THE TEXAS MESS: MARITAL PROPERTY CHARACTERIZATION OF TRUST INCOME

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I. INTRODUCTION

The last time the Texas Supreme Court considered the marital property character of income of a trust funded with a spouse's separate property was in 1890.[1] Since then, a spouse's rights to control and manage her own property and the income it generates has evolved, divorce has become more common, estate planning has become more sophisticated, and income tax and estate tax consequences have come to bear on this issue.[2] Accordingly, both the lower Texas appellate courts and the federal courts have grappled with this issue with mixed results, "creat[ing] one of the more obtuse areas of Texas law."[3] As this article demonstrates, the appellate courts in Fort Worth, San Antonio, Texarkana, and Tyler all follow one rule; the Dallas Court of Appeals refers to a different principle; and the appellate courts in both Corpus Christi and Houston (the 14th District) apply yet another theory.[4] As a matter of constitutional interpretation, this issue begs for clarification by the Texas Supreme Court.[5]

The source of this inconsistent rule application among Texas courts is the clash between two divergent sources of property law.[6] In one corner is article XVI, section 15 of the Texas constitution based on Spanish civil law, which defines the couple's marital property rights as the property the couple acquires during their marriage.[7] In the other corner is the law of trusts, which recognizes and upholds the settlor's property right to convey property in trust to the beneficiaries of the settlor's choosing, provided that such conveyance does not violate public policy.[8] All too often, courts and commentators take the position—or simply make an assumption—that one

1. *See* Martin Brown Co. v. Perrill, 13 S.W. 975 (Tex. 1890).
2. *See* Oliver S. Heard Jr. et al., *Characterization of Marital Property*, 39 BAYLOR L. REV. 909, 942 (1987).
3. *Id.* at 942.
4. *See infra* Part III.
5. *See infra* Part VI.
6. *See* TEX. CONST. art. XVI, § 15; TEX. PROP. CODE ANN. § 111.035(b) (West 2007).
7. TEX. CONST. art. XVI, § 15.
8. *See* PROP. § 111.035(b).

set of principles should trump the other; they form an opinion without giving much, if any, consideration to the different purposes of each of these competing principles and without recognizing that they can possibly strike a consistent and workable balance between the two.[9]

This article begins with a historical summary of the relevant aspects of the law of marital property and trusts, and it explains certain unique features of Texas law that raise the issue addressed in this article—the characterization of a beneficiary spouse's interest in the income of a trust funded with separate property.[10] Next, Part III of this article discusses the evolution of three general approaches to such characterization under the current case law, and Part IV of this article details how different circumstances might affect this characterization under each of these approaches.[11] This article concludes with a discussion of two coherent and workable approaches, each of which seeks to strike a balance between these two different areas of property law.[12]

II. CIVIL LAW AND COMMON LAW FOUNDATIONS

A. Community Property in Texas

Texas law provides that all property owned by a spouse prior to the marriage, or acquired by a spouse during the marriage, must be either separate property or community property.[13]

> A spouse's separate property consists of: (1) the property owned or claimed by the spouse before marriage; (2) the property acquired by the spouse during marriage by gift, devise, or descent; and (3) the recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage.[14]

By negative definition, "[c]ommunity property consists of [all] property, other than separate property, acquired by either spouse during marriage."[15] Within this definitional framework, there is a statutory presumption that "[p]roperty possessed by either spouse during or on dissolution of marriage is . . . community property" unless there is clear and convincing proof to the contrary.[16]

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9. *See* Heard Jr. et al., *supra* note 2, at 913–14.
10. *See infra* Part II.
11. *See infra* Parts III, IV.
12. *See infra* Part V.
13. *See* Hilley v. Hilley, 342 S.W.2d 565, 567 (Tex. 1961), *superseded by constitutional amendment*, TEX. CONST. art. XVI, § 15.
14. TEX. FAM. CODE ANN. § 3.001 (West 2012).
15. TEX. FAM. CODE ANN. § 3.002 (West 2012).
16. TEX. FAM. CODE ANN. § 3.003 (West 2012).

Upon divorce, a court cannot divide a spouse's separate property and additionally, when the other spouse dies, such property is not subject to intestate or probate administration; "[e]ach spouse has the sole management, control, and disposition of that spouse's separate property[,]" including the right to freely gift or devise that property.[17] On the other hand, upon divorce, community property is subject to just and right division by the courts and upon the death of a spouse, one-half of any community property passes to the surviving spouse, and the other half passes to the deceased spouse's devisees or heirs.[18] Except with respect to the conveyance of the homestead:

> Each spouse has the sole management, control, and disposition of the community property that the spouse would have owned if single, including: (1) personal earnings; (2) revenue from [the spouse's] separate property; (3) recoveries for personal injuries; and (4) the increase and mutations of, and the revenue from, all property subject to the spouse's sole management, control, and disposition.[19]

Generally speaking, the spouses must act jointly with respect to all other community property.[20]

While the laws in all nine community property states within the United States are unique, this article focuses on Texas law.[21] That said, in a nation with such a mobile population, the unique aspects of Texas law may affect the character of marital property in a different state as quasi-community property subject to equitable division in a Texas divorce proceeding.[22] Texas law may also affect the disposition of community property acquired in Texas by couples who subsequently migrate to another state.[23]

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17. TEX. FAM. CODE ANN. § 3.101 (West 2012).

18. *See* TEX. FAM. CODE ANN. § 7.001 (West 2012). *See also* Dakan v. Dakan, 83 S.W.2d 620, 626 (Tex. 1935). If the deceased spouse attempts to devise the entire community estate, the surviving spouse may elect to take either: (1) one-half of the community estate; or (2) as a beneficiary, according to the terms of the will. *Id.*

19. TEX. FAM. CODE ANN. §§ 3.102(a), 5.001 (West 2012). This category of community property is also referred to as "special community property."

20. FAM. § 3.102(c) (discussing the sale, conveyance, and encumbrance of the homestead).

21. *See* Tony Vecino, *Boggs v. Boggs: State Community Property and Succession Rights Wallow in ERISA's Mire*, 28 GOLDEN GATE U. L. REV. 571, 591 (1998).

22. *See* TEX. FAM. CODE ANN. § 7.002 (West 2012).

23. *See, e.g.*, *In re* Marriage of Whelchel, 476 N.W.2d 104, 110 (Iowa Ct. App. 1991). *See also* Stanley M. Johanson, *The Migrating Client: Estate Planning for the Couple from a Community Property State*, in 9TH ANNUAL UNIV. MIAMI INST. ON EST. PLAN., 800 (Miami, FL: University of Miami, 1975). Currently, fifteen common law states have enacted a version of the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA), which provides for the testamentary disposition of only one-half of any imported community property upon the death of a spouse, including income and proceeds from community property. ALASKA STAT. ANN. §§ 13.41.005–13.41.055 (West 2012); ARK. CODE ANN. §§ 28-12-101 to -113 (West 2010); COLO. REV. STAT. ANN. §§ 15-20-101 to -111 (West 2012); CONN. GEN. STAT. ANN. §§ 45a-458 to -466 (West 2004); FLA. STAT. ANN. §§ 732.216–.228 (West 2010); HAW. REV. STAT. §§ 510-2 to -30 (West 2012); KY. REV. STAT. ANN. §§ 391.210–.260 (West

1. The Evolution of Article XVI, Section 15 of the Texas Constitution

Although Texas is not unique in including marital property definitions within its constitution, Texas courts have been distinctively dogmatic in asserting their authority as the exclusive arbiters of constitutional interpretation with respect to characterizing community and separate property.[24] In this area, the scope of the legislature's authority is confined to delineating the rights of management, control, and the disposition of marital property; the rights of creditors; and the formalities and parameters of constitutionally authorized marital property agreements.[25] As such, any discussion of the relevant tenets and the development of case law must necessarily begin with a review of the history and evolution of article XVI, section 15 of the Texas constitution and its statutory predecessors.

The ganancial property system—later known as the community property regime—is routed in the concept of the marriage as a partnership, as well as the idea that giving each spouse an equal share of the industry and labor of both of the spouses better serves the economic, moral, and social goals of marriage as an institution.[26] The Spanish conquistadors introduced, and Mexico maintained, the ganancial property system over many of the territories that form the southern and western borders of what is now the United States of America.[27] As states acquired their independence from Mexico, they could choose to either retain the Spanish civil law system or adopt the common law system along with the rest of the United States.[28] In these isolated and rugged frontiers, wives usually worked on farms and ranches alongside their husbands, and when their husbands were away, wives took up the duties as heads of their households.[29] As such, recognition of marriage as a partnership of equals held relative appeal as compared to the common law doctrine of coverture, in which wives merged into their husbands' legal identity and lost virtually all their property rights other than mere title to real estate.[30] In the context of divorce, however,

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2012); MICH. COMP. LAWS ANN. §§ 557.261–.271 (West 2013); MONT. CODE ANN. §§ 72-9-101 to -120 (2013); N.Y. EST. POWERS & TRUSTS LAW §§ 6-6.1 to -.7 (McKinney 2002); N.C. GEN. STAT. ANN. §§ 31C-1 to -12 (West 2013); OR. REV. STAT. ANN. §§ 112.705–.775 (West 2013); UTAH CODE ANN. §§ 75-2b-101 to -111 (West 2012); VA. CODE. ANN. §§ 64.2-315 to -324 (West 2012); WYO. STAT. ANN. §§ 2-7-720 to -729 (West 2012).

24. *See* Joseph W. McKnight, *Texas Community Property Law: Conservative Attitudes, Reluctant Change*, 56 LAW & CONTEMP. PROBS. 71, 98 (1993).

25. *See* Arnold v. Leonard, 273 S.W. 799, 804–05 (Tex. 1925).

26. *See* WILLIAM Q. DE FUNIAK & MICHAEL J. VAUGHN, PRINCIPLES OF COMMUNITY PROPERTY § 11.1, at 24 (2d ed. 1971).

27. *Id*. at 24–25.

28. *Id.*

29. *Id.* at 25.

30. *Id.* at 25–26.

which was rare in the nineteenth century, there was a trade-off to this partnership concept of marital property—no permanent alimony.[31]

In Texas, the origin of marital property law began in 1820 in the Mexican territories of Spain when "Moses Austin, a citizen of the United States, requested that Governor Martinez donate a tract of land for foreign colonization."[32] In response "to this request, the Spanish government issued a decree authorizing viceroys and governors to grant tracts of land to colonists moving into [what is now] Texas."[33] Even after Mexico won its independence from Spain in 1824, Stephen F. Austin, Moses Austin's son, successfully pursued the land grant.[34] Although Mexico continued applying the Spanish civil law, most of its Anglo colonists did not; it is also clear that the Louisiana Civil Code of 1825 would prove influential in the early development of Texas law.[35] As a result, the colonists' first enactment of criminal and civil codes—the "Instructions and Regulations" of 1824—contained a mix of both Spanish civil law and English common law.[36]

In 1836, with independence from Mexico came the adoption of Texas's first constitution, the Constitution of the Republic of Texas, a constitution that did not contain any specific provisions governing marital property.[37] On January 20, 1840, a year after it enacted the common law system of coverture, the Congress of the Republic of Texas enacted a statute that adopted the common law as its general body of legal principles, but at the same time, this statute also carved out a system of marital property law based on Spanish civil law.[38] The 1840 act generally characterized all property as common property, while carving out a specific definition of the wife's separate property to include the lands, slaves, and paraphernalia that the wife brought into the marriage; the land and slaves that the wife acquired by gift, devise, or descent during the marriage; and any increases in such slaves during the marriage[39] The 1840 act only addressed the ownership of the wife's separate property because under the common law doctrine of coverture, the husband already had virtually full control over all of the property.[40]

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31. *See* Cameron v. Cameron, 641 S.W.2d 210, 218–19 (Tex. 1982).

32. 38 ALOYSIUS A. LEOPOLD, TEXAS PRACTICE: MARITAL PROPERTY AND HOMESTEADS § 1.17, at 23 (West 1993).

33. *See id.*

34. *Id.*

35. *See id.*

36. *See id.* § 1.18, at 25. *See* McKnight, *supra* note 24, at 73–74.

37. *See* LEOPOLD, *supra* note 32, § 1.21, at 34.

38. *See id.* § 1.22, at 37. *See* McKnight, *supra* note 24, at 75.

39. LEOPOLD, *supra* note 32, § 1.22, at 37–38. *See also* McKnight, *supra* note 24, at 75.

40. Cartwright v. Hollis, 5 Tex. 152, 159 (1849); LEOPOLD, *supra* note 32, § 1.22, at 37–38. *See* McKnight, *supra* note 24, at 75.

Article VII, section 19 of the Texas constitution of 1845, which Texas adopted upon joining the United States, included the following provision governing marital property rights:

> All property, both real and personal, of the wife, owned or claimed by her before marriage, and that acquired afterwards by gift, devise, or descent, shall be her separate property; and laws shall be passed more clearly defining the rights of the wife in relation as well to her separate property as that held in common with her husband. Laws shall also be passed providing for the registration of the wife's separate property.[41]

On March 13, 1948, the legislature replaced the 1840 act with a statute that separately defined the separate property of both the husband and wife; it included "all property, both real and personal" that the spouses acquired before their marriage or that which the spouses obtained during their marriage by gift, devise, or descent, as well as "the increase of land or slaves thus acquired."[42] Although the meaning of the term "increase" eventually became the subject of some judicial controversy, the Texas Supreme Court ultimately concluded that this statutory language was no broader than the constitutional definition.[43] In any event, despite the fact that Texas adopted new constitutions in both 1861 (upon seceding from the Union) and 1866 (upon rejoining the Union), the constitutional provision of 1845 remained unchanged.[44] The Texas constitution of 1869—the so-called "Reconstruction Constitution"—simply provided that "[t]he rights of married women to their separate property, real and personal, and the increase of the same, shall be protected by law."[45] Aside from changes in punctuation and grammatical form, article XVI, section 15 of the 1876 constitution represented a return to the language of the 1845 provision.[46]

Since 1876, Texas has adopted several amendments to article XVI, section 15. The November 2, 1948 amendment allows spouses to agree in writing to partition current or future community property into separate property without prejudice to pre-existing creditors.[47] The November 4,

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41. TEX. CONST. OF 1845, art. VII, § 19, *available at* http://tarlton.law.utexas.edu/constitutions/text/DART07.html.

42. 1847–1848 Tex. Gen. Laws 77, § 2, *reprinted in* 3 H.P.N. Gammel, *The Laws of Texas 1822–1897*, at 77, 78 (Austin, Gammel Book Co. 1898).

43. Arnold v. Leonard, 273 S.W. 799, 802 (Tex. 1925). *See, e.g.*, De Blane v. Lynch, 23 Tex. 25 (1859). *See also* LEOPOLD, *supra* note 32, § 1.25 at 41.

44. *See* TEX. CONST. OF 1861, art. VII, § 19, *reprinted in* 5 H.P.N. Gammel, *The Laws of Texas 1822–1897*, at 19 (Austin, Gammel Book Co. 1898). *See also* LEOPOLD, *supra* note 32, § 1.25, at 41.

45. TEX. CONST. OF 1869, art. XII, § 14, *available at* http://tarlton.law.utexas.edu/constitutions/text/GART12.html.

46. *Compare* TEX. CONST. OF 1845, art. VII, § 19, *available at* http://tarlton.law.utexas.edu/constitutions/text/DART07.html, *with* TEX. CONST. OF 1876, art. XVI, § 15, *available at* http://tarlton.law.utexas.edu/constitutions/text/IART16.html.

47. *See* TEX. CONST. art. XVI, § 15 (amended 1948). The 1948 amendments also removed the language regarding the registration of the wife's separate property and replaced the phrase "her separate

1980 amendment recast the 1948 clause as gender-neutral, and it added two new provisions to article XVI, section 15—one provision allows spouses to agree in writing to treat the current or future income from one spouse's separate property as that spouse's separate property, and the other provision creates a presumption that one spouse's gift of property to the other spouse also include the income that could arise from that gifted property.[48] Finally, the November 3, 1987 amendment allows spouses to agree in writing that if one spouse dies, all or part of the spouses' community property becomes the surviving spouse's property.[49] The November 2, 1999 amendment allows spouses to agree in writing to convert all or part of their separate property, whether owned by either or both of them, to community property.[50]

2. The Inception of Title Rule

The Texas constitution defines separate property as the property that a spouse owns or claims before the marriage and the property that a spouse acquires during the marriage by gift, devise, or inheritance.[51] Under the inception of title rule, as interpreted by Texas courts, "[t]he date of acquisition of the right rather than the date of acquiring possession or of the final vesting of the title, is determinative" of the character of marital property as community or separate.[52] With respect to property that a spouse acquires prior to the marriage, the same is true for the term "claim."[53]

That said, however, with regard to characterizing the property, the inception of title rule is not the end of the story.[54] Consistent with the principles of Spanish civil law, if the labor or industry of either spouse or the community funds of both spouses causes the value of the spouse's separate property to increase, the community may be entitled to some measure of reimbursement.[55]

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property" with the phrase "the separate property of the wife." *Id.* The Texas Supreme Court has a longstanding aversion to spouses defining their own marital property rights, which culminated with its decision in *King v. Bruce* and the adverse tax consequences that arose therefrom. King v. Bruce, 201 S.W.2d 803, 809 (Tex. 1947). *See* McKnight, *supra* note 24, at 85–86.

48. TEX. CONST. art. XVI, § 15 (amended 1980).

49. TEX. CONST. art. XVI, § 15 (amended 1987).

50. TEX. CONST. art. XVI, § 15 (amended 1999).

51. TEX. CONST. art. XVI, § 15.

52. 1 OCIE SPEER & EDWIN S. OAKES, SPEER'S MARITAL RIGHTS IN TEXAS, § 388, at 564–65 (4th ed. 1961).

53. *Id.* § 403, at 602.

54. *See infra* Part II.A.2.

55. *See* TEX. FAM. CODE ANN. §§ 3.006, 3.404 (West 2012); Vallone v. Vallone, 644 S.W.2d 455, 459 (Tex. 1982); DE FUNIAK & VAUGHN, *supra* note 26, § 73, at 168–70.

3. Income from Separate Property Under the Spanish Rule

In *De Blane v. Hugh Lynch & Co.*, the Texas Supreme Court first articulated the rule that income from separate property (in this case, it was cotton grown on the wife's separate land through the labor of her separate slaves) would be classified as community property as follows:

> The principle which lies at the foundation of the whole system of community property is, that whatever is acquired by the joint efforts of the husband and wife, shall be their common property. It would be an unnecessary consumption of time, to quote authorities for this proposition.
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> It is true, that in a particular case, satisfactory proof might be made, that the wife contributed nothing to the acquisitions; or, on the other hand, that the acquisitions of property were owing wholly to the wife's industry. But from the very nature of the marriage relation, the law cannot permit inquiries into such matters. The law, therefore, conclusively presumes that whatever is acquired, except by gift, devise or descent, or by the exchange of one kind of property for another kind, is acquired by their mutual industry. If a crop is made by the labor of the wife's slaves on the wife's land, it is community property, because the law presumes that the husband's skill or care contributed to its production; or, that he, in some other way, contributed to the common acquisitions.[56]

The definition of separate property became constitutional in 1845, and since then, Texas courts have consistently characterized certain items—such as rents, dividends, and interest generated from separate property—as community property.[57] Such characterization of income from separate property was generally consistent with the tenets of Spanish civil law. The rule appropriately evolved within a predominately land-based economy where "most things till touched by the hand of man are wholly unproductive [and] requir[e] labor to make useful the natural growth of the earth."[58]

Among the other community property regimes, Idaho, Louisiana, and Wisconsin follow this so-called "Spanish rule."[59] That said, of all of the jurisdictions that follow the Spanish rule, Texas law is particularly

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56. De Blane v. Hugh Lynch & Co., 23 Tex. 25, 28–29 (1859).

57. *See* SPEER & OAKES, *supra* note 52, §§ 416–17, at 617–19. While cash dividends of separate stock or mutual funds are considered community income, capital gains distributions are considered mutations. *See* Jones v. Jones, 804 S.W.2d 623, 627 (Tex. App.—Texarkana 1991, no writ).

58. *See* DE FUNIAK & VAUGHN, *supra* note 26, § 71, at 160–61. *See also* GEORGE MCKAY, A COMMENTARY ON THE LAW OF COMMUNITY PROPERTY § 176, at 242 (1910).

59. *See* IDAHO CODE ANN. § 32-906 (West 2006); LA. CIV. CODE ANN. art. 2339 (2008); WIS. STAT. ANN. § 766.31(4) (West 2009). By contrast, Arizona, California, Nevada, New Mexico, and Washington all apply the divergent "American rule." *See* ARIZ. REV. STAT. ANN. § 25-213(A) (2007); NEV. REV. STAT. ANN. § 123.130 (West 2011); CAL. FAM. CODE § 770(a)(3) (West 2004); NEV. REV. STAT. ANN. § 123.130 (West 2011); N.M. STAT. ANN. § 40-3-8(E) (2012); WASH. REV. CODE ANN. §§ 26.16.10, 26.10.20 (West 2005 & Supp. 2013).

inflexible for spouses with separate property. For example, in Idaho, Louisiana, and Wisconsin, spouses have an option to unilaterally re-characterize the income from their own separate property and opt out of the Spanish rule.[60] Furthermore, the Wisconsin statute also provides that unless the trust's terms provide otherwise, any distribution of principal or income to a married beneficiary from a trust funded by a third party is characterized as the beneficiary's "individual" property.[61]

In any case, the language of the *De Blane* opinion highlights three aspects of the Spanish rule that have played an important role in the development of Texas marital property law: the doctrine of mutations, the rule of implied exclusion, and the doctrine of onerous title.[62]

4. The Doctrine of Mutations

In one of the earliest marital property law cases, *Love v. Robertson*, the Texas Supreme Court considered the ownership of two slaves upon the husband's death, whereby the husband's heir established that the husband had purchased one slave for $700 and partially purchased another slave by making a down payment of $330 using his separate funds.[63] The court ruled that both slaves were the husband's separate property, subject to a community claim for the amount owed on the purchase price of the second slave as of the date of the husband's death.[64] Although the court recognized the conflicting principles of Spanish civil law, it instead drew upon the law of business partnerships favoring the separate property characterization over the community.[65]

Under a strict application of the rule of implied exclusion, one could certainly argue that any gains realized from the sale of separate property during the marriage should be considered community property.[66]

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60. *See* LA. CIV. CODE ANN. art. 2339 (2008); IDAHO CODE ANN. § 32-906 (West 2006); WIS. STAT. ANN. §§ 766.31(7p), 766.59 (West 2009). Subject to certain formalities, a spouse in Louisiana or Wisconsin may simply declare, in writing, that income from certain separate property will be characterized as separate property. *See* LA. CIV. CODE ANN. art. 2339 (2009); WIS. STAT. ANN. §§ 766.31(7p), 766.59 (West 2009). In Idaho, re-characterization can be achieved in two steps: (1) spouses can convey their separate property to a strawperson; and (2) the strawperson can execute an instrument of conveyance back to the spouse expressly, characterizing any income from the asset as separate property. IDAHO CODE ANN. § 32-906 (West 2006). *See also* William A. Reppy, Jr., *Strategies for Strengthening the Case for Separate Property Classification of Assets Under Idaho Law*, 26 IDAHO L. REV. 425, 447–50 (1990).

61. WIS. STAT. ANN. § 766.31(7)(a) (West 2009).

62. *See infra* Part II.A.4–6.

63. *See* Love v. Robertson, 7 Tex. 6, 6–7 (1851).

64. *See id.* at 11–12.

65. *Id.* at 7–8. Similarly, the early courts concluded that the term "increase," which was included within the statutory definition of separate property in the 1848 act, encompassed only the profits that a spouse made in the sale or exchange of property. *See, e.g.*, Evans v. Purinton, 34 S.W. 350, 353 (Tex. Civ. App.—Fort Worth 1896, writ ref'd).

66. *See infra* Part II.A.5.

Nonetheless, consistent with Spanish civil law, courts continue to adhere to the rule that mutations and changes do not affect the character of property as separate so long as the original source for its acquisition can be traced and identified by clear proof.[67]

5. The Rule of Implied Exclusion

In *Kellett v. Trice*, a case decided nearly a century before the 1999 Texas constitutional amendment, the Texas Supreme Court considered the effect of a transfer of separate property to a strawperson in trust attempting to convert the assets into the spouses' community property.[68] The court held that when spouses acquire property by gift during their marriage, the constitutional definition determines the character of that property and not the agreement of the spouses—that is, property received by gift is always separate property, regardless of who the donor is.[69]

The *Kellett* case set the stage for the rule of implied exclusion, which the Texas Supreme Court first pronounced in *Arnold v. Leonard*, the most ubiquitous case in Texas marital property law.[70] Beginning in 1911, the Texas Legislature enacted a series of statutes that whittled away at the common law restrictions of coverture and expanded the powers of married women with respect to marital property.[71] Among these changes was an attempt to characterize rents and revenue derived from a spouse's separate property as that spouse's separate property.[72] Referencing the constitutional definition of separate property, the Texas Supreme Court explained the following:

> [T]here is an implied prohibition against the legislative power to either add to or withdraw from the circumstances specified. . . . Since rents and revenues derived from the wife's separate lands are entirely with out [sic] the constitutional definition of the wife's separate property, . . . it follows that the [statutes] which undertake to make rents and revenues from the wife's separate lands a part of her separate estate, are invalid.[73]

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67. *See, e.g.*, Stephens v. Stephens, 292 S.W. 290, 295 (Tex. Civ. App.—Amarillo 1927, writ dism'd w.o.j.); DE FUNIAK & VAUGHN, *supra* note 26, § 73, at 168; MCKAY, *supra* note 58, § 177, at 244–45. S*ee also* SPEER & OAKES, *supra* note 52, § 389.

68. *See* Kellett v. Trice, 66 S.W. 51, 52–53 (Tex. 1902), *superseded by constitutional amendment*, TEX. CONST. art. XVI, § 15.

69. *See id.* at 53–54. *Accord* Tittle v. Tittle, 220 S.W.2d 637, 641 (Tex. 1949).

70. *See* Arnold v. Leonard, 273 S.W. 799, 801–02 (Tex. 1925).

71. *See id.* at 801–04.

72. *See id.*

73. *Id.* at 802, 804.

Simply put, the rule of implied exclusion provides that the constitutional definition of separate property is exclusive and if the property that spouses acquire during their marriage does not fall squarely within the strict constitutional definition, then such property is, by negative implication, community property.[74]

Following the *Arnold* decision and preceding the constitutional changes in 1948, Texas courts invalidated any attempts by spouses to change the constitutional characterization rules by agreement.[75] As far as the courts were concerned, the character of marital property was based on the circumstances of acquisition, as described in the constitutional definition.[76]

That said, the rule of implied exclusion created a system that deviated from the Spanish civil law.[77] For example, under the latter, both spouses could jointly receive gifts of property that were considered common.[78]

Notwithstanding the supremacy of the constitutional definition, there is one notable exception when the Texas Legislature successfully added a statutory category of separate property.[79] In 1925, the Texas Legislature enacted a statute that provided the following: "[C]ompensation for personal injuries sustained by the wife shall be her separate property, except such actual and necessary expenses as may have accumulated against the husband for hospital fees, medical bills, and all other expenses incident to the collection of said compensation."[80] Citing the *Arnold* opinion, the El Paso Court of Appeals held that this statute was unconstitutional.[81] But in 1972, the Texas Supreme Court overruled the decision of the El Paso Court of Appeals and upheld the 1925 statute based on the following reasoning:

> [I]t is our conclusion that, in adopting the provisions of Section 15 of Article 16 of our constitution, the people did not intend to change the

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74. *See* Thomas M. Featherston Jr. & Julie A. Springer, *Marital Property Law in Texas: The Past, Present and Future*, 39 BAYLOR L. REV. 861, 868 (1987). The *Kellett* opinion precipitated this strict reading of the Texas constitution; the court held that spouses could not gift separate property to the community through the use of a trust because all of the gifts that the spouses acquired during their marriage were separate property as a matter of constitutional law. *See id.* at 865–66. That said, the 1999 amendment to the Texas constitution now allows spouses to agree to transmute their separate property into community property. *See supra* Part II.A.1.

75. *See* King v. Bruce, 201 S.W.2d 803, 807–08 (invalidating an attempt to partition community property into separate property of the spouses). *See generally* Gorman v. Gause, 56 S.W.2d 855 (Tex. Comm'n App. 1933, judgm't adopted) (invalidating an agreement between the spouses, which stipulated that there would be no community property), *superseded by constitutional amendment*, TEX. CONST. art. XVI, § 15.

76. *See, e.g.*, *King*, 201 S.W.2d at 807–08.

77. *See supra* Part II.A.4–5.

78. *See* MCKAY, *supra* note 58, § 168, at 234.

79. *See* Graham v. Franco, 488 S.W.2d 390, 396 (Tex. 1972).

80. N. Tex. Traction Co. v. Hill, 297 S.W. 778, 779 (Tex. Civ. App.—El Paso 1927, writ ref'd) (quoting TEX. REV. CIV. STAT. ANN. art. 4615 (West 1925) (repealed 1970)).

81. *See id.* at 780.

> common law or the Spanish law under which Texas operated so as to make a cause of action for injuries to the wife an asset of the community. A personal injury, and the chose in action created, was not "property" at common law as then understood, and it was not property "acquired" by any community effort. If it was "property" under the common law, the Spanish law, or the Texas law, its character was separate, or personal, to the wife. In using the word "property," the framers of the constitution apparently had in mind property which could be given, bought and sold, and passed by will or by inheritance.[82]

Such language reveals how the Texas Supreme Court defines property and explains what it means to acquire such property within the meaning of the doctrine of onerous title, which is discussed in the next section.[83]

6. The Doctrine of Onerous Title

Beyond the strict application of the rule of implied exclusion, another important consideration plays a role in the characterization of marital property—the distinction between onerous title and lucrative title.[84] Onerous title arises when either spouse acquires property through labor, industry, or other valuable consideration (other than consideration consisting wholly of such spouse's separate property).[85] In contrast, lucrative title arises as a product of a third party's donative intent.[86] Under Spanish civil law, property acquired by onerous title was characterized as common property, but unless the donor indicated otherwise, property acquired by lucrative title was characterized as the donee spouse's separate property.[87] In *De Blane*'s explanation for the conclusive presumption behind these statutory—and now constitutional—definitions, the Texas Supreme Court cited a fundamental principle of community property law: property that is acquired by the joint efforts of the spouses is considered community property.[88]

Over a century later, in *Norris v. Vaughan*, the Texas Supreme Court considered the characterization of oil and gas royalties, looking beyond the doctrine of mutations to whether the petitioner could meet the "burden to prove an expenditure of community effort so as to impress community

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82. *Graham*, 488 S.W.2d at 395. "[T]he recovery is a replacement, in so far as practicable, and not the 'acquisition' of an asset by the community estate." *Id.* at 394.

83. *See infra* Part II.A.6.

84. *See* DE FUNIAK & VAUGHN, *supra* note 26, § 62, at 127.

85. *See id.*

86. *See id.*

87. *Id.* at 127–28. Spanish civil law excluded remuneratory gifts from the classification of lucrative title. *See id.* § 70. *See also* Hardin v. Hardin, 681 S.W.2d 241 (Tex. App.—San Antonio 1984, no writ) (classifying contributions to a trust by a former employer of the beneficiary spouse as a gift).

88. De Blane v. Hugh Lynch & Co., 23 Tex. 25, 29 (1859).

character upon the separate asset."[89] The court also noted that each spouse who owns separate property has the right to exercise "[r]easonable control and management . . . necessary to preserve the separate estate and put it to productive use" without necessarily characterizing the output of such efforts as community.[90] In contrast, with respect to leases negotiated and acquired by spouses during the marriage but attributed to one spouse's talent and labor, "community rights may attach to any beneficial estate . . . whether perfected or merely inchoate."[91]

In *Graham v. Franco*, the court noted that in *Norris*, it "reverted to [an affirmative] test more akin to that prevailing under the Spanish and Mexican law, and several [of its] early opinions . . . dealing with community property."[92] A broad application of the doctrine of onerous title could certainly contradict the rule of implied exclusion.[93] Nonetheless, the Texas Supreme Court has used the doctrine of onerous title, and courts should continue to apply this doctrine in deciding close cases.

B. Texas Trust Law

The law of express trusts is governed by the Texas Trust Code, and to the extent not inconsistent with that statute, an established body of common law developed by the Texas courts.[94] Under this body of law, a trust is considered a fiduciary relationship with respect to certain property that arises from the manifestation by a settlor (or "trustor" or "grantor") of an intention to subject a trustee, who holds legal title to the property, to equitable duties to deal with the property for the benefit of another person—the beneficiary.[95] In this regard, the Texas Trust Code provides as follows:

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89. Norris v. Vaughan, 260 S.W.2d 676, 680 (Tex. 1953).

90. *Id.* at 681.

91. *Id.*

92. Graham v. Franco, 488 S.W.2d 390, 392 (Tex. 1972). That said, in the *Graham* opinion, the court's discussion of the doctrine of onerous title is dicta. *See id.* at 393 ("It is not necessary, however, to here make a decision on the correctness or applicability of *Norris v. Vaughan* and related cases and the concept of 'onerous title.'").

93. For example, the rule of implied exclusion provides that even rents and revenues derived from separate property acquired by gift, devise, or bequest belong to the community. *See supra* Part II.A.5.

94. *See* TEX. PROP. CODE ANN. §§ 111.001, .003, .005 (West 2007). The Texas Trust Code, contained within Subtitle B of Title 9 of the Texas Property Code, effectively substituted the former Texas Trust Act and applies to all trusts and transactions relating to such trusts created on or after January 1, 1984, and all transactions related to trusts created before that date. *Id.* Within this article, as in the Texas Trust Code, the term "trust" refers to an "express trust," as opposed to the equitable remedies of a "constructive trust" or a "resulting trust." *Id.*

95. *See* TEX. PROP. CODE ANN. § 111.004(4) (West 2007).

> A trust may be created by:
> (1) a property owner's declaration that the owner holds the property as trustee for another person;
> (2) a property owner's inter vivos transfer of the property to another person as trustee for the transferor or a third person;
> (3) a property owner's testamentary transfer to another person as trustee for a third person;
> (4) an appointment under a power of appointment to another person as trustee for the donee of the power or for a third person; or
> (5) a promise to another person whose rights under the promise are to be held in trust for a third person.[96]

To create an express trust, the following must be present: the settlor must have the necessary capacity to make a transfer title, or possession, to the subject trust property; the settlor must intend to create a trust relationship; there must be trust property; and unless the trust consists of personal property and the trustee is neither the settlor nor the beneficiary, there must be written evidence of the terms of the trust.[97] By its terms, the trust may be revocable or irrevocable, but if the terms are silent on this issue, the trust is considered revocable.[98]

The settlor determines the rules for the distribution and use of trust property.[99] Generally speaking, through the use of a trust, the settlor may attach the appropriate strings to condition and delay the enjoyment of the trust property, and in certain circumstances, may even protect a beneficiary's interest against third parties.[100] For example, spendthrift trusts contain provisions that prohibit the voluntary or involuntary transfer of a beneficial interest "before payment or delivery of [that] interest to the beneficiary"; however, such provisions are not enforceable to "prevent the [settlor-beneficiary's] creditors from satisfying claims from the settlor's interest in the trust estate."[101] Similarly, when the trustee has the discretion to make distributions to the beneficiary, neither the beneficiary nor the beneficiary's creditors may force the trustee to distribute trust income, and the court may not substitute its own discretion for that of a trustee unless there is fraud, misconduct, or clear abuse of discretion.[102]

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96. TEX. PROP. CODE ANN. § 112.001 (West 2007).
97. *See* TEX. PROP. CODE ANN. § 112.002, .004, .005, .007 (West 2007).
98. *See* TEX. PROP. CODE ANN. § 112.051 (West 2007).
99. *See* TEX. PROP. CODE ANN. § 112.033 (West 2007).
100. *See* TEX. PROP. CODE ANN. § 112.035 (West 2007).
101. PROP. § 112.035(a), (d).
102. Di Portanova v. Monroe, 229 S.W.3d 324, 330 (Tex. App.—Houston [1st Dist.] 2006, pet. denied) (explaining that a guardian could not seek a declaratory judgment to compel a trustee to make distributions for the benefit of the ward when discretion was limited to what the trustee considered the beneficiary's best interests). Put another way, the right of a beneficiary's transferee or creditor to

Unless public policy demands otherwise, a court will uphold a settlor's property right to establish a trust under Texas law.[103] As noted above, a settlor may not effectively shield assets from liability to the settlor's own creditors by transferring those assets to a spendthrift trust for the settlor's own benefit.[104] Even with respect to a third party-settled trust, a court may order the trustee of a spendthrift trust to fulfill the beneficiary parent's child support obligation from trust assets that the beneficiary parent would otherwise be required to receive or, in the case where distributions are discretionary, from the income of the trust.[105]

C. The Problem of Characterizing Income from a Separate Property Trust

Unlike a corporation or a partnership, a trust is not considered a separate legal entity under Texas law, but a form of property ownership in which a settlor transfers legal title to the trustee and equitable title to the beneficiaries.[106] It is often said that the beneficiaries are the "real owners" of the trust property vis-à-vis the trustee, the settlor, and the estate of a predeceased beneficiary.[107] Nonetheless, in other contexts, the trustee is clearly treated as the owner of the trust property.[108] With respect to the third party beneficiary of a spendthrift trust and a discretionary trust, certain important incidents of ownership are clearly lacking—namely, alienability and liability of property for the owner's creditor claims.[109]

From this duality of legal and equitable interests comes the discord with marital property law.[110] Although property one spouse acquired during the marriage by gift, devise, or inheritance was an individual right protected

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compel a distribution from a discretionary trust cannot exceed that of the beneficiary. *See* RESTATEMENT (SECOND) OF TRUSTS § 155 cmt. b (1957).

103. *See* TEX. PROP. CODE ANN. § 112.031 (West 2007).

104. *See* PROP. § 112.035(d).

105. *See* TEX. FAM. CODE ANN. § 154.005 (West 2007). However, such liability is secondary, as the trustee may only be ordered to make such disbursements after the court has ordered the beneficiary-parent to pay a certain amount of child support. *See* Kolpack v. Torres, 829 S.W.2d 913, 916 (Tex. App.—Corpus Christi 1992, writ denied); *In re* Marriage of Long, 542 S.W.2d 712, 719 (Tex. Civ. App.—Texarkana 1976, no writ).

106. TEX. PROP. CODE ANN. § 111.004(4) (West 2007 & Supp. 2012). *See also* SPEER & OAKES, *supra* note 52, § 450, at 30. As such, if the sole trustee is, or becomes, the sole beneficiary, then the legal title and equitable interests are said to merge, and the trust ceases to exist, unless it is a third party-settled spendthrift trust. *See* TEX. PROP. CODE ANN. § 112.034 (West 2007).

107. *See e.g.*, Hallmark v. Port/Cooper-T. Smith Stevedoring Co., 907 S.W.2d 586, 589 (Tex. App.—Corpus Christi 1995, no writ); City of Mesquite v. Malouf, 553 S.W.2d 639, 644 (Tex. Civ. App.—Texarkana 1977, writ ref'd n.r.e.); Arnold v. S. Pine Lumber Co., 58 Tex. Civ. App. 186, 123 S.W. 1162, 1168 (Texarkana 1909, writ dism'd).

108. *See, e.g.*, TEX. PROP. CODE ANN. § 114.082 (West 2008).

109. *See* 72 TEX. JUR. 3D TRUSTS §§ 35, 37 (2003); Hughes v. Jackson, 81 S.W.2d 656, 659 (Tex. 1935) ("[A discretionary] trust may be so created that no interest vests in the [beneficiary, and] . . . no interest goes to the third party until the trustee[] ha[s] exercised [such] discretion.").

110. *See supra* Part II.A.

from common sharing under Spanish civil law, the deferred enjoyment of the trust relationship did not exist in this system.[111]

That said, the degree of conflict between these two sets of principles is ultimately limited by the doctrine of mutations.[112] As a general matter, when a spouse who is both a settlor and a beneficiary conveys separate property to a trustee, both the legal and equitable interests in the property retain the same character.[113] The same is true of a trust funded with community property.[114] Therefore, the issue of controversy is not the characterization of the property transferred to the trustee before or during the marriage or the proceeds or mutations from such property, but rather the income generated by the property during the marriage within the meaning of the Spanish rule.[115] As such, the remainder of this article is limited to addressing the following questions: Under what circumstances, if any, should the income of a trust funded with one spouse's separate property be characterized as community property? Should the right to trust income be treated as a property interest, retained or acquired as part of the original conveyance of separate property—a mutation that retains its original character? Or should the trust income that is earned or received during the marriage be treated like any other income the spouses acquired during the marriage? Part III discusses attempts of the courts and commentators to answer these questions and the resulting evolution of three different theories.[116]

III. THE PREVAILING THEORIES FOR CHARACTERIZING TRUST INCOME

For marital property characterization issues to arise under Texas law, a trust must be funded with separate property or assets that would have constituted separate property had the beneficiary spouse acquired them directly.[117] Thus, if assets are transferred to a trust during the marriage, the beneficiary spouse must first establish that the assets were acquired by the beneficiary spouse prior to the marriage or the transfer is attributable to a gift, devise, or bequest; otherwise, the trust and all of its income are characterized as community property.[118] In addition, during the marriage, the beneficiary spouse must have an interest in the trust income.[119]

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111. *See* DE FUNIAK & VAUGHN, *supra* note 26, § 69, at 154.

112. *See supra* Part II.A.4.

113. *See, e.g.*, Hopper v. Hopper, 270 S.W.2d 256, 258 (Tex. Civ. App.—Dallas 1954, writ dism'd).

114. *See, e.g.*, Pratt v. Godwin, 61 Tex. 331, 334 (1884).

115. *See supra* Part II.A.3.

116. *See infra* Part III.

117. *See* Dickinson v. Dickinson, 324 S.W.3d 653, 659 (Tex. App.—Fort Worth 2010, no pet.) (holding that a community estate has no interest during the time that the beneficiary spouse is only a remainder beneficiary).

118. *See id.* at 658–59.

119. *See id.*

To address the problem of characterizing income from a separate property trust, related questions of judicial interpretation must be answered in accordance with the inception of title rule. Under what circumstances does a beneficiary spouse's interest in trust income become "property," and when is such trust income "acquired" within the meaning of the Texas constitution? Does the beneficiary spouse acquire the equitable interest in trust income when the settlor transfers assets to the trust, or can an interest in trust income only be acquired only after the trust assets have actually generated income? Or does the beneficiary spouse only acquire a property interest when something is actually received from the trustee? The Texas courts have adopted no less than three distinct theories to address these threshold questions.

A. The No-Greater-Interest/Present Possessory Right Rule

1. Early Case Law: From Creditor Claims to Divorce

The first and the last time the Texas Supreme Court directly ruled upon the characterization of a spouse's interest in trust income was in *Hutchison v. Mitchell*.[120] In 1852, the husband conveyed a tract of land and twenty-eight slaves to a third party trustee, stating that the trustee "should 'permit [the wife] to retain said property in her own possession and for her own sole and separate use,' and should permit her 'to receive the rents, issues and profits' of said property"; in 1858, the husband assisted the trustee to use the proceeds and the crops generated from the trust to acquire another plantation subject to a trust "for the separate use, occupation and enjoyment of [the wife], free from the intervention and control of all other persons whomsoever."[121] The wife held the power to direct the trustee to sell, exchange, or convey the property, and the trustee was to "convey the legal title to her heirs upon her death, unless otherwise directed by her will."[122] Several years later, one of the husband's creditors sought execution against the trust property acquired from the proceeds of the original land and the crops the husband grew on that land.[123] Recognizing that the crops would have been community property if the trust assets had been conveyed directly to the wife, the court concluded that "the separate equitable estate of the wife is fully recognized, and the rules of the common law, and no other law, apply."[124]

120. *See generally* Hutchinson v. Mitchell, 39 Tex. 488 (1873).
121. *Id.* at 488.
122. *Id.*
123. *Id.* at 491–92.
124. *Id.* at 493.

> We can find nothing in any of the constitutions or laws of the state or republic which would prevent a married man from declaring an express trust in favor of his wife, and giving her the exclusive use and enjoyment of all the rents, issues and profits of the trust estate, provided there is no fraud in the transaction against creditors.[125]

The court rejected the creditor's argument that only the trust principal—not trust income—could be considered separate property.[126] Rather, trust law effectively trumped community property law, and the trustee was deemed the owner of the trust property and its income notwithstanding the wife's rights to possession and use.

Several decades later, the United States Court of Appeals for the Fifth Circuit rejected the *Hutchison* opinion "as a decision of the Semicolon or Carpet Bag Court of Texas, and therefore not authoritative."[127] However,

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125. *Id.*

126. *Id.* at 488.

127. Comm'r v. Porter, 148 F.2d 566, 568 (5th Cir. 1945), *aff'g*, 2 T.C. 1244 (1943). In doing so, the Fifth Circuit cited *Taylor v. Murphy*. Taylor v. Murphy, 50 Tex. 291 (1878). In *Taylor*, referring to the decision of *Roundtree v. Texas*, Chief Justice Moore indicated that "in my individual opinion . . . I cannot regard the opinion of this tribunal as authoritative exposition of the law involved in the cases upon which it was called to pass, but merely as conclusive and binding determinations of the particular case in which such opinion was expressed." *Id.* at 295; *Roundtree v. Texas*, 32 Tex. 286 (1869).

The Military Court decided *Roundtree*. *See* James R. Norvell, *Oran M. Roberts and the Semicolon Court*, 37 TEX. L. REV. 279, 281–83 (1958–1959). During the period of tumultuous congressional reconstruction, the military commander of Louisiana and Texas, Major General Phillip Sheridan, removed all of the members of the Supreme Court of Texas and appointed their successors, who served from the latter part of 1867 through 1869. *See id.* As an associate justice of the supreme court later observed, the Military Court "had no Texas constitutional basis and hence its decisions do not operate as precedents under the rule of stare decisis." *Id.* at 287.

That said, the successor to the Military Court decided the *Hutchison* case. *Id.* at 284–87. In the election of November 30, 1869, while still under military rule, Texas adopted a new constitution and elected a new governor, E.J. Davis. *Id.* Under the constitution of 1869, the Supreme Court of Texas had three members appointed by the governor. *Id.* This version of the Supreme Court served from 1870 through 1873. *Id.* In its final reported case, *Ex parte Rodriguez*, based on the presence of a semicolon in the constitution, the court made a textually acceptable, but politically unpalatable, decision attempting to invalidate the election of December 2, 1873. *Id.*; *Ex parte* Rodriguez, 39 Tex. 706 (1873). The decision of this so-called Semicolon Court was disregarded. 37 TEX. L. REV. at 284–87. In January 1874, Governor Davis's term ended and newly-elected Governor Richard Coke appointed a different slate of judges pursuant to constitutional amendments increasing the number of justices from three to five. *Id.*

The Fifth Circuit is not the first court to confuse the decisions of the Military Court with those of the Semicolon Court. *Id.* at 287 n.21. To be sure, due in large part to the unpopularity of its final decision, the Semicolon Court had its own detractors. *Id.* Chief Justice Oran Roberts, who was appointed by Governor Coke, wrote that "no Texas lawyer likes to cit [sic] any case from the volumes of the Supreme Court reports which contain the decisions of the court that delivered that opinion, and their cases are, as it were, tabooed by the common consent of the legal profession." Oran M. Roberts, *The Political, Legislative, and Judicial History of Texas for Its Fifty Years of Statehood, 1845–1895*, 2 WOOTEN, A COMPREHENSIVE HISTORY OF TEXAS 1, 201 (1898), *as quoted in* James R. Norvell, *Oran M. Roberts and the Semicolon Court*, 37 TEX. L. REV. 279, 281–83 (1958–1959). That said, the perception of wholesale illegitimacy of the Semicolon Court opinions is questionable. Unlike the Military Court, its authority was based on the Constitution of 1869—the same authority under which Governor Coke was elected. *Id.* Moreover, subsequent justices of the Supreme Court of Texas,

the United States Claims Court has since recognized the *Hutchison* opinion—and correctly so.[128]

With the exception of its equivocal decision in *Martin Brown Co.*, a case that also involved the claims of a husband's creditors, the Texas Supreme Court never again considered these issues.[129] Nonetheless, the lower appellate court opinions have consistently maintained that assets held in trust are not the property of either spouse.[130]

In *Shepflin v. Small*, the husband's judgment creditors erroneously instituted garnishment proceedings against a tenant of the wife's separate real property for back rent due.[131] Consistent with the law at the time, whereby the husband had authority over the wife's assets, the husband and wife then transferred all of the wife's separate real property to a family member "as trustee, in trust to collect the rents and appropriate the same to the support and maintenance of the wife and to the education and maintenance of their children."[132] The court held "the conveyance to [the trustee] in trust had the effect of withdrawing the rents from the community estate, except so far as they had been subjected to the writ of garnishment."[133]

To be sure, the court's subsequent ruling in *Kellett*, which thwarted an attempt by the spouses to use a trust to convert separate property into community property, overruled these cases.[134] Nonetheless, the courts carried the fundamental principles forward.[135]

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including Judge Roberts, did in fact explicitly cite or overrule opinions of the Semicolon Court. *Id.* at 290–91. Finally, contrary to the aspersions cast in the *Porter* case, only one of the four members who served during the short term of the Semicolon Court—Judge Moses Walker—could be classified as a "carpetbagger." *Id.* at 294. *See also* Hans W. Baade, *Chapters in the History of the Supreme Court of Texas: Reconstruction and "Redemption" (1866-1882)*, 40 ST. MARY'S L. J. 17, 78–121 (2008).

128. Wilmington Trust Co. v. United States, 4 Cl. Ct. 6 (1983), *aff'd*, 753 F.2d 1055 (Fed. Cir. 1985). *See also* Frank G. Newman, *Income Distributions from Trusts—Separate or Community Property?*, 29 TEX. B. J. 449, 450 (1966) ("Although this decision was rendered during the reconstruction era, an otherwise sound decision should not be discredited on that basis alone.").

129. The court affirmed that the husband's business creditor could not reach the interest collected by a trustee for the wife with respect to a loan made from the trust to the husband's business, but noted that "[a]s to the grounds of that conclusion, we are not in accord." Martin Brown Co. v. Perrill, 13 S.W. 975, 977 (Tex. 1890).

130. *See infra* Part III.B–C.

131. Shepflin v. Small, 23 S.W. 432, 432 (El Paso 1893, no writ).

132. *Id.*

133. *Id.* at 433. Two years after the *Shepflin* case, the court considered a case with a similar trust and concluded, in dicta, that "[t]he property belonged to the wife, and she had the right to convey the land to a trustee so as *to withdraw the rents from the community estate*, and obtain therefrom a support for herself and children." Monday v. Vance, 32 S.W. 559, 559 (San Antonio—1895, no writ) (emphasis added). *See also* Sullivan v. Skinner, 66 S.W. 680 (San Antonio—1902, writ ref'd) (refusing to allow one of the husband's creditors to garnish the rents the wife received pursuant to a devise of a life estate).

134. *See supra* notes 87–88 and accompanying text.

135. *See infra* Parts III.B–C, IV.

McClelland v. McClelland was the first case in which a Texas court considered the characterization of trust income in a divorce proceeding.[136] At the time of the divorce, the husband was the beneficiary of a testamentary trust established under his father's will, and during his lifetime, the trustee was to make cash distributions to the husband for his support and maintenance and additional advances if he was "provident and careful."[137] In denying the wife's claim to the undistributed trust income, the court focused on the testator's right to devise the property and its income, exempting those assets from the beneficiary's liabilities through what was "in effect" spendthrift trust, and concluded as follows:

> Those of his creditors or others who should seek an interest in the estate through him would have no greater right than he would have, and the limitation upon his right thus imposed would extend to a claim asserted by his wife, who was seeking to recover an interest in this estate. If the income arising from the estate was not available to [the husband] and could not be reached by him, the right of his wife would be no greater than his, and she would not be allowed to work out and enjoy a right in his estate that was denied him.[138]

The court also ruled that there was no community interest in the amounts that the trustee distributed to the husband or in the property acquired from those distributions.[139] The court appeared to view the trust property and its income as the object of the devise.[140] The beneficiary spouse did not have a property interest until the trustee made distributions from the trust, and the court—giving the most deference to the testator who established the trust—treated the income that the beneficiary spouse received as a gift, and thus, separate property.[141] Like the decisions in *Hutchison* and *Shepflin*, in addressing whether a beneficiary spouse acquired property from a trust, the *McClelland* court treated the non-beneficiary spouse like any other creditor of a beneficiary.[142]

The *McClelland* decision predated the *Arnold* case, in which the court characterized separate property in strict accordance with the constitutional definition that was applicable to the relevant circumstances.[143] As such, one could argue that the *Arnold* decision overruled the *McClelland* opinion to the extent that the husband actually acquired trust income.

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136. *See generally* McClelland v. McClelland, 37 S.W. 350 (Waco—1896, writ ref'd).
137. *Id.* at 354–56.
138. *Id.* at 358
139. *Id.* at 359.
140. Harvie Branscomb Jr. & G. Ray Miller Jr., *Community Property and the Law of Trusts*, 20 SW. L.J. 699, 725 (1966).
141. *See McClelland*, 37 S.W. at 359.
142. *See id.* at 358–59.
143. *See* Arnold v. Leonard, 273 S.W. 799, 800–01 (Tex. 1925).

However, at least two courts have explicitly rejected this notion.[144] Several decades later, in 1967, the Fort Worth Court of Civil Appeals followed the *McClelland* opinion in *Buckler v. Buckler*; in *Buckler*, the court considered a question identical not only to that presented in *McClelland*, but also to that addressed by another appellate court, in *Currie v. Currie*.[145] In the latter case, the husband was the beneficiary of a testamentary trust (established in his great-grandfather's will) whereby the trustee was granted certain discretion to allocate receipts and expenditures between income and principal (including estate tax installments) to make trust distributions to the husband when the trustee determined the husband had "attained sound discretion and good business judgment."[146] The wife attempted to assert that the amounts of undistributed income used by the trustee to pay estate taxes were community property.[147] The court concluded that "[s]ince [the husband] would not have any claim to such income other than an expectancy interest in the corpus, it cannot be said that the community estate would acquire any interest."[148]

2. *The* Long *Case: The Present Possessory Interest Rule*

In *Long*, the Texarkana Court of Civil Appeals considered the effect of a trust provision that is not uncommon within modern trusts.[149] The husband was the beneficiary of an irrevocable trust established by his parents prior to his marriage for which one-half of the trust property was distributable when the husband attained the age of twenty-five and the rest of the trust property was distributable when the husband attained the age of thirty.[150] Additionally, the trustee was given discretion to make distributions of trust income to the husband when the husband attained the age of twenty-one, which was shortly after he was married.[151] When the husband attained the age of twenty-five, several months before the suit for divorce was filed while the spouses were separated, the husband orally communicated his intent to allow the trustees to continue to manage his share of the distributable trust assets.[152] The court ultimately found that, at the age of twenty-five, the trust terminated as to the one-half portion over

144. *See* Currie v. Currie, 518 S.W.2d 386 (Tex. Civ. App.—San Antonio 1974, writ dism'd); Buckler v. Buckler, 424 S.W.2d 514 (Tex. Civ. App.—Fort Worth 1967, writ dism'd).

145. *See Currie*, 518 S.W.2d at 388–89; *Buckler*, 424 S.W.2d at 515. The details of the trust are not discussed in the opinion except to note that, as in *McClelland*, the terms and provisions "so restricted and defined [the beneficiary spouse's] rights and interests as to exclude his entitlement to undistributed income which the trustees had not seen fit to deliver to him." *Buckler*, 424 S.W.2d at 516.

146. *Currie*, 518 S.W.2d at 388–89.

147. *Id.* at 388.

148. *Id.* at 389.

149. *In re* Marriage of Long, 542 S.W.2d 712, 715 (Tex. Civ. App.—Texarkana 1976, no writ).

150. *Id.*

151. *Id.* at 717.

152. *Id.* at 716.

which the husband held a "present possessory interest" and which became his separate property.[153] In light of the subsequent judicial interpretations, it is notable that in *Long*, the court did not classify all of the undistributed income from the trust as community, but only the income attributable to the one-half of the trust property over which the husband held a present possessory right and only to the extent that such income was earned after the husband's right to such trust property became possessory.[154] The existence of a present possessory interest over one-half of the husband's trust distinguished this case from the *Currie* case, which involved a right to distributions that was within the trustee's discretion.[155] In essence, the *Long* court merely extended the no-greater-interest rule from the concept of actually acquiring trust property through distributions (as in *McClelland*) to constructively acquiring trust property to the extent that the beneficiary spouse holds an unfettered right to withdraw trust assets.[156]

Two years later, the same appellate court denied the community estate an interest in the undistributed income earned by a probate estate, spendthrifts trusts established by third parties, and self-settled trusts funded with separate property.[157] Again, the court concluded "neither spouse actually or constructively acquired the undistributed trust and estate income during the marriage."[158]

Almost two decades later, with respect to trusts that the beneficiary spouse established prior to the marriage, the Fort Worth Court of Appeals applied this same analysis when it heard *Lemke v. Lemke* and *Lipsey v. Lipsey*.[159] In a pair of related cases, the Tyler Court of Appeals also applied this analysis to characterize a mandatory income interest as separate property when the beneficiary spouse did not have a present possessory right to the principal.[160] However, consistent with the court's analysis in

153. *Id.* at 717.

154. *See id.*

155. *Id.* at 718. The court also stated that the facts mirrored those in the case of *Mercantile National Bank at Dall. v. Wilson*, but the court appears to have misread the facts of that case by noting that "undistributed income was in the hands of the trustees but the beneficiary had a present possessory interest in the funds." *Id. See* Mercantile Nat'l Bank at Dall. v. Wilson, 279 S.W.2d 650 (Tex. Civ. App.—Dallas 1955, writ ref'd n.r.e.). Rather, the terms of the self-settled trust in the *Mercantile National Bank* case left the distribution of trust income to the discretion of the third party trustee. *Id.* at 653. *See infra* note 195 and accompanying text.

156. *See Long*, 542 S.W.2d at 718–19.

157. *See In re* Marriage of Burns, 573 S.W.2d 555, 556–57 (Tex. Civ. App.—Texarkana 1978, writ dism'd).

158. *Id.* at 557.

159. Lipsey v. Lipsey, 983 S.W.2d 345, 351 (Tex. App.—Fort Worth 1998, no pet.); Lemke v. Lemke, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied).

160. *See* Cleaver v. George Staton Co., 908 S.W.2d 468, 470 (Tex. App.—Tyler 1995, writ denied) [hereinafter *Cleaver I*]; Cleaver v. Cleaver, 935 S.W.2d 491, 493–94 (Tex. App.—Tyler 1996, no pet.) [hereinafter *Cleaver II*].

Long, the income subsequently earned on the undistributed trust income would be characterized as community property.[161]

3. The Relationship Between the Right to Possession and Acquisition

The courts in *McClelland*, *Long*, and their progeny equate the concept of acquisition for marital property characterization purposes with possession—either actual possession or an unfettered right to possession of the underlying trust property.[162] That is, until the beneficiary spouse had such actual or constructive possession of the trust property, the courts would not consider any income from that property as community property. That said, certain commentators have criticized these holdings as inconsistent with a series of Texas Supreme Court cases decided between 1965 and 1976 that characterized retirement plan assets.[163]

In *Herring v. Blakeley*, which involved an employer profit-sharing plan and an annuity funded by the employee spouse's contributions during the marriage, the supreme court ruled that there was no requirement that community property be reducible to immediate possession before the divorce court could exercise jurisdiction to determine each of the spouse's rights in such assets.[164] In *Busby v. Busby*, the court extended the doctrine to include United States military retirement benefits, even where the entitlement to such benefits could be subsequently changed or eliminated by federal statute.[165] In both of these cases, the employee spouse's rights were vested in the sense that the employee spouse had done all that he needed to do to claim the rights.[166] In other words, the question was not so much whether the employee-spouse would receive the retirement benefits but when and how much. In both cases, the court held that the trial judge could address timing issues in fashioning the appropriate remedy.[167]

In *Cearley v. Cearley*, the court significantly extended these principles to military retirement benefits that had not yet vested at the time of divorce;

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161. *See Cleaver I*, 908 S.W.2d at 470; *Cleaver II*, 935 S.W.2d at 493–94.

162. *See supra* Parts III.A.1 and III.A.2.

163. *See* Donald R. Smith, *Characterization of Marital Property*, J. STATE BAR OF TEX. PROF'L DEV. PROGRAM, ADVANCED FAM. L. COURSE, at 145 (1991); Harvey L. Davis, *Income Arising from Trusts During Marriage Is Community Property*, 29 TEX. B.J. 901, 976 (1966).

164. Herring v. Blakeley, 385 S.W.2d 843, 847 (Tex. 1965).

165. Busby v. Busby, 457 S.W.2d 551, 554–55 (Tex. 1970) (*superseded by statute*, Department of Defense Authorization Act, 1983, Pub. L. No. 97–252 § 1001, 96 Stat. 730–35, *as stated in* Thomas v. Piorkowski, 286 S.W.3d 662, 669 (Tex. App.—Corpus Christi 2009, no pet.). In this case, the amount of the retirement benefits distributed to the husband-employee could be changed or eliminated by federal statute, as pointed out in a vigorous dissenting opinion. *Id.* at 555 (Walker, J., dissenting). Although the amount of retirement benefits may be subject to change, one must consider the likelihood that military retirement benefits would be completely terminated by an act of the United States Congress, which may be the reason this "contingency" was disregarded in the majority opinion.

166. *Herring*, 385 S.W.2d at 845; *Busby*, 457 S.W.2d at 553–54.

167. *See Herring*, 385 S.W.2d at 845; *Busby*, 457 S.W.2d at 553–54.

that is, the employee-spouse had not completed the requisite period of service to receive the benefits at the time of the divorce.[168] The court held that both vested and nonvested pension rights represent a property interest and to the extent that such rights derive from employment during the marriage, they comprise a community asset.[169] Notably, the *Cearley* court quoted the following language from the Supreme Court of California's opinion in *Brown v. Brown* (overruling its own prior case law):

> This mischaracterization of pension rights has, and unless overturned, will continue to result in inequitable division of community assets. *Over the past decades, pension benefits have become an increasingly significant part of the consideration earned by the employee for his services. As the date of vesting and retirement approaches, the value of the pension right grows until it often represents the most important asset of the marital community.*[170]

As both courts saw it, a contrary decision would "[compel] an inequitable division of rights acquired through community effort."[171] That said, it is worth noting that at the time of the divorce, the employee's service could be terminated—voluntarily or involuntarily—and the employee could receive nothing.[172] However, as emphasized in the language quoted above, the court appeared to invoke the doctrine of onerous title as a matter of necessity.[173] That is, these benefits represented the fruits of labor provided during the marriage and to leave them off the tale out of a slavish adherence to the inception of title rule was simply acceptable to the court.[174] Instead, it adopted a remedy to deal with these contingencies—it would award an appropriate portion of the pension on a prospective basis as amounts were paid after the divorce decree.[175]

The *Herring*, *Busby*, and *Cearley* cases all involved a spouse's right to benefits established with earnings from or as a result of the provision of personal services that a spouse provided during the marriage.[176] Outside of this context, the Texas Supreme Court has refused to expand the scope of these holdings.[177]

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168. Cearley v. Cearley, 544 S.W.2d 661, 665–66 (Tex. 1976).

169. *See id.*

170. *Id.* at 664 (emphasis added) (quoting *In re* Marriage of Brown, 544 P.2d 561, 566 (Cal. 1976)).

171. *Id.* at 663 (quoting *Brown*, 544 P.2d at 562).

172. *See id.* at 563.

173. *See* Vallone v. Vallone, 644 S.W.2d 455, 462–63 (Tex. 1982) (Sondock, J., dissenting).

174. *See id.*

175. *Cearley*, 544 S.W.2d at 664.

176. *See generally* Herring v. Blakeley, 385 S.W.2d 843 (Tex. 1965); Busby v. Busby, 457 S.W.2d 551 (Tex. 1970), *superseded by statute*, Uniformed Services Former Spouses' Protection Act, 10 U.S.C. § 1408, *as stated in*, Thomas v. Piorkowski, 286 S.W.3d 662 (Tex. App.—Corpus Christi 2009, no pet.); *Cearley*, 544 S.W.2d at 661.

177. *See, e.g.*, Nail v. Nail, 486 S.W.2d 761, 764 (Tex. 1972) (refusing to apply the *Busby* holding to characterize accrued good will as community property).

Neither *Herring*, *Busby*, nor *Cearley* involved a gift from a third party.[178] In the typical private trust, even when the beneficiary spouse is the trustee, there is no time, talent, or toil expended to generate income from separate property.[179] In the context of a separate property trust, does the doctrine of onerous title need to trump the principles of the inception of title rule?

Several decades later, because of changes in the applicable federal law, the courts have significantly circumscribed their continued application of the *Herring*, *Busby*, and *Cearley* opinions.[180] Generally speaking, when determining the character of trust income, Texas courts have not discussed these cases.[181] Suffice to say, there is enough of a distinction between the circumstances and the policies behind each of these decisions and the context of a private trust such that courts have avoided dismissing the present possessory interest rule entirely.

B. The Conduit Principle

1. The Federal Estate Tax Cases (1948–1980)

In 1948, federal courts applied a new approach to marital property characterization—the idea that a beneficiary spouse effectively owns the trust property, and thus, the trust is merely a conduit for the income generated by that property.[182] Commentators subsequently referred to this approach as the "conduit principle."[183] These cases centered around what is now section 2036(a) of the Internal Revenue Code, which generally provides that the decedent's taxable estate includes the value of assets gifted during the decedent's lifetime for which the decedent retained certain rights to the income therefrom.[184] All of these cases involved a gift of community property to an irrevocable trust for the lifetime benefit of just

178. *See Herring*, 385 S.W.2d at 846; *Busby*, 457 S.W.2d at 553; *Cearley*, 544 S.W.2d at 662.

179. *See* TEX. FAM. CODE ANN. § 3.402 (West 2012).

180. *See* ANNE E. MELLEY, *Marital Property*, 3 TEX. FAM. L. SERV. § 18:61–:63 (West 2003).

181. In one case involving a trust that a former employer established, the court does reference the *Herring* case for the proposition that benefits paid on retirement may not be a gift even though the employee never made any contributions to the plan. Hardin v. Hardin, 681 S.W.2d 241, 243 (Tex. App.—San Antonio 1984, no pet.). *See also* Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 12–13 (1983) (distinguishing the *Herring* case involving a plant funded with community property).

182. *See* Branscomb & Miller, *supra* note 140, at 714. In the context of the income tax, until 1948, the federal courts had never considered the characterization of undistributed trust income before the underlying trust terminated. *See generally* McFaddin v. Comm'r, 2 T.C. 395 (1943), *aff'd in part, rem'd in part to* 148 F.2d 570 (5th Cir. 1945). In this sense, the Fifth Circuit's conduit approach to the estate tax cases is not so much inconsistent with, as it is an evolution of, the equitable interest theory.

183. *See* Branscomb & Miller, *supra* note 140, at 714.

184. *See* I.R.C. § 2036(a) (West 2012). As the federal estate and gift tax regimes are, for the most part, unified, the practical effect of section 2036(a) is to undo the lifetime gift with the retained interest valued at the date of the gift and bring the assets gifted back to the donor-decedent's taxable estate at a value determined on the date of death. *See* I.R.C. § 2001(b) (West 2012).

one spouse.[185] Under Texas law, the beneficiary spouse's interest in the trust principal was separate property; but upon the death of the other spouse, the following question arose: Under the Spanish rule, does the donor spouse retain rights to community income in the assets gifted to a trust for the other spouse, thereby resulting in the inclusion of a portion of those assets in the taxable estate?

In *Estate of Hinds v. Commissioner*, the United States Tax Court concluded that under the circumstances, a portion of the trust assets would be included in the donor spouse's gross estate.[186] In effect, because the decedent spouse held a community property right to income from separate property, the court treated the decedent spouse as a de facto owner of the trust. For both procedural reasons and practical reasons, the Fifth Circuit affirmed the United States Tax Court's judgment "[w]ithout . . . at all approving the decision of the Tax Court."[187] Nonetheless, for over two decades, the government continued to take the position that the decision in *Hinds* was good law.[188]

In 1977, the United States Tax Court decided two additional estate tax cases in the government's favor and in accordance with its decision in *Hinds—Estate of Castleberry v. Commissioner* involved an outright gift and *Estate of Wyly v. Commissioner* involved a lifetime gift in trust.[189] In *Frankel v. United States*, a federal district court reached an opposite result in favor of the estate.[190] Eventually, the Fifth Circuit considered all three of these cases on appeal and ultimately held that the donor spouse could not be said to have retained a right to income within the meaning of section 2036(a).[191] While the Fifth Circuit based its decision in large part on the construction of the estate tax statute, for the first time, it considered the effects of each spouse's management powers under the Texas statutes.[192] That is, with respect to income from separate property, which is the donee spouse's special community property, the court concluded that the donor spouse only had "'ownership' in an almost abstract sense."[193]

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185. *See* Branscomb & Miller, *supra* note 140, at 713.

186. Estate of Hinds v. Comm'r, 11 T.C. 314, 322–23 (1948), *aff'd on other grounds*, 180 F.2d 930 (5th Cir. 1950) (citing the *Porter* opinion and consistently applying the Fifth Circuit's interpretation of Texas community property law from that opinion).

187. *Estate of Hinds*, 180 F.2d at 932.

188. *See* Rev. Rul. 75-504, 1975-2 C.B. 363, *revoked by* Rev. Rul. 81-221, 1981-1 C.B. 178.

189. *See generally* Estate of Castleberry v. Comm'r, 68 T.C. 682 (1977); Estate of Wyly v. Comm'r, 69 T.C. 227 (1977). These decisions ultimately prompted a proposed amendment to the Texas constitution providing for a presumption that interspousal gifts include the income from the gifted property. *See supra* Part II.A.

190. *See Wyly*, 610 F.2d at 1285.

191. *See id.* at 1294.

192. *See id.* at 1288–89.

193. *Id.* at 1289.

2. The Mercantile National Bank *Case*

Prior to the Fifth Circuit's shift away from the conduit principle, the Dallas Court of Civil Appeals applied—or more accurately, merely assumed the application of—this approach in *Mercantile National Bank v. Wilson*.[194] Shortly before getting married, the wife created an irrevocable trust for her own benefit with assets received from her father, naming her father as the trustee "to keep said bonds for [her] and collect the interest thereon and to reinvest the revenue derived therefrom, or to deliver same to [her]."[195] When her husband died, a creditor of his estate asserted that the trust income earned during their marriage, whether distributed or undistributed, represented community property subject to the debts of the husband's estate.[196] Without citing any case law, the court concluded that the trust income was income from the wife's separate property, but like the wife's separate property, the income was exempt from the husband's debts by statute.[197] Since the courts' decisions in the nineteenth century creditor cases, the Texas Legislature had adopted a statute exempting a spouse's special community property, including income from the spouse's separate property, from the other spouse's creditor claims.[198] As such, the court's characterization was dicta because, regardless of whether the trust income could have been characterized as separate property or income from separate property, the decision would have been the same.[199] Still, this opinion remains an anomaly in Texas case law.[200]

In 1966, Professor Harvey Davis argued that Texas marital property law mandates the use of the conduit principle.[201] Davis's first conceptual step was to discard all pre-1925 case law as contrary to the Texas Supreme Court's opinion in *Arnold*, which he quoted as follows:

> The test during coverture relates to the *method* by which the property is *acquired*. If the method be by *gift, devise,* or *descent* to the wife, then the Constitution makes the property belong to the wife's separate estate. If the *method of acquiring* during marriage be *different*, then the property

194. *See generally* Mercantile Nat'l Bank at Dall. v. Wilson, 279 S.W.2d 650 (Tex. Civ. App.—Dallas 1955, writ ref'd n.r.e.).

195. *Id.* at 653.

196. *Id.* at 653–54.

197. *Id.* at 654.

198. *See* Newman, *supra* note 128, at 532.

199. *See id.*

200. *See id.* The United States Claims Court distinguished *Mercantile National Bank* case from prior Texas case law because the trust was self-settled, and because it terminated on the death of the wife's parents, the wife had an expectation of recapturing the corpus during her lifetime. Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 11 (1983), *aff'd*, 753 F.2d 1055 (Fed. Cir. 1985).

201. *See* Davis, *supra* note 163, at 901–02.

> falls without the class of separate estate of the wife, as fixed by the Constitution.[202]

In *Arnold*, the actual issue was whether the legislature could alter the exclusive, constitutional definition of separate property as the courts had previously interpreted it.[203] Yet, before property can be characterized as community or separate, one must first determine whether that property has been acquired, and the *Arnold* case did not foreclose a court's ability to interpret what acquisition means, constitutionally speaking.[204] In this regard, one could make the argument that a spouse acquires an equitable interest in the income of a trust funded with separate property upon creation.[205]

Nonetheless, Professor Davis concluded that the conduit principle should apply in all instances:

> [I]t is seen that a married spouse may receive a vested equitable title to the trust corpus as a gift, either before or during marriage. This trust corpus is separate property. During marriage, income arises from the trust corpus. This income is community property upon the moment of its creation because it is not property acquired by gift, devise or descent. It makes no difference that the income is not then distributed or is not reduced to possession or cannot be reduced to possession by the married beneficiary. It is and remains community property nonetheless.[206]

In essence, the trust relationship is merely a conduit for the beneficiary spouse's true ownership of trust assets. Unlike the equitable interest theory (discussed below), it matters not whether the trust income is distributed because the terms of the trust are irrelevant.[207] To Professor Davis, a trust is not a product of property law; rather, the terms of trust are reduced to

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202. Davis, *supra* note 163, at 901–02 (quoting *Arnold v. Leonard*, 273 S.W. 799, 801 (Tex. 1925) (emphasis supplied by Professor Davis)).

203. *Arnold*, 273 S.W. at 803.

204. *See id.*

205. *See* Reynolds v. Reynolds, 388 So.2d 1135, 1149–50 (La. 1980) (Dixon, C.J., dissenting in part and concurring in part on rehearing) ("[T]he distributed income, in my view, was not the 'fruit' of the beneficiary's separate property, but was the materialization of the gift of a future interest in property."). The case involved the characterization of both distributed and undistributed income, with respect to a discretionary spendthrift trust. *Id.* at 1136–37. The beneficiary spouse did not execute and record affidavit of paraphernality to declare the trust distributions as her separate property, as permitted under Louisiana law. *Id.* at 1137. The court held that the beneficiary spouse never acquired incidents of ownership over the undistributed income, which was under the control and dominion of the trustee, but that the distributions of trust income *did* belong to the community. *Id.* at 1142. *See also* DE FUNIAK & VAUGHN, *supra* note 26, § 71.2, at 164–65.

206. Davis, *supra* note 163, at 977.

207. *Id.* at 976–77. Query how title to trust property falls into the community where multiple beneficiaries may be entitled to discretionary distributions. Any attempt by a court to invade and divide the undistributed trust income upon the death or divorce of a beneficiary would invariably affect the other beneficiaries.

nothing more than a contract, and like spouses could not agree to change the character of community property or separate property at the time the *Arnold* case was decided, a settlor cannot change the marital property character of income from separate property.[208]

Professor Davis's strident advocacy of the conduit principle was not without detractors who correctly observed that treating all distributed and undistributed trust income as community property disregards every settlor's property right to delineate the trust beneficiaries and makes every non-beneficiary spouse a de facto beneficiary.[209] The conduit principle does not attempt to balance the interests of the settlor and the interests of the spouses. Rather, marital property law simply trumps trust law.

Within a year after his views were published, Professor Davis made arguments before the Fort Worth Court of Civil Appeals in *Buckler v. Buckler*, a case factually similar to *McClelland*.[210] The court, in disagreeing with Professor Davis's take on the scope of the *Arnold* decision, noted the following:

> *Arnold v. Leonard* held that property acquired during marriage other than as the result of gift, devise or descent necessarily could not be part of the separate estate, in view of the Texas Constitution, and hence would have the character of community property. The decision does overrule a portion of the holding in *McClelland*, but it does not overrule the holding which is material to the question before us. As to such the Supreme Court, which disposed of the application for writ of error in *McClelland* by the notation 'writ refused,' has not had occasion to reconsider the decision therein made. It is not the province of a Court of Civil Appeals to anticipate that the Supreme Court would, if afforded the opportunity, reverse itself as applied to a prior holding it has made. We are bound by the prior holdings of that court, specific or construable.[211]

Since the *Mercantile National Bank* case was decided, no Texas court has entertained the notion that all trust income earned during a beneficiary spouse's marriage, whether distributed or undistributed, should be uncharacterized as community property.

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208. Davis, *supra* note 163, at 976.

209. *See* William V. Counts, *Trust Income—Separate or Community Property?*, 30 TEXAS B.J. 851, 916–17 (1967).

210. *See* Buckler v. Buckler, 424 S.W.2d 514, 516 (Tex. Civ. App.—Fort Worth 1967, writ dism'd).

211. *Buckler*, 424 S.W.2d at 516. The Fourteenth District Court of Appeals has also rejected the notion that the *McClelland* opinion is no longer valid in light of the Texas Supreme Court's opinion in *Arnold*. Sharma v. Routh, 302 S.W.3d 355, 363 n.13 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

C. The Equitable Interest Theory

Following the changes in marital property law that emerged after the turn of the century, nearly three decades passed before the courts considered characterizing a beneficial interest in a trust—first in the federal income tax cases and then among the Texas appellate courts. In this context, the courts have developed the "equitable interest theory."[212] Under this theory, an equitable interest in a trust is considered property acquired by the beneficiary spouse for marital property law purposes.[213] That said, the particular application of this theory depends upon the answers to two questions: (1) is the beneficiary spouse's interest in trust income considered property acquired when the beneficial interest vested (as opposed to when the income is earned or distributed); and (2) must the beneficiary spouse actually hold a beneficial interest in the trust principal for the Spanish rule to apply to the trust income received? [214]

1. The Federal Income Tax Cases (1925–1983): The Presumptive Equitable Interest in Trust Principal as Property

In the context of federal income tax, the United States Supreme Court answered both of the foregoing questions in the negative.[215] Under the original Income Tax Act of 1913, taxable income was defined as "gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent."[216] In *Irwin v. Gavit*, an individual taxpayer who was only entitled to a share of the income of a testamentary trust argued that because he had no interest in the trust principal, the gift that he received was his equitable interest in the income; and as such, the distributions from the trustee should not have been subject to income tax.[217] The Court disagreed:

> [A] gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund. Apart from technicalities, we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it.[218]

It is important to note that this presumptive concept of a beneficiary's interest in trust principal instructed the federal courts' interpretations of Texas law in a time before married couples in community property states

212. Branscomb & Miller, *supra* note 140, at 713.
213. *See id*.
214. *See* Counts, *supra* note 209, at 914–95.
215. *See* Irwin v. Gavit, 268 U.S. 161, 167–68 (1925).
216. *Id.* at 166.
217. *See id.*
218. *Id.* at 167.

were allowed to file joint returns and effectively split their separate taxable income.

In *Terry v. Commissioner*, the husband and wife each recognized half of the taxable income that the wife received as a distribution from a testamentary trust on the grounds that such income constituted community property.[219] The government argued for the proposition that the trust income should have been treated as the wife's separate property, and in making this argument, the government cited the *McClelland* opinion.[220] However, the Board of Tax Appeals concluded that the distributions represented community property and noted that the *McClelland* holding, unless confined to spendthrift trusts, could conflict with the subsequent decision of the Texas Supreme Court in the *Arnold* case.[221] In affirming the judgment of the Board of Tax Appeals, the Fifth Circuit parroted the holding in *Gavit*, explaining that "[t]he devise to her of the income and profits from that property for life had the effect of giving her the property itself for life."[222]

In 1945, a series of similar United States Tax Court cases culminated in *Commissioner v. Porter*, a Fifth Circuit decision that involved spendthrift trusts that a father established and administered in New York for the benefit of his married daughters who resided in Texas.[223] In its opinion, the court summarily disregarded the authority of the *Hutchison* and *Sullivan* cases, incorrectly dismissed the holding of the *McClelland* case as dealing only with undistributed income; and concluded as follows:

> [I]n view of the generally prevailing rule in Texas, that income from separate property falls when received into the community, it is certainly true that if by the use of a trust instrument this general rule can be departed from, the instrument must, in the most precise and definite way, and by the use of language of unmistakable intent, make that desire and intention clear. There is not a line in the trust instruments in question here to even suggest that the settlor of these trusts intended to change, as to the income his daughters should receive, the ordinary results flowing from the marriage state. . . . As long as the income was in the hands of the trustees and undistributed it was protected, but as soon as it was paid over, it passed to the daughters as their property, freely and completely alienable,

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219. Terry v. Comm'r, 26 B.T.A. 1418, 1418–19 (1932), *aff'd*, 69 F.2d 969 (5th Cir. 1934).

220. *Id.* at 1419.

221. *Id.* at 1420.

222. *Terry*, 69 F.2d at 969.

223. *See* Comm'r v. Porter, 148 F.2d 566, 567 (1945). *See also* Snowden v. Comm'r, 2 T.C.M. (CCH) 509 (1944), *aff'd*, 148 F.2d 569 (5th Cir. 1945); McFaddin v. Comm'r, 2 T.C. 395 (1943), *aff'd in part, remanded in part to* 148 F.2d 570 (5th Cir. 1945); Sims v. Comm'r, T.C.M. (CCH) 508 (1944), *aff'd*, 148 F.2d 574 (5th Cir. 1945).

> and as fully subject as any other unrestricted property of theirs to the ordinary impact of the law.[224]

Notably, however, the court conditioned its intimation that the clearly expressed intent of the settlor could alter the classification of a beneficial interest in trust income on whether "in the [sic] light of the constitutional definition of separate property and of *Arnold v. Leonard*, supra, such purpose could be effectively expressed."[225] In other cases the court decided in series with the *Porter* decision, the court added that the existence of a spendthrift clause was immaterial to its analysis.[226]

In weighing the persuasive value of a federal court's interpretation of Texas law, one must appreciate that a federal court's agenda for determining matters of income taxation differs from that of a Texas court determining the marital property rights of a spouse or creditor.[227] In this respect, the nature of the question involved in these tax cases—the character and taxability of distributed trust income—has necessarily limited the scope of the federal court's inquiry.[228] The above-quoted language states that as long as the trust income remained *undistributed*, it was protected. On the other hand, in at least one other case from this same period, the language of the Fifth Circuit seems to echo the conduit principle.[229] In effect, the only significant difference between the conduit principle and the federal courts' permutation of the equitable interest theory (which presumes that there is always an interest in the trust principal) is timing—the former treats trust income as community property when it is earned, while the latter considers trust income to be as a claim of the community only when it is distributed. In this regard, if the undistributed trust income was not already subject to income taxation at the trust level, then it is conceivable that the federal courts could have stretched their interpretation of Texas law to adopt the conduit principle.

In the context of federal income tax, these cases represent the last word of the federal courts. Congress enacted section 12 of the Internal Revenue Code of 1948, which allowed all spouses to effectively split their income for federal income tax purposes, regardless of whether items of taxable income would be considered community or separate property.[230] With the

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224. *Porter*, 148 F.2d at 568–69.

225. *Id.* at 568.

226. *See Sims*, 148 F.2d at 574; *McFaddin*, 148 F.2d at 573–74.

227. *See Terry*, 26 B.T.A. at 1420 ("What the [United States] Supreme Court has called income may not in Texas escape tax through a local decision that it is a bequest.").

228. In only one case from this period did the federal courts consider the nature of undistributed trust income, and in that case, the income was earned after the trust was supposed to terminate by its own terms. *See McFaddin*, 148 F.2d at 573–74.

229. *See* Comm'r v. Wilson, 76 F.2d 766, 769 (5th Cir. 1935), *rem'g*, BTA Memo 1933-261 ("The corpus is theirs in equity, the legal title being conveyed to the trustee expressly for their benefit."); Branscomb & Miller, *supra* note 140, at 714.

230. *See* Newman, *supra* note 138, at 533–35. *See also* I.R.C. § 6013 (West 2012).

addition of section 102 of the Internal Revenue Code in 1954, income derived from a gift, devise, or bequest became taxable by statute.[231] As such, in the realm of income tax law, this characterization issue is now moot.[232]

In 1983, the United States Claims Court decided the last of the reported federal cases discussing the characterization of distributed and undistributed trust income in the context of the federal estate tax.[233] In *Wilmington Trust Co. v. United States*, the wife was the beneficiary of seven irrevocable trusts established during her marriage by her parents and her husband for which she was only entitled to mandatory income distributions.[234] The sole issue before the court was the characterization of the property the wife acquired from trust distributions and the undistributed income that remained in the trusts.[235] The government contended that because such items were community property, one-half of the value should have been included in the husband's gross estate.[236] However, after thoroughly discussing the Texas case law and criticizing the Fifth Circuit's analysis of those cases, the court concluded as follows:

> It is true, as stated by the Fifth Circuit in *Porter*, that the generally prevailing rule in Texas is "that income *from separate property* falls when received into the community" . . . , but the court in both cases seemingly overlooked the circumstance that the income involved in each case was "from" a trust corpus, and the trust corpus was not the "separate property" of the beneficiaries of the trust. The beneficiaries had no right to or control over the corpus of the trust. Those powers were vested in the trustee.[237]

The United States Claims Court took a position was contrary to the United States Supreme Court's rationale in *Gavit*, a decision which is never even mentioned.[238] That is, the United States Claims Court acknowledged the no-greater-interest rule reflected in the early Texas case law and concluded that: (1) a spouse does not acquire any property until an income distribution

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231. *See id. See also* I.R.C. § 102 (West 2012).

232. *See* Newman, *supra* note 128, at 535.

233. Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 8–9 (1983), *aff'd*, 753 F.2d 1055 (Fed. Cir. 1985).

234. *Id.* at 7–8.

235. *Id.* at 8.

236. *Id.*

237. *Id.* at 14 (emphasis in original, citations omitted).

238. *See* Irwin v. Gavit, 268 U.S. 161, 167–68 (1925). In *Wilmington Trust*, the court noted that six of the seven trusts were settled by third parties and contained spendthrift provisions. *Wilmington Trust*, 4 Cl. Ct. at 7–8. But from its decision pertaining to all of the trusts, it is unclear whether and to what extent these factors were relevant. *See id.*

is actually made; and (2) the resulting distribution is considered a gift to the beneficiary spouse, and thus, separate property.[239]

In any case, the Texas appellate courts have not yet adopted the presumptive equitable interest theory. However, at least two commentators have advocated for this approach on the grounds that even with respect to a trust where income distributions are discretionary, the beneficiary can bring suit to compel distributions and hold the trustee liable for mismanaging the assets.[240] As the argument goes, these rights constitute a sufficient property interest in the constitutional sense.[241]

2. *The* Ridgell *and* Sharma *Cases: The Actual Equitable Interest in Trust Principal as Property*

As another permutation of the equitable interest theory, two Texas courts held that an actual interest in the trust corpus constitutes property for marital property characterization purposes, such that any of the distributions of trust income to the beneficiary spouse who holds such an interest would be considered community property.[242] This approach differs from the federal income tax cases in that it does not presume that an interest in income necessarily includes an interest in corpus, and therefore, a beneficial interest that only provides for the distribution of income is not considered community property.[243]

In *Ridgell v. Ridgell*, the Corpus Christi Court of Appeals considered two testamentary trusts that were established for the benefit of the wife by her parents.[244] The trustee was directed to pay all of the net income from the trust to the wife "quarter-annually or monthly as [the wife] may from time to time elect" and was the discretion to distribute principal to or for the benefit of the wife and her children in accordance with the following standard:

> [A]s the Trustee . . . deems appropriate for their proper support, care and maintenance in reasonable comfort in accordance with their accustomed manner of living after taking into consideration, to the extent the Trustee

239. *See Wilmington Trust Co.*, 4 Cl. Ct. at 14.

240. *See* Branscomb & Miller, *supra* note 140, at 714.

241. *See id.*

242. *See* Ridgell v. Ridgell, 960 S.W.2d 144, 145–48 (Tex. App.—Corpus Christi 1997, no writ); Sharma v. Routh, 302 S.W.3d 355, 372–73 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

243. *See supra* Part III.C.1.

244. *Ridgell*, 960 S.W.2d at 145–48. *Ridgell* also involved a self-settled trust, funded with separate property, with the purpose of securing a loan to acquire real property for the wife's daughter and granddaughter ("Trust #3"), but because the underlying loan held by the trust was subsequently extinguished with other expenditures of separate property and none of the increases in the stock holdings of the trust were attributable to items of income, the trust estate maintained its separate property status. *Id.* at 150–51. Another trust ("Trust #1") dissolved prior to the marriage. *Id.* at 146.

> deems advisable, any income or resources of such beneficiaries, outside this trust, know [sic] to the Trustee and reasonably available for these purposes.[245]

On each of the wife's birthdays beginning with the fortieth birthday and ending with the fiftieth, the trustee was directed to make principal distributions to the wife of the lesser of $25,000 or three percent of the value of the trust assets.[246] The wife reached the age of forty and married the husband in 1978), and the divorce proceeding commenced in 1994.[247]

After citing *Long*, *Mercantile*, and *Wilmington*, the court articulated a rather curious synthesis of Texas case law:

> If the trust property may be considered her separate property, then the income it generated during the marriage may constitute community property. If [the beneficiary spouse] receives income distributions from the trusts, the income must be community property. If [the beneficiary spouse] does not receive income from the trusts and has no more than an expectancy interest in the corpuses, the income remains separate property.[248]

At first blush, the second sentence suggests that the court adopted the presumptive equitable interest theory (a mandatory distribution of income necessarily meaning that the beneficiary spouse has an interest in trust principal), and the third sentence intimates that the conduit principle might apply to the undistributed trust income if the beneficiary spouse has "more than an expectancy interest in" trust principal.[249] However, the ultimate holding of *Ridgell*—"the testamentary trusts grant to [the wife] possessory interests in the net incomes of the trusts and expectancy interests in the trust corpuses, revealing, at least *prima facie*, that the trust incomes during the marriage are community property"—appears to require that the beneficiary spouse hold *some* interest in principal before characterizing distributions of trust income as community in nature.[250] The court also found that the terms of the trusts did not reflect an "unmistakable intent" on the part of the settlors *not* to have the trust income characterized as community property,

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245. *Id.* at 148 n.3.

246. *Id.* at 148–49, n.3.

247. *See id.* at 145–46.

248. *Id.* at 148.

249. *Id.* at 148–49 (explaining that "[b]ecause [the wife] became a beneficiary by devise, her separate estate has equitable title to the trusts generally"). This "expectancy interest" language appears to be derived from the opinion in *Currie*, in which the court held that "[s]ince [the husband] would not have any claim to such income other than an expectancy interest in the corpus, it cannot be said that the community estate would acquire any interest." Currie v. Currie, 518 S.W.2d 386, 389 (Tex. Civ. App.—San Antonio 1974, writ dism'd). In that case, distributions from the trust were within the "uncontrolled discretion" of the trustee. *Id.* at 388.

250. *Ridgell*, 960 S.W.2d at 149.

notwithstanding the presence of a spendthrift provision.[251] As such, the court characterized *all* of the trust income distributed to the wife during the marriage as community property.[252]

One must carefully consider what it means to have an expectancy interest in trust principal sufficient to cause *all* of the income distributions to be treated as community property. In *Ridgell*, for the first eleven years of the marriage, the wife received mandatory distributions of only a portion of the trust principal. While the court gave lip service to the *Long* opinion, the rules adopted by each of these courts produce very different results.[253] For example, assume that one of the trusts involved in the *Ridgell* case held $1 million in assets on January 1, 1979, earning income at a rate of 5% per year, and for the sake of illustrative simplicity, assume the wife's birthday was December 31. If the wife had opted to defer any of the mandatory income and principal distributions until the end of 1980, the character of the distributions would be determined as follows:

		[a] 1979:	[b] 1980:
[1]	Trust assets, beginning balance:	$1,000,000	$1,050,000
[2]	Annual trust income:	50,000	52,500
[3]	Actual distributions of income and principal:	-	152,500
[4]	Trust assets, ending balance (line [1] + line [2] - line [3]):	$1,050,000	$ 950,000
[5]	Unitrust amount (in 1979, line [1][a] x 3%; in 1980, line [1][a] - line [6][a] x 3%):	$ 30,000	$ 29,250
[6]	Principal that may be withdrawn (lesser of line [5] or $25,000):	$ 25,000	$ 25,000
	Character of Distribution - *Long* Opinion:		
[7]	Present possessory interest on 12/31/79 (line [2][a] + line [6][a]):		$ 75,000
[8]	Portion of trust constructively received (line [7] ÷ line [4][a]):		7.143%
[9]	Community property distributed - portion of 1980 income attributable to present possessory interest (line [2][b] x line [8]):		$ 3,750
[10]	Separate property distributed (line [3] – line [9]):		$ 148,750

251. *Id.*
252. *Id.*
253. *See id.* at 148–49.

	Character of Distribution - *Ridgell* Opinion:	
[11]	Community property distributed - all trust income since beneficiary had more than an expectancy interest in principal (lines [2][a] + [2][b]):*	$ 102,500
[12]	Separate property distributed (line [3] – line [6]):	$ 50,000

* assumes undistributed income is not added to principal each year

Note that in *Ridgell*, principal distributions to the wife were left to the trustee's discretion for approximately four years before dissolution of the marriage (1990 to 1994).[254] Although the opinion does not describe the specific amounts of income and principal that the trustee distributed during this period, the language of the court's holding is all-inclusive, suggesting that a trustee's discretionary right to distribute trust principal to the spouse is also sufficient to characterize *all* distributions of trust income as community property.[255]

In *Sharma v. Routh*, the most recent opinion to broadly address these issues, the Fourteenth District Court of Appeals in Houston adopted a rule similar to the rule that the *Ridgell* court applied.[256] Specifically, the court considered the character of income distributed from two testamentary trusts that were established for a husband by his predeceased wife—the Marital Trust and the Family Trust.[257] From the Marital Trust, the husband was entitled to quarterly distributions of income, as well as the following distributions:

> [S]uch amounts of trust principal to [the husband] as are necessary, when added to the funds reasonably available to [the husband] from all other sources known to [the trustee] . . . to provide for [the husband's] health, support and maintenance in order to maintain him, to the extent reasonably possible, in accordance with the standard of living to which [the husband] is accustomed at the time of [the settlor's] death.[258]

From the Family Trust, the husband could receive discretionary income and principal distributions under a standard similar to the provisions for distribution from the marital trust.[259] Both trusts provided for the remainder to pass to charity after the husband's death.[260] During the subsequent marriage, the husband received income distributions from both trusts and donated the amounts to charity, and although he was the trustee of the trust,

254. *See id.* at 145–46.
255. *See id.* at 148–49.
256. Sharma v. Routh, 302 S.W.3d 355, 364 (Tex. App.—Houston [14th Dist.] 2009, no pet.).
257. *Id.* at 357–58.
258. *Id.* at 364.
259. *Id.* at 358.
260. *Id.* at 368–69.

he did not exercise his discretion to make principal distributions to himself.[261]

In the context of some rather egregious circumstances, the court ruled that none of the income distributions from either of the trusts were community property.[262] In doing so, it announced the following rule:

> We conclude that, in the context of a distribution of trust income under an irrevocable trust during marriage, income distributions are community property only if the recipient has a present possessory right to part of the corpus, even if the recipient has chosen not to exercise that right, because the recipient's possessory right to access the corpus means that the recipient is effectively an owner of the trust corpus.[263]

Notwithstanding this language's similarity to the present possessory interest approach adopted in *Long*, as well as the likelihood that the *Sharma* case's outcome would have been the same under that approach, the *Sharma* court's definition of a possessory right is far broader than the standard articulated in *Long*.[264] Although it is clear that "some potential right" to trust principal would not be sufficient to constitute property acquired for marital property characterization purposes, the *Sharma* court concluded that if the trustee "determined that such distributions were necessary for his maintenance[,]" then the beneficiary spouse would have a present possessory right.[265] Although arguably dicta, this rule places *Sharma* more in line with the equitable interest theory advanced in *Ridgell*.[266] As one commentator described, "any interest at all in the corpus" is sufficient to classify all trust income distributable to the beneficiary spouse as community.[267]

In their herculean efforts to find a property interest in a trust upon which to link the characterization of trust income, the *Ridgell* and *Sharma*

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261. *Id.* at 358.

262. *Id.* at 357. The husband filed for divorce within a few months after the marriage. *Id.* If the income from the two trusts had been classified as community property, then as a result of a seventeen-month marriage, the wife would have been entitled to half of the $2,304,018 in trust distributions—all of which had been donated by the husband to charity. *See id.* at 358–59.

263. *Id.* at 364. The quoted language referring to "ownership," similar to the language used by the *Ridgell* court, often sounds like an application of the conduit principle, which treats all trust property as owned by the beneficiary spouse. *See supra* Part III.B. However, whereas the conduit principle subjects undistributed trust income to classification as community property, the equitable interest theory assumes income can only be acquired when distributed by the trustee. *See supra* Part III.B.1.

264. *Id.* at 368; *In re* Marriage of Long, 542 S.W.2d 712, 718 (Tex. Civ. App.—Texarkana 1976, no writ.).

265. *Sharma*, 302 S.W.3d at 362, 365.

266. The *Sharma* court noted that the *Ridgell* opinion "does not distinguish between remainder beneficiaries and income beneficiaries who do not have a present possessory interest in the trust corpus[,] . . . this distinction is significant." *See id.* at 365 n.19. Nonetheless, the latter opinion supports the rule adopted in *Sharma*. *Id.*

267. Stephen M. Orsinger & Harold C. Zuflacht, 25 STATE BAR OF TEX., 32ND ANNUAL MARRIAGE DISSOLUTION INSTITUTE OF THE STATE BAR OF TEXAS, at 10 (2009) [hereinafter Orsinger & Zuflacht].

courts have announced a rule that is not only arbitrary but also divorced from economic reality.[268] Consider the following example of a trust funded by a third party with the following fairly common provisions: (1) the trustee has discretion to distribute income—and if necessary, principal—for the health, education, maintenance, and support of the beneficiary spouse during her lifetime; and (2) any income that the trustee has not distributed is added to the principal at the end of each year. Assume that in Year 1 and Year 2, the trust assets earn interest and dividends of $85,000 and $75,000, respectively, and after determining that the beneficiary spouse needs $80,000 per year, the trustee makes these distributions accordingly. According to the language of the *Sharma* opinion, these distributions would presumably be classified as follows:

	Distribution to Beneficiary Spouse:	Trust Income:	Principal Distributed:	Trust Income Classified as Community Property:
Year 1:	$ 80,000	$ 85,000	None	None
Year 2:	$ 80,000	$ 75,000	$ 5,000	$ 75,000

Because the trustee failed to exercise discretion to distribute any principal in Year 1, the beneficiary spouse would not have a present possessory right to the trust principal and would not acquire any portion of the trust property. Thus, as the *Sharma* opinion suggests, none of the trust income distributed by the trustee would be classified as community property.[269]

But what about Year 2? On the last day of Year 1, the undistributed income is added to principal, and the fiduciary accounting starts over. Because the trustee exercised discretion to distribute principal in Year 2 (to the extent the distribution exceeded trust income), all of the trust income that the trustee distributed to the beneficiary is community property. If that interest in trust principal is considered the property that generates community income, as the *Sharma* opinion indicates, then this mere $5,000 worth of principal is considered to have yielded a 1,500% return on investment.[270] On the other hand, would the *Sharma* court disregard the trust provision that indicates that reclassifies undistributed income as principal each year?

At worst, the *Sharma* opinion offers a formulation of the equitable interest theory that produces arbitrary and absurd results. At best, the *Sharma* opinion poses more questions than answers. For example, the language above gives the trustee the authority to make principal

268. *See infra* note 301 and accompanying text.
269. *See Sharma*, 302 S.W.3d at 364.
270. *See id.*

distributions only after trust income is exhausted. Thus, by its very terms, the trustee must always distribute trust income before trust principal. As such, although the above illustration assumes that the Year 2 trust income becomes community property, one must ask how a beneficiary spouse can acquire income from separate property before acquiring the separate property itself.

Suppose instead that a savvy settlor simply reversed the sequence of two words in this example as follows: the trustee is granted discretion to distribute *principal—and, if necessary, income*—for the health, education, maintenance, and support of the beneficiary spouse during her lifetime. This slight modification would result in practically no difference in the obligations and rights between the trustee and the beneficiary spouse. In either case, the trustee would be liable to the beneficiary spouse according to the same fiduciary standard for distribution, and to the extent of the trust's distributable net income, the beneficiary spouse would still be subject to federal income taxation.[271] However, under the *Sharma* rule, as a result of this one small change, presumably none of the distributions would be classified as community property until *all* trust principal is distributed.[272] As this example and the next section demonstrate, in their theoretically attempts to parse the proverbial trees, the *Ridgell* and *Sharma* courts have not only lost sight of the forest, but they have left the settlor and the trustee with a full battery of chainsaws.

3. The Use and Misuse of Fiduciary Accounting Principles

In the nineteenth century, the choice of trust investments were simple and predictable: stocks and bonds paying quarterly dividends and interest, real estate yielding monthly rents, farms producing annual crops, and ranches raising regular livestock.[273] Using the analog of the legal life estate, settlors could simply designate income beneficiaries and remainder beneficiaries with relative certainty as to what quantum of benefits the settlor would convey.[274] By the end of the twentieth century, however, the scope of available investment vehicles proliferated, and as such, the prudent investor rule increased the demands of the trustee.[275] Unless the trust's

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271. *See* I.R.C. § 662(a) (West 2012).

272. *See Sharma*, 302 S.W.3d at 357.

273. *See, e.g.,* Shepflin v. Small, 23 S.W. 432, 432–33 (El Paso 1893, no writ). *See generally* John H. Langbein & Richard A. Posner, *Market Funds and Trust Investment Law* (1976), FACULTY SCHOLARSHIP SERIES, Paper 498, at 3–5, *available at* http://digitalcommons.law.yale.edu/fss_papers/498.

274. *See* Stephen P. Johnson, *Trustee Investment: The Prudent Person Rule or Modern Portfolio Theory, You Make the Choice*, 44 SYRACUSE L. REV. 1175, 1178 (1993).

275. *See* 4 AUSTIN W. SCOTT ET AL., SCOTT & ASCHER ON TRUSTS § 19.1.7, at 1405 (5th ed. 2007) [hereinafter SCOTT & ASCHER ON TRUSTS] ("A trustee can no longer fulfill the trustee's investment duties merely by investing in property of one or more certain types.").

terms provided otherwise, the trustee is expected to diversify in order to manage risk.[276] The dictates of both the marketplace and the law have evolved away from standards that distinguish between income and principal to simply maximizing "total return."[277] Likewise, the author submits that settlors have become less reliant upon concepts of income and principal in defining the relative interests of beneficiaries.

Effective January 1, 2004, the Texas Legislature adopted modified versions of the Uniform Prudent Investor Act and the Uniform Principal and Income Act (TUPIA).[278] The Uniform Prudent Investor Act delineates the trustee's duties with respect to investing in recognition of "modern portfolio theory" (the centerpiece of which is the duty to diversify investments), all of which may be expanded, restricted, eliminated, or otherwise altered by the terms of the trust.[279] The TUPIA governs the allocation of receipts and disbursements among income beneficiaries and remainder beneficiaries, and one of the primary purposes of this act is "to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of 'income' as traditionally perceived in terms of interest, dividends, and rents."[280] Unlike the marital property characterization principles—which, as indicated in *Arnold*, are constitutionally fixed—the provisions of TUPIA that classify specific items as trust income or trust principal are subject to the following rules:

- Under the terms of the trust, the settlor may expressly define what constitutes income and principal, and in doing so, may deviate entirely from the default rules provided under TUPIA.[281] The settlor may also include provisions that allow the trustee to accumulate income and add the undistributed income to the balance of principal each year.[282]
- The settlor may expressly grant the trustee the discretion to allocate receipts and disbursements between income and principal and deviate entirely from the default rules as

276. *See* 4 SCOTT & ASCHER ON TRUSTS, *supra* note 275, § 19.2, at 1427–34.

277. *See* 4 SCOTT & ASCHER ON TRUSTS, *supra* note 275, § 20.10.2, at 1579.

278. *See* TEX. PROP. CODE ANN. §§ 116.001, et seq., 117.001, et seq. (West 2007 & Supp. 2012) (originally enacted by Acts 2003, 78th Leg., ch. 659, § 1, ch. 1103 § 1).

279. PROP. §§ 117.003(b), 117.005.

280. UNIFORM PRINCIPAL AND INCOME ACT prefatory note (1932) (revised 2000).

281. PROP. § 116.004(a)(1). In the context of marital property characterization, the Texas courts appear to grant the settlor great deference in characterizing what would otherwise by fiduciary accounting income as principal. *See* Taylor v. Taylor, 680 S.W.2d 645, 649 (Tex. App.—Beaumont 1984, writ ref'd n.r.e.).

282. PROP. § 116.004(a)(4).

provided under the TUPIA.[283] The settlor may also excuse the trustee of the duty to exercise such discretion impartially by expressing intent to favor one or more beneficiaries.[284]

- Subject to certain conditions, the TUPIA grants any disinterested trustee the power to adjust between income and principal to the extent the trustee considers it necessary to comply with the prudent investor rule in situations when the trustee is required or authorized to make distributions based on a measure of trust income and cannot otherwise comply with the duty of impartiality to both income and remainder beneficiaries by following the terms of the trust or the TUPIA rules.[285] Included among the many factors the trustee may consider in exercising this power to adjust are the intent of the settlor and the identity and circumstances of the beneficiaries.[286] A court may not override the trustee's decision to exercise or not exercise this discretionary power to adjust unless there is an abuse of discretion by the trustee.[287]
- Under the TUPIA, a trustee is not required to make trust property productive of income unless the settlor claimed the federal gift or estate tax marital deduction with respect to the transfer of property to the trust, the mandatory income beneficiary has not received sufficient amounts of income and principal, and the mandatory income beneficiary has expressly requested that trustee make the trust property productive of income.[288]

Even if the specific classifications set forth in the TUPIA apply—either by default or because the trustee has opted to use them as a safe harbor—those rules may diverge from the judicial characterizations of property acquired during the marriage.[289] While the TUPIA rules generally require an equitable split of mineral royalties between income and principal, for purposes of marital property characterization, such receipts are generally considered proceeds from, or a mutation of, the underlying land.[290]

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283. *See* PROP. § 116.004(a)(2).

284. *See* PROP. § 116.004(b).

285. *See* TEX. PROP. CODE ANN. § 116.005(a), (c)(6), (7) (West 2007 & Supp. 2012).

286. *See* PROP. § 116.005(b)(2), (3).

287. *See* TEX. PROP. CODE ANN. § 116.006(a) (West 2007 & Supp. 2012).

288. *See* TEX. PROP. CODE ANN. § 116.176 (West 2007). *See generally* I.R.C. §§ 2056(a), (b)(5), (b)(7), (b)(8), 2523(a), (e), (f), (g), 2056A (West 2012) (setting forth the requirements of a trust qualifying for the estate and gift tax marital deduction).

289. *See* PROP. § 116.176.

290. *See* TEX. PROP. CODE ANN. § 116.174(a)(3), (d), (e) (West 2007 & Supp. 2012); Norris v. Vaughan, 260 S.W.2d 676, 679–80 (Tex. 1953). In the context of the federal income tax, the Fifth Circuit opted to apply the marital property characterization of oil and gas royalties. *See* Comm'r v.

Within this context, consider the application of the equitable interest theory—as pronounced in the *Sharma* opinion—to a situation in which the settlor expressly grants the trustee the discretion to allocate receipts between income and principal and distribute *either* income or principal (or both) to the beneficiary spouse.[291] During a period when the trust assets generate $100 of dividends and the trustee decides to distribute the $100 to the beneficiary spouse, the trustee could either: (1) classify the $100 in dividends as principal (rather than income); or (2) charge the entire distribution to principal.[292] Either way, the beneficiary spouse would have an equitable interest in trust principal but no interest in trust income. Thus, the trustee could unilaterally prevent what would otherwise constitute income (under both marital property and trust law)—the amount that is now in the hands of the beneficiary spouse—from being characterized as community property. Although the beneficiary spouse could conceivably claim that the *amount* distributed was insufficient, under the circumstances, it is unlikely that the beneficiary spouse could challenge the exercise of the trustee's discretion when it comes to classifications of income and principal.[293] Furthermore, acting alone, the non-beneficiary spouse appears to lack the standing to challenge the exercise of the trustee's discretion because even if the trust income was community in nature, it would also be subject to the beneficiary spouse's sole management authority.[294]

Generally speaking, the relevance of fiduciary accounting principles should be limited to determining *how much* a designated income beneficiary would receive when either: (a) income distributions are mandatory; or (b) discretionary distributions are expressly limited to

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Wilson, 76 F.2d 766, 770 (5th Cir. 1935). The Texas courts have yet to consider the conflict between these two bodies of law.

291. *See supra* Part III.C.2.

292. In a discretionary trust such as this, the trustee has no fiduciary duty to maximize the production of income versus principal. *See* RESTATEMENT (THIRD) OF TRUSTS § 79, cmt. f, at 134 (2007).

293. *See* TEX. PROP. CODE ANN. § 116.006 (West 2007 & Supp. 2012); RESTATEMENT (THIRD) OF TRUSTS § 87, at 242 ("When a trustee has discretion with respect to the exercise of a power, its exercise is subject to supervision by a court only to prevent abuse of discretion.").

294. Cleaver v. George Staton Co., 908 S.W.2d 468, 471 (Tex. App.—Tyler 1995, writ denied). At least one appellate court has allowed a non-beneficiary spouse to conduct discovery with respect to third party-settled spendthrift trusts over which the trustee had "sole discretion" to make distributions to the beneficiary spouse. *See* Lucas v. Lucas, 365 S.W.2d 372, 376 (Tex. Civ. App.—Beaumont 1962, no writ). The beneficiary spouse was receiving annual amounts of $35,000 to $40,000 from the trust for several years that ceased since the petition for dissolution had been filed, and the beneficiary spouse filed a motion to reduce the amount payable in temporary alimony and child support be reduced to $1,000 per month because of a purported lack of funds. *Id.* Said the court, "[W]e think [the non-beneficiary spouse] would be entitled to inquire into the incomes of the various trusts and the amounts, regularity and time of support payments which have been made [to the beneficiary spouse] as beneficiary." *Id.* Although the discovery request was not based on determining whether and to what extent the trust income constituted community property, the court appeared to leave open this possibility. *Id. See also* Havens v. Lee, 694 S.W.2d 1, 2 (Tex. App.—Houston [1st Dist.] 1984, no writ).

income. Outside of these limited contexts, the application of fiduciary accounting principles is generally academic.[295] By defining marital property rights in terms of mutable distinctions between principal and income, subverting the interests of the non-beneficiary spouse becomes little more than an exercise in form over substance for sophisticated settlors, trustees, and the lawyers who advise them.

IV. FACTORS AND NONFACTORS IN CHARACTERIZING TRUST INCOME

While Part III explained the three theoretical approaches that federal and Texas courts have adopted to characterize trust income from a separate property trust, Part IV explores how a number of different circumstances could potentially affect these characterizations under each of these different approaches.[296]

A. The Identity of the Settlor and the Source of Trust Funds

If a beneficiary spouse establishes and funds a trust with separate property, before or during the marriage, the doctrine of mutations dictates that the trust principal should remain the settlor's separate property.[297] The real issue is whether the characterization of income that those trust assets

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295. That said, two commentators have advocated using fiduciary accounting principles to determine character of trust distributions, at least in the context of applying the conduit principle:

> Such an approach is consistent with community property law, if it is accepted that trust property is neither community nor separate, but property of the trust. From this point of view, the collective rights of the beneficiary, viewed as an abstraction, are considered as the "property" from which the income flows, and distributions are classified as community income when made out of income of the trust, as determined for trust accounting purposes, much as corporate dividends are community income when declared in cash or property out of accumulated corporate profits.

Branscomb & Miller, *supra* note 140, at 718. But as other commentators are keen to point out, a trust is not an entity like a corporation. *See, e.g.,* Thomas M. Featherston, Jr., *Texas Family Property: Integrating Trusts & Estates & Marital Property Law*, 36 STATE BAR OF TEX., 32ND ANNUAL ADVANCED ESTATE PLANNING & PROBATE COURSE, at 40 (2008). Although a board of directors can elect to pay a dividend, it has far less discretion to determine what constitutes "net assets" or "surplus" available for distribution than a trustee would have. Compare TEX. BUS. ORG. CODE ANN. § 21.314(a) (West 2012) with TEX. PROP. CODE ANN. §§ 116.004(a)(2), (b), 116.005 (West 2007 & Supp. 2012). Generally Accepted Accounting Principles (GAAP) and other objective methods of accounting mandated in the commercial context are far less flexible than the TUPIA classifications, and a board's deviation from these methods of accounting is far more likely to result in adverse consequences than a trustee's deviation from the TUPIA. *See generally* S.E.C. v. Caserta, 75 F.Supp.2d 79, 90–92 (E.D.N.Y. 1999) (discussing the role of GAAP in federal securities actions). For example, the Texas Trust Code grants a trustee broad discretion to make an allowance for depreciation. *See* TEX. PROP. CODE ANN. § 116.203 (West 2007). By contrast, if a business enterprise fails to make an appropriate allowance for depreciation "contrary to commercial custom and usage," it could be liable for "false and misleading" financial statements. *See* Cameron v. First Nat'l Bank of Galveston, 194 S.W. 469, 474 (Tex. Civ. App.—Galveston 1917, writ ref'd).

296. *See infra* Part IV.

297. *See* Ridgell v. Ridgell, 960 S.W.2d 144, 149 (Tex. App.—Corpus Christi 1997, no pet.).

generate during the marriage is affected by the fact that the beneficiary spouse transferred the assets to the trust.

Several lower appellate courts have applied the no-greater-interest/present possessory interest rule to self-settled trusts, at least when the trustee had discretion to distribute income to the beneficiary spouse.[298] As discussed later in this section, these holdings beg an important question: By simply transferring the property to an irrevocable trust where the spouse retains the income interest, can a spouse change the character of trust income from separate property without the consent of the other spouse? By doing so, has the settlor spouse lost anything or given anything away in the process? Or does such a trust merely serve as a vehicle to do what the spouse could not otherwise do under the Texas constitution?

The *Mercantile National Bank* case also involved a self-settled trust, although nothing in the opinion explicitly linked this circumstance to the dicta adopting the conduit principle.[299] In his support of the conduit principle, Professor Davis has argued that the Texas Supreme Court's rulings in *Herring* and in *Brown v. Lee* "clearly demonstrate that the community property system of Texas forms a pattern whereby constitutionally the property rights of the spouses are definitely fixed, and cannot be enlarged or diminished by legislative, judicial or contractual processes, even though the contractual process is attempted by means of a spendthrift discretionary trust."[300] As previously discussed, the application of the conduit principle unduly sacrifices all concerns for settlors' legitimate property rights at the altar of article XVI, section 15 of the constitution.[301] As the settlor's identity changes, however, Professor

298. *See* Lipsey v. Lipsey, 983 S.W.2d 345, 347–51 (Tex. App.—Fort Worth 1998, no pet.); Lemke v. Lemke, 929 S.W.2d 662, 664–65 (Tex. App.—Fort Worth 1996, writ denied); *In re* Marriage of Burns, 573 S.W.2d 555, 556–58 (Tex. Civ. App.—Texarkana 1978, writ dism'd); Shepflin v. Small, 23 S.W. 432, 433 (Tex. Civ. App.—El Paso 1893, no writ).

299. *See* Mercantile Nat'l Bank at Dall. v. Wilson, 279 S.W.2d 650, 653 (Tex. Civ. App.—Dallas 1955, writ ref'd n.r.e.). The *Sharma* court distinguished the *Mercantile National Bank* case as involving a situation in which the beneficiary spouse, as both the sole settlor and the sole beneficiary, could not make a gift of the trust property to herself. Sharma v. Routh, 302 S.W.3d 355, 366 n.20 (Tex. App.—Houston [14th Dist.] 2009, no pet.). Thus, no portion of the trust income could be considered separate property. *Id.*

300. Davis, *supra* note 163, at 976. *See* Brown v. Lee, 371 S.W.2d 694, 699 (Tex. 1963). In the *Brown* case, the court ruled that where an insured-husband and beneficiary-wife died in a common disaster, the proceeds from the life insurance policies acquired with community funds constituted community property. *Id.* As such, one-half of the proceeds passed under the laws of descent and distribution to the wife's heir, which was, under the statutes governing survival in the case of the simultaneous deaths of the insured and beneficiary of a life insurance policy, the estate of the insured husband. *Id.* at 696–97. Curiously enough (given Professor Davis's position regarding the rule of implied exclusion), a majority of the court rejected the notion that its ruling ran afoul of the dictates of *Arnold* by allowing a statute to supersede the constitutional definitions of marital property. *See id.* at 697–98.

301. *See supra* Part III.B.2.

Davis's argument becomes more persuasive.[302] Unlike the laws in Louisiana and Wisconsin, the Texas constitution does not allow a spouse to unilaterally change the character of income from separate property.[303] Therefore, a spouse should not be able to fund a trust with her own separate property for her own benefit during the marriage and by doing so unilaterally change the nature of income that would otherwise classified as community property into separate property.[304]

Other commentators suggest that if the beneficiary spouse is also the settlor, the other spouse "should be able to pierce the trust's veil to establish the marital character of actual trust distributions or even the retained interest of the settlor/spouse."[305] However, in the absence of any facts giving rise to an alter ego claim, simply allowing a court to access all of the trust income could have the effect of subverting the settlor spouse's legitimate right to identify her own beneficiaries without necessarily advancing the precepts of Texas marital property law.[306]

B. The Powers of the Spouse as Beneficiary

Under the no-greater-interest/present possessory interest rule, the assets of a revocable trust—over which the settlor spouse clearly holds a possessory right—would be characterized as her separate property, and all income from the trust would be characterized as community property.[307] The same is true of an irrevocable trust over which the beneficiary spouse holds a general power of appointment, or more specifically, the power to

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302. Note that the court in the *Wilmington Trust* case distinguished the *Mercantile National Bank* holding on the grounds that the trust in the latter case was self-settled and the settlor spouse "had an expectation of recapturing the corpus of the trust during her lifetime." Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 11 (1983), *aff'd*, 753 F.2d 1055 (Fed. Cir. 1985).

303. *See* discussion *supra* Part II.A.3.

304. *See* Ridgell v. Ridgell, 960 S.W.2d 144, 149 (Tex. App.—Corpus Christi 1997, no pet.).

305. Featherston & Springer, *supra* note 74, at 903. *See infra* Part IV.C. Although no party has ever made an alter ego claim in a Texas case involving a self-settled trust, the courts have mentioned that such a claim could theoretically exist with the appropriate facts. *See* Lemke v. Lemke, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied); *In re* Marriage of Burns, 573 S.W.2d 555, 556 (Tex. Civ. App.—Texarkana 1978, writ dism'd).

306. In this regard, a spouse is free to give away her separate property without the consent of the other spouse even if it has the potential to generate income that would belong to the community. *See* FAM. § 3.101; Bohn v. Bohn, 455 S.W.2d 401 (Tex. Civ. App.—Houston [1st Dist.] 1970, writ dism'd). By the same token, the interests of third party beneficiaries in a trust funded with separate property for which the settlor spouse has no present possessory right should not be infringed in the interest of protecting the community estate. *See supra* Part II.C. Rather, a remedy that balances the legitimate interests of marital property law and trust law should simply prevent the settlor-spouse from having her cake and eating it too—receiving the benefit of income earned during the marriage from separate property while maintaining its character as separate property. *See infra* Part V.

307. *See supra* Part III.A.2. In this regard, a certain degree of caution is appropriate for spouses who move to Texas with separate revocable trusts that generate income intended to be each settlor spouse's own separate property. An express agreement between the spouses that meets constitutional requirements is the best resolution for this problem. *See supra* Part II.A.1.

appoint trust property to herself.[308] This is essentially the same present possessory right—the right would allow the beneficiary spouse to withdraw half of the trust assets at the age of thirty—that the court in *Long* discussed.[309] It is also common for a trust instrument to grant a beneficiary "Crummey" rights that allow the beneficiary to withdraw the lesser of the amount that a third party gifts to the trust or the amount of the third party's available annual gift tax exclusion.[310] Arguably, income that the trust earns from the property subject to the power during the time that the right is exercisable should also be characterized as community property.

The *Long* court did not address what would happen if the beneficiary spouse's present possessory right expired before the beneficiary spouse exercised that right. For federal gift tax purposes, the lapse of a general power of appointment by a beneficiary spouse may be considered a gift by the beneficiary spouse back to the trust.[311] Although a Texas statute provides that a beneficiary does not become a settlor of a trust merely because that beneficiary holds certain general powers of appointment or because that beneficiary allows such powers to lapse, the statute's applicability is limited to determining whether the beneficiary's exposure to creditor claims is proper.[312]

C. The Identity of the Trustee

In the relatively few reported cases in which the court mentions that the beneficiary spouse served as the trustee of a separate property trust, the circumstance was not dispositive.[313] In the *Sharma* case, the court merely noted that "[the non-beneficiary spouse] did not allege, and [she] does not assert on appeal, that the trusts were created, funded, or operated in fraud of her rights, nor has she pleaded that the trusts should be disregarded or that

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308. *See supra* Part III.A.2. For federal estate and gift tax purposes, a beneficiary holds a general power of appointment over any portion of a trust that the beneficiary may appoint to herself, her estate, her creditors, or the creditors of her estate, resulting in an inclusion of the assets subject to the power in the beneficiary's taxable estate if the beneficiary still holds the power upon her death or a taxable gift if the power is exercised for another person or released during the beneficiary's lifetime. *See* I.R.C. §§ 2041, 2514 (West 2012). However, as an exception to the statutory rule, a general power of appointment over assets constituting no more than the greater of 5% of the value of the trust assets or $5,000 may lapse without estate or gift tax consequences. *See* I.R.C. §§ 2041(b)(2), 2514(e).

309. *See In re* Marriage of Long, 542 S.W.2d 712, 715 (Tex. Civ. App.—Texarkana 1976, no writ).

310. *See* Crummey v. Comm'r, 397 F.2d 82, 87–88 (9th Cir. 1968); Georgiana J. Slade, *Personal Life Insurance Trusts*, 807-2ND TAX MGMT. PORT. (BNA) at A-11 (2009). In some cases, these rights expire within some fixed period after making a gift to the trust (e.g., thirty days), and in other cases, *Crummey* rights may "hang" on for longer periods as is necessary for avoidance of adverse estate and gift tax consequences to the beneficiary. *See* Slade at A-17–19.

311. *See* Slade, *supra* note 310, at A-17.

312. *See* TEX. PROP. CODE ANN. § 112.035(d), (e)(2), (f)(3) (West 2007 & Supp. 2012).

313. *See, e.g.*, Sharma v. Routh, 302 S.W.3d 355, 358 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

the trusts are [the beneficiary spouse's] alter egos."[314] That said, the case law does not indicate how these claims might apply in the context of a trust relationship.[315]

The only situation in which the fraud on the spouse claim can apply is when a spouse gratuitously transfers her special community property, over which she has sole rights of control, to a third party with the actual intent to deprive the other spouse of the use and enjoyment of the assets or to the extent that the amount transferred is capricious or excessive.[316] Under the Spanish rule, the fraud on the spouse claim does not apply to transfers of separate property despite the fact that all separate property has the potential to generate community income.[317] As such, in the context of a separate property trust, a claim of fraud on the non-beneficiary spouse would be necessarily limited to challenging the exercise of the trustee spouse's discretion to not make distributions of trust income to herself and allow the trust income to pass to the other trust beneficiaries.

The alter ego theory generally allows a trial court to pierce the veil of the corporate form, and this theory holds individuals liable for corporate debt when "it appears that the individuals are using the corporate entity as a sham to perpetrate a fraud, to avoid personal liability, avoid the effect of a statute, or in a few other exceptional situations."[318] In the context of divorce, the alter ego theory provides an equitable remedy independent of the right of reimbursement for the community to directly characterize corporate assets as part of the community estate.[319] Although a Texas trust is a relationship between legal and equitable owners of property and not an entity, the courts often fail to appreciate the difference.[320] That said, assuming that the applicable analogs for a shareholder and for an officer or director of a corporation are the beneficiary and the trustee, respectively, the non-beneficiary spouse must establish the following: "(1) unity between the separate property [trust] and the [beneficiary] spouse such that the separateness of the [trust] has ceased to exist, and (2) the [beneficiary]

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314. *Id.* at 366.

315. Although it is difficult to imagine how claims of fraud on the spouse or the alter ego theory could apply when the beneficiary spouse has no formal authority over the trust assets, two appellate courts mentioned these claims in the context in which the beneficiary spouse was not the trustee. *See In re* Marriage of Burns, 573 S.W.2d 555, 556–67 (Tex. Civ. App.—Texarkana 1978, writ dism'd); Lemke v. Lemke, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied).

316. *See* Horlock v. Horlock, 533 S.W.2d 52, 55 (Tex. Civ. App.—Houston [14th Dist.] 1975, writ dism'd w.o.j.); Givens v. Girard Life Ins. Co. of Am., 480 S.W.2d 421, 424 (Tex. Civ. App.—Dallas 1972, writ ref'd n.r.e.) *superseded by statute*, Act of June 6, 1991, 72nd Leg., R.S., ch. 242, § 11.03, 1991 TEX. GEN. LAWS 1043–45 (current version at TEX. INS. CODE §§ 542.051–.061).

317. *See Givens*, 480 S.W.2d at 424–26.

318. Torregrossa v. Szelc, 603 S.W.2d 803, 804 (Tex. 1980) (quoting Pace Corp. v. Jackson, 284 S.W.2d 340, 351 (Tex. 1995)). *See generally* Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986).

319. *See* Zisblatt v. Zisblatt, 693 S.W.2d 944, 952 (Tex. App.—Fort Worth 1985, writ dism'd).

320. *See In re* Marriage of Burns, 573 S.W.2d 555, 557 (Tex. Civ. App.—Texarkana 1978, writ dism'd) (referring to the eight trusts as "entities"); Orsinger & Zuflacht, *supra* note 267, at 13.

spouse's improper use of the [trust] damaged the community estate beyond that which might be remedied by a claim for reimbursement."[321] Thus, based on the cases involving corporations, the mere fact that one spouse is both the sole trustee and the sole beneficiary does not support an alter ego claim.[322] Even if the beneficiary spouse acts as the trustee and uses the trust funds like her own personal pocketbook, the non-beneficiary spouse must demonstrate a loss to the community, such as a lack of compensation for services provided as trustee.[323]

D. Mandatory Versus Discretionary Distributions and the Naked Income Interest

Some commentators are tempted to oversimplify the characterization of trust income from a separate property trust on the basis of whether the trustee *must* distribute the income to the beneficiary spouse during the marriage.[324] However, more nuanced considerations exist under Texas case law.

As an initial matter, one must necessarily consider the following threshold questions: By what means is an income interest in a trust acquired for marital property characterization purposes? Does a beneficiary spouse acquire trust income when the property transfers to the trust and the spouse becomes a beneficiary? Or is trust income acquired only when it is earned? Or, in the case of a discretionary trust, is trust income acquired only when the trustee exercises discretion to make a distribution to the beneficiary spouse? Is *when* even the right question to ask? Perhaps, *how* is the more relevant question.

Under the no-greater-interest/present possessory right rule, the question of timing of acquisition is separate from the question of how acquisition occurs. In other words, acquisition occurs when the beneficiary spouse actually or constructively receives the trust property or income; but

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321. Lifshutz v. Lifshutz, 61 S.W.3d 511, 517 (Tex. App.—San Antonio 2001, pet. denied) (alterations supplied) (citations omitted). *See also* Robbins v. Robbins, 727 S.W.2d 743, 746 (Tex. App.—Eastland 1987, writ ref'd n.r.e.); Zisblatt v. Zisblatt, 693 S.W.2d 944, 950–51 (Tex. App.— Fort Worth 1985, writ dism'd).

322. *See Robbins*, 727 S.W.2d at 747; Goetz v. Goetz, 567 S.W.2d 892, 896 (Tex. App.—Dallas 1976, no writ). In the corporate context, a successful alter ego claim often involves the underpayment of salary or other diversions of personal time and efforts towards enhancing the value of corporate separate property. *See, e.g.*, Young v. Young, 168 S.W.3d 276, 282–83 (Tex. App.—Dallas 2005, no pet.).

323. *See Lifshutz*, 61 S.W.3d at 518. Under the equitable interest theories espoused in the *Ridgell* and *Sharma* opinions, it is at least conceivable that the non-beneficiary spouse could assert that the beneficiary spouse failed to exercise its discretion as trustee in a manner that would result in the distribution of community income. *See* Sharma v. Routh, 302 S.W.3d 355, 361–62 (Tex. App.—Houston [14th Dist.] 2009, no pet.); Ridgell v. Ridgell, 960 S.W.2d 144, 147–50 (Tex. App.—Corpus Christi 1997, no pet.).

324. *See, e.g.*, LEOPOLD, *supra* note 32, § 6.11 ("Under general principles of Texas law, all income from a trust consisting of separate property which must be paid to a spouse during the marriage is community property.").

if the trust was funded prior to marriage or funded by gift, the *means* of acquiring the trust income is the same regardless of the timing.[325] Thus, the distinction between mandatory and discretionary provisions is relevant only after—and to the extent that—the beneficiary spouse has acquired the unfettered right to possess the property that generated the trust income.

Under the conduit principle, the beneficiary spouse is treated as the true owner of the underlying trust property.[326] In this regard, the *Sharma* court made the following observation:

> [T]hough the *Arnold* case did not involve trust income or a devise or gift of income, the *Arnold* court suggested that, if a spouse owns the property that generates income during the marriage, then the income results from the ownership of the property rather than any gift or devise that may have bestowed the income-generating property on the spouse in the past.[327]

Although the *Sharma* court did not adopt the conduit principle, the court's reasoning seems to be particularly applicable to the conduit principle. The timing and means of acquisition are both tied to the generation of income by the trust property, and the standard for distribution—whether mandatory or discretionary—is irrelevant.[328]

In the context of the equitable interest theory, addressing these questions is more complicated. For the equitable interest theory to apply in such a way that any trust income could ever be classified as community property, one must necessarily reject the notion that an income interest in a trust can be acquired by the same means and at the time when the spouse first becomes a beneficiary.[329] This assumption is not without valid

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325. *See* Cleaver v. Cleaver, 935 S.W.2d 491, 493 (Tex. App.—Tyler 1996, no writ) ("[The beneficiary spouse's] income from the trust is her separate property because her interest was established before her marriage and was conveyed by gift or devise.").

326. *See supra* Part III.B.1.

327. Sharma v. Routh, 302 S.W.3d 355, 361–62 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

328. In support of this contention, Professor Davis cited *Gohlman, Lester & Co. v. Whittle*, a case that involved a creditor claim against cotton grown on the wife's separate land pursuant to a contract executed by her husband and distinguished between the management and ownership rights of the spouses. Gohlman, Lester & Co. v. Whittle, 273 S.W. 808, 809 (1925). That is, even though a spouse may have sole rights of management and control over certain community income, the income still belongs to the community. *See id.* Professor Davis views this opinion as "authority for the principle that although a trustee may have exclusive control of income arising from the corpus of a trust during marriage the fact of such control does not change the status of the income as community property." Davis, *supra* note 163, at 902, 975. To be sure, certain opinions imply that the spouse who holds management rights over community property acts as trustee for the other. *See* Howard v. Commonwealth Bldg. & Loan Ass'n, 94 S.W.2d 144, 145 (Tex. Comm'n. App. 1936). But to compare the duties that a managing spouse owes to the other spouse under Texas marital property law to all of the powers and duties that all trustees owe under all trusts is dubious at best. With respect to separate property, no spouse owes any duties to the other spouse. *Cleaver*, 935 S.W.2d at 496. Unlike the general fiduciary duty of a trustee, a spouse may simply choose to make the separate property unproductive. *See* TEX. PROP. CODE ANN. § 117.004(c)(5), (7) (West 2007).

329. *See* Branscomb & Miller, *supra* note 140, at 713.

criticisms—namely, why is an income interest any less of a property right than an interest in trust principal? Generally speaking, when a settlor funds the trust and a spouse becomes a beneficiary, she receives a bundle of rights that are enforceable against the trustee, including the right (albeit limited) to compel the trustee to make the property productive of income.[330] Simply based on the fact that the income has not yet been earned, why is it necessary to unbundle these rights and parse the equitable interests between principal and income?

To characterize trust income as community property as it is earned, one must necessarily take the position that such income was, in fact, generated from property the spouse already acquired.[331] Under the equitable interest theory, this property right is an equitable interest in principal.[332] However, in the context of a naked income interest—when the beneficiary spouse can never receive any of the underlying trust property—this basis for characterizing trust income falls apart.

In the early income tax cases, both the Fifth Circuit and the United States Supreme Court simply presumed from the existence of an income interest there was always some underlying interest in the trust property.[333] Prior to a Texas constitutional amendment that specifically addressed the character of income from interspousal gifts, the Fifth Circuit maintained this position in the context of the federal estate tax.[334] With respect to naked income interests, however, the United States Claims Court and the Federal Circuit Court of Appeals came to a contrary conclusion in the *Wilmington Trust* case.[335] These courts recognized that because the beneficiary spouse never acquired any interest in the trust principal, the principal never became the beneficiary spouse's separate property, and thus, such trust income could never be classified as community property.[336] Although some commentators have suggested that the *Wilmington Trust* decision ended the debate, only one Texas appellate court has ruled upon the characterization of a naked income interest.[337] It is clear that the result

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330. *See supra* Part II.B.

331. *See supra* Part III.C.

332. *See supra* Part III.C.

333. *See* TEX. PROP. CODE ANN. § 116.176 (West 2007). *See also supra* Part III.C.I.

334. Wyly v. Comm'r, 610 F.2d 1282, 1289 (5th Cir. 1980).

335. Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 14 (1983), *aff'd*, 753 F.2d 1055 (Fed. Cir. 1985).

336. *See id*.

337. Featherston & Springer, *supra* note 74, at 902. *Cleaver v. Cleaver* involved a testamentary trust established for the benefit of a wife when she was thirteen years old. Cleaver v. Cleaver, 935 S.W.2d 491, 492–93 (Tex. App.—Tyler 1996, no pet.). Approximately two years into the marriage, the wife attained the age of twenty-one and became eligible to receive mandatory distributions of income, with her children to receive the remainder upon her death. *Id.* However, the third party trustee was also the manager of several business interests held as part of the trust estate and made scant dividends or other disbursements from the business entities during the marriage. *Id.* at 493. As a result, upon divorce, the characterization issues centered on the undistributed income of the businesses. *See id.* at 496. Because the husband conceded that the wife's interest as a beneficiary of the trust was her separate

would be the same under the permutation of the equitable interest theory that the courts in *Ridgell* and *Sharma* both adopted.[338] That is, to characterize trust income as community property, the beneficiary spouse must have some actual interest in principal.[339]

Nonetheless, other commentators have suggested that courts should distinguish between mandatory and discretionary standards for distributions of income when it comes to marital property characterization.

> A better approach to the resolution of the issue is to focus on the nature of the interest of the spouse/beneficiary in the trust. A spouse/beneficiary who has a mandatory interest in the income (i.e., the income must be paid on a periodic basis to the beneficiary) has an interest in the trust very similar to a life tenant's interest; accordingly, income distributed to a spouse/beneficiary pursuant to a mandatory income interest should be community property. However, if the spouse/beneficiary has a discretionary interest in the trust's income, the income distributed in the discretion of the trustee should have a separate character like a gift.[340]

That is, in the context of a discretionary income interest, the trustee is the real donor, and as such, the beneficiary may not acquire the property by gift until the trustee actually chooses to make a distribution.[341] But in the context of a third party-settled trust, regardless of who the donor is and when the trust earns income, these arguments fail to address one critical question: How is a mandatory income interest any more or any less acquired by gift than a discretionary income interest? In other legal contexts, the trustee's exercise of discretion is not considered a gift by the trustee unless it is made pursuant to a general power of appointment.[342] Even if one considers the trustee's exercise of discretion as the completion of a gift by the settlor, the ultimate means of acquisition is the still the

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property received prior to marriage, the court never actually ruled upon the issue of whether a naked income interest constitutes community property. *Id.* at 493–94. Rather, the court applied the present possessory interest rule set forth in the *Long* opinion and held that to the extent that the wife earned the dividends but did not receive them at the time of the divorce, the wife held a present possessory interest in the trust property, and the trust income that was generated from those undistributed dividends would constitute community property. *Id.* at 196.

338. *See supra* Part III.C.2.

339. Sharma v. Routh. 302 S.W.3d 355, 372 (Tex. App.—Houston [14th Dist.] 2009, no pet.). In this respect, the *Sharma* court makes a the following curious distinction: Whereas an interest in the income of a trust established by a third party can only be acquired by gift or devise, an interest in both the income and the principal of a trust established by a third party can be acquired by some other means. *Id.* at 361–62.

340. Featherston & Springer, *supra* note 74, at 902.

341. Counts, *supra* note 209, at 916–17. *But see* Branscomb & Miller, *supra* note 140, at 714 (adopting a rule that distinguishes between mandatory and discretionary income interests necessarily "create[s] a difficult problem of determining in each particular case whether the degree of discretion over trust distributions is sufficient to preclude a community character for the distributions").

342. *See, e.g.*, I.R.C. §§ 2514(c)(1); Rev. Rul. 78-398, 1978-2 C.B. 237.

original trust instrument, regardless of whether distributions are mandatory or discretionary.[343]

E. Distributed Versus Undistributed Income

Under the no-greater-interest/present possessory right rule, the marital property characterization of the beneficiary spouse's interest in trust income does not depend on whether the trustee actually makes a distribution to beneficiary spouse.[344] Rather, to the extent (and only to the extent) that the beneficiary spouse has an unfettered right to the underlying trust assets, the income that is generated from such assets would be considered community property regardless of whether the trustee distributes it or not.[345]

Under the conduit principle, whether the trustee distributes the income is irrelevant. Because the beneficiary spouse is considered the true owner of the trust property, the trust income would always be considered community property.[346] This aspect highlights the most significant criticism of the conduit principle—permitting the non-beneficiary spouse to invade the trust to acquire the undistributed income could damage the interests of non-spouse beneficiaries who could be entitled to such income and subverts the settlor's rights to designate who benefits from the trust property and how.[347] If the beneficiary spouse did not receive any benefit and is not unconditionally entitled to receive a benefit from the trust income, then the non-beneficiary spouse has little to complain about in any equitable sense.[348] That said, this criticism of the conduit principle is far less persuasive when the beneficiary spouse is also the settlor.[349]

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343. *See* GERRY W. BEYER, TEXAS TRUST LAW: CASES AND MATERIALS 2 (2d ed. 2007) ("[T]he payments made to or for the benefit of the beneficiary must be consistent with the instructions in the trust instrument.").

344. *See* McClelland v. McClelland, 37 S.W. 350, 359 (Tex. Civ. App. 1896, writ ref'd).

345. *See In re* Marriage of Long, 542 S.W.2d 712, 717 (Tex. Civ. App.—Texarkana 1976, no writ).

346. *See supra* Part III.B; Branscomb & Miller, *supra* note 140, at 722.

347. *See supra* note 209 and accompanying text.

348. For the same reasons, the courts will protect the undistributed interest of a beneficiary in a spendthrift trust from the beneficiary's own creditors—at least when the beneficiary has not funded the trust. *See* Parscal v. Parscal, 148 Cal. App. 3d 1098, 1102–03 (1983). As one appellate court has noted:

> The doctrine that property may be made inalienable by such declaration of [a spendthrift] trust rests upon the theory that a donor has the right to give his property to another upon any conditions which he sees fit to impose, and that, inasmuch as such a gift takes nothing from the prior or subsequent creditors of the beneficiary to which they previously had the right to look for payment, they cannot complain that the donor has provided that the property or income shall go or be paid personally to the beneficiary and shall not be subject to the claims of creditors.

Id. at 1100. *See also* Nichols v. Eaton, 91 U.S. 716, 727 (1875) ("Why a parent, or one who loves another, and wishes to use his own property in securing the object of his affection, as far as property can do it, from the ills of life, the vicissitudes of fortune, and even his own improvidence, or incapacity for self-protection, should not be permitted to do so, is not readily perceived.").

349. *See supra* Part IV.A. *See also Parscal*, 148 Cal. App. 3d at 1103.

Under the equitable interest theory that the courts in both *Ridgell* and *Sharma* adopted, it would appear that only the trust income that is distributed to the beneficiary spouse could be classified as community property, at least when a spendthrift trust is involved.[350] To be sure, the language of the *Ridgell* opinion is somewhat ambiguous on this point, and the *Sharma* court only ruled upon the characterization of distributed trust income.[351] But what distinguishes this permutation of the equitable interest theory from the conduit approach is that under the former, the mere earning of income within the trust is not the equivalent of the beneficiary spouse's acquisition of income.[352] Rather, only the income that the trustee distributes during the marriage is considered acquired during the marriage, provided the beneficiary spouse had the requisite interest in trust principal.[353]

F. Spendthrift Provision

If a court upholds the principles of protecting settlors' property rights to dispose of their property as they wish, it would seem that the same court must also honor any spendthrift provision vis-à-vis the claims of a non-beneficiary spouse. Unfortunately, most of the reported cases that mention the presence or the absence of a spendthrift provision also fail to indicate how this aspect would make a difference when characterizing trust income.[354]

In holding that a non-beneficiary spouse in a divorce cannot reach the undistributed income of a third party-settled trust, the *McClelland* court pointed out that the will in question had in effect created a spendthrift trust.[355] Although there was no explicit connection made in that opinion, the presence of the spendthrift provision (preventing beneficiary spouses from assigning or transferring their beneficial interests) would be relevant if the test for characterizing trust income was based upon the notion that the non-beneficiary spouse could have no greater interest than that of the beneficiary spouse.[356]

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350. *See supra* Part III.C.2.

351. *See id*. *See also* Sharma v. Routh, 302 S.W.3d 355, 362 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

352. *See supra* Part III.C.

353. *See id*. Whether trust income is distributed or not may be irrelevant under an equitable interest theory if the law considers the interest in the trust income as property the beneficiary acquired by gift or devise and thus, always separate property in the context of a third party-settled trust. *See supra* note 214 and accompanying text.

354. *See In re* Marriage of Burns, 573 S.W.2d 555, 556–67 (Tex. Civ. App.—Texarkana 1978, writ dism'd); Buckler v. Buckler, 424 S.W.2d 514, 515 (Tex. Civ. App.—Fort Worth 1967, writ dism'd); Mercantile Nat'l Bank v. Wilson, 279 S.W.2d 650, 659 (Tex. Civ. App.—Dallas 1995, writ ref'd); Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 8 (1983), *aff'd*, 753 F.2d 1055 (Fed. Cir. 1985).

355. McClelland v. McClelland, 37 S.W. 350, 358 (Tex. Civ. App. 1896, writ ref'd).

356. *See id.*

Under the conduit principle, the existence of a spendthrift provision appears to have no effect on the character of trust income. Citing *Herring v. Blakeley*, Professor Davis argued that because the non-beneficiary spouse does not stand in the position of a creditor, the non-beneficiary spouse's community property rights are not affected.[357]

In the federal income tax cases adopting a presumptive equitable interest theory, the Fifth Circuit observed that, assuming *arguendo* that a settlor *could* unilaterally characterize trust income as separate property within the terms of the trust, "[t]here is nothing in the fact that a trust is a spendthrift trust designed to protect property from creditors and from alienation by the beneficiary from which such an inference or implication could be drawn."[358] In contrast to *McClelland*, the federal income tax cases suggest that the effectiveness of a spendthrift protection clause depends on whether the trustee distributed the income in question.[359] In *Ridgell*, the Corpus Christi Court of Appeals adopted the same position.[360] On the other hand, the *Lemke* court found that because the spendthrift provision limited the right of the beneficiary spouse to possess the trust income and principal and the trustee had discretion to make distributions, the undistributed trust income could not be classified as community property.[361]

In any event, no court has treated the non-beneficiary spouse like a creditor of the beneficiary spouse in the context of a spendthrift trust; rather, the courts have considered how the spendthrift provision affected the beneficiary spouse's rights to the trust income and the trust principal.[362] In this regard, at least with respect to the no-greater-interest/present possessory right rule, the absence of a spendthrift provision could conceivably be relevant. That is, if a beneficiary spouse could transfer her beneficial interest for value to a third party, then the argument could be made that she holds a present possessory right. That said, the only two courts that have expressly considered the characterization of income from both spendthrift trusts and non-spendthrift trusts made no distinction between the two.[363]

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357. *See* Davis, *supra* note 163, at 978.

358. Comm'r v. Porter, 148 F.2d 566, 568 (5th Cir. 1945). *See also* Comm'r v. Sims, 148 F.2d 574 (5th Cir. 1945).

359. *See Porter*, 148 F.2d at 568–69. *See also McClelland*, 37 S.W. at 358.

360. Ridgell v. Ridgell, 960 S.W.2d 144, 149 (Tex. App.—Corpus Christi 1997, no pet.).

361. Lemke v. Lemke, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied). However, *Lemke* involved self-settled trusts. *See id.* at 663. As such, the income and assets of the trust would not have been protected from the claims of the creditors of the beneficiary spouse. *See* TEX. PROP. CODE ANN. § 112.035(d) (West 2007).

362. *See* Davis, *supra* note 163, at 978.

363. *In re* Marriage of Burns, 573 S.W.2d 555, 556–57 (Tex. Civ. App—Texarkana 1978, writ dism'd); Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 8 (1983).

G. Expressions of the Settlor's Intent

Under Texas law, a third party donor cannot create community property by making a gift to a married couple.[364] But can a third party settlor change the marital property characterization of a trust income by including express terms within the trust? Under the current law, the answer is unclear but such language could not hurt.[365]

In characterizing trust income in the context of divorce, the *McClelland* court noted the following:

> It is not the purpose and object of the statutes that create the community interest of husband and wife in property to prevent a testator from making a disposition of his property to either upon conditions and trusts [that] limit the right of the beneficiary, or restrict his interest to a limited extent, and define what its character shall be. This is the right of the testator. The law did not impose upon him the duty of devising and bequeathing his property to his son, and when he elected to do so he had the authority to determine what interest in his estate the son should enjoy; and, having defined this interest, the wife, by force of community statutes, could not exceed and extend it.[366]

However, some commentators have since asserted that the Texas Supreme Court overruled this aspect of the *McClelland* opinion.[367] Specifically, the court in *Arnold* effectively prohibited private parties from altering the character of community property through "contractual processes" except those specifically authorized by the Texas constitution.[368]

In any case, the no-greater-interest/present possessory right rule implicitly recognizes that a non-beneficiary spouse is not intended to be a trust beneficiary.[369] A non-beneficiary spouse can only earn trust income from trust property that the beneficiary spouse acquired, either actually or constructively.[370]

Because the conduit principle allows a court to disregard the trust relationship and directly award the undistributed income to the non-beneficiary spouse, courts that adopt this principle would not likely care about the settlor's intent within the trust instrument. In *Mercantile National Bank*, the only case with dicta that supports the conduit principle, the trust

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364. *See* Jones v. Jones, 804 S.W.2d 623, 627 (Tex. App.—Texarkana 1991, no writ).

365. *See* SPEER & OAKES, *supra* note 52, § 451, at 32–33 (illustrating an example of language a settlor should include in the terms of a trust).

366. McClelland v. McClelland, 37 S.W. 350, 358 (Tex. Civ. App. 1896, writ ref'd). *See* Branscomb & Miller, *supra* note 140, at 723–25. *See generally* Sullivan v. Skinner, 66 S.W. 680 (considering a bequest to the wife "for her sole and separate use").

367. *See* Branscomb & Miller, *supra* note 140, at 723.

368. *See* Davis, *supra* note 163, at 976.

369. *See McClelland*, 37 S.W. at 358.

370. *See id.*

did not contain a provision regarding the characterization of income, although the court did note that the trustee could not play accounting games with accumulated income to avoid characterization as community property.[371]

In contrast, certain courts that have adopted the equitable interest theory have noted the importance of the settlor's intent. In the *Porter* case, a federal court opined that Texas courts would probably allow the settlor to effectively dictate the marital property character of trust income under the express terms of the trust.[372] Subsequently, in a case of the proverbial horse following the cart, the Corpus Christi Court of Appeals cited the *Porter* opinion to intimate that the express terms of the trust could be effective to characterize trust income for marital property purposes.[373] In any case, "the [trust] instrument must, in the most precise and definite way, and by the use of language of unmistakable intent, make that desire and intention clear."[374]

V. DEVELOPING A CONSISTENT AND COHERENT APPROACH

The inconsistencies between the three approaches the courts have used to characterize trust income as either community or separate property reflects a larger problem. That is, the courts' articulations of these approaches give very little consideration to the threshold questions of whether and under what circumstances the principles of marital property law can and should be applied in concert with the principles of trust law.[375] The final portion of this article proposes how Texas courts could develop rules to balance these two areas of property law and provide a consistent and coherent set of guidelines for spouses, settlors, and trustees.[376]

At least one commentator has observed that because marital property law is expressly set forth in the Texas constitution and trust law is not; the former should simply trump the latter.[377] Clearly the constitutional nature

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371. *See* Mercantile Nat'l Bank v. Wilson, 279 S.W.2d 650, 659–60 (Tex. Civ. App.—Dallas 1995, writ ref'd).

372. *See* Comm'r v. Porter, 148 F.2d 566, 568 (5th Cir. 1945).

373. Ridgell v. Ridgell, 960 S.W.2d 144, 149 (Tex. App.—Corpus Christi 1997, no pet.).

374. *See Porter*, 148 F.2d at 568. *See also Ridgell*, 960 S.W. at 149; Estate of Hinds v. Comm'r, 11 T.C. 314, 322–23 (1948).

375. *See Porter*, 148 F.2d at 568.

376. Several commentators have articulated well-reasoned criticisms of, and alternatives to, civil law characterizations of community and separate property on death and divorce. *See, e.g.*, Shari Motro, *Labor, Luck, and Love: Reconsidering the Sanctity of Separate Property*, 102 NW. U. L. REV. 1623 (2008); Carolyn J. Frontz & Hanoch Dagan, *Properties of Marriage*, 104 COLUM. L. REV. 75 (2004). However, this article does not address the extent to which the Texas version of Spanish civil law broadly accomplishes its purported objectives in the twenty-first century. In the absence of significant constitutional change, it is unlikely that Texas courts will alter the current marital property scheme. *See* Cameron v. Cameron, 641 S.W.2d 210, 218–19 (Tex. 1982).

377. *See* Davis, *supra* note 163, at 976.

of marital property characterizations is not the end of the story, as the Texas Supreme Court has noted:

> There is another constitutional problem. The protection of one's right to own property is said to be one of the most important purposes of government. That right has been described as fundamental, natural, inherent, inalienable, not derived from the legislature and as preexisting even constitutions. Article I, section 19, of the Texas Constitution explains that no citizen of this state shall be deprived of his property except by the due course of the law of the land. The due course that protects citizens requires not only procedural but also substantive due course.[378]

As a substantive constitutional right, "[o]ne person's property may not be taken for the benefit of another private person without a justifying public purpose, even though compensation be paid."[379] Thus, for example, although courts may order parents to pay child support out of their separate property, courts may not compel parents to transfer separate property to their spouse.[380] It should follow that if a spouse's beneficial interest in a trust is separate property, there is a constitutional interest in protecting it that is no more or less significant than the spouses' interest protecting in community property.[381]

Furthermore, because article XVI, section 15 of the Texas constitution was intended to carve out an exception to the common law with respect to marital property rights, this provision makes no mention of trusts.[382] For one to assert that marital property law trumps trust law only begs the following question: When (and to what extent) is a beneficial interest in a trust considered "property" that is considered "owned," "claimed," or "acquired" by a spouse within the meaning of the Texas constitution?[383]

Finally, although conspicuously absent from most of the relevant opinions to date, the courts must consider a settlor's property rights. The Texas Supreme Court considers a settlor's right to dispose of property as she sees fit to be inviolate:

> Property in a thing consists not merely in its ownership and possession, but in the unrestricted right of use, enjoyment *and disposal*. Anything which destroys any of these elements of property, to that extent destroys the property itself. . . . The right to acquire and own property, *and to deal with it and use it as the owner chooses*, so long as the use harms nobody,

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378. Eggemeyer v. Eggemeyer, 554 S.W.2d 137, 140 (Tex. 1977) (citations omitted).
379. *Id.* at 140–41 (quoting Thompson v. Consol. Gas Utils. Corp., 300 U.S. 55, 80 (1936)).
380. *See id.* at 142; *Cameron*, 614 S.W.2d at 218–19.
381. *See Eggemeyer*, 554 S.W.2d at 140–41; *Cameron*, 614 S.W.2d at 218–19.
382. *See* notes 39–42 and accompanying text.
383. *See* TEX. CONST. art. XVI, § 15.

> is a natural right. It does not owe its origins to constitutions. It existed before them.[384]

These property rights should extend to one's right to transfer property in trust—the right to determine who will benefit from the property, when, and how. It seems axiomatic that if a settlor does not expressly designate a person as a beneficiary (for example, a non-beneficiary spouse), then that person should not be able to benefit from the trust or be permitted to enforce the trust against the trustee.[385] As a general rule of trust law, a settlor has a right to dictate the use, enjoyment, and disposition of her trust property, and such right is circumscribed only when the purpose of the trust is illegal or the terms of the trust would otherwise require the trustee to commit an act that is criminal, tortious, or contrary to public policy.[386] The public policy exception is not applied lightly, even when the protected interest is that of the spouse of a beneficiary.[387]

Within this conceptual framework, the remainder of this article proposes two alternative approaches that attempt to better balance the parties' interests as protected by marital property law and trust law. The first approach—a permutation of the present possessory interest rule with an exception for self-settled trusts—leans toward the interests of protecting the settlor's property rights and supports a more expansive definition of a beneficiary spouse's separate property.[388] The second approach—a modified application of the conduit principle—leans toward the interests of the non-beneficiary spouse and supports a more expansive definition of community property.[389]

To be sure, the law never strikes a perfect balance of competing interests; but either of these two alternative approaches would represent an improvement over the current manifestations of the no-greater-interest/present possessory right rule, the conduit principle, and the equitable interest theory applied by the Texas courts. In its current form,

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384. *Id.* (emphasis supplied) Spann v. Dall. 235 S.W. 513, 514–15 (Tex. 1921).

385. *See* RESTATEMENT (SECOND) OF TRUSTS §§ 126, 200 (1959). However, a court could find that the settlor intended a distributive standard such as "support" to include the dependents of a beneficiary. *See* 1A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 157.1, at 190–91 (4th ed. 1987) [hereinafter SCOTT & FRATCHER ON TRUSTS].

386. *See* TEX. PROP. CODE ANN. § 112.031 (West 2007); RESTATEMENT (THIRD) OF TRUSTS § 29 cmt. i (2003); RESTATEMENT (SECOND) OF TRUSTS § 62 cmt. k (1959).

387. *See* SCOTT & FRATCHER ON TRUSTS, *supra* note 385, § 62, at 282 ("It seems to me extremely dangerous to limit the power of disposition on any general notion of impolicy, without some definite rule or principle being shown to apply to the case.") (quoting Egerton v. Earl Brownlow, 4 H.L.C. 1, 68, 70 (1853)). *See also, e.g.*, Erickson v. Erickson, 266 N.W. 161, 164 (Minn. 1936), *reh'g denied*, 267 N.W. 426, 427 (1936) (holding that the interests of providing a spouse with alimony from the beneficiary spouse should not "transcend the right of the donor to do as he pleases with his own property and to choose the object of his bounty" in the absence of "some justifiable interpretation of the donor's language").

388. *See infra* Part V.A.

389. *See infra* Part V.B.

the no-greater-interest/present possessory interest rule offers an undue opportunity for a spouse to unilaterally convert income from separate property into separate property without necessarily losing the benefit of that income.[390] The pure conduit principle reflects no balancing of interests—by allowing a non-beneficiary spouse to reach the undistributed income of a trust without regard to whether the beneficiary spouse will benefit from that income, there is no consideration for the property rights of the settlor or the other trust beneficiaries.[391] The equitable interest theory, as articulated by the Texas, would likely produce outcomes that are, at best, arbitrary in reflecting economic reality, and at worst, unduly susceptible to manipulation by settlors and trustees.[392]

A. The Present Possessory Interest Rule with a Self-Settled Marital Trust Exception

Under the no-greater-interest/present possessory interest rule, trust income from a separate property trust is characterized as community property only from the time, and only to the extent, that the beneficiary spouse has received an actual or a constructive possessory interest in the trust property.[393] Notwithstanding the perfunctory readings of the *Long* opinion by a few appellate courts, the present possessory interest rule is relatively easy to apply and understand.[394] The continued application of this rule would be consistent with the Texas Supreme Court's only unequivocal opinion that relates to these issues and a majority of the lower appellate court opinions.[395]

The present possessory interest rule is premised upon the notion that a spouse cannot acquire marital property—whether community or separate—until the spouse has an unfettered right to possession.[396] As previously discussed, critics of this rule assert that, based upon a series of retirement benefit cases decided by the Texas Supreme Court, a right to possession is not a necessary condition for the acquisition of marital property.[397] In the thirty-six years since the last of these cases were decided, the scope of these opinions have been limited to the relatively narrow context in which one spouse's employment or other personal services has yielded a "present contingent right subject to divestment."[398] These circumstances compelled the court to characterize assets acquired by onerous title—in particular,

390. *See supra* notes 349–50 and accompanying text.
391. *See supra* note 209 and accompanying text.
392. *See supra* Part III.C.2 and Part III.C.3.
393. *See supra* Part III.A.2.
394. *See supra* notes 294–96 and accompanying text.
395. *See supra* Parts III.A.1, III.A.2.
396. *See supra* Parts III.A.1, III.A.2.
397. *See supra* Part III.A.3.
398. Taggart v. Taggart, 552 S.W.2d 422, 423 (Tex. 1977).

remuneration for a spouse's personal services—as community property.[399] But, if there was a continuum for marital property characterization between onerous and lucrative title, the income earned from a separate property trust would fall towards the latter end of the spectrum, certainly more so than the fruits of a spouse's labor.[400]

Applying the public policy exception under the trust law, there is one situation in which the present possessory interest rule should not apply—when the settlor's property rights should take a back seat to the policies of maintaining and protecting community income.[401] As discussed, during the marriage, a spouse should not be allowed to establish and fund a trust with her own separate property to unilaterally accomplish what would otherwise require the other spouse's consent under the Texas constitution—the transmutation of community property (income from separate property) into separate property.[402] The limited purpose of this exception is to prevent the settlor spouse from having her cake (changing the character of income from separate property by placing legal ownership within the trust) and eating it too (realizing the benefit of that trust income in the form of distributions). That said, under Texas law, a spouse has the right to gift her separate property—including all of the future income from such property—to a third party without the other spouse's consent.[403] As such, a rule that characterizes all trust income from any self-settled trust established during marriage as community property would be overbroad, especially in situations when the beneficiary spouse's right to such income is discretionary. Rather, community property characterization should not attach to the trust income until the beneficiary spouse actually receives, or is absolutely entitled to receive, the income of the trust.[404] In applying this public policy exception to the present possessory right rule, courts could strike a more reasonable balance between the legitimate interests of both spouses by applying the deferred conduit approach to self-settled trusts established during the marriage.[405]

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399. *See id.*

400. *See supra* Part II.A.6.

401. This public policy exception would be akin to the exception to spendthrift protections for self-settled trusts. *See supra* notes 109–11 and accompanying text.

402. *See supra* notes 349–50 and accompanying text.

403. One commentator has suggested that if the self-settled trust considered in the *Burns* case had been established with separate property with "intent to defraud" the non-beneficiary spouse, then the court could have invalidated the provision in the trust that classified undistributed and accumulated income as principal and declared the income to be community property. LEOPOLD, *supra* note 32, § 6.13, at 173. However, notwithstanding the dicta in that opinion, a claim for fraud on the spouse does not apply to a gift of separate property. *See supra* notes 364–65 and accompanying text.

404. This exception would be consistent with much of the existing case law by limiting the right of non-beneficiary spouse to distributed income. *See* Lipsey v. Lipsey, 983 S.W.2d 345, 351 (Tex. App.—Fort Worth 1998, no pet.); Lemke v. Lemke, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied); *In re* Marriage of Burns, 573 S.W.2d 555, 557–58 (Tex. Civ. App.—Texarkana 1978, writ dism'd); Shepflin v. Small, 23 S.W. 432, 433 (Tex. Civ. App.—El Paso 1893, no writ).

405. *See infra* Part V.B.

B. The Deferred Conduit Approach

As an alternative that favors a more expansive definition of community property, the courts could also adopt a deferred conduit approach whereby any trust income generated during the marriage would be characterized as community property subject to the following important modifications to the pure conduit principle:[406]

> 1. For these purposes, what constitutes community income generated from separate property would be determined under marital property law principles. To allow such determinations to be made by the terms of the trust and the TUPIA would provide too much discretion to the settlor and the trustee to manipulate what constitutes principal and income or would tend to result in arbitrary outcomes, thereby defeating the purpose of tipping the balance in favor of reasonably protecting the interests of the non-beneficiary spouse.[407]
> 2. The only income that would be considered community property is that income that is both generated by the trust assets during the marriage and distributed to the beneficiary spouse during or after the dissolution of the marriage.[408] Thus, with respect to a trust funded with separate property, all rents, dividends, and interest would be considered potential community income. If necessary, the undistributed balance of community income earned during the marriage could be awarded on a prospective basis—the non-beneficiary spouse would receive a share of each distribution made to the beneficiary spouse after dissolution of the marriage.[409]
> 3. In characterizing distributions made to the beneficiary spouse, an income-out-first rule would apply similar to the community-out-first rule applicable to commingled accounts.[410] Any amount distributed to the beneficiary spouse would be considered a distribution of community income to the extent of the undistributed balance of all community income generated during the marriage immediately prior to the distribution, and the balance of accumulated community income would be computed without

406. *See supra* Part III.B.

407. *See supra* Part III.C.3.

408. In this respect, this deferred conduit approach could also be described as a variation of the presumptive equity interest theory. *See supra* Part III.B.1.

409. This aspect echoes the approach the courts took in dividing of pension and other benefits that had not yet vested at the time of the order of dissolution. *See supra* Part III.A.3.

410. *See* Mercantile Nat'l Bank at Dall. v. Wilson, 279 S.W.2d 650, 659–60 (Tex. Civ. App.—Dallas 1995, writ ref'd).

> regard to the terms of the trust.[411] This rule would minimize the ability of a trustee to exercise discretion under the terms of the trust for the primary purpose of thwarting the interests of the non-beneficiary spouse.[412]
>
> 4. To the extent that the beneficiary spouse has an unfettered right to withdraw an amount from the trust or the trustee has failed to make a mandatory distribution to the beneficiary spouse upon dissolution of the marriage, the court could order the trustee to distribute such amounts to the extent of the non-beneficiary spouse's current interest in the undistributed community income generated during the marriage. Such a rule would prevent the trustee from dragging her heels without harming the interests of the settlor or the other beneficiaries.

To illustrate, suppose that in 2011, a trust was established by a husband's parents during the marriage. The terms of the trust grant the trustee discretion to distribute income or principal as she deems advisable for the health, education, maintenance, or support of the husband and his brother. During the marriage, the trust assets generate investment income; the trustee pays investment management fees; and the trustee makes distributions to both the husband and his brother. However, the husband and wife separate and divorce at the end of 2012. The following illustrates how a deferred conduit approach could be applied before and after the divorce:

		2011	2012	2013
	Trust Receipts & Expenditures:			
[1]	Interest & dividends:	$ 200,000	$ 150,000	$ 175,000
[2]	Net capital gains:	300,000	250,000	275,000
[3]	Total receipts (line [1] + line [2]):	500,000	400,000	450,000
[4]	Investment management fees:	20,000	16,000	18,000
[4a]	Expenditures allocated to interest & dividends (line [1] ÷ line [3] x line [4]):	8,000	6,000	7,000
	Distributions to Beneficiaries:			
[5a]	To husband:	$ 150,000	$ 50,000	$ 50,000
[5b]	To husband's brother:	50,000	50,000	150,000
[5c]	Total distributions:	$ 200,000	$ 100,000	$ 200,000

411. For example, terms of the trust providing that undistributed income is to be added to principal annually or granting the trustee the discretion to charge distributions to principal would be disregarded for these purposes. *See supra* Part III.C.3.

412. *See supra* Part III.C.3.

	Community Income:			
[6]	Current community income (if married, excess of line [1] over line [4a]):	$ 192,000	$ 144,000	N/A
[7]	Prior years' undistributed community income (prior year line [10], if any):	–	–	44,000
[8]	Amount of community income available for distribution (line [6] + line [7]):	$ 192,000	$ 144,000	$ 44,000
[9]	Deemed distribution of community income (lesser of line [5c] or line [8]):	$ 192,000	$ 100,000	$ 44,000
[10]	Ending balance of undistributed community income (line [8] – line [9]):	–	$ 44,000	–
	Character of Distributions to Husband:			
[11]	Community property (line [5a] ÷ line [5c] x line [9]):	$ 144,000	$ 50,000	$ 11,000
[12]	Separate property (line [5a] – line [11]):	6,000	–	39,000
[13]	Total distributions (line [11] + line [12]):	$ 150,000	$ 50,000	$ 50,000

Under the divorce decree, the parties could settle the community claim to the undistributed community income of the trust, or the court could order the ex-husband to pay to the ex-wife one-half of such amounts that are ultimately distributed to the ex-husband. For example, in 2013, the ex-husband could be required to pay the ex-wife half of the previously undistributed community property received by the ex-husband ($5,500).

Although this approach tips the balance in favor of a more expansive definition of community property than the no-greater-interest/present possessory right rule, it is also consistent with the following notion under Texas trust law that the beneficiary is the real owner of the trust property.[413] Furthermore, the above modifications to the conduit principle would eliminate any need to give special consideration to the identity of the settlor and trustee, the powers of the beneficiary spouse, whether the distributions were mandatory or discretionary, or the settlor's intent.[414]

VI. CONCLUSION

The marital property characterization of trust income is unique under Texas law by virtue of the fact that income from separate property is characterized as community property, and there nothing that the spouse who

413. *See supra* note 107 and accompanying text.
414. *See supra* Part IV.A, B, C, E, G.

owns the property can unilaterally do to change that.[415] As a result, two critical questions arise: How should the income of a trust funded before the marriage or by a gift or devise be characterized, and what are the relevant circumstances in making such a determination?

Because the applicable law is constitutional, it is generally up to the courts to determine how these issues are resolved; but ever since the Texas Supreme Court made its one and only unequivocal decision in this area over a century ago, the applicable constitutional provisions have changed, the court's own interpretation of those provisions have changed, the contexts for determining these issues have changed, and the breadth of trust provisions and trust investments have changed.[416] The courts have adopted three separate approaches—the no-greater-interest/present possessory right rule, the conduit principle, and the equitable interest theory—to address these issues; but none of these approaches are conceptually consistent with the others.[417] As such, these issues are ripe for consideration by the Texas Supreme Court.

In addition to the inconsistencies, none of these three approaches achieves a sufficient balance between the interests of protecting both the right of a non-beneficiary spouse to community income and every settlor's property right to designate trust beneficiaries.[418] To a certain degree (and in certain circumstances), these interests will inevitably clash. But by making significant modifications to the present possessory right rule or the conduit principle, as proposed in this article, courts could reach a more reasonable, consistent, and coherent balance between each of these competing interests.[419]

415. *See supra* Part II.C.
416. *See supra* Part III.A.1.
417. *See supra* Part III.
418. *See supra* Part V.
419. *See supra* Part V.