authorize non-pro rata agreements within revocable trust agreements.

<u>Note</u>: *In a typical Texas-style joint revocable trust situation, the husband and wife, as joint settlors of the trust, have already agreed as to the disposition of the trust estate, including perhaps a non-pro rata distribution of community assets by the trustee, upon the death of the first spouse.*

IV. THE EMPLOYEE'S RETIREMENT PLAN

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

A. Application of the Apportionment Rule

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

B. Tracing the Separate Interest

The employee spouse should be permitted to trace the assets in the plan on the date of the marriage into their "traceable mutations" in existence at the time of the marriage's dissolution. Definitive case authority for this position is lacking since most authority is found in court decisions involving defined benefit plans and not defined contribution plans. *See Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983); *Taggart v. Taggart*, 552 S.W.2d 422 (Tex. 1977); and *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976) (defined benefit plans are to be apportioned based on the relative time periods). Subsequent courts of appeals have failed to consistently distinguish defined contribution and defined benefit plans. *Iglinsky v. Iglinsky*, 735 S.W.2d 536 (Tex. App.—Tyler 1987, no writ) and *Hatteberg v. Hatteberg*, 933 S.W.2d 522 (Tex. App.—Houston [1st Dist.] 1994, no writ), recognized the differences.

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

C. Section 3.007

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

1. Defined Benefit Plans

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

2. Defined Contribution Plans

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

3. Other Plans

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

Note: *Assume an employee was participating in a retirement plan prior to marriage. Upon marriage, under the "inception of title rule," the employee's interest in the plan would appear to be separate property and the spouse might have a claim for reimbursement for any contributions during the marriage. But, as explained in IV, A, supra, that's not the rule since Texas uses the "apportionment" approach. However, if the employee is not able to overcome the community presumption that attaches to a defined contribution plan by tracing per Tex. Fam. Code § 3.007, the employee may have a separate claim for reimbursement in the event of divorce. See* Horlock v Horlock, *553 S.W.2d 52 (Tex. App.—Houston [14th] 1975). See VIII, infra.*

V. THE PARTICIPANT'S DEATH

Prior to the Retirement Equity Act of 1984, federal law granted the participant's spouse very few rights to share in the participant's retirement benefits. REA's legislative history reflects Congress' "community property type" view that marriage is a partnership and that retirement benefits are derived from the contributions of both spouses and guarantee to the participant's spouse certain rights in different types of plans. For example, REA requires that the participant's retirement benefits in a pension plan (whether the participant's interest is community or separate under state law) be paid in the form of a "qualified joint and survivor annuity" ("QJSA"), if the participant survives until retirement age. If a vested participant in such a plan dies before retirement, REA makes the surviving spouse a plan beneficiary with an interest called a "qualified preretirement survivor annuity" ("QPSA"). The mandatory spousal rights mandated by REA can be waived by the participant's spouse. Internal Revenue Code, 26 U.S.C.A. § 401(a), 417.

A. Different Types of Plans

The "ERISA rights" of the participant's spouse are governed by not only ERISA (U.S.C.A. Title 29) but also the Internal Revenue Code (U.S.C.A. Title 26), as well as the I.R.S., Departments of Labor and Treasury interpretations of the two. The result is an incredibly complicated set of rules that do not lend themselves to easy explanation. Accordingly, as part of the estate planning process, a participant should inquire as to what are the spouse's rights in the participant's particular plan. The plan itself may even mandate a result different from the one prescribed by federal law.

B. Coordination of Plan Benefits

If the spouse is the sole beneficiary of both the decedent's will and the designated beneficiary of the plan benefits, planning is relatively simple. However, if the decedent's will contains a credit shelter (bypass trust), fully funding the trust can be complicated if a significant portion of the decedent's estate consists of plan benefits and there are not sufficient non-plan probate assets available to take advantage of the available exemption amount. Rather than funding the trust with plan benefits, a non-prorata distribution of the entire community estate may be desirable so that the surviving spouse receives 100% of the retirement plan benefits and 100% of other community assets are used to fund the credit shelter trust.

C. Taxable Exchange

A post-death agreement by the surviving spouse (because of an election will or otherwise) to accept as her share of the entire community estate (probate and nonprobate), the employee's retirement benefits in exchange for her one-half of other community assets passing into the bypass trust would appear to be a taxable event for income tax and gift tax purposes. *See* III, A, B, *supra*. So, could this taxable event be avoided with a non-pro rata agreement of both spouses or a revocable trust plan? *See* III, F, G, *supra*.

D. Super Election

Absent the surviving spouse's voluntary consent, can the participant spouse force the surviving spouse to accept such a non-pro rata division by an "election"? Traditionally the doctrine of election has required the electing spouse's benefit and detriment to be found in the same disposition (e.g., the deceased spouse's will or revocable trust). However, some commentators have argued for the "super election" in view of the prevalent use of probate and nonprobate dispositions as part of a comprehensive estate plan. For example, a husband designated his wife as beneficiary of a $1 million life insurance policy, but purports to specifically devise in his will both halves of a certain $100,000 community asset to his kids by a prior marriage without naming his wife as a beneficiary in the will. Should she be able to accept the $1 million and also assert her rights to one-half of the community asset specifically devised to the kids? Or, if she accepts a significant benefit in the comprehensive plan, shouldn't she be deemed to have accepted the detriment in another part of the plan? *See* Fraud on the Community, IX, *infra*.

E. IRAs and SEPs

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

Note: *See IX, K, infra, for a Texas case addressing group life insurance benefits.*

VI. THE NON-PARTICIPANT'S DEATH

The Texas Supreme Court in both *Allard*, *supra*, and *Valdez, supra,* recognized that the participant's spouse has a community interest in the participant's retirement plan that can pass probate or nonprobate to the spouse's heirs/devisees or beneficiaries. However, ERISA also provides that retirement benefits may not be assigned or alienated. 29 U.S.C. § 1056(d). § 401(a)(2) of the Internal Revenue Code also provides that the benefits must be for the exclusive benefit of the participant. Can these conflicting state and federal law concepts be reconciled?

A. Federal Preemption

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

B. *Boggs v. Boggs*

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

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

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

C. Consequences of *Boggs*

The non-participant spouse can own a community interest in the participant's ERISA retirement plan during the marriage (and in the event of divorce, the community property portion of the plan is subject to equitable division by the Texas divorce court); however, if the marriage terminates because of non-participant's death prior to the participant's retirement, the non-participant's community one-half interest in the plan effectively terminates. Federal law prohibits that interest from passing to the deceased spouse's heirs, devisees or beneficiaries.

1. Probate Inventory

Accordingly, in the author's opinion, the decedent's interest should not be listed on the decedent's inventory, appraisement and list of claims since it is not a probate asset – it doesn't pass to the decedent's heirs/devisees and it is not subject to administration.

2. The 706

Similarly, the decedent's interest would not appear to be an item included in the decedent's gross estate for federal estate tax purposes since the decedent did not have the ability to transfer it (as opposed to reflecting the decedent's one-half interest in the gross estate and claiming the marital deduction since it "passed" to the surviving participant spouse). The estate tax is an excise tax on the decedent's ability to "transfer" property at death, and *Boggs* took away the decedent's power to transfer the former community property interest.

Note: *It may be advisable to disclose why the decedent's interest was not included as a probate asset or a claim on the inventory and list of claims or as gross estate item on the 706 – Boggs v. Boggs.*

D. Non-Pro Rata Division

After the non-participant spouse's death, can the participant agree to accept 100% of the participant's retirement plan and allow the participant's one-half interest in other community assets to pass under the deceased spouse's will to or for the benefit of third parties, such as directly to the children or to a fund the bypass trust for the benefit of the participant and the children. The answer would appear to be an obvious "yes." But, it would also appear that the participant would be making a taxable gift since the spouse would not be receiving any value in exchange for giving up the participant's interest in the other assets. If the gift is to the "bypass trust" in which the participant has an interest, IRC Section 2036 would be an additional concern.

E. Pre-Death Planning

The type of planning suggested in III, F, G, *supra*, would appear to be more problematic in view of *Boggs.* Thus, as an alternative, perhaps the couple could consider a partition and exchange agreement under Tex. Fam Code § 4.102 resulting in the participant's interest in the plan becoming the participant's separate property and other assets the non-participant spouse's separate property available to fund the bypass trust upon the non-participant spouse's death, an alternative which has its own risks. For example, if the participant dies first, the newly-created separate assets of the non-participant spouse would not receive a step-up in income tax basis.

VII. POST-RETIREMENT BENEFITS

Assume a Texas participant retired prior to the non-participant's death, withdrew from the retirement plan and received with the non-participant spouse's consent (i) a lump sum distribution; (ii) a lump sum distribution which was "rolled over" into an IRA; or (iii) a monthly annuity contract. Further, assume the participant and the participant's spouse had been married during the entire period of the participant's participation. It is this author's belief that all of the post-retirement benefits remain community property subject to the participant's sole management and control under Texas law.

A. Subsequent Divorce

Accordingly, if the couple then divorces, all of the post-retirement benefits would be subject to just and right division by the Texas divorce court. *Boggs* does not mandate a different result. In fact, the *Boggs'* holding supports this conclusion since, after retirement, the benefits are not subject to ERISA's anti-alienation provisions. The justification for federal preemption in *Boggs* is not applicable following retirement and the distribution of the retirement benefits.

B. Non-Participant's Death

If the marriage terminates not in divorce, but because of the non-participant's death, her interest in the annuity, if any, likely terminates by the very nature of the annuity contract the couple agreed to upon the participant's retirement. However, the non-participant's one-half interest in any lump sum distribution should pass to her heirs or devisees, absent some nonprobate contractual arrangement. Likewise, her one-half of the rollover IRA should pass to her heirs or devisees, absent some nonprobate contractual arrangement, since the anti-alienation rules of ERISA do not apply to IRAs.

Note: *Some argue that Boggs extends ERISA's anti-alienation rules to IRAs, but, in this author's opinion, it does not. The IRA in Boggs was funded after the death of the non-participant spouse when the participant later retired. At the time of Dorothy Bogg's death, the ERISA benefits were still undistributed and in the possession of the plan administrator. The*

Supreme Court even noted that, had they divorced, Dorothy could have devised to her sons any interests she may have acquired in the benefits through a QDRO.

C. Participant's Death

If the marriage terminates because of the participant's death after retirement, the participant's interest in the annuity terminates, but the annuity may continue for the spouse's benefit, depending on the terms of the annuity contract. The participant's community one-half interest in the lump sum distribution passes to his heirs or devisees, and the non-participant spouse retains her half, absent some contractual nonprobate disposition. The rollover IRA likely passes to the designated beneficiary of the IRA, if any; otherwise, the surviving spouse retains her one-half interest, and the participant's one-half passes to his heirs or devisees. Any attempt by the participant to assign by a nonprobate contractual arrangement more than his half of the IRA to someone other than the spouse would be subject to the "fraud on the community" rule. *See* IX, *infra*.

D. Non-Rollover IRAs

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

E. Conclusions

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

VIII. CLAIMS FOR REIMBURSEMENT

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

A. Application at Death

In *Dakan v. Dakan,* 125 Tex. 305, 83 S.W.2d 620 (1935), the court held that a community claim for reimbursement existed at the owner's death, thereby placing the surviving spouse to an equitable election (i) to accept any benefits conferred in the will and waive the claim, or (ii) to assert the claim and waive any benefits under the will. It would also follow that the claim exists upon the death of the non-owner, thereby possibly imposing a duty on the personal representative to pursue the claim against the surviving owner/spouse.

B. 2009 Legislation

SB 866 (effective 9/1/09) contained another major overhaul to the Texas Family Code.

1. Intent

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

2. Reimbursement Defined

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

3. Equitable Principles

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

4. Use and Enjoyment

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

5. Surviving Spouse's Election

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

6. Equitable Lien

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

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

7. Equitable Claims

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

8. Non-Reimbursable Claims

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

9. Marital Property Agreement

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

C. Death of Claimant Spouse

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

1. Duty of Personal Representative

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

2. Liquidity Problems

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

3. Conflict of Interests

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

D. Claimant as the Surviving Spouse

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

1. Conflict of Interests

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

2. Election

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

3. Other Problems

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

IX. FRAUD ON THE COMMUNITY

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

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

Note: *ERISA regulated retirement plans are treated differently as well. _See_ V and VI, _supra_.*

A. Consequences of Joint Management

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

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

B. Fiduciary Obligation

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

C. The Managing Spouse's Duty

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

D. Burden of Proof

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

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

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

E. Remedies Generally

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

F. The *Schlueter* Case

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

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

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

G. Death of a Spouse

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

1. The *Harper* Case

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

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

2. Examples

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

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

H. *Street v. Skipper*

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

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

1. Third Party Designation?

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

2. Tweaking the Facts

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

3. Election?

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

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

I. Illusory Transfers

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

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

J. Fraud on Creditors

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

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

K. Federal Preemption

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

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

X. COMMUNITY PROPERTY IN THE REVOCABLE TRUST

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

A. Professional Responsibility

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

B. Creation and Funding

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

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

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

2. Is not deemed void because one spouse unilaterally attempted to transfer community property subject to joint control into the trust under Tex. Fam. Code §3.102;

3. Does not amount to a partition of community property under Section 4.102 of the Texas Family Code unless that is desired by the parties;

4. Does not work a commingling of community and separate funds as to risk losing the separate character of the separate property, unless that is desired by the parties;

5. Does not convert one spouse's retained equitable interest in his or her sole management community property into joint community property and thereby expose it to liability for the contractual debts of the other spouse; and

6. Defines which assets the trustee should use to provide for, and pay the debts of, the spouses while both are alive, and to satisfy claims of creditors upon the first spouse's death.

Note: *Texas community property law may create a unique planning opportunity when one spouse is incapacitated. Following a judicial declarations of incapacity, the other spouse, in the capacity of the community administrator, is granted the sole power of management, control and disposition of the entire community estate. Does this authority give the managing spouse the power to create and fund a revocable trust? Absent the judicial declaration, the competent spouse still retains sole authority over his/her special community property. In* Land *v.* Marshall*, the Texas Supreme Court held that the husband's creation of a revocable trust with his sole management community without his wife's joinder was not void as to the wife's one-half interest, but voidable at her election under the "illusory transfer" doctrine.*

C. Distributions

Careful consideration should be given to the trustee's duty to support the couple while both are still surviving. Generally, the terms of the trust should specify whether trust income is to be distributed or retained and if distributed, whether distributions to the husband, wife, or both, are appropriate. It may be advisable to distribute what would otherwise be a spouse's special community income (income from separate property or existing special community property) to that particular spouse. If such income is retained, it may be advisable to hold and invest it, in trust, as "special community." When the trustee is authorized to distribute income or principal for the spouses pursuant to an ascertainable standard, the terms of the trust need to specify what sources are to be exhausted first (i.e., use separate before community, or use community before separate and which type of community is expended first—special or joint). A different set of distribution criteria may be appropriate during those periods the spouses are incapacitated.

D. Power of Revocation

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

1. Joint Revocation

If the power to revoke is retained jointly by the couple, the couple's equitable interest in the trust would appear to be their joint community property even though some of the community assets in the trust were a spouse's special community property prior to funding. Converting special community property into joint community property affects the relative marital property rights of the husband and wife. For example, an asset which would have been exempt from certain debts of a particular spouse would become liable. See Brooks v. Sherry Lane National Bank. 788 S.W. 2d 874 (Tex. App—Dallas 1990). See IV. A., *supra.*

2. Unilateral Revocation

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

Note: *If unilateral revocation is desired, the more considered solution may be to allow one spouse, with notice to the other, to withdraw their special community and any joint community property with the joint community property being distributed in both names.*

3. "Joint and Several" Revocation

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

E. Subsequent Incapacity of a Settlor

As with any revocable trust, the trust document should address the effect the possible incapacity of a settlor will have on the power of revocation. Can an agent under a durable power of attorney revoke on behalf of the settlor/principal? Can a guardian revoke the ward's revocable trust? Is the power of revocation a non-delegable power? See Weatherly v. Byrd. 566 S.W.2d 292 (Tex. 1972). The questions evolve even further if the settlor is married and the trust is funded with the incapacitated spouse's special community property or joint community property. Do Sec. 883 of the Texas Probate Code and Sec. 3.301 of the Texas Family Code permit the other spouse to revoke the trust on behalf of the incapacitated spouse? Texas law provides no clear answers to these questions, thus, the document should address all of them.

F. Effect of Divorce

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

1. Powers of Appointment

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

2. Void and Voidable Transfers

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

3. Separate Trust Estate

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

4. Transfers to Third Parties

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

5. Revocable Trusts Becoming Irrevocable

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

6. Income Taxes

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

7. Planning for Divorce

While Section 472 voids provisions in favor of the former spouse and the former spouse’s relatives, in the event of a subsequent divorce, other problems exist if the trust is a joint revocable trust that provides for “joint revocation” and does not address what happens to the power of revocation in the event of a divorce. Further, it is not difficult to imagine the problems trying to interpret and construe the remaining terms of the trust. In that situation, it would likely serve both settlors to address these issues in the divorce settlement.

Awkward as it might be, it would be even better to address the possibility of a subsequent divorce in the trust agreement and how it would impact the power of revocation and the other terms of the trust.

G. Death of First Spouse

Upon the death of the first spouse to die, the decedent's separate property and one-half interest in the community assets are normally placed in a continuing decedent's trust or are distributed in accordance with the provisions of the trust document. For further discussion, See X, *infra*¸Non-Pro Rata Distributions.

H. Survivor's Interests

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

I. Amending the Survivor’s Trust

Quite often these joint trusts do allow the surviving spouse to amend the “survivor’s trust” after the death of the first spouse, but are silent about any unilateral amendment while both are living.

Generally no problems are encountered if both of the spouses agree to an amendment. But, what if one spouse wants to amend but other does not (or cannot). Generally, this is not permitted unless stated in the trust.

However, if the amendment only impacts the disposition of the surviving spouse’s property after the first spouse’s death, but the trust is silent on the point, can a spouse make those changes while both are alive? Even then, is notice necessary?

Obviously, this is an issue that should be addressed in the trust agreement. If the trust permits unilateral changes, it should include not only the dispositive provisions but any and all administrative provisions as applied to that survivor's dispositive provisions including but not limited to who could serve as trustee of any trusts that spring up after the death of one or both of the settlors.

J. Planning Considerations

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

K. Community Property Basis

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

XI. TRAP FOR THE MEDICAID UNWARY

In their excellent article presented this summer at the UT's Estate Planning Guardianship and Elder Law Conference, Clyde Farrell and Bliss Pak reported: "Prior to December 1, 2006, a trustee of a revocable trust could own the home while retaining its exempt character for Medicaid eligibility provided the home did not exceed the Deficit Reduction Act of 2005 value limitation (which was then $500,000, increased to $525,000 in 2012).

"Therefore, before December 1, 2006, conveying a residence to a revocable trust appeared to be sufficient to avoid the Medicaid estate recovery program. It was treated as exempt with regard to the transferor's Medicaid eligibility as if he or she owned it outright, and it passed outside the probate estate at death.

"However, effective December 1, 2006, a residence held by a revocable trust is *not* treated as exempt. The following rules apply:

- An application by a person whose residence is in a revocable trust will be denied if the value of the residence gives him or her (or the couple, if there is a community spouse) more than the allowable amount of resources. However, if the property is "removed from the trust" (presumably, conveyed from the trustee to the applicant personally), eligibility can be established—but not until the first day of the first calendar month after the removal has occurred.

- When eligibility is redetermined (usually annually), the original application and other documents in the case will be reviewed to determine whether there is a residence in a revocable trust. If so, a notice will be sent to the client that the residence will be counted as a resource. Unless the residence is removed from the trust before the re-determination due date (12 days after the date on the notice that re-determination is required), eligibility will be terminated.

- Both upon initial application and in the annual review, the worker will determine whether the equity in the residence exceeds the limit ($525,000 in 2012). If so, the client will be notified and given a "rebuttal process."

"Loss of exemption of the home is not the only disadvantage of revocable trust planning for a Medicaid applicant. In addition, a revocable trust has the following potential disadvantages as an estate planning device if the grantor (or either spouse) ever applies for Medicaid:

- A trust established in the revocable trust at the death of the community spouse for the institutionalized spouse may be counted as a resource (although it should not be if established by will, as discussed immediately above).

- Withdrawals of corpus are treated as "income."

- If the trust becomes irrevocable upon the incapacity of the settlor, or upon the death of the spouse, then the corpus will count as a resource (as discussed below) but the settlor will not have the legal authority to revoke the trust and engage in Medicaid planning or other estate planning (such as gifting).

- When there is a spouse who is not on Medicaid, assets must be removed from the trust and titled in her or his name before the first annual review after eligibility is established. After that time the institutionalized spouse cannot have more than $2,000 in countable resources in her or his name.

"If the Medicaid planning client already has a revocable trust, consider carefully whether one or more of these considerations indicate it should be revoked and replaced with a will-based estate plan…"

Farrell and Pak recommend that the settlor of an existing revocable trust, if still competent, execute a durable power of attorney giving the agent the authority to revoke the trust, and/or reconvey assets to the settlor, in the event it becomes advisable in the future.

They further warn that, in husband/wife situations, where one spouse is a Medicaid beneficiary, a revocable trust established by either or both spouses can create problems for the Medicaid beneficiary spouse (i.e., the revocable trust assets being counted as possible disqualifying resources). They recommend that a traditional testamentary plan creating a testamentary trust for the Medicaid beneficiary is a better planning solution.

See *What Every Estate Planner Needs to Know About Medicaid*, pgs. 4-7, H. Clyde Farrell and Bliss Burdett Pak, Estate Planning, Guardianship and Elder Law Conference, August 9-10, 2012, in Galveston, Texas.

APPENDIX

TOP TEN
TESTAMENTARY PLANNING CHECKLIST
(When Planning for Marital Property Issues) *

1. Consider specific devise of non-employee's community property interest in all employee benefits (including stock options/deferred income and qualified retirement benefits) to the employee spouse, thereby avoiding practical administration problems and maintaining tax flexibility.

2. Consider specific devise of deceased spouse's community property interest in surviving spouse's IRAs to the surviving spouse, thereby avoiding practical administration problems and maintaining tax flexibility.

3. Consider whether deceased spouse's community property interest in insurance on life of surviving spouse should be devised to the insured spouse or to the intended beneficiaries or to an insurance trust; if devised to surviving spouse, the insured can create an insurance trust, or let the policy lapse, or do whatever needs to be done in a non-fiduciary role – perhaps even disclaim in favor of the intended beneficiaries or to an insurance trust as provided in the will.

4. Consider directing executor/trustee to deliver to surviving spouse the community property interest of surviving spouse in any community property insurance on decedent's life payable to the estate or payable directly to a testamentary trust, thereby avoiding any fraud on the community or election issues

5. Consider whether to include specific "waiver" of claims of reimbursement and/or "fraud on the community":

    - This may be a customary provision in long-term marriages, but may not be universal in second marriages, particularly when there is no premarital or marital agreement.
    - Consider "waiver" only after offset for claims going the other direction, including to any consequential election issues.

6. Consider authorizing executor to make non-pro rata division of entire community estate (with or without consent of the surviving spouse) and any consequential tax or election issues.

7. Include provision that distributions and benefits under will or testamentary trusts are intended to be the beneficiary's separate property.

8. Check the "boilerplate" provisions of the will:

- Confirm the will is not being executed pursuant to any contract per Tex. Prob. Code § 59A (unless, of course, it is – then comply with Section 59A).

- Confirm that the testator only intends to devise the testator's separate property and one-half of the community (unless, of course, the testator intends to expressly put the spouse to an express election).

- Confirm that the executor's power provisions and debt payment provisions are consistent with Tex. Prob. Code §§ 156 and 177 and Tex. Fam. Code §§ 3.202 and 3.203. (For example, a direction for the executor to pay debts from the residuary estate could be interpreted as a direction to pay 100% of a debt out of the decedent's separate and one-half of the community, even though one-half of the debt should be paid with the surviving spouse's one-half of the community.)

9. Coordinate disposition of nonprobate assets, like insurance on deceased spouse's life and the decedent's retirement plans; generally, at least one-half of community life insurance proceeds and retirement benefits should be made payable to surviving spouse to avoid any "fraud on the community" issues under Texas law and all retirement benefits should be made payable to the surviving spouse to avoid "ERISA" issues under federal law. **

10. Review brokerage accounts and significant bank accounts (even stock certificates) for language that expressly grants "survivorship rights" under Texas law, thereby directing those assets to pass nonprobate – may need to eliminate "survivorship rights" to coordinate with the planning. This process should include careful review of the account agreements from out-of-state financial institutions that may impliedly create "survivorship rights" under the laws of another state pursuant to the agreement's "choice of law provision."

* This checklist was adapted from the one Stephanie Donaho of Locke, Lord, Houston, presented at the SBOT Advanced Estate Planning Course in 2012.

** See "It Should Not Be This Hard: A Look at Trusts as Beneficiaries of Retirement Benefits," Al Golden, and "The Minimum Distribution Rules Affecting IRAs and Qualified Plans in a Nutshell . . . A Guide for the Perplexed," Noel Ice. Both presented at SBOT Advanced Estate Planning Course in 2012.