TARRANT COUNTY PROBATE BAR ASSOCIATION

MARITAL PROPERTY ISSUES
IN ESTATE PLANNING

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May 3, 2007

I. Introduction.

Most Estate Planning for married couples is done for both spouses on a coordinated basis. The couple usually has a single investment advisor, a single insurance professional, a single accountant, a single banker, and a single attorney advising them. This is certainly not the only method nor should it be. There are many cases when separate representation is called for and advisable. Most issues arising in the Estate Planning context do so as a result of the characterization of the marital property. This outline summarizes some of the issues, which arise in the context of Estate Planning, as well as some post-mortem issues relating to spouses and marital property. References in the Outline to IRC are to the Internal Revenue Code of 1986, as amended, references to TFC are to the Texas Family Code, and references to TPC are to the Texas Probate Code.

II. Estate Planning For Married Individuals.

A. Tax Considerations In Estate Planning.

1. General Nature of Estate Tax System. The Federal tax laws impose a tax on the lifetime or testamentary transfer of assets. In the context of our Federal estate tax system, the Executor of the Estate is required under these laws to aggregate and value all assets owned by the decedent as of the date of death, subtract all debts and expenses, and pay estate taxes on the balance to the extent that such number exceeds the applicable estate tax exemption (which is currently $2,000,000), discussed below. Thus, the liability for Federal estate taxes will arise, if at all, only to the extent that the decedent's taxable Estate exceeds this estate tax exemption. Secondly, Congress decided to exempt all assets which are left directly to or in trust for the surviving spouse under what is referred to as the "unlimited marital deduction," likewise discussed below. Unfortunately, the surviving spouse's Estate will incur a substantial Federal estate tax liability if and to the extent that the marital assets exceed the applicable estate tax exemption. The Federal estate tax rate is as high as 45% of the net value of the Estate assets.

2. Applicable Exemption For Gift And Estate Taxes. The Internal Revenue Code provides for a one-time exemption against gift and estate taxes that can be used during a person's lifetime or at one's death, which is currently $2,000,000. In other words, each individual may transfer, free of gift and/or estate taxes, $2,000,000 worth of property through 2007. In the event a person transfers property in excess of his or her $2,000,000 exemption amount ($1,000,000 of which may be utilized during life), such excess will be subject to either the gift or estate tax unless an exclusion or deduction otherwise applies (e.g., the unlimited martial deduction, described below).

As a result of the 2001 Tax Act, this exemption will gradually increase to $3,500,000 as follows:

YEAR OF DEATH	**AVAILABLE "EXEMPTION"**
2006-2008	$2,000,000
2009	$3,500,000
2010	ESTATE TAX REPEAL
2011	$1,000,000

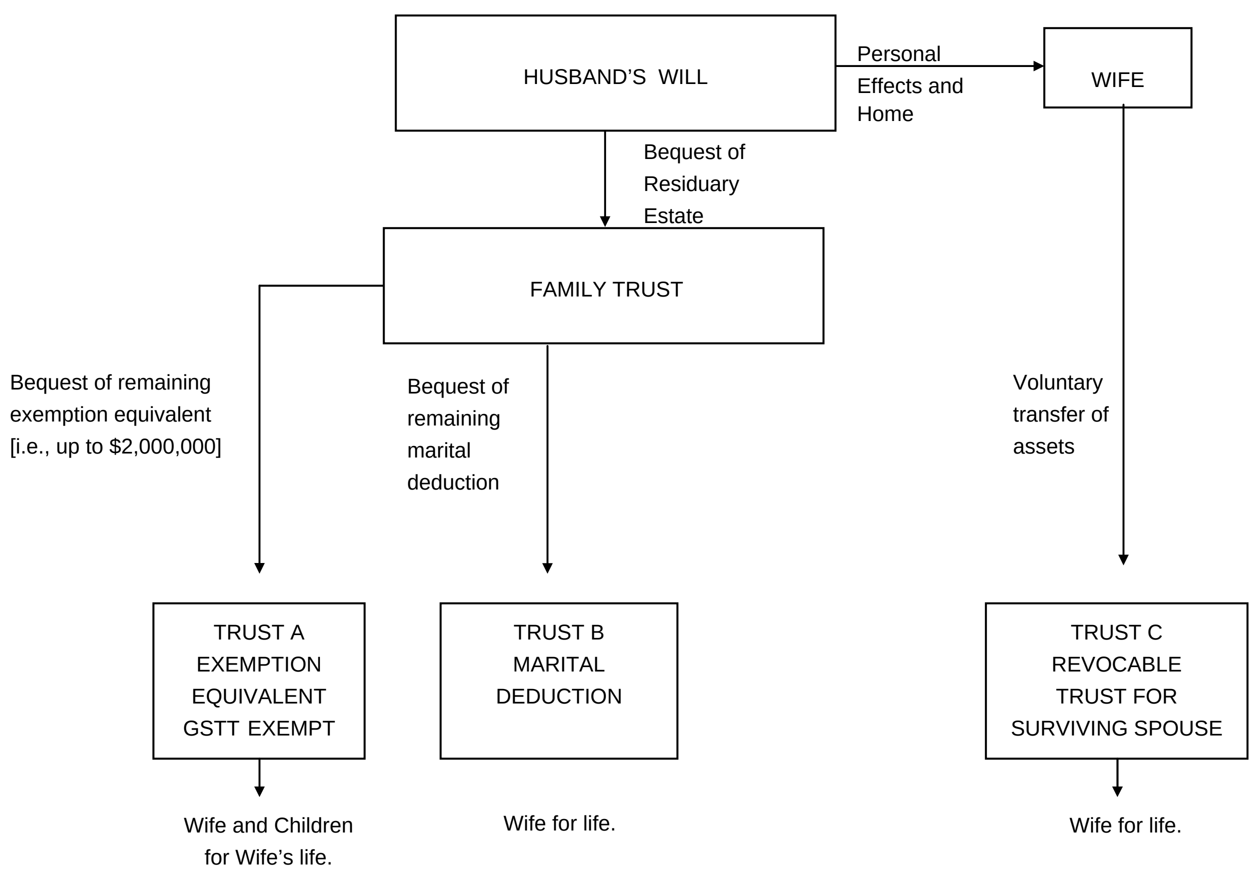
With a properly designed Estate Plan, therefore, the Estate a married couple can exempt an amount of property equal to the combination of their respective estate tax exemptions, or currently $4,000,000.

3. **<u>Unlimited Marital Deduction</u>.** Congress passed the Economic Tax Recovery Act in 1981, which provided married individuals with the opportunity to transfer an unlimited amount of property to and between each other without paying any gift or estate taxes. The rationale behind the enactment of the unlimited marital deduction was to treat married individuals as one economic unit and therefore exempt transfers between them for Federal wealth transfer tax purposes. For example, if one spouse dies and leaves property to the other spouse under his or her Will in excess of the $2,000,000 exemption equivalent amount, the surviving spouse would otherwise be required to pay a Federal estate tax. Therefore, the unlimited marital deduction provides that to the extent property is left to the surviving spouse, outright or in a special marital trust, such property will not be exposed to potential Federal estate taxes until the death of the surviving spouse.

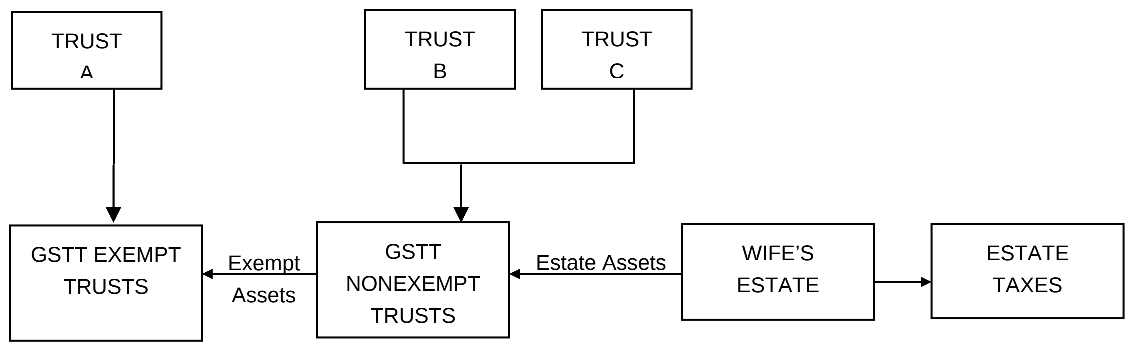
4. **<u>Generation-Skipping Transfer Tax ("GST")</u>.** Congress was concerned that wealthy individuals may seek to circumvent additional gift or estate taxes by transferring their assets in such a way as to bypass their children for Federal wealth transfer tax purposes. For example, one can transfer assets to a trust for the lifetime benefit of a child, with any remaining assets passing to the grandchildren thereafter. Even though the child receives benefits from the trust during his or her lifetime, the remaining assets passing thereafter to the grandchildren are not subject to Federal estate taxes because such trust assets were not “owned” by the child at his or her death.

To curb these perceived tax "abuses", Congress enacted the GST provisions as part of the 1986 Tax Reform Act. In addition to applicable gift or estate taxes, the GST provisions impose a flat 45% tax on transfers which "skip" generations for Federal gift and/or estate taxes. Fortunately, however, Congress likewise provided several techniques to successfully circumvent these additional GST taxes. For example, each person is given a $2,000,000 GST exemption wherein assets can still be "skipped" through successive generations without being subject to such additional GST taxes. The GST Exemption matches the Estate tax Exemption as set forth in the table on the preceding page.

5. **<u>Typical Estate Planning For Married Couple</u>.** As a result of the Federal transfer tax structure, an Estate Plan for a married couple must accomplish more than simply passing the assets to the surviving spouse and at the survivor's death passing the assets to the children. Such a plan will attract the most transfer tax and probably result in very disappointed beneficiaries. The following illustrates a typical fully developed Estate Plan that takes advantage of both the estate tax and GST tax exemptions:



The following procedures then become applicable following the death of the second spouse:



B. **<u>Planning to Fully Utilize Unified Credit</u>.**

1. **<u>Use of a Credit Shelter/Exemption Equivalent Trust</u>.** The most popular method for utilizing the predeceasing spouse's exemption equivalent amount is to fund a credit shelter/exemption equivalent trust. In the diagram above, the Trust A is the credit shelter/exemption equivalent trust.

2. **<u>Preventing "Estate Stacking" Through A Disclaimer</u>.** If, upon the death of the predeceasing spouse, there is no exemption equivalent trust in the predeceasing spouse's estate plan, it may still be possible to prevent "estate stacking" by having the surviving spouse make a disclaimer. By disclaiming property equal to the predeceasing spouse's exemption equivalent (which the surviving spouse would have received from the predeceasing spouse), the survivor prevents those assets from being "stacked" in the survivor's estate.

[<u>Planning Note</u>: Always consider the use of a disclaimer when a client or a client's family member dies. This planning must be completed within 9 months of the date of death.]

a. **<u>Advantages</u>.** By disclaiming an amount equal to the predeceasing spouse's exemption equivalent, the survivor avoids having this property in the survivor's gross estate. Since only the amount of the exemption equivalent is disclaimed, the predeceasing spouse's estate does not incur any estate tax. IRC § 2010(a). If the survivor accepted the property and then transferred it, a gift would be made by the survivor thereby wasting the survivor's exemption equivalent. IRC § 2511(a). However, a qualified disclaimer is not a gift so the property passes free of any gift tax consequences. IRC § 2518(a).

b. **<u>Disadvantages</u>.** If a disclaimer is made, the survivor will be deprived of the property disclaimed as well as the income from the property. Also, the disclaimed property will pass in accordance with the terms of the predeceasing spouse's Will as if the survivor was not living.

III. Short Course on Marital Property Law.

Generally, the law of the state where one resides at the time title is acquired will control the nature of the ownership of each asset. The character of property follows people as they move from state to state. Texas is one of ten states (including New Mexico and Louisiana) which follows the “community property” system. The community property system manifests the social and legal belief that property acquired by spouses during marriage should be construed as one total "community" of property. Regardless of how title to community property is taken, it belongs to the marital partnership in the absence of a written agreement to the contrary. In the non-community property ("common law") states, for most purposes, property acquired during marriage is deemed to be the separate property of the spouse who acquired it.

In Texas, all property owned by spouses is either "community property" or the "separate property" of one of the spouses. A spouse’s separate property is his or her own, but community property is owned one-half by husband and one-half by wife. The character of property is important in the estate planning context because of the many legal consequences that derive from property being either community or separate. For instance, the character of property determines (i) how it is managed and controlled by the respective spouses during marriage and following the death of a spouse; (ii) what liabilities it is subject to; (iii) various tax aspects of the property; and (iv) how it is divided and distributed at the termination of the marriage by death or divorce.

A. **Definition of Separate Property**. The Texas Constitution, the Texas Family Code, and the Texas Courts define a spouse’s "separate property" as:

1. Property owned or claimed by the spouse before marriage;

2. Property acquired during the marriage by gift, devise or inheritance;

3. Amounts recovered for personal injuries sustained by the spouse (except for money paid for loss of earning capacity, which is community property)

4. All income or property arising from a gift of property from one spouse to the other; and

5. Assets acquired during marriage with separate funds, or with the proceeds of the sale of separate assets. An increase in the value of separate property is still separate property.

EXAMPLE: Jane Doe bought 100 shares of stock prior to her marriage. During her marriage, Jane sold the stock and used the proceeds of sale to buy a parcel of land. Although the land was acquired during the marriage and was not itself acquired by gift or inheritance or under a will, the land is Jane's separate property because it was acquired with separate funds.

6. Other examples of separate property (assuming spouses have not agreed otherwise) include:

(a) Bonuses and royalties from separate property minerals.

(b) A gift of property to both spouses. In this case, one-half of the property would be held by each spouse as tenants in common.

B. **<u>Definition of Community Property</u>**. The Texas Family Code negatively defines "community property" to be all property acquired during marriage that is not "separate property." TFC § 3.002. Some examples of community property (assuming spouses have not agreed otherwise) include:

1. During marriage, the income of either spouse derived from either separate or community property is community property. Furthermore, all income acquired by either spouse as compensation for services is community property.

2. Cash dividends from separate property stocks.

3. Interest from separate property bonds and certificates of deposit.

4. Offspring from separate property animals.

C. **<u>Presumption of Community Property</u>**.

1. In Texas, all assets possessed by either spouse during or at dissolution of the marriage (i.e., upon divorce, upon the death of one of the spouses, etc.) are presumed to be community property.

2. The evidence needed to overcome the presumption must be "clear and convincing" evidence. The community presumption is especially strong in cases where there has been commingling or mixing of separate and community property, as in a bank account. It is thus possible that if adequate records are not kept, separate property may lose its identity and become community property. The burden is on the spouse contending that the property is not community property to prove the character of the property. This is often difficult to do.

3. Commingled separate property will not be community if it can be traced to its separate property origin. However, there is no reimbursement for separate property that has become community property by commingling.

D. **<u>Inception of Title Rule</u>**.

1. The separate or community character of an asset is determined at the time the asset is acquired. If title to an asset is acquired before marriage, it is the acquiring spouse's separate property. If, thereafter, improvements are made on the property by the expenditure of community funds or labor, this does not change the property's character or classification as separate property, but raises only the possibility (usually in the event of divorce) of a claim by the other spouse for reimbursement for the community funds expended.

2. A spouse's interest in assets is determined according to the laws of the state in which the couple was domiciled at the time the assets were acquired. That original character is not altered when the couple thereafter moves to a community property state. For example, in a common law state, property acquired from a husband's efforts during marriage is "his" property, and if the couple thereafter moves to Texas, it remains his "separate property."

E. **<u>Quasi-Community Property</u>**. A natural extension of the inception of title rule applies when spouses migrate from a non-community property state to a community property state like Texas. The general rule is that property acquired in a non-community property state will maintain its character as determined under the laws of the state in which the property was acquired. Accordingly, when a property is owned by one spouse and the couple moves to Texas, the property will be considered the separate property of the owner spouse. As this rule of law could result in a severe injustice to a couple which has recently moved to Texas and then obtains a divorce, the concept of quasi-community property was developed to protect such spouses. Quasi-community property is generally determined to be property which would have been community property if acquired in Texas. Quasi-community property is capable of division upon divorce as if it were community property. *See*, *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982).

> THE QUASI-COMMUNITY PROPERTY RULE IS APPLICABLE ONLY UPON DIVORCE. IT IS NOT APPLICABLE UPON THE DISTRIBUTION OF ASSETS UPON THE DEATH OF A SPOUSE. TFC § 7.002(1).

F. **<u>Planning For New Texas Residents</u>.** The laws of the State of Texas regarding community and separate property apply to married persons while domiciled in the State of Texas. Accordingly, when spouses move to Texas from a non-community property jurisdiction, all of their assets become subject to the rules regarding marital property characterization. As indicated previously, the general rule is that property acquired in a non-community property state will maintain its character as determined by laws of the state in which the property was acquired. However, once the spouses become domiciled in Texas, all income and earnings on all property is the community property of the spouses. Most people moving into a community property jurisdiction are unfamiliar with the property characterization laws. Accordingly, at a minimum, the couple should be advised as to the community property system and advised to take one of the following actions:

1. **Do Nothing.** If the clients do nothing with respect to their financial affairs, all of the income generated by the separate property brought to Texas will be community property. In many cases, the community property income will become co-mingled with the original separate property corpus, and at some point, the separate property may become untraceable. As a result of the presumption that all property is community property, unless it can be shown by clear and convincing evidence that it is the separate property of one spouse, the co-mingling may unintentionally convert separate property into community property by default.

2. **Do Nothing But Keep Very Good Records.** A second alternative is for the clients to simply keep very accurate records as to the initial corpus of the separate property and allow the accumulation of community property income. This method would preserve the separate property character of the initial corpus and provide the clear and convincing evidence as to its separate property character.

3. **Keep The Income And Corpus Separate.** In order to facilitate the record keeping, the clients may wish to arrange their financial affairs so that items of income, including earnings, interest and dividends on separate property investments, are segregated into a separate community property account, leaving the corpus of the separate property asset free from any community property taint.

4. **Marital Property Agreement.** The final alternative for the clients is to enter into a marital agreement which clarifies the character of the property and the income generated by the property. For example, the marital agreement could be limited to a particular asset and provide that all income generated by that asset will be separate property. This avoids any co-mingling of the reinvested income. To be effective, such agreements must meet all the requirements of TFC § 4.101, et. seq. Alternatively, the spouses can enter into an agreement to convert separate property into community property. TFC § 4.201, et. seq.

5. **Summary Of Planning For A New Resident.** Regardless of which action the clients decide to take, it is important that they (i) understand the basics of the community property regime, and (ii) understand the consequences of the characterization of property as it relates to distribution upon death, division upon divorce, management during the marriage and the issues related to taxation of such assets.

IV. **<u>The Role Of Property Characterization In Estate Planning</u>.**

The characterization of marital property plays an important role in the estate planning process. How property is distributed upon death of a spouse, the management of the assets during marriage, the rights of creditors both during the marriage and following the death of a spouse and the taxation of such property are all affected by the character of the property held by the spouses.

A. **<u>Distribution Of Marital Property Upon Death</u>.** Upon the death of a spouse, his or her interest in property passes either by a Will (i.e., testate distribution) or if no Will, then by the laws of descent and distribution (i.e., intestate distribution), or by specific beneficiary designation or other contractual arrangement (i.e., life insurance, joint accounts and retirement accounts).

1. **<u>Intestate Distribution</u>.** When a person passes away without a Will, the laws of descent and distribution in the Texas Probate Code determine the distribution of the decedent's property. Specifically, § 38 of the Texas Probate Code deals with the distribution of separate property and § 45 of the Texas Probate Code deals with the distribution of the community property assets. It is important to note that the concept of quasi-community property is not applicable to the distribution of assets upon the death of a spouse.

a. **<u>Separate Property Intestate Distribution</u>.** Section 38(b) of the Texas Probate Code provides that if a person dies leaving a spouse, then the surviving spouse will take 1/3 of the personal estate and the balance of the personal estate shall go to the children and the descendants of the deceased. In addition, the surviving spouse will be entitled to an estate for life in 1/3 of the land, with remainder to the children and descendants of the deceased spouse. If there are no children, then the surviving spouse shall be entitled to all of the personal estate and to ½ of the lands, the other half of the land will pass to the decedent's heirs at law.

b. **<u>Community Property Intestate Distribution</u>.** Section 45 of the Texas Probate Code provides that upon the death of a spouse, ½ of the community estate is owned by the surviving spouse. In other words, the laws of intestate distribution do not affect the surviving spouse's interest in the community property. The decedent's interest in the community property, will pass to the surviving spouse if the deceased has no children or descendants, or all surviving children and descendants of the deceased spouse are <u>also</u> children and descendants of the surviving spouse. If there are children or descendants of the deceased spouse who are <u>not</u> children of the surviving spouse, then the deceased's ½ interest in the community property will pass to <u>all</u> children and descendants of the deceased spouse.

2. **<u>Testate Distribution</u>.** Under the laws of Texas, a decedent has the right to dispose of his or her interest in all property. Therefore, a decedent's Will will dispose of 100% of his or her separate property and his or her ½ interest in the community property. If the Will of the decedent attempts to distribute the surviving spouse's interest in the community property, the surviving spouse may be put to a "widow's election."

   From an estate planning perspective, it is therefore very important to not only know the client's assets, but also know the separate or community property character of the property

B. <u>Management Of Assets During Marriage</u>.

1. **<u>Separate Property</u>.** A spouse has the authority to manage and dispose of his or her separate property without the joinder or consent of the other spouse.

2. **<u>Sole Management Community Property</u>.** Each spouse has the sole right to control, manage and dispose of the community property that he or she would have owned if single, including but not limited to personal earnings, separate property income, recoveries for personal injuries and income from sole management community property (which is generally referred to as a spouse's "special community" property). The Texas Family Code also allows a measure of protection to third parties dealing with a spouse by providing that property held in a spouse's name or in his or her possession and not subject to written evidence of ownership is presumed to be subject to the sole management and control of that spouse. Also, a third person dealing with a spouse is entitled to rely on the spouse's authority to deal with the property if the property in question is presumed to be subject to the sole control of the spouse and the person dealing with the spouse is not a party to fraud on the other spouse or another person and does not have actual or constructive notice of the spouse's lack of authority.

3. **<u>Joint Management Community Property</u>.** Joint management community property is all other community property other than the sole management community property. Such property is subject to the joint management and disposition decisions of the spouses.

C. <u>Rules of Marital Property Liability</u>.

1. The Texas Family Code provides that each spouse has a duty to support his or her minor children and the other spouse when the other spouse is

unable to support himself or herself. A spouse who fails to discharge this obligation is liable to any person who provides such support.

2. The Texas Family Code also provides specific rules for marital property liability.

(a) A spouse's separate property is not subject to liabilities of the other spouse.

(b) Community property subject to a spouse's sole management (special) is not subject to non-tortuous liabilities of the other spouse (i.e. bank debt) or any liabilities of the other spouse incurred before marriage.

(c) All community property is subject to tortuous liabilities of either spouse incurred during marriage.

(d) Different rules may apply with respect to federal tax liabilities, even if the tax liabilities were incurred prior to marriage.

The chart on the following page illustrates the application of these rules:

TYPE OF LIABILITY	PROPERTY SUBJECT TO LIABILITY Joint Management Community Property	Sole Management Community Property	Separate Property
1. Contracts of Other Spouse Before Marriage	**X**		
2. Contracts of Other Spouse During Marriage	**X**		
3. Torts of Other Spouse Before Marriage	**X**		
4. Torts of Other Spouse During Marriage	**X**	**X**	
5. Debts Incurred by Other Spouse for Necessities	**X**	**X**	**X**
6. Own Contracts (Before or During Marriage)	**X**	**X**	**X**
7. Own Torts (Before or During Marriage)	**X**	**X**	**X**

D. **Marital Property And Transfer Tax Planning.** The character of marital property affects a client's planning with respect to the federal transfer taxes (i.e., gift tax, estate tax, and GST tax).

1. **Gift Tax Planning.**

a. **Gift Of Community Property.** A gift of community property is considered a gift of ½ of the property by each spouse. Accordingly, each spouse should file a separate Federal Gift Tax Return (IRS Form 709), reporting ½ of the gift. No gift-splitting election is required or should be made with respect to a gift of community property. In this regard, it is also irrelevant that the community property is the sole management community property of one of the spouses.

b. **<u>Gift Of Separate Property</u>.** A gift of separate property by a spouse will require the filing of a federal gift tax return by the donor spouse. The non-donor spouse, however, may make an election to gift-split the gift with the donor spouse. IRC § 2513(a)(2). Some important rules to keep in mind when gift-splitting are as follows: (i) if the election to gift-split is made, all gifts of separate property made by the spouses during the year <u>must</u> be split. In other words, you may not elect to split only some of the gifts; (ii) the election to split gifts will also cause the non-donor spouse to be treated as the Transferor of such property for GST tax purposes. IRC § 2652(a)(2) and Treas. Reg 26.2652-1(a)(4); (iii) once made—election is irrevocable; and (iv) care must be taken when electing gift-splitting in the context of a spousal ILIT. For example, if husband has established a spousal ILIT for wife, and is making a gift of separate property to the ILIT, the election to split gifts by the wife may have dire consequences. In other words, the gift-split election may cause wife to be treated as the settlor of such trust which will cause inclusion of a portion of the ILIT assets in her gross estate for Federal estate tax purposes.

2. **<u>Federal Estate Tax Planning</u>.** If the predeceasing spouse does not have sufficient separate property in addition to his or her ½ of the community property, there is a potential that the first spouse's exemption equivalent/credit shelter trust will be underfunded. Therefore, when reviewing a client's estate plan, it must be determined whether each spouse has sufficient assets to fully fund his or her exemption equivalent/credit shelter trust. This is becoming more and more important as the exemption amounts rise.

> EXAMPLE: Assume that Mr. and Mrs. Peal have a $2,000,000 community property estate and Mrs. Peal has inherited $2,000,000 worth of property, which she holds as her separate property. If Mr. Peal dies first, his entire estate will consist of his $1,000,000 interest in the community property estate. If such property passes to an exemption trust for the benefit of Mrs. Peal, such assets will not be included in Mrs. Peal's estate, however, she will have a gross estate of $3,000,000. In this circumstance, they should consider increasing Mr. Peal's estate by either a gift by Mrs. Peal to Mr. Peal of her separate property, or the conversion of some of the separate property into community property. This will allow Mr. Peal to fully fund his exemption equivalent trust and maximize the federal estate tax savings on the death of Mrs. Peal.

a. **<u>Utilization of "Poor" Spouse's Exemption Equivalent Through Lifetime Marital Gift</u>.** If the "poor" spouse dies first, estate tax savings can be missed without proper planning. In this regard, if the poor spouse does not have sufficient assets to equal the exemption equivalent, the rich spouse should consider making a lifetime gift under the marital deduction in an amount which will enable the poor spouse's estate to have enough assets in it equal to the exemption equivalent. IRC § 2523(a). Therefore, if the poor spouse dies first, at least the poor spouse can utilize his exemption equivalent. In making this gift, the rich spouse can provide for this gift in a QTIP trust, take the marital deduction so the gift is free of gift tax, have the amount of the exemption equivalent included in the poor spouse's estate so that no estate taxes are incurred, and then pass the assets to the rich spouse's designated beneficiaries. IRC § 2523(f).

b. **<u>Converting Separate Property into Community Property</u>.** Until recently, it was impossible for a couple in Texas to convert their respective separate property into community property. The Family Harmony Bill of 1999 (along with a constitutional amendment) revised the Texas Family Code to allow a married couple to convert their separate property to community property. Section 4.201 et. seq. of the Texas Family Code now provides for a Marital Agreement which will convert separate property into community property.

Instead of the rich spouse making a gift to the poor spouse and creating separate property, the rich spouse may now convert a portion of his or her separate property into community property. This conversion has other advantages as well.

[1] **<u>Step-Up In Basis</u>.** Under Section 1014 of the Internal Revenue Code, property received from a decedent gets a new basis for Federal income tax purposes equal to the fair market value of the asset as of the appropriate valuation date. It is clear under Section 1014 that both halves of the community property receive the new basis. Accordingly, owning appreciated property as community property will ensure that the surviving spouse receives a new basis in the property.

[2] **<u>Avoidance of Tracing on First Death</u>.** It is fundamental that a person's will only affects his or her interest in community property and his or her separate property. On the death of a spouse owing separate property, it is necessary for the surviving spouse to trace all separate property in order to reach the proper disposition of assets, to determine the proper funding of trusts, and determine the proper taxation of the assets. If the separate property has been commingled, this

may become a very difficult (and expensive chore). Converting the property into community property will ease the administration of the estate in many respects.

[3] **Management of Converted Assets.** It is possible under the Agreement to provide that the donor spouse may retain the management rights over the transmuted property, a right that is not possible with a gift of separate property.\

There is also at least one disadvantage to converting separate property to community property:

Potential Increase in Creditor Exposure. A spouse's separate property is not liable for the tortious or contractual liabilities of the other spouse (unless such contractual liabilities were incurred for necessaries). By converting separate property into joint management community property, a spouse exposes such property to all contractual liabilities of both spouses and all tortious liabilities of both spouses. If, however, the property is converted into sole management community property, the additional exposure is limited to only tortious liabilities of the other spouse arising during the marriage.

V. Community Property Issues In Trust and Partnerships.

The characterization of marital property is often complicated by the fact that a spouse may be a beneficiary of a trust or a partner in a Family Partnership.

A. Property In Trust.

The characterization of income as well as the principal of a Trust as to the beneficiary depends upon several factors including the identity of the settlor, the intention of the settlor, the identity of the Trustee, and the terms of the Trust regarding distributions. The existence of these factors has caused a multitude of cases which struggle with the classification issue.

1. **Self-Settled Trust Prior To Marriage.** If a spouse is the settlor as well as a beneficiary of a trust, it is clear that the spendthrift provisions of Texas Trust Code § 112.035 will not be applicable and a creditor will be able to reach whatever interest the settlor has retained as a beneficiary. The income of a trust, which a spouse creates prior to marriage, should retain its separate property character. This was the case in *Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App. – Ft. Worth 1996, writ denied) where an independent Trustee had the discretion to distribute income to the settlor spouse from a trust which was established prior to marriage.

2. **<u>Self-Settled Trust Established After Marriage</u>.** In a case where a Trust is established for the benefit of the settlor and the settlor transfers his or her separate property to such trust, the income generated by the Trust assets will constitute community property. This will be true regardless of whether the settlor is acting as a trustee. This result is simply reached by remembering that a spouse may not unilaterally convert community property into separate property. If the income of such a self-settled trust were treated as separate property, then the settlor spouse would have unilaterally converted community property into separate property. In the case of *In Re: Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App. – Texarkana 1978, writ dismissed) the court held that undistributed income was not community property. The court in *Burns*, however, went on to say that had the income actually been distributed, it would have constituted community property. *Id.* at 557. It is worth noting that at least two Texas Supreme Court cases have found contrary to *Burns* and do not distinguish between income that has or has not been distributed in this circumstance.

3. **<u>Non-Self-Settled Trust</u>.** Where the settlor is not the beneficiary, income earned on the trust assets will generally be separate property if distributed to the beneficiary or not marital property at all if retained in the Trust. This general rule is supported by several Texas cases including *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex. App. – Tyler 1996, no writ), *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. App. – Ft. Worth 1967, writ dism'd.), and *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App., 1896, writ ref'd.).

   An exception to the separate property character of income exists if the beneficiary spouse has an absolute right to the principal. For example, in *In Re: Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App. – Texarkana 1976, no writ), a spouse was entitled to receive a portion of the principal of the trust upon obtaining the age of 25, however, no distribution was made. As a result, the court, in a later divorce action treated the income earned on the corpus of the trust which was required to be distributed to the beneficiary spouse as community property. However, income earned on the corpus of the trust prior to attaining the age of 25 years as well as the income on the corpus which was not required to be distributed retained its separate property character.

4. **<u>The Mandatory Income Trust</u>.** If a Trust is established by a third party for the benefit of a spouse, and the Trust requires or mandates that all income be distributed to the spouse, the separate or community property character of such distribution is subject to differing theories. One theory is that if the beneficiary also has an interest in the corpus of the Trust, then the income associated with that corpus should be considered community property income. That was the holding in *Ridgell v. Ridgell*, 960 S.W.2d

144 (Tex. Civ. App. – Corpus Christi, 1997, no writ). Most think that Ridgell was incorrectly decided – the court followed Fifth Circuit cases from the 1930's and 1940's that would no longer be consistent with Texas law.

In a case where the beneficiary spouse had a mandatory income interest, but did not have an interest in the corpus of the Trust, the Court concluded that the income was the separate property of the beneficiary since that was the subject of the gift. *Wilmington Trust Co. v. United States*, 753 F.2d 1055 (5th Cir. 1985). Wilmington represents the majority view today, with the unresolved question remaining of what nature of interest in the corpus of the trust the beneficiary would need to have in order for the outcome to change. It would seem to be consistent with existing caselaw that the interest in the corpus would need to be unfettered, essentially making the trust a self-settled trust.

5. **Planning Considerations.** Accordingly, when establishing a trust for a beneficiary, it is advisable to include language in the Trust Agreement which indicates the settlor's intent that the income of the Trust be treated as the separate of the beneficiary. It seems fairly clear under the cases cited above that absent a mandatory income provision, such income will retain its separate property character. In the event of a mandatory distribution trust, the settlor should make clear that the gift to the Trust is the mandatory income distribution to the beneficiary. Such an express statement of intent by the settlors would be of assistance in a subsequent contest as to the character of the distributed income.

B. **Property Of Family Limited Partnership.** As Family Limited Partnerships ("FLPs") proliferate the Estate Planning landscape, special attention should be paid to the marital property issues which arise in this area. Specifically, in the establishment of an FLP, attention must be paid to the nature of the property contributed to the partnership, the nature of the partnership interest received as a result of the contribution, and consideration should be given to the income generated by the partnership assets.

1. **Nature of Property Contributed to Partnership.** Either separate or community property may be contributed to the Partnership. It is clear, however, that once property is contributed to the Partnership, it is no longer the property of the partner spouses. Section 154.001(c) of the Texas Business Organizations Code ("TBOC") states "a partner is not a co-owner of partnership property," and section 154.002 follows with "a partner does not have an interest that can be transferred, voluntarily or involuntarily, in partnership property." As a result, it would appear that the property loses any separate or community property character unless the partnership agreement itself states otherwise.

2. **<u>Character of Partnership Interest</u>.** If separate property is contributed to the Partnership, it would appear that the partnership interest received in return for such contribution constitutes the contributing spouse's separate property. Any different conclusion would allow a spouse to convert separate property to community property without meeting the requirements of the Texas Constitution and Family Code. Likewise, the Partnership interest received as a result of a contribution of community property to a Family Limited Partnership should constitute the community property of the contributing spouses. Section 154.001(b) of the TBOC states "a partner's partnership interest may be community property under applicable law" and section 154.001(a) states "a partner's partnership interest is personal property for all purposes."

3. **<u>Partnership Income</u>.** Regardless of whether the partnership interests themselves are community or separate property, distributions of partnership income will constitute community property (absent a marital agreement between the spouses). The more difficult question is characterizing <u>undistributed</u> partnership income relating to a separate property partnership interest. One case which holds that undistributed income of a partnership is community property is *In Re: Marriage of Higley*, 575 S.W.2d 432 (Tex. Civ. App. – Amarillo 1978, no writ). The *Higley* case cites the federal taxation concept that all partnership income flows to the partners as support for its community property finding. However, *Marshall v. Marshall*, 735 S.W. 2d 587 (Tex. App. Dallas – 1987) is more representative of the prevailing rule. The Court in *Marshall* explained that partnership funds later used to pay a separate tax debt were neither community funds nor separate funds prior to distribution from the partnership, because they were not owned by either spouse.

   It is important to note that the TBOC provisions affecting partnerships which clearly adopt an entity type theory were enacted following the *Higley* case. As the income of the partnership belongs to the Partnership, as opposed to the partners, it would appear, following the entity theory expressed by the TBOC and in *Marshall*, that until distributed, the income is neither separate nor community.

VI. <u>Marital Property Issues And Life Insurance</u>.

Life insurance is a critically important part of the estate planning process. Determining the marital property character of the policy, as well as the dollars used for premium payments, can affect both the taxation and distribution of the proceeds of policy.

A. **<u>Estate Tax Inclusion</u>.** The proceeds of an insurance policy on the life of the decedent will be included in the decedent's estate in two circumstances. First, if the proceeds are receivable by the executor of the estate and secondly, if the decedent possessed at his death any incidents of ownership over the policy, exercisable either alone or in conjunction with any other person. IRC § 2042. Generally speaking, the term "incidents of ownership" refers to the economic benefits of the policy and includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy. Treas. Reg. 20.2042-1(c)(2).

B. **Amount Includable.** If the policy is the separate property of the decedent, then 100% of the proceeds will be includable in the gross estate if either of the two conditions in IRC § 2042 exist. The issue gets more complicated if the policy is community property. If the policy is community property and the beneficiary is the surviving spouse, or if the estate of the insured is the beneficiary and the surviving spouse is the beneficiary of the estate, it may not matter what the proper amount to be included is. However, the issue becomes quite apparent if the beneficiary is someone other than the surviving spouse.

For example, let's assume that husband and wife own a community property policy on husband's life and husband has designated his children from a prior marriage as the beneficiaries. In such a case, presumably, upon husband's death, only ½ of the proceeds are includable in his Estate, and assuming there is no fraud on the surviving spouse at the time the beneficiary designation was made, wife will be treated as having made a gift of her ½ interest in the proceeds to husband's children. Treasury Reg. § 25.2511-1(h)(9). This Treasury Regulation is directly on point in the context of a third party being designated as beneficiary.

In a case where the estate of the husband (as opposed to a third party) was the beneficiary of a community property policy, the Fifth Circuit Court of Appeals found that the provision of §2042 stating that "the gross estate shall include the value of all property…to the extent of the amount receivable by the executor as insurance under policies on the life of the decedent" covered the situation. The Fifth Circuit found that 100% of the proceeds were includable in the Decedent's Estate. *Estate of Street v. Comm'r.*, 152 F.3d 483 (5th Cir. 1998).

Some important facts are necessary to put the *Street* case into perspective.

First, the wife had elected against the Will and claimed that she was entitled to her ½ community property interest in the proceeds. The state district court, however, determined that the Estate was entitled to 100% of the proceeds as husband had a right to designate his estate as beneficiary.

Second, it was the Estate in the tax case arguing for a 50% inclusion and a 50% gift by the wife.

Third, if the Fifth Circuit had concluded that only ½ was included, it would have meant that wife had made a gift of her ½ interest in the policy to husband's Estate. The *Street* case may be a prime example of bad fact making a bad law.

C. **<u>Planning For Non-Insured's Death</u>.** Another important aspect of planning with insurance is consideration of how to treat the community property interest of the non-insured spouse upon his or her death.

1. **<u>Estate Inclusion</u>.** The amount to be included in the non-insured's Estate will be ½ of the value of all community property policies. The value on the date of death of the non-insured spouse will be the value of the policy at that time (i.e., its cash value as opposed to face value). If the policy is passed to the surviving spouse, then upon the insured's death, 100% of the policy proceeds will be included in the insured's estate under IRC § 2042.

   In a case highly favorable to the taxpayer, the Fifth Circuit found that the estate of the insured spouse, having been predeceased by the non-insured spouse, only includes ½ of the proceeds of a community property policy on the theory that the non-insured's estate had not been "settled" in such a manner as to cut off its interest in ½ of the proceeds. In *Cavanaugh v. Comm'r.*, 51 F.3d 597 (5th Cir. 1995), the non-insured spouse died and ½ of the value of the policy was reported on her Federal Estate Tax Return. Before her Estate had been settled, the insured spouse died. The Executor of his Estate only included ½ of the proceeds of the policy on the theory that the other ½ of the proceeds belong to the non-insured spouse's Estate.

2. **<u>Planning Opportunities</u>.** While the Taxpayers in *Cavanaugh* were fortunate to have the court rule in their favor, if the result in that case is desired, extreme care should be taken during the planning process. In this regard, there are always two planning circumstances which should be identified and addressed.

   The first planning opportunity is the ability of the non-insured spouse to pass his or her community property interest in a policy to the children on the first death. This will remove one-half of the proceeds of the policy from the estate of the surviving insured spouse. However, following the non-insured spouse's death, care should be taken to properly document the ownership of one-half of the policy in the children following the non-insured's death.

   Secondly, an opportunity exists for the non-insured spouse to pass his or her interest to a Bypass Trust established for the insured surviving spouse. However, as most Bypass Trusts established for the benefit of the surviving spouse appoint the surviving spouse as the Trustee of such Trust, a problem will arise with respect to the incidents of ownership test under IRC § 2042. In other words, if the policy is owned by a Bypass Trust, and the surviving spouse serves as Trustee, the surviving spouse will have retained the incidents of ownership of such interest owned by the Trust resulting in 100% inclusion of the proceeds in the insured surviving spouse's estate. The IRS has indicated, however, that if structured properly, the proceeds can avoid inclusion in the insured's Estate if the surviving spouse does not serve as the Trustee of the Trust, and all premiums of the policy attributable to the Trust are paid by the Trust itself. See PLR 9748020.

D. **<u>Community Property Issues and Irrevocable Life Insurance Trusts</u>.** The Irrevocable Life Insurance Trust (or "ILIT") is an important tool used in Estate Planning. If used correctly, it removes 100% of the proceeds of a life insurance policy from the taxable estate of the insured and his or her spouse. In many cases, the ILIT is established by purchasing a policy on one spouse, and designating the other, non-insured spouse, as a beneficiary of the ILIT. In non-community property states, this practice is very common, and the operation of such spousal ILITs is not complicated by the existence of community property. However, when such a spousal ILIT is attempted in Texas, extreme care must be taken to accomplish the desired objective (i.e., exclusion of 100% of the insurance proceeds from the Estates of both the insured spouse and beneficiary spouse).

1. **<u>Procedures For Establishing A Spousal-ILIT In A Community Property Jurisdiction</u>.** The spouse establishing the spousal ILIT must be the sole contributor of assets to the Trust. In other words, only the separate property of the insured settlor spouse may be contributed to the spousal ILIT.

2. **<u>Transfer of Existing Policy</u>.** If an existing policy is transferred to the spousal ILIT, it is critical that such policy be partitioned into the separate property of the insured spouse prior to the transfer of the policy to the Trust. This must be done pursuant to a written agreement between the parties to partition and gift the non-insured spouse's interest in the policy to the insured spouse.

3. **<u>Gifts To Trust</u>.** All contributions to the Trust, for the purpose of paying premiums (or for any other purpose) must be traceable to a separate property source of the insured spouse. Accordingly, this often means that a sufficient amount of cash must be partitioned to create sufficient separate property funds for the insured spouse to contribute to the Trust. If the preceding procedures are not followed, the result will be at least a partial inclusion of the trust proceeds in the non-insured spouse's Estate under IRC § 2036.

4. **<u>Contingent Marital Trust</u>.** Finally, it is also important to note that most spousal ILITs will not qualify as a marital deduction trust upon the death of the first spouse. Accordingly, if transferring an existing policy to such a Trust, care must be taken to anticipate the consequences of death within three (3) years of the transfer. In this regard, Section 2035 and Section 2042 will cause inclusion of the proceeds in the estate of the insured spouse if death occurs within three (3) years of the date of the transfer of the policy. If this occurs, and the proceeds of the policy are payable to the Trustee of the spousal ILIT, which does not qualify for the marital deduction, an immediate estate tax may be due upon the insured's death. Accordingly, if dealing with an existing policy, it is usually advisable for the spousal-ILIT to contain a contingent marital deduction trust to avoid the unintended tax on the insured's death within three (3) years of the transfer.

VII. <u>Estate Planning For Qualified Plans And IRAs</u>.

Our Federal laws contain a complex web of rules and regulations with respect to distributions from and the taxation of qualified plans and individual retirement accounts.

A. <u>Considerations When Surviving Spouse Is Beneficiary</u>. As a general rule, designating the surviving spouse as the death beneficiary of an IRA or qualified plan provides maximum planning flexibility for the participant's family. This is because a surviving spouse is entitled to rollover the IRA or qualified retirement plan to his or her own IRA. Prop. Treas. Reg. §1.408-8, Q&A 4(b). If this is done, then the minimum distribution rules, which were applicable during the participant's life, are discarded and the spouse is treated as the participant and a whole new set of minimum distribution calculations are performed treating the spouse as the participant.

In a typical situation, therefore, a spouse will rollover the IRA into his or her own IRA and elect to take minimum distributions over the joint life expectancy of the spouse and a new "designated beneficiary". Presumably, the new designated beneficiary would be a child or grandchild thereby extending the payout.

B. <u>Estate Planning Considerations</u>. Death of a non-participant spouse in community property states raises unique ownership issues with respect to IRAs and qualified plans. Specifically, the rights of a non-participant spouse in the participant's IRA or qualified plan directly affects the Estate Planning process in several ways. As a general rule, qualified plans and IRAs and other retirement type benefits are subject to the same marital property characterization rules discussed above. In other words, if such benefits were accrued and earned during marriage in Texas, they are assumed to be community property. This concept was reinforced by the Texas Supreme Court case of *Allard v. Frech*, 754 S.W.2d 111 (Tex. 1988) dealing with railroad retirement benefits. Additionally, even the federal law regarding retirement benefits recognizes a spousal interest in retirement benefits upon divorce by providing for qualified domestic relations orders (or "QDRO's") under ERISA. A QDRO allows a portion of retirement benefits accrued in a Qualified Plan during marriage to be reserved for the non-participant spouse interest following a divorce. Notwithstanding the recognition of the community property of such retirement benefits, there is significant confusion as to the ability of a non-participant spouse to dispose of his or her interest in a community property retirement account upon the non-participant's death.

Historically, Texas Law has recognized a non-participant spouse's community property interest in a qualified plan, IRA or other retirement account, and treated such interest as a probate asset distributable under the non-participant spouse's estate planning documents. See *Allard v. Frech*.

Following *Allard v. Frech*, a California case arose addressing the issue of qualified plan benefits. See *Ablamis v. Roper*, 937 F.2d 1450 (9th Cir. 1991). In *Ablamis*, the Ninth Circuit found that while indeed a non-participant spouse had certain community property rights during marriage, upon the non-participant spouse's death, the right of the non-participant spouse to dispose of his or her community property interest lapsed. Following the *Ablamis* decision, the Fifth Circuit in *Boggs v. Boggs*, 82 F.3d 90 (5th Cir. 1996), addressed the rights of a non-participant spouse in a Louisiana community property retirement account, and ruled that the non-participant spouse had a right to dispose of her community property interest in a qualified plan.

As a result of the conflict between the Ninth and Fifth circuit, the *Boggs* case was appealed to the United States Supreme Court. In 1997, the Supreme Court reversed the Fifth Circuit decision in *Boggs v. Boggs*, 177 S.Ct. 1759 (1997) discussed below.

1. ***Boggs v. Boggs*.** The United States Supreme Court addressed the issue of Federal law preemption in the case of *Boggs v. Boggs*. In reversing the Fifth Circuit, the Supreme Court found that Federal law pre-empted a predeceasing non-participant's right to devise his or her community property interest in a qualified plan. In other words, the non-participant's right to devise his or her community property interest in a qualified plan essentially disappears at his or her death prior to the death of the participant. There are two important caveats to this preemption issue.

First, the *Boggs* preemption holding is based on Federal preemption law (i.e., ERISA) applicable only to qualified plans. An IRA is not a "qualified plan" for purposes of ERISA. Therefore, the non-participant spouse's community property interest in an IRA is devisable under his or her Will at his or her death. See *Allard v. Frech*, 754 S.W.2d 111 (Tex. 1988).

Second, the issue of a rollover IRA from a qualified plan was not specifically resolved by the *Boggs* decision. It would appear, however, that once plan assets have been rolled-out of the qualified plan to an IRA, the Federal preemption over qualified plans would cease. In any event, from a planning standpoint, the practitioner must consider the possibility that such preemption over a rollover IRA either does or does not occur.

2. **Estate Planning Recommendations.** Care should be taken in the drafting of Estate Plans to avoid an inadvertent bequest of a non-participant's interest in an IRA (or qualified plan for that matter) to someone other than the participant. For example, if the non-participant's Estate Plan provides for a bequest of his or her entire estate to a credit-shelter Trust and one or more Marital Deduction Trusts, the result would be a bequest of his or her community property interest in the surviving participant's IRA to one or more of such Trusts.

While in some cases, this may be desirable so that the non-participant's interest in the IRA may help fund an otherwise under-funded credit shelter Trust, it would be undesirable for such assets to be allocated to a Marital Deduction or QTIP Trust.

Accordingly, the practitioner should include a specific bequest of the non-participant's community property interest in qualified plans and IRAs in the name of the participant directly to the surviving participant.

C. **Summary Of General Rules.** Although, there are as many exceptions as there are clients a few general rules are useful to provide a starting point to help navigate the treacherous seas of planning for qualified plans in IRAs.

1. **Designate Spouse As Primary Beneficiary.** A married participant will be in a position for maximum deferral if his or her spouse is designated as the primary beneficiary of the IRAs and qualified plans. The primary reason for this is because of the spouse's ability to rollover the IRA or qualified plan begins minimum distribution using a much younger beneficiary, presumably a child or a grandchild. Designating the surviving spouse as primary beneficiary is also consistent with the far majority of our client's primary objective of providing security for the surviving spouse.

2. **Provide For Contingent Bequest to Exemption Equivalent Trust.** If funding the exemption equivalent Trust is a concern, a contingent beneficiary to such Trust as a result of the spouse's disclaimer can be added to maximize flexibility.

3. **Always Have A Designated Beneficiary.** In the event of an unmarried participant (which would include the rollover IRA of a non-participant surviving spouse) or a married participant who elects not to designate his or her spouse as beneficiary, there should always be a designated beneficiary on the IRAs and qualified plans. This will allow (i) the use of the joint life expectancy during the participant's life for purposes of minimum distributions; and (ii) following the participant's death, the use of the life expectancy of the designated beneficiary for minimum distribution purposes. The alternative to having a designated beneficiary is that the plan assets will be distributed in full by December 31 of the fifth year following the participant's death. A "designated beneficiary" must be an individual. The beneficiaries of the Trust may be considered "designated beneficiaries" if the Trust meets some very strict requirements.

4. **Coordination Of Estate Planning Documents.** All Estate Planning documents should be coordinated with the beneficiary designations on IRAs and qualified plans. This should specifically include a devise of the non-participant's spouse's interest in all retirement accounts in the name of the participant directly to the participant.

D. Conclusion. Coordination of a client's beneficiary designations and elections regarding their IRAs and qualified plans is critical to the success of the overall Estate Plan. Due to the dizzying array of options and the overall complexity of the law (not to mention the propensity of Congress to shift gears and change the ground rules), our attention to these matters is sometimes not what it should be. Accordingly, boiling down this complex area into a few general rules is obviously an oversimplification. However, I believe they are helpful as a starting point for the important analysis which must be done for each of our clients.