SEPARATE BUT EQUAL: PROPOSAL FOR HARMONIZING THE RULES FOR MARITAL PROPERTY CHARACTERIZATION OF BENEFICIAL INTERESTS IN AND DISTRIBUTIONS FROM TRUSTS WITH THOSE APPLICABLE TO SIMILAR TYPES OF PROPERTY

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I. INTRODUCTION

The marital property rules currently used in Texas for characterizing beneficial interests in and distributions from trusts have not been formulated and applied consistently by the circuit courts.[1] Thus far, the Supreme Court of Texas has not resolved this inconsistency.[2] To make matters worse, the circuit courts currently do not use rules logically consistent with the marital property rules generally applicable to characterization of similar types of property.[3] This article will describe the different approaches circuit courts have used and the different rules they have developed. The article will also propose the adoption of standard rules that will harmonize all of these approaches and allow the rules for characterizing beneficial interests in and distributions from trusts to exist in logical parity with the rules for characterizing similar types of property.

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1. *See infra* Part IV.
2. *See infra* Part IV.
3. *See infra* Part IV.

Under the inception of title doctrine in Texas, marital property is characterized as separate or community property.[4] Property is characterized at the time of its acquisition and retains that character until the marriage is dissolved.[5] Ownership interests in and distributions from organizations that constitute legal entities are subject to special rules.[6] The marital property subject to characterization is the ownership interest in the entity.[7] Because the entity—not the spouse—owns the property, it is not marital property subject to characterization.[8] Thus, property owned by a corporation or partnership is not marital property of a spouse owning an interest in the entity; instead, the marital property is the ownership interest in the entity, such as the corporate stock or partnership interest.[9] In addition, income earned by a corporation or partnership belongs to the entity and not to a spouse owning an interest in the entity until the entity distributes the income to the owner.[10]

In some jurisdictions, a trust is a legal entity separate from the owners of the beneficial interests in the trust.[11] If that is true under Texas law, then the rules for characterizing beneficial interests in and distributions from trusts should be consistent with the rules for characterizing ownership interests in and distributions from other separate entities, such as corporations and partnerships. However, none of the characterization rules currently used by the circuit courts are consistent with the rules applicable to other separate entities. The Supreme Court of Texas has ruled in cases not involving marital property law that trusts are not legal entities at all; rather, they constitute a fiduciary relationship

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4. *See, e.g.*, Creamer v. Briscoe, 109 S.W. 911, 912 (Tex. 1908) (holding "that the character of title to property as separate or community depends upon the existence or nonexistence of the marriage at the time of the incipiency of the right in virtue of which the title is finally extended"). Separate property is treated as though no marriage exists. *See id.* Neither spouse has an ownership interest of any kind in the other spouse's separate property. *See id.* Thus, spouses must be awarded their separate property in a divorce, and each spouse has the power to dispose of his or her separate property at death without regard to the other spouse. *See generally* Eggemeyer v. Eggemeyer, 554 S.W.2d 137 (Tex. 1977); Cameron v. Cameron, 641 S.W.2d 210 (Tex. 1982).

5. *See, e.g.*, Dakan v. Dakan, 83 S.W.2d 620, 627 (Tex. 1935) (holding that the improvement of separate property with community funds does not change the status of the property; instead, this may create equities in favor of the community).

6. *See infra* Part II.B.

7. *See infra* Part II.B.

8. *See, e.g.*, Thomas v. Thomas, 738 S.W.2d 342, 343 (Tex. App.—Houston [1st Dist.] 1987, writ denied) ("[A] court upon divorce may award only shares of stock, and not corporate assets."); McKnight v. McKnight, 543 S.W.2d 863, 867 (Tex. 1976) ("[T]he rights of a divorcing spouse can only attach to the husband's interest in the partnership and not specific partnership property.").

9. *See, e.g.*, *Thomas*, 738 S.W.2d at 343; *McKnight*, 543 S.W.2d at 567.

10. *See, e.g.*, *Thomas*, 738 S.W.2d at 343 ("[C]orporate earnings remain corporate property until distributed."); Marshall v. Marshall, 735 S.W.2d 587, 595–96 (Tex. App.—Dallas 1987, writ ref'd n.r.e.) (holding that partnership funds are not marital property until the partnership distributes them to the partners, at which point they constitute income acquired from a partnership interest and are thus community property).

11. *See, e.g.*, United States v. Harrison, 653 F.2d 359, 361 (8th Cir. 1981) ("[A trust] is a formally organized entity, legally distinct from its trustees."); Leon Hall Price Found. v. Baker, 577 S.E.2d 779, 781 (Ga. 2003) ("It is a generally accepted principle that a trust is a [legal] entity separate from its beneficiaries.").

between the trustee and the trust property.[12] Accordingly, the property interest owned by a trust beneficiary is simply an equitable interest in the trust property. If that is also true under Texas marital property law, then the rules for characterizing beneficial interests in and distributions from trusts should be consistent with the rules for characterizing ownership interests in and income earned by other types of income-producing property. However, none of the characterization rules currently used by the circuit courts are consistent with those rules either.[13]

This inconsistency exists because trusts are created for many different reasons and, as a result, take many different forms.[14] Many trusts are structurally complex, and courts have struggled to apply marital property characterization rules to them in a consistent manner.[15] The result is a hodgepodge of different approaches and rules applied by the various circuit courts.[16] The problem is confusion for litigants and trial courts attempting to determine applicable rules for characterizing interests in and distributions from trusts. Therefore, a logical and consistent set of rules is necessary.

Section II of this article will describe the marital property rules not only for characterizing income-producing property and the income produced by such property, but also for characterizing the ownership interests in and distributions from separate entities other than trusts, such as corporations and partnerships.[17] Section III will discuss the issue of whether a trust is, or should at least be treated for marital property characterization purposes as, a legal entity separate from the owners of the beneficial interests in the trust.[18] Section IV will describe the different approaches utilized by the circuit courts, and the different rules they have developed as a result, to characterize beneficial interests in and distributions from trusts.[19] Section V will propose standard rules that will (1) harmonize these various approaches and rules currently used and (2) allow the rules for characterizing beneficial interests in and distributions from trusts to exist in logical parity with the rules for characterizing similar types of property, regardless of whether a trust is treated as a separate legal entity or not.[20] The source of the legal reasoning underlying these proposed rules is the United States Supreme Court, which utilized such reasoning to resolve a complex issue that arose in the first two decades after the adoption of the United States federal income tax.[21]

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12. *See* Ditta v. Conte, 298 S.W.3d 187, 191–92 (Tex. 2009); Ray Malooly Trust v. Juhl, 186 S.W.3d 568, 570 (Tex. 2006); Huie v. DeShazo, 922 S.W.2d 920, 926 (Tex. 1996).
13. *See infra* Part IV.
14. *See infra* Part IV.
15. *See infra* Part IV.
16. *See infra* Part IV.
17. *See infra* Part II.
18. *See infra* Part III.
19. *See infra* Part IV.
20. *See infra* Part V.
21. *See infra* Part V.

II. MARITAL PROPERTY CHARACTERIZATION RULES

A. Income-Producing Property

Characterization of marital property in Texas is controlled by the state constitution, which defines separate property generally as all property acquired prior to marriage and property acquired during marriage by gift or inheritance.[22] The Texas Family Code further provides that (1) property acquired during marriage and not meeting the definition of separate property falls under the characterization of community property, (2) all property owned during marriage is presumed to be community property, and (3) a spouse desiring to prove that specific property is separate property has the burden to do so by clear and convincing evidence.[23]

Texas courts have adopted a number of doctrines and rules providing various means for rebutting the community property presumption.[24] One rule particularly relevant to the issues discussed in this article is the doctrine of inception of title. The courts adopted this doctrine to determine whether property was acquired prior to the marriage.[25] Generally property is treated as acquired when a person obtains an indefeasible right to acquire the property. Property can thus be treated as acquired for purposes of this doctrine prior to the time title actually passes.[26] The important point for the purposes discussed here is that property is characterized when it is acquired (or at least treated under this doctrine as being acquired), and it retains that characterization for all purposes thereafter until the dissolution of the marriage.[27]

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22. TEX. CONST. art. XVI, § 15. The Texas constitution also provides a means for spouses to agree in a pre- or post-marital agreement to characterize property as separate property and to agree to convert separate property during marriage to community property. *See id.*

23. *See* TEX. FAM. CODE ANN. §§ 3.002–.003 (West 2006). *See also* Carter v. Carter, 736 S.W.2d 775, 777 (Tex. App.—Houston [14th Dist.] 1987, no writ) ("To overcome that presumption, a spouse asserting separate ownership must clearly trace the original separate property into the particular assets on hand during marriage.").

24. For example, Texas courts have adopted the doctrine of "tracing," which allows a spouse to prove property owned during marriage is separate property because it is traceable to other property that was separate property. *See generally* Tarver v. Tarver, 394 S.W.2d 780 (Tex. 1965).

25. *See generally* Langston v. Langston, 82 S.W.3d 686, 688 (Tex. App.—Eastland 2002, no pet).

26. *See generally* Welder v. Lambert, 44 S.W. 281 (Tex. 1898). For example, courts have held that property is "acquired" under this doctrine when an earnest money contract is executed by the parties with respect to property. *See, e.g.*, *Carter*, 736 S.W.2d at 779 (holding that property was separate property because an earnest money contract was executed prior to the marriage and thus right to title to the property preceded the marriage). The prospective purchaser under such an agreement acquires a right of specific performance when he has performed his obligations under the agreement and thus has an indefeasible right to acquire the property. *See id.*

27. *See, e.g.*, Dakan v. Dakan, 83 S.W.2d 620, 627 (Tex. 1935) (holding that the improvement of separate property with community funds does not change the status of the property but may create equities in favor of the community).

The doctrine of inception of title can cause numerous inequitable results.[28] A common example of such a result exists where a spouse acquires property prior to the marriage that is subject to a mortgage.[29] After the marriage, community property funds are used to pay the mortgage.[30] If the spouses divorce, the property is characterized as the separate property of the spouse who owned it at the time of the marriage, but the property now exists free of the burden of the mortgage at the expense of the community property estate.[31] Texas courts have adopted the equitable doctrine of reimbursement to address the inequity resulting from these facts.[32] Generally, the court will impose an obligation on the benefitted spouse's estate to reimburse the contributing estate—in this case, the community property estate—for the principal amount of the mortgage paid by the contributing estate.[33]

Income produced by property is characterized as community property without regard to whether the property that produced such income is community property or separate property.[34] The Supreme Court of Texas held that this result is required by the definition of separate property in the state constitution and the state legislature does not have the power to enact legislation providing that income from the separate property of a spouse is the separate property of that spouse.[35]

B. Separate Entities Other than Trusts

1. Ownership Interests in the Entity

The doctrine of inception of title has caused special concerns with respect to organizations that constitute legal entities separate from the individual spouses who own interests in such entities, and the courts have created rules to

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28. *See generally* Penick v. Penick, 783 S.W.2d 194, 196 (Tex. 1988) (explaining that attempts to offset benefits through reimbursement are unsettled).

29. *See generally* Leighton v. Leighton, 921 S.W.2d 365, 367 (Tex. App.—Houston [1st Dist.] 1996, no writ).

30. *Id.*

31. *See* TEX. FAM. CODE ANN. § 3.402(a)(3) (West 2006). *See also* TEX. FAM. CODE ANN. § 3.404(b) (West 2006) (stating that a reimbursement claim does not create a new property ownership interest); *Carter*, 736 S.W.2d at 780 (stating that separate property remains separate even if community funds are spent).

32. *See generally Penick*, 783 S.W.2d at 195. The reimbursement doctrine was codified by the Texas Legislature in 2009 with respect to certain fact patterns. *See generally* TEX. FAM. CODE ANN. §§ 3.401–.410 (West 2006). The example provided in the text is representative of a fact pattern that is included in the new statutory scheme. *See* FAM. § 3.402(a)(3).

33. *See generally Penick*, 783 S.W.2d at 196 ("[T]he payment by one marital estate of the debt of another creates a prima facie right of reimbursement."); FAM. § 3.402(a)(3).

34. *See* Colden v. Alexander, 171 S.W.2d 328, 334 (Tex. 1943). The lone exception to that rule applies when the income-producing property was received by the owner spouse as a gift from the other spouse. *See* TEX. FAM. CODE ANN. § 3.005 (West 2006). In that event, in addition to the income-producing property being characterized as separate property because it was acquired by gift, the income from such property is presumed to be separate property also. *See* FAM. § 3.005.

35. Arnold v. Leonard, 273 S.W. 799, 803 (Tex. 1925).

address those concerns.[36] As mentioned previously, the inception of title doctrine requires that property be characterized when it is acquired (or at least when treated as being acquired). Furthermore, the property retains that character for all purposes thereafter until the dissolution of the marriage.[37] Thus, a spouse who forms a separate entity (e.g., a corporation) prior to marriage will be able to claim the ownership interest in that entity (the corporate stock) as separate property.[38] If the marriage results in a divorce, the stock must be awarded to the owner spouse.[39] Property owned by the separate entity is not marital property and thus has no relevance in a divorce or probate proceeding.[40]

These rules can create significant inequities in certain situations. For example, suppose W created a corporation prior to her marriage to H and owns all of the stock. During the marriage, W devotes all of her professional time to the corporate business and the business is wildly successful, resulting in the corporation increasing in value by $5 million. Texas courts have consistently held that increases in value of separate property do not affect its characterization.[41] Property qualifies for characterization under the inception of title doctrine when it is acquired and retains that character for all purposes thereafter until the dissolution of the marriage.[42] W will thus be awarded the stock in the divorce and will receive all benefits associated with the increase in value of the stock during the marriage.[43] The inequity of that result is due to W devoting all of her professional time to the corporate business; to the extent that the increase in value of the stock is due to W's efforts, her separate estate benefitted at the expense of the community estate because courts have

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36. *See generally* Thomas v. Thomas, 738 S.W.2d 342, 343 (Tex. App.—Houston [1st Dist.] 1987, writ denied).

37. *See, e.g.*, Dakan v. Dakan, 83 S.W.2d 620, 627 (Tex. 1935) (holding that the improvement of separate property with community funds does not change the status of the property but may create equities in favor of the community). *See also* TEX. FAM. CODE ANN. § 3.006 (West 2006) (stating that inception of title doctrine determines ownership interests).

38. *See Thomas*, 738 S.W.2d at 343. *See generally* FAM. § 3.006.

39. *See generally* Eggemeyer v. Eggemeyer, 554 S.W.2d 137, 140 (Tex. 1977); Cameron v. Cameron, 641 S.W.2d 210, 215–16 (Tex. 1982).

40. *See, e.g.*, *Thomas*, 738 S.W.2d at 343 (holding that in a divorce, the court may award shares of stock but not corporate assets); McKnight v. McKnight, 543 S.W.2d 863, 867 (Tex. 1976) (holding that the rights of a divorcing spouse can only attach to a partnership interest and not to specific partnership property). *Thomas* involved a Subchapter S corporation, which meant that the corporation elected not to be taxed like a corporation but like a partnership. *Thomas*, 738 S.W.2d at 343. Partnerships are not taxed at the partnership level; partnership income is passed through to the individual partners on their individual tax returns. *Id.* The court held that was irrelevant for marital property characterization purposes, stating that "[t]he shareholder in a Subchapter S corporation has no greater rights over corporate property than a shareholder in any other corporation." *Id.* at 344.

41. *See* Jensen v. Jensen, 665 S.W.2d 107, 109 (Tex. 1984); Dawson-Austin v. Austin, 920 S.W.2d 776, 788 (Tex. App.—Dallas 1996) *rev'd*, 968 S.W.2d 319 (Tex. 1998) ("[A]n increase or decrease in the value of the item of separate property is an inherent part of the item and cannot be separated from it.").

42. *See, e.g.*, *Dakan*, 83 S.W.2d at 627 (holding that the improvement of separate property with community funds does not change the status of the property but may create equities in favor of the community).

43. *See Thomas*, 738 S.W.2d at 343–44.

consistently held that the time, toil, and effort of each spouse belongs to the community estate.[44]

The Supreme Court of Texas faced this issue in the divorce case *Vallone v. Vallone*.[45] During the marriage, the husband (H) received certain restaurant assets as a gift from his father; those assets were clearly H's separate property.[46] Subsequently, H formed a corporation for the purpose of operating a restaurant business.[47] The initial capitalization for the corporation consisted in part of the restaurant assets H received from his father.[48] The trial court determined that 47% of the initial capitalization of the corporation was H's separate property and 53% was community property.[49] In characterizing the corporate stock, the court determined that it was acquired during the marriage, but 47% of it was acquired in exchange for the restaurant assets which were H's separate property.[50] Utilizing the concept of tracing, the court determined that 47% of the stock was H's separate property.[51] The trial court also determined that the stock increased in value during the marriage by almost $1 million.[52]

The wife (W) argued on appeal that such increase in value should be taken into account in characterizing the stock.[53] Specifically, she made the following two arguments: first, the corporation was H's "alter ego" and should thus be disregarded for purposes of characterizing marital property assets in the divorce;[54] second, H's separate property estate owed reimbursement to the community property estate for the value of community time, talent, and labor contributed to H's separate property estate.[55]

"Alter ego" is a corporate law doctrine generally used as one of the bases for determining whether a court should "disregard the corporate fiction" and impose personal liability on a corporation's shareholders for obligations of the corporation.[56] This is sometimes referred to as "piercing the corporate veil."[57] One important goal of incorporating a business is to achieve the limited liability that the owners of the business enjoy by operating the business in corporate form.[58] Unless the owners personally guarantee corporate obligations, they

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44. *See* Vallone v. Vallone, 644 S.W.2d 455, 458 (Tex. 1982) ("It is fundamental that any property or rights acquired by one of the spouses after marriage by toil, talent, industry or other productive faculty belongs to the community estate.").

45. *Id.* at 465–67.

46. TEX. FAM. CODE ANN. § 3.001(2) (West 2006).

47. *Vallone*, 644 S.W.2d at 457.

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 458.

54. *Id.*

55. *Id.*

56. *See* Castleberry v. Branscum, 721 S.W.2d 270, 271–72 (Tex. 1986).

57. *See* Lifshutz v. Lifshutz, 61 S.W.3d 511, 516 (Tex. App.—San Antonio 2001, pet. denied).

58. *See Castleberry*, 721 S.W.2d at 271.

usually do not face personal liability for those obligations.[59] But to maintain that limited liability, the shareholders must operate the corporation in a manner that respects the identity of the corporation separate from its shareholders. The Supreme Court of Texas stated the following:

> Alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice. . . . It is shown from the total dealings of the corporation and the individual, including the degree to which corporate formalities have been followed and corporate and individual property have been kept separately, the amount of financial interest, ownership and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes. . . . Alter ego's rationale is: "if the shareholders themselves disregard the separation of the corporate enterprise, the law will also disregard it so far as necessary to protect individual and corporate creditors."[60]

When a court determines to "disregard the corporate fiction," it effectively disregards the corporate entity and treats the corporate assets as if they were owned by the shareholders individually; the corporate business is thus treated as if it was being operated as a sole proprietorship or partnership.[61] The limited liability normally enjoyed by corporate shareholders ceases to exist.[62]

Such a determination by a court has major implications with regard to characterizing marital property.[63] As explained earlier, a spouse who forms a corporation prior to marriage will be able to claim the ownership interest in that entity (the corporate stock) as separate property because of the inception of title doctrine.[64] If a divorce ensues, the stock must be awarded to the owner spouse.[65] Property owned by the separate entity is not marital property and thus has no relevance in a divorce or probate proceeding.[66] However, if a court determines that the corporation is the "alter ego" of the shareholder spouse, the court will disregard the corporate entity and treat the corporate assets as if they are owned by the shareholder spouse; the spouse will then lose the advantage of the separate property characterization of the corporate stock and be forced to

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59. *See id.* at 271–72.

60. *Id.* at 272.

61. *See id.* at 271–72; *Lifshutz*, 61 S.W.3d at 516.

62. *See Castleberry*, 721 S.W.2d at 271.

63. *See Lifshutz*, 61 S.W.3d at 516.

64. *See* Rusk v. Rusk, 5 S.W.3d 299, 303 (Tex. App.—Houston [14th Dist.] 1999, pet. denied) (explaining that the inception of title doctrine establishes the character of property interests and when a party gains the right to claim the property).

65. *See generally* Eggemeyer v. Eggemeyer, 554 S.W.2d 137 (Tex. 1977); Cameron v. Cameron, 641 S.W.2d 210 (Tex. 1982).

66. *See, e.g.*, Thomas v. Thomas, 738 S.W.2d 342, 343 (Tex. App.—Houston [1st Dist.] 1987, writ denied) (holding that upon divorce, a court may award only shares of stock and not corporate assets). *See also* McKnight v. McKnight, 543 S.W.2d 863, 867 (Tex. 1976) (holding that the rights of a divorcing spouse can attach only to the husband's interest in the partnership and not specific partnership property).

rebut the community property presumption as to each corporate asset.[67] Overcoming this presumption is the identical burden the spouse would have to carry if the business had been operated as a sole proprietorship rather than in corporate form.[68] A spouse operating a business as a sole proprietorship and attempting to carry the burden of proof that assets of the business are separate property is unlikely to be successful.[69] Even if the business was commenced prior to marriage, most of the assets currently owned were likely acquired after marriage and were probably not acquired in a manner that would make them easily traceable to assets that at one time could be characterized as separate property.[70]

The court in *Vallone* held that determining "whether a corporation is an 'alter ego' [of its shareholders] for purposes of determining whether assets held in the corporation's name should be treated as community property is an issue of fact."[71] Both the trial court and the appellate court determined that the corporation was not H's "alter ego" and W preserved no error of law on that point.[72] Thus, the court held that it was bound by the finding of the lower courts that the corporation was not H's "alter ego."[73]

The court then turned to W's reimbursement argument.[74] W argued at trial for reimbursement to the community property estate for money or property contributed by that estate to H's separate property estate.[75] On appeal, she argued that H's separate property estate owed reimbursement to the community property estate for the value of community time, talent, and labor contributed to H's separate property estate.[76] The court first discussed the right of reimbursement generally, stating that it is purely an equitable right and applies when one marital property estate improves another marital property estate.[77] Courts have historically utilized the reimbursement right when "funds or assets of one estate are used to benefit and enhance another estate without itself receiving some benefit."[78] The court stressed that "[i]t is fundamental that any

67. *See Lifshutz*, 61 S.W.3d at 516 (describing the application of the principles of "alter ego" and "piercing the corporate veil" to divorce cases as "reverse piercing," thereby allowing "the divorce court to characterize as community property corporate assets that would otherwise be the separate property of one spouse"). The court further stated that "[t]he concepts of alter ego and piercing are applied in divorce cases to achieve an equitable result[—]a just and right settlement of the marital estate." *Id.*

68. *Id.*

69. *Id.*

70. *See, e.g.*, Hardee v. Vincent, 147 S.W.2d 1072, 1074 (Tex. 1941) (holding that although the wife could prove that sole proprietorship business was her separate property as of approximately two years prior to trial, inventory and fixtures were bought and sold after that date and the wife could not prove that the money used to purchase inventory and fixtures owned at the time of trial came from her separate property estate).

71. Vallone v. Vallone, 644 S.W.2d 455, 458 (Tex. 1982).

72. *Id.* at 457–58.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 458.

77. *Id.*

78. *Id.* at 459.

property or rights acquired by one of the spouses after marriage by toil, talent, industry or other productive faculty belongs to the community estate."[79] The court held for the first time that "it also arises when community time, talent and labor are utilized to benefit and enhance a spouse's separate estate, beyond whatever care, attention, and expenditure are necessary for the proper maintenance and preservation of the separate estate, without the community receiving adequate compensation."[80] The court was careful to emphasize that "the right of reimbursement is not an interest in property . . . , but an equitable right that arises upon dissolution of the marriage."[81] Although the court held favorably with regard to the substance of W's reimbursement argument made on appeal, the court denied the appeal because W's pleadings specified a cause of action for reimbursement to the community property estate for money or property contributed by that estate to H's separate property estate, not for the value of community time, talent, and labor contributed by the community property estate to H's separate property estate.[82]

Vallone was a 5–4 decision and was the subject of a vigorous dissent.[83] The dissenting opinion primarily argued that the community time, talent, and labor contributed to a spouse's separate property estate must be taken into account in characterizing the spouse's ownership interest in the separate entity to which such time, talent, and labor is contributed, rather than give rise to a reimbursement claim in favor of the community property estate.[84] Two years later, however, in *Jensen v. Jensen*, the Supreme Court of Texas affirmed the majority's opinion in *Vallone* with regard to time, talent, and labor reimbursement.[85] The court in *Jensen* described the deciding issue as "how to treat, upon divorce, corporate stock owned by a spouse before marriage but which has increased in value during marriage due, at least in part, to the time and effort of either or both spouses."[86] The court discussed the differences between a reimbursement approach to this issue and a so-called "community ownership" theory, stating that "[c]ommon to both theories is the general concept that the community should receive whatever remuneration is paid to a spouse for his or her time and effort because the time and effort of each spouse belongs to the community."[87] The court's description of the community ownership theory was the argument advanced by the dissent in *Vallone*: community time, talent, and labor contributed to a spouse's separate property estate must be taken into account in characterizing the spouse's ownership interest in the separate entity to which such time, talent, and labor is

79. *Id.* at 458.
80. *Id.* at 459.
81. *Id.* at 458–59.
82. *Id.* at 459.
83. *Id.* at 468.
84. *Id.* at 460.
85. Jensen v. Jensen, 665 S.W.2d 107, 110 (Tex. 1984).
86. *Id.* at 109.
87. *Id.*

contributed, rather than give rise to merely a reimbursement claim in favor of the community property estate.[88] By affirming *Vallone*'s choice of the reimbursement theory, the court noted the consistency of the theory with the Texas constitution's definition of separate property and the long-standing adoption by Texas courts of the inception of title doctrine.[89] The court concluded that the reimbursement theory "is a reasonable means of assuring that the community will be fully reimbursed for the value of community assets, i.e., time and effort expended, while at the same time providing that the property interest of the separate estate is also protected and preserved."[90]

"A partnership is a legal entity separate from its [partners]" and is treated the same as a corporation for marital property characterization purposes.[91] Thus, a spouse who acquires an interest in a partnership prior to marriage will be able to claim that partnership interest as separate property.[92] If the marriage ends in divorce, the partnership interest must be awarded to the owner spouse.[93] Property owned by the partnership is not marital property and thus has no relevance in a divorce or probate proceeding.[94]

2. Distributions from the Entity

Corporations and partnerships periodically make distributions of money or property to their shareholders and partners.[95] These distributions are ordinarily

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88. *Id.*

89. *Id.*

90. *Id.* The Texas legislature codified the doctrine in 2009 with respect to certain fact patterns. *See generally* TEX. FAM. CODE ANN. §§ 3.401–.410 (West 2006). The legislature included reimbursement claims for time, talent, and labor in the new statutory scheme. *See* FAM. § 3.402(a)(2). Such claims, however, are described in the statute somewhat differently than they are described in *Vallone* and *Jensen*; specifically, the statute includes a claim for reimbursement for "inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse." *Id.* It is doubtful that courts will apply the statute in a manner different than they have dealt with these claims thus far, but that remains to be seen.

91. Rawhide Mesa-Partners, Ltd. v. Brown McCarroll, L.L.P., 344 S.W.3d 56, 60 (Tex. App.—Eastland 2011, no pet.).

92. *See Jensen*, 665 S.W.2d at 107–10.

93. *See generally* Eggemeyer v. Eggemeyer, 554 S.W.2d 137 (Tex. 1977); Cameron v. Cameron, 641 S.W.2d 210 (Tex. 1982).

94. *See* McKnight v. McKnight, 543 S.W.2d 863, 867 (Tex. 1976) (holding a divorcing spouse only has a right to the partnership interest and not to specific partnership property). In 1961, Texas adopted the Uniform Partnership Act and the entity theory of partnership. *See* Marshall v. Marshall, 735 S.W.2d 587, 593–94 (Tex. App.—Dallas 1987, writ ref'd n.r.e.). Under the entity theory, the partnership, rather than the individual partners, owns the partnership property. *Id.* at 594. Partnership property is not characterized as marital property. *Id.* However, a partnership interest is characterized as marital property. *Id.* Under the aggregate theory of partnership, partnership property is owned by the individual partners. *Id.* at 593. In 2006, Texas adopted the Texas Business Organizations Code (TBOC), which still embraces the entity theory of partnership. *See* TEX. BUS. ORGS. CODE ANN. §§ 1.001–402.014 (West 2006).

95. *See* TEX. BUS. ORGS. CODE ANN. § 21.302 (West 2012).

treated as the distribution of income earned by the entity.[96] Consistent with the marital property characterization rules discussed above with regard to income-producing property and the income produced by such property, Texas law characterizes distributions of income from corporations and partnerships as community property without regard to whether the ownership interest in such corporation or partnership is characterized as community property or separate property.[97] Thus, Texas law characterizes payment of cash dividends by a corporation to its shareholders and distributions of partnership income from a partnership to its partners as community property.[98]

A corporation may occasionally make a dividend distribution to its shareholders in the form of its own stock (commonly referred to as a stock dividend).[99] Texas courts have held that if the original stock is separate property, the additional stock received as a dividend is separate property as well.[100] The additional stock is treated as a mutation of the original stock and thus separate property under the tracing doctrine.[101]

A corporation or partnership may liquidate its business and dissolve. Should this occur, the shareholders or partners will receive distributions in liquidation of their stock or partnership interests.[102] In *LeGrand-Brock v. Brock*, the husband (H) owned stock that was his separate property because he had acquired it before the marriage.[103] The board of directors of the corporation passed a resolution to dissolve the corporation, liquidate its assets, and distribute the proceeds to the shareholders in complete cancellation or

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96. *See* LeGrand-Brock v. Brock, 246 S.W.3d 318, 322 (Tex. App.—Beaumont 2008, pet. denied) (stating that cash dividends from stock are treated as income); *Marshall*, 735 S.W.2d at 595 (holding that distributions from a partnership to a partner were distributions of income).

97. *See LeGrand-Brock*, 246 S.W.3d at 322 (stating that cash dividends from stock are community property); *Marshall*, 735 S.W.2d at 595 (holding that distributions from a partnership to a partner were community property).

98. *See LeGrand-Brock*, 246 S.W.3d at 322 (explaining that a distribution by a corporation to its shareholders may legally constitute a dividend even if it is not formally designated as a dividend by the board of directors because all such distributions have the legal effect of a dividend). *See also Marshall*, 735 S.W.2d at 594 (expressing the view that all distributions by a partnership to its partners are effectively distributions of income because, under the Uniform Partnership Act, there can be no distributions that would constitute a return of capital). It is difficult to conceive of a distribution by a corporation or partnership, that is not in full or partial redemption of its corporate shares or partnership interests, that would not be treated as income for marital property characterization purposes.

99. *See LeGrand-Brock*, 246 S.W.3d at 322. The lone exception to that rule applies when the corporate stock or partnership interest was received by the owner spouse as a gift from the other spouse; in addition to the stock or partnership interest being characterized as separate property because it was acquired by gift, Texas law presumes the income from such property to be separate property as well. *See* TEX. FAM. CODE ANN. § 3.005 (West 2006); *LeGrand-Brock*, 246 S.W.3d at 322.

100. *See, e.g.*, Carter v. Carter, 736 S.W.2d 775, 777–78 (Tex. App.—Houston [14th Dist.] 1987, no writ).

101. *Id.* This rule recognizes the notion that a stock dividend does not add anything of value to what the shareholders originally owned because stock dividends dilute the value of the shares. *Id.* Although the shareholders own more shares after the stock dividend than they did before the distribution, the total value of their shares remains the same. *Id.*

102. TEX. BUS. ORGS. CODE ANN. §§ 11.001(2)–(8) (West 2011).

103. *LeGrand-Brock,* 246 S.W.3d at 320.

redemption of all the stock.[104] H received liquidating distributions totaling nearly $7 million.[105] The wife (W) argued that the corporation made the liquidating distributions from its retained earnings, and the distributions were, therefore, cash dividends and should be characterized as community property because they were essentially income generated from H's separate property stock.[106] The court explained that there was no question that H received the distributions because of the total dissolution of the corporation and liquidation of its assets.[107] Further, the resolution of the board of directors required the corporation "to distribute its remaining assets to its shareholders 'in complete cancellation or redemption of all the shares of capital stock of the [c]ompany[.]' It is immaterial to the characterization of the property in this case that the assets distributed on dissolution were the corporation's retained earnings."[108] The court held that H received those distributions in exchange for H's separate property stock, and the distributions were thus H's separate property under the tracing doctrine.[109]

It is clear from the above discussion that corporations and partnerships are treated consistently under Texas law for purposes of marital property characterization. This treatment aligns with the legislative intent underlying the Texas Business Organizations Code (TBOC)—to treat various entities formed and regulated by the TBOC consistently.[110] The TBOC applies to many entities including corporations, general partnerships, limited partnerships, and limited liability companies, but all such entities can basically be divided into two groups: corporations and partnerships.[111] The other entities not specifically discussed here will be treated consistently with corporations and partnerships for purposes of marital property characterization.

III. ARE TRUSTS SEPARATE LEGAL ENTITIES?

In some jurisdictions, a trust is a legal entity separate from the owners of the beneficial interests in the trust.[112] If that is the case under Texas law, at least with respect to characterizing marital property, then the rules for characterizing beneficial interests in and distributions from trusts should be

104. *Id.*
105. *Id.*
106. *Id.* at 321.
107. *Id.* at 322.
108. *Id.*
109. *Id.*
110. *See* Daryl B. Robertson, Robert Hamilton, & George W. Coleman, *Introduction to Texas Business Organizations Code*, 38 TEX. J. BUS. L. 57, 63 (2002) (explaining that Texas adopted the TBOC in 2006 to replace the various statutory schemes that previously regulated those entities).
111. *See id.* at 61.
112. *See, e.g.*, United States v. Harrison, 653 F.2d 359, 361 (8th Cir. 1981) (holding that under Missouri law, a trust is a formally organized entity legally distinct from its trustees); Leon Hall Price Found. v. Baker, 577 S.E.2d 779, 781 (Ga. 2003) (stating that it is a generally accepted principle that a trust is a legal entity separate from its beneficiaries).

consistent with the rules for characterizing ownership interests in and distributions from other separate entities, such as corporations and partnerships. The Supreme Court of Texas has ruled that, at least for certain purposes, trusts are not legal entities at all but rather constitute a fiduciary relationship between the trustee and the beneficiaries with respect to the trust property.[113]

In *Huie v. DeShazo*, Huie was the trustee of three testamentary trusts, and one of the beneficiaries sued him for breach of fiduciary duties.[114] Huie had previously hired an attorney to represent him in his capacity as trustee of one of the trusts, and the attorney had been compensated from the trust for such representation.[115] In his deposition, the attorney claimed attorney-client privilege and refused to answer questions regarding the trust.[116] One of the arguments advanced by the beneficiary was that the attorney-client privilege did not apply between the attorney and Huie because the trust itself was the attorney's actual client rather than Huie as the trustee.[117] The court held that such an approach would be inconsistent with the law of trusts and cited to the Texas Trust Code, stating that "[t]he term 'trust' refers not to a separate legal entity but rather to the fiduciary relationship governing the trustee with respect to the trust property."[118] The court noted that under the Texas Trust Code, a trust is created by the devise of property by a settlor to a trustee, it is the trustee who holds the trust property for the benefit of the trust beneficiaries, and it is the trustee who is authorized to hire counsel.[119] Accordingly, the court held that the attorney represented "Huie in his capacity as trustee, not the 'trust' as an entity."[120]

In *Ray Malooly Trust v. Juhl*, a trust was sued for breach of a lease and a judgment was entered against it.[121] The trust appealed, arguing that it was not a legal entity under Texas law and thus did not have the capacity to be sued.[122] The court held that "[t]he general rule in Texas (and elsewhere) has long been that suits against a trust must be brought against its legal representative, the trustee."[123]

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113. *See* Ditta v. Conte, 298 S.W.3d 187, 191–92 (Tex. 2009); Ray Malooly Trust v. Juhl, 186 S.W.3d 568, 570 (Tex. 2006); Huie v. DeShazo, 922 S.W.2d 920, 926 (Tex. 1996).

114. *Huie*, 922 S.W.2d at 921–22.

115. *Id.* at 922.

116. *Id.*

117. *Id.* at 926.

118. *Id.* (citing section 111.004 of the Texas Property Code, which provides that "'[e]xpress trust' means a fiduciary relationship with respect to property which arises as a manifestation by the settlor of an intention to create the relationship and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another person").

119. *Id.*

120. *Id.*

121. Ray Malooly Trust v. Juhl, 186 S.W.3d 568, 569 (Tex. 2006).

122. *Id.*

123. *Id.* at 570.

In *Ditta v. Conte*, Ditta filed a lawsuit seeking to remove the trustee of a trust.[124] The probate court held in favor of Ditta, and the trustee appealed, arguing that Ditta's action was barred by the statute of limitations applicable to claims for breach of fiduciary duty.[125] The court held that no statute of limitations period applies to trustee removal actions, basing its holding in part on the nature and character of trusts as fiduciary relationships.[126] The court cited to *Huie* for the proposition that "[a] trust is not a legal entity; rather it is a 'fiduciary relationship with respect to property.'"[127]

Whether a trust is a separate legal entity from its beneficiaries under Texas law in situations different from those present in *Huie*, *Malooly*, and *Ditta* remains an open question.[128] A Texas appellate court distinguished *Huie*, limiting its holding to the specific facts presented; the court stated that the issue in *Huie* was "whether a trustee who retains an attorney to advise him on matters regarding trust administration must disclose the substance of conversations between the trustee and the attorney," whereas the issue the court was dealing with in *NationsBank of Texas v. Akin, Gump, Hauer & Feld* was "whose assets were to be considered when determining consumer status" in an action for violations of the Texas Deceptive Trade Practices Consumer Protection Act.[129] On the other hand, a federal circuit court applying Texas law cited to *Malooly* and *Huie*, and stated the following:

> We see no good reason to expect the Texas courts to deviate from these decisions to hold that a trust is a separate legal entity for purposes of requiring a bankruptcy trustee to plead and prove an alter-ego claim to reach self-settled assets held by an entity wholly-owned by a spendthrift trust.[130]

Whether a trust is a separate legal entity from its beneficiaries for marital property characterization purposes is a question that has not yet been directly decided by the Supreme Court of Texas, although one could certainly conclude from the discussion above that the court would hold that it is not.[131] Interestingly, as will be discussed in Section IV, Texas appellate courts have effectively treated trusts as separate legal entities for purposes of marital property characterization of beneficial interests in trusts and undistributed trust income, but the courts have not done so in characterizing trust income distributed by the trustee to the beneficiaries.[132] In any event, the rules proposed in Section V of this article achieve the same results regardless of

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124. Ditta v. Conte, 298 S.W.3d 187, 189 (Tex. 2009).

125. *Id.*

126. *Id.* at 192.

127. *Id.* at 191.

128. *See* Tooke v. City of Mexia, 197 S.W.3d 325, 334 (Tex. 2006).

129. NationsBank of Tex., N.A. v. Akin, Gump, Hauer & Feld, L.L.P., 979 S.W.2d 385, 391 (Tex. App.—Corpus Christi 1998, no pet.).

130. *In re* Bradley, 501 F.3d 421, 433–34 (5th Cir. 2007).

131. *See* Sharma v. Routh, 302 S.W.3d 355, 364 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

132. *See id.*; Rigdell v. Rigdell, 960 S.W.2d 144, 148 (Tex. App.—Corpus Christi 1997, no pet.).

whether a trust is treated as a separate legal entity for marital property characterization purposes.

IV. CIRCUIT COURT DECISIONS CHARACTERIZING BENEFICIAL INTERESTS IN AND DISTRIBUTIONS FROM TRUSTS

As stated previously, the marital property rules used currently in Texas for characterizing beneficial interests in and distributions from trusts have not been consistently formulated and applied by the different courts of appeals—a problem that the Supreme Court of Texas has not yet resolved.[133] This lack of consistency occurs because trusts are created for many different reasons and, as a result, take many different forms.[134] Many trusts are structurally complex devices, and courts have struggled to understand them and to apply marital property characterization rules to them in a consistent manner.[135]

Generally, a trust is created when a settlor transfers legal title to property to a person (trustee) who agrees to hold such title for the benefit of another (beneficiary).[136] Most trusts are voluntarily created for a specific purpose but sometimes equitable trusts, usually referred to as resulting trusts[137] or constructive trusts,[138] exist by operation of law.[139] Generally, the terms of a trust are governed by a written trust document executed by the settlor.[140] A trust may be an inter vivos trust (created during the lifetime of the settlor) or a testamentary trust (created at the death of the settlor by the terms of a will).[141] A trust may be revocable or irrevocable.[142] Revocable trusts are generally used

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133. *See Sharma*, 302 S.W.3d at 364.

134. *See* Dickinson v. Dickinson, 324 S.W.3d 653, 659 (Tex. App.—Fort Worth 2012, no pet.); Taylor v. Taylor, 680 S.W.2d 645, 649 (Tex. App.—Beaumont 1984, writ ref'd n.r.e.); *In re* Marriage of Burns, 573 S.W.2d 555, 557 (Tex. App.—Texarkana 1978, writ dism'd).

135. *See Rigdell*, 960 S.W.2d at 148; Cleaver v. Cleaver, 935 S.W.2d 491, 493 (Tex. App.—Tyler 1996, no writ); Cleaver v. George Staton, Inc., 908 S.W.2d 468, 470 (Tex. App.—Tyler 1995, writ denied).

136. *See* TEX. PROP. CODE ANN. § 112.001 (West 2011) (describing allowable methods of creating a trust in Texas); TEX. PROP. CODE ANN. § 111.004(14) (West 2011) (defining "settlor" as the creator of a trust); PROP. § 111.004(2) (defining "beneficiary" as a person for whose benefit property is held in trust).

137. *See generally* RESTATEMENT (THIRD) OF TRUSTS §§ 440–42 (2003); Wright v. Wright, 132 S.W.2d 847, 849 (Tex. 1939). For example, resulting trusts can arise under Texas law when legal title to property is acquired by one person and the purchase price is paid by another. RESTATEMENT (THIRD) OF TRUSTS §§ 440–42 (2003). Generally, the person paying the consideration for the property is presumptively treated as the beneficial, or equitable, owner of the property, and the record title owner is treated as holding the equitable title in a resulting trust for the benefit of the equitable owner. *Id.* A resulting trust is generally not presumed when such persons are related or when the person paying the consideration disclaims the beneficial interest in the property. *Id.*

138. A court can impose constructive trusts to achieve equity in appropriate circumstances. For example, if a person acquires property by actual or constructive fraud, a court may order that this person holds such property in a constructive trust for the benefit of the rightful owner. *See, e.g.*, *In re* Marriage of Braddock, 64 S.W.3d 581, 586–87 (Tex. App.—Texarkana 2001, no pet.) ("A constructive trust is not actually a trust, but is an equitable remedy imposed by law to prevent unjust enrichment resulting from an unconscionable act.").

139. *See* PROP. § 111.004(4).

140. *See* TEX. PROP. CODE ANN. § 112.004 (West 2011).

141. *See* TEX. PROP. CODE ANN. § 112.002(2)–(3) (West 2011).

142. *See* TEX. PROP. CODE ANN. § 112.051 (West 2011).

for estate planning purposes to allow property to pass at the death of the settlor without the necessity of probate.[143] Irrevocable trusts are also used for estate planning purposes to make inter vivos gifts of property and prevent such property from being included in the settlor's estate for purposes of the federal estate tax.[144] Trusts are especially important for this purpose and for testamentary purposes when gifts are being made to minors or others to whom the settlor is unwilling to grant immediate use and benefit of the property.[145] Retirement plans are created and operated by the use of trusts.[146] The employer irrevocably transfers property each year to the retirement trust for the benefit of its employees to fund its obligations under the plan.[147]

A beneficiary of a trust can be classified as an income beneficiary (a beneficiary who is entitled to receive distributions of trust income) or a remainder beneficiary (a beneficiary who is entitled to receive distributions of trust principal when an income interest ends).[148] A trust may provide for mandatory distributions of income or principal during the life of the trust, or a trust may give the trustee discretion over whether such distributions should be made.[149] Many trusts contain so-called spendthrift provisions.[150] A spendthrift provision states that the interest of a beneficiary of either income or principal "may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee."[151] The basic purpose of a spendthrift provision in a trust is to permit a settlor "creating the trust to protect a beneficiary against his own improvidence."[152] A beneficiary may, for example, absent a spendthrift provision , assign his beneficial interest outright for a payment in cash or as security for an obligation and then use the cash proceeds for some purpose that might be characterized as foolish or wasteful. Such a provision prevents assignments of beneficial interests in trusts from having legal effect and prevents a judgment creditor from executing on the beneficial interest in the trust to satisfy the judgment.[153] Under Texas law, "if the settlor is also a beneficiary of the trust," a spendthrift provision applicable

143. *See* Glenn Kansch, *Frequently Asked Questions About Living Trusts*, TEX. PROBATE, http://texasprobate.net/faqs/faqs_about_living_trusts.htm (last visited Aug. 30, 2012).

144. *See, e.g.*, Nipp v. Broumley, 285 S.W.3d 552, 559 (Tex. App.—Waco 2009, no pet); Ayers v. Mitchell, 167 S.W.3d 924, 928–29 (Tex. App.—Texarkana 2005, no pet.).

145. *See, e.g.*, *In re* White Intervivos Trusts, 248 S.W.3d 340, 341 (Tex. App.—San Antonio 2007, no pet.); Anthony J. Medico, *Trusts for Minors, Why Do You Need Them and How Do They Work?*, EST. PLAN. & OTHER LEGAL DISCUSSIONS (Jan. 18, 2010, 3:15 PM), http://blog.ctnews.com/medico/ 2010/01/18/trusts-for-minors-why-do-you-need-them-and-how-do-they-work/.

146. *See, e.g.*, Lipsey v. Lipsey, 983 S.W.2d 345, 351 (Tex. App.—Fort Worth 1998, no pet.).

147. *See* TEX. PROP. CODE ANN. § 121.001 (West 2011).

148. *See* TEX. PROP. CODE ANN. § 116.002(5), (11) (West 2011) (defining income beneficiary and remainder beneficiary).

149. *See* PROP. § 116.002(6), (7).

150. *See* TEX. PROP. CODE ANN. § 112.035(a) (West 2011).

151. *Id.*

152. *See In re* Townley Bypass Unified Credit Trust, 252 S.W.3d 715, 720 (Tex. App.—Texarkana 2008, no pet.).

153. *Id.* at 718–19.

to the settlor does not prevent the settlor's judgment creditors from executing on the settlor's beneficial interest.[154]

The marital property characterization rules applicable to revocable trusts have created no legal issues and have thus not been addressed by Texas courts. This is perhaps because revocable trusts are treated for many legal purposes as if the settlor is the owner of the trust property.[155] No functional difference exists for marital property characterization purposes between holding title to property individually versus holding such title in a revocable trust: the settlor can revoke the trust at any time and recover ownership of the property.[156] Thus, for marital property characterization purposes, the settlor should be treated as the owner of the trust property; the property would then be characterized as community or separate property under the normal rules, and any income from such property is community property.[157] If the income is paid to an income beneficiary who is not the settlor, the payment of the income to this beneficiary should be treated as a gift from the settlor.[158] If the beneficiary is married, the payment received would thus be the beneficiary's separate property.[159]

Inconsistencies have arisen when courts attempted to apply marital property characterization rules to irrevocable trusts.[160] *McClelland v. McClelland* was one of the first Texas cases dealing with marital property characterization of interests in trusts.[161] *McClelland* is a divorce case in which the husband (H) was a beneficiary of a testamentary trust.[162] The will creating the trust provided for periodic mandatory distributions to H for his life and gave the trustee authority to make additional discretionary distributions to H.[163] The

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154. *See* PROP. § 112.035(d).

155. *See generally* I.R.C. §§ 671, 676 (West 1986); Martin J. Placke, *Creditors' Rights in Nonprobate Assets in Texas*, 42 BAYLOR L. REV. 141, 143 (1990). For federal income tax purposes, for example, revocable trusts are referred to as "grantor trusts" and the income from the trust property is taxed to the settlor; the settlor is treated as the owner of the trust property. *See generally* §§ 671, 676; Martin J. Placke, *Creditors' Rights in Nonprobate Assets in Texas*, 42 BAYLOR L. REV. 141, 143 (1990). For federal estate and gift tax purposes, a transfer of property to a revocable trust is ordinarily not treated as a taxable gift because the transfer is not considered complete, and the value of the property transferred is included in the transferor's gross estate. *See generally* I.R.C. §§ 2038, 2511(c) (West 1986) (repealed 2010); Treas. Reg. § 25.2511-2(b) (1999); Martin J. Placke, *Creditors' Rights in Nonprobate Assets in Texas*, 42 BAYLOR L. REV. 141, 143 (1990). Again, the settlor is basically treated as the owner of the trust property. *See generally* §§ 2038, 2511(c) (repealed 2010); Treas. Reg. § 25.2511-2(b); Martin J. Placke, *Creditors' Rights in Nonprobate Assets in Texas*, 42 BAYLOR L. REV. 141, 143 (1990).

156. Placke, *supra* note 155, at 147.

157. *See id.* at 143–44.

158. *See* TEX. FAM. CODE ANN. § 3.102 (West 1997).

159. That result is consistent with the federal income tax law, which treats such income as taxable to the settlor and the payment of such income to the income beneficiary as a gift from the settlor. *See generally* §§ 671, 676; Placke, *supra* note 155, at 147. It is also consistent with the federal estate tax law, which treats the payment of such income to the income beneficiary as a gift from the settlor at the time it is paid rather than treating the transfer of property to the trust as a gift. *See generally* § 2511(c); Treas. Reg. § 25.2511-2(b).

160. *See, e.g.*, Sharma v. Routh, 302 S.W.3d 355, 364 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

161. McClelland v. McClelland, 37 S.W. 350, 356 (Waco 1896, writ ref'd).

162. *Id.*

163. *Id.*

will further provided that the trust would terminate upon H's death, with the remainder to be distributed to H's heirs.[164] The trustee made all mandatory distributions to H required by the trust but made no discretionary distributions to H.[165] The wife (W) argued that the will did not provide for the property to be held in trust, but rather, H was to receive the property outright and the accumulated income earned by such property was thus community property.[166] The court first determined that the will did provide for the transfer of the property in trust.[167] The court then stated that the trust created by the will was "what is technically understood to be a spendthrift trust," inferring from the provisions of the will that the property was transferred to the trust subject only to the obligation to make the mandatory distributions to H.[168] Creditors or others—including W—seeking an interest in the trust property through H "would have no greater right than he would have."[169] If the income from the trust property "was not available to [H], 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."[170] The court concluded that W "had no interest in the property conveyed by the will that she could reach."[171] One possible interpretation of this opinion is that the court merely treated the trust as an entity separate from H, and the court treated the trust property and the undistributed income from the property as belonging to the trust, rather than H.[172] Thus, at the time of the divorce, no marital property existed to characterize.[173] If this is what the court intended, the court appears to significantly rely on its determination that the trust was a spendthrift trust, and therefore, H had no right to reach the trust income. However, the court went further and addressed the characterization of the mandatory distributions H received during the marriage.[174] The court characterized those distributions as H's separate property because they were "devised to him by the will" and were thus inherited by H.[175] This conclusion ignores the question of whether the distributions were made to H from trust income or corpus. Normally when a spouse inherits property, the property itself is separate property but the income from the property is community property.[176] No discussion exists in this opinion regarding whether the distributions were inherited property or income

164. *Id.*
165. *Id.* at 357.
166. *Id.* at 351.
167. *Id.* at 358.
168. *Id.* at 350.
169. *Id.*
170. *Id.*
171. *Id.* at 359.
172. *See id.*
173. *See id.*
174. *See id.*
175. *See id.*
176. TEX. CONST. art. XVI, § 15.; *accord* Colden v. Alexander, 171 S.W.2d 328, 334 (Tex. 1943).

from property or how the analysis might differ depending on whether the inherited property is held in trust or is transferred outright to a spouse.[177]

Remarkably, this issue was not again considered by a Texas appellate court until 1955.[178] In *Mercantile National Bank at Dallas v. Wilson*, the Mercantile National Bank at Dallas (Bank) brought suit against Roberta Ray Wilson (Roberta) for payment of a promissory note originally made by George O. Wilson (George), Roberta's husband.[179] George had died and Bank was seeking payment of the note.[180] Bank agreed that Roberta was not personally liable on the note, but prior to marrying George, Roberta had created a trust of which she was the sole beneficiary.[181] Roberta could not revoke the trust until after the trustee died.[182] Distributions from the trust to Roberta were entirely in the discretion of the trustee.[183] The trust was dissolved shortly after George's death with the trust assets distributed to Roberta.[184] Bank argued that the trust income that accrued during the marriage, along with property purchased with that income, was community property and was thus subject to Bank's claim.[185] Roberta argued that the property was her separate property and was not subject to payment of the note.[186] The court decided the case in favor of Roberta based on other issues not relevant here but in the process, the court decided that the trust income was community property of Roberta and George.[187] The problem with the manner in which the court disposed of that issue was that it did so with no accompanying analysis; the court simply and conclusively stated that the income was community property.[188] The court apparently failed to consider any possible effect that the dissolution of the trust and distribution of the trust assets to Roberta after George's death may have had on this issue because it described the issue as "whether or not the undistributed profits or income from the trust in the hands of the trustee is community property."[189] But with no accompanying analysis indicating how the court reached its conclusion, this case is of little assistance to subsequent courts and litigants.

In a line of cases beginning in 1967 with the decision in *Buckler v. Buckler*, an approach was developed for characterizing trust corpus and undistributed trust income from irrevocable trusts.[190] *Buckler* is a divorce case

177. *McClelland*, 37 S.W. at 350.
178. Mercantile Nat'l Bank at Dallas v. Wilson, 279 S.W.2d 650, 650 (Tex. App.—Dallas 1955, writ ref'd n.r.e.)
179. *Id.* at 651.
180. *Id.*
181. *Id.* at 651–53.
182. *Id.* at 653.
183. *Id.*
184. *Id.* at 651.
185. *Id.*
186. *Id.*
187. *Id.* at 653–54.
188. *Id.*
189. *Id.*
190. Buckler v. Buckler, 424 S.W.2d 514, 517 (Tex. App.—Fort Worth 1967, writ dism'd)

in which the husband (H) was a beneficiary of what the court referred to as "spendthrift trusts."[191] The issue was the characterization of undistributed income that had accumulated in the trusts during the marriage.[192] The court stated that *McClelland* had held "that undistributed trust income was not community property where the trustee had the right to withhold it from the trust beneficiary because of [a] provision to such effect in the trust instrument."[193] Because that was also the situation in *Buckler*, the court then focused on whether the holding in *McClelland* was correct.[194] The court noted that the wife applied for a writ of appeal from the Supreme Court of Texas and the writ was refused.[195] The court stated that it was "inconceivable that the matter here under consideration was not made a point of error before the Supreme Court in that case," and determined the following:

> [T]he Supreme Court, which disposed of the application for writ of error in McClelland by the notation "writ refused", [sic] 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.[196]

Thus, the court simply followed *McClelland* and decided the case in favor of H.[197]

This issue arose again in 1974 in *Currie v. Currie*, a divorce case in which the husband (H) was a beneficiary of two testamentary trusts.[198] H's great-grandfather's will created one trust (Trust I), and H's grandfather's will created the other (Trust II).[199] Trust I had very little undistributed income remaining at the time of the divorce, but the wife (W) argued that the community estate should be reimbursed for estate taxes that had been paid from income earned by the trust.[200] The will creating Trust I authorized the trustee to pay the estate taxes from income earned by the trust prior to any such income accruing to the beneficiaries.[201] The court held that the community property estate acquired no interest in such income because H had no claim to it "other than an expectancy interest in the corpus."[202] The will creating Trust II provided that all income of

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191. *Id.* at 515.
192. *Id.*
193. *Id.* (citing McClelland v. McClelland, 37 S.W. 350 (Tex. Civ. App.—Waco 1896, writ ref'd)). This is not verbatim what the court held in *McClelland*, but is probably a reasonable interpretation. *See McClelland*, 37 S.W. at 359.
194. *Buckler*, 424 S.W.2d at 515–16.
195. *Id.* at 515.
196. *Id.* at 515–16.
197. *Id.* at 516–17.
198. Currie v. Currie, 518 S.W.2d 386, 388 (Tex. App.—San Antonio 1974, writ dism'd).
199. *Id.*
200. *Id.* at 389.
201. *Id.*
202. *Id.*

the trust was required to be paid to the testator's daughter during her lifetime; "[o]n her death, the corpus [of the trust] was to be divided into separate trusts for her surviving children," one of whom was H.[203] The daughter was still living at the time of the divorce.[204] W argued that the income that had accumulated in the trust that had not been spent by the testator's daughter was the community property of H and herself.[205] Because the life beneficiary of the trust (testator's daughter) was still living, the court held that H was not yet entitled to receive anything from the trust and had not received anything as of the time of the divorce.[206] The court did not cite to *McClelland*, *Buckler*, or any other cases in making its decision, but its holding is consistent with *McClelland* and *Buckler*: Because H had no right under either of the trust instruments to any undistributed trust income as of the time of the divorce, the community property estate acquired no interest in any such undistributed income.[207]

In re Marriage of Burns is a divorce case decided in 1978 in which the husband (H) was the beneficiary of several trusts.[208] H's parents and grandparents created three trusts that "were 'spendthrift trusts' in that their assets were not subject to alienation, attachment or assignment by [H] or his creditors."[209] H created three more trusts—two before the marriage and then, using his separate property, the third during the marriage.[210] None of the three trusts created by H contained "spendthrift" provisions.[211] Five of those six "trusts were 'discretionary trusts' in that the trustee or trustees could either withhold or distribute the income and/or corpus at their sole discretion."[212] The remaining trust did not provide for distribution of income or corpus but "directed that the corpus and accumulated income would be distributed to" H at a certain date.[213] Two additional trusts were testamentary trusts established by the wills of H's parents, both of whom died during the marriage; those trusts were unfunded at the time of trial, but both parents' wills had been probated.[214] The court stated that the two additional trusts were "spendthrift trusts" and "discretionary trusts."[215] H was not the trustee of any of the eight trusts.[216] The wife (W) argued that the undistributed income earned by all of the trusts during the marriage was community property.[217] The court noted that W did not argue

203. *Id.* at 389–90.
204. *Id.* at 390.
205. *Id.*
206. *Id.*
207. *Id.*
208. *In re* Marriage of Burns, 573 S.W.2d 555, 556 (Tex. App.—Texarkana 1978, no writ).
209. *Id.*
210. *Id.*
211. *Id.* at 556–57.
212. *Id.* at 557.
213. *Id.*
214. *Id.*
215. *Id.*
216. *Id.* at 556–57.
217. *Id.* at 556.

that any of the trusts "were created, funded or operated in fraud of her rights" or that any of the trusts were the "alter ego" of H.[218] The court then announced its agreement with the *Buckler* and *Currie* decisions.[219] However, the court pointed out some distinctions between the facts of those cases and the facts in *Burns*.[220] For example, the court was uncertain in *Currie* whether any income would ever be available for distribution to the beneficiary spouse, and the trust in *Buckler* was a spendthrift trust but three of the trusts in *Burns* were not.[221] In spite of these distinctions, the court in effect held consistently with those decisions by focusing on the definition of community property in the Texas Family Code as "property, other than separate property, acquired by either spouse during marriage."[222] Because the undistributed trust income "had not been distributed to [H] nor [had] he [had] a present or past right to require its distribution so as to compel a finding that there [had been] a constructive acquisition," the court stated that the trusts—not H—acquired and owned the income, which was "not subject to the division by the court."[223] Thus, while phrasing their respective holdings somewhat differently, the courts in *McClelland*, *Buckler*, *Currie*, and *Burns* reached consistent conclusions using effectively the same reasoning: Because the beneficiary spouse had no right under the trust instruments to any undistributed trust income as of the time of the divorce, the community property estate acquired no interest in any such undistributed income.

Subsequently, two appellate courts relied on the standard from the *Burns* decision when faced with the issue of characterizing undistributed trust income in a divorce.[224] *Lemke v. Lemke* and *Lipsey v. Lipsey* were divorce cases decided in 1996 and 1998, respectively.[225] In *Lemke*, the husband (H) was the beneficiary of a trust that he created prior to the marriage with funds received from the settlement of a lawsuit.[226] The trust was a spendthrift trust and provided the trustee with the sole discretion to distribute income and corpus to H in amounts the trustee deemed appropriate for H's health, education, maintenance, and welfare.[227] H was not the trustee.[228] The court noted, as did the court in *Burns*, that "there was no suggestion that the [trust was] created,

218. *Id.* at 557.
219. *Id.*
220. *Id.*
221. *Id.*
222. *Id.*
223. *Id.* at 557–58. *See also* McClelland v. McClelland, 37 S.W. 350, 359 (Waco 1896, writ ref'd) (stating that an allowance from a trust received by one spouse was separate property); Buckler v. Buckler, 424 S.W.2d 514, 515 (Tex. App.—Fort Worth 1967, writ dism'd) (stating that the undistributed trust income was not community property); Currie v. Currie, 518 S.W.2d 386, 390 (Tex. App.—San Antonio 1974, no writ) (stating that trust income earned during the marriage by one spouse was not part of the community estate).
224. Lemke v. Lemke, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied); Lipsey v. Lipsey, 983 S.W.2d 345, 347 (Tex. App.—Fort Worth 1998, no pet.).
225. *Lemke*, 929 S.W.2d at 662; *Lipsey*, 983 S.W.2d at 345.
226. *Lemke*, 929 S.W.2d at 663.
227. *Id.*
228. *Id.*

funded, or operated in fraud of the wife or as an alter ego of [H]," and the court described the relevant issue as "whether the undistributed income earned by the [trust] during the marriage was community property."[229] The court described *Burns* as the leading case regarding this issue and noted that H's trust "contained a spendthrift clause, which prevented [H] from alienating, anticipating, assigning, encumbering, or hypothecating his interest in the principal or income of the trust" and that the trustee "had the absolute discretion to distribute as much of the corpus and income of the trust [to H] as she deemed appropriate."[230] The court then stated that it was following *Burns* in holding that "the undistributed trust income that accrued during [H's] marriage [to W] remained a part of the separate trust estate and was not subject to division by the court because it was not community property."[231]

In *Lipsey*, the husband (H) was the beneficiary of a trust created prior to the marriage with funds that he "rolled-over" from a pension plan into a 401(k) plan, which was held and managed as a trust and governed by the Employee Retirement Income Security Act (ERISA).[232] H was not the trustee and received no distributions from the trust.[233] The trust prohibited H from receiving or compelling distribution of income from the trust until he reached a specific age, which he had not yet reached at the time of the divorce.[234] The trust had the characteristics of a spendthrift trust as required by ERISA.[235] The court noted, as did the court in *Burns*, that the wife (W) did "not assert that the [trust] was established, funded, or operated in fraud of her rights, nor [did] she allege that the trust was the alter ego of [H]."[236] The court disposed of a number of issues dealing with the application of ERISA, but the ultimate issue for the court to decide was whether the undistributed income earned by the trust during the marriage was community property.[237] The court, citing *Lemke* and *Burns*, held that H had not acquired the undistributed trust income because the income had not been distributed to him during the marriage, and he had no right to compel such a distribution.[238] Such income "remained a part of the trust estate and [was] not subject to division by the trial court."[239] W argued that although H did not actually acquire the undistributed trust income, he acquired the income "constructively."[240] She argued that when H retired, he became entitled to receive a lump-sum distribution from his pension plan and

229. *Id.* at 664.
230. *Id.*
231. *Id.*
232. Lipsey v. Lipsey, 983 S.W.2d 345, 347 (Tex. App.—Fort Worth 1998, no pet.).
233. *Id.*
234. *Id.* at 348.
235. *Id.* at 349.
236. *Id.* at 347.
237. *Id.* at 347, 351.
238. *Id.* at 351.
239. *Id.*
240. *Id.*

constructively acquired those funds.[241] Thus, any income generated from those funds during marriage became community property.[242] The court explained that accepting W's argument would establish a rule characterizing "all income from self-settled trusts, whether created before or after marriage, [as] community property," which would conflict with *Burns*.[243]

The case law dealing with the marital property rules for characterizing trust corpus and undistributed trust income from irrevocable trusts appears consistent among the various circuit courts.[244] If a trust is funded before or during marriage with separate property, courts have characterized the trust corpus as separate property of the beneficiary spouse.[245] Undistributed trust income is separate property of the beneficiary spouse so long as the spouse has not done either of two things: (1) actually acquired such income or (2) constructively acquired such income because of a right to require distribution.[246] Whether these decisions are correct from an analytical perspective will be discussed in Section V. As discussed earlier regarding the decision in *McClelland*, one possible interpretation of these decisions is that the courts perhaps treated the trusts as entities separate from their beneficiaries and treated the trust property and undistributed income from such property as belonging to the trusts rather than such beneficiaries.[247] Under this analysis, if a spouse is a beneficiary of a trust, the marital property subject to characterization is the beneficial ownership interest in the trust, not the trust property or undistributed income.[248] What happens to distributions of trust income to a beneficiary spouse? Do courts treat distributions of trust income the same for characterization purposes as distributions from corporations and partnerships? If so, acquisition of the trust income would result in characterizing such income as community property.[249]

Wilmington Trust Company v. United States dealt with the issue of how to characterize income distributed from irrevocable trusts.[250] *Wilmington* is a case dealing with the federal estate tax in which the court was required to apply Texas law.[251] The Internal Revenue Service (IRS) assessed additional estate taxes with regard to a federal estate tax return that was filed following the death of a married man (H).[252] H's estate filed an action in the United States Claims

241. *Id.*
242. *Id.*
243. *Id.*
244. *See generally* Lemke v. Lemke, 929 S.W.2d 662 (Tex. App.—Fort Worth 1996, writ denied); *Lipsey*, 983 S.W.2d at 347.
245. *Lemke*, 929 S.W.2d at 664; *Lipsey*, 983 S.W.2d at 351.
246. *Lemke*, 929 S.W.2d at 664; *Lipsey*, 983 S.W.2d at 351.
247. McClelland v. McClelland, 37 S.W. 350, 358 (Waco 1896, writ ref'd); *Lemke*, 929 S.W.2d at 664; *Lipsey*, 983 S.W.2d at 345.
248. *See McClelland*, 37 S.W. at 350; *Lemke*, 929 S.W.2d at 664; *Lipsey*, 983 S.W.2d at 345.
249. *McClelland*, 37 S.W. at 350; *Lemke*, 929 S.W.2d at 662; *Lipsey*, 983 S.W.2d at 345.
250. Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 7 (1983).
251. *Id.* at 8.
252. *Id.* at 7.

Court challenging the assessment.[253] At the time of H's death, his spouse (W) held certain property in her name consisting of stock in six corporations and five bank accounts; she also served as the beneficiary of seven trusts.[254] During the marriage, the trusts accumulated undistributed trust income.[255] W had acquired the stock and bank accounts with distributions of income that she received from the trusts.[256] None of this property was included in the estate tax return as assets of H's estate because the estate treated it as separate property of W.[257] All of the trusts were created during the marriage and were irrevocable.[258] Six of the trusts were created by W's parents, and the other trust was created by H; all of the trusts were created either *inter vivos* or by testamentary gift.[259] All seven trusts entitled W to receive mandatory distributions of the net income of the trusts but no distributions of principal.[260] Six of the trusts contained "a spendthrift provision prohibiting the assignment or alienation of [W's] beneficial interest, or the attachment of that interest by her creditors."[261] The IRS argued that one-half of the value of all of the stock and bank accounts and one-half of the undistributed trust income should have been included in the estate tax return as assets of H's estate because it was all community property.[262] The court concluded that the income, both distributed and undistributed, from the seven trusts earned during the marriage was W's separate property.[263] The court explained that W never acquired, and would never acquire, the corpus of any of the trusts; such corpus was thus not her separate property nor was the trust income from such corpus.[264] What she acquired, according to the court, "and what she used to purchase the stocks and establish the bank accounts . . . was the income from the trust property. As the income resulted from gifts made to trustees for [W's] benefit, the income necessarily constituted her separate property . . . ."[265]

In attempting to apply Texas law, the court in *Wilmington* reviewed numerous Texas cases dealing with the marital property characterization of trust income, including *McClelland*, *Mercantile National Bank*, and *Buckler*, but

253. *Id.*
254. *Id.*
255. *Id.* at 7–8.
256. *Id.*
257. *Id.* at 8.
258. *Id.*
259. *Id.*
260. *Id.*
261. *Id.*
262. *Id.*
263. *Id.* at 14.
264. *Id.*
265. *Id. See also* McClelland v. McClelland, 37 S.W. 350, 359 (Waco 1896, writ ref'd) (holding that distributions from a testamentary trust were separate property because they were devised by the will and were thus inherited property).

surprisingly not *Currie* or *Burns*.[266] Other cases the court discussed included early and mostly awkward attempts by Texas courts to deal with this issue.[267] For example, the court discussed *Hutchison v. Mitchell*, decided in 1873 by the Supreme Court of Texas.[268] The husband in this case (H) conveyed certain real property "in trust 'for the separate use, occupation and enjoyment'" of his wife, and the issue was whether rents and profits of the trust property were subject to H's debts.[269] The court decided they were not stating simply that nothing in Texas law "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."[270] The court in *Wilmington* cited also to a 1890 case decided by the Supreme Court of Texas, *Martin Brown Company v. Perrill*, in which the court held that trust income was the separate property of the wife but could not agree on the rationale for such determination.[271] These cases are not helpful in addressing this issue because they are devoid of legal analysis.

Other cases cited by the court are either similarly unhelpful or not on point. One such case, *In re Marriage of Long*, reaches results inconsistent with those discussed above, in part by misconstruing the facts and holding of *Mercantile National Bank*.[272] *Long* is a divorce case in which the husband (H) was a beneficiary of an irrevocable trust created prior to the marriage.[273] The trust provided that after H attained the age of twenty-one, the trustees had the absolute discretion to distribute as much of the income of the trust to H as they deemed appropriate.[274] When H attained the age of twenty-five, he would be entitled to distribution of one-half of the balance of trust corpus and accumulated income, and he was entitled to the remaining balance of the trust when he attained the age of thirty.[275] H married his wife (W) before he attained the age of twenty-five.[276] When H turned twenty-five and became entitled to the first trust distribution, he orally instructed the trustees to continue to manage the one-half share of trust corpus and accumulated income that he was entitled to receive.[277] W argued that the income earned by the trust during the marriage

266. *See Wilmington Trust*, 4 Cl. Ct. at 8 (discussing *McClelland*, 37 S.W. at 350; Mercantile Nat'l Bank at Dallas v. Wilson, 279 S.W.2d 650 (Tex. App.—Dallas 1955, writ ref'd n.r.e.); Buckler v. Buckler, 424 S.W.2d 514 (Tex. App.—Fort Worth 1967, writ dism'd)).

267. *Id.* at 8–14.

268. *Id.* at 9 (citing Hutchinson v. Mitchell, 39 Tex. 487 (1873)).

269. *Id.*

270. *Id.* (quoting *Hutchinson*, 39 Tex. at 492).

271. *Id.* (citing Martin Brown Co. v. Perrill, 13 S.W. 975, 977 (Tex. 1890)).

272. *Id.* (citing *In re* Long, 542 S.W.2d 712, 718 (Tex. App.—Texarkana 1976, no writ)).

273. *Long*, 542 S.W.2d at 715.

274. *Id.* at 717.

275. *Id.* at 715.

276. *Id.*

277. *Id.* at 716.

was community property.[278] The court cited to *Mercantile National Bank* for the proposition that "[i]ncome received by a married beneficiary on the trust corpus to which the beneficiary is entitled has been held to be community property" and to *Currie* for the proposition that "[t]rust income which a married beneficiary does not receive, and to which he has no claim other than an expectancy interest in the corpus, has been held not to be community property."[279] The court stated that in *Mercantile National Bank,* "undistributed income was in the hands of the trustees but the beneficiary had a present possessory interest in the funds," which is a mischaracterization of the facts of that case.[280] The court then held, based on that mischaracterization, that because H had the right as of the time he attained the age of twenty-five to the distribution of one-half of the balance of trust corpus and accumulated income, all income subsequently earned by the trust with respect to the aggregate amount that was distributable to H at the age of twenty-five was community property.[281]

The court in *Long* could have reached the same conclusion as to the subsequently earned income by simply applying the marital property rules discussed above for characterizing undistributed trust income—the *Burns* line of cases; to review, if a trust is funded during marriage with separate property, undistributed trust income will be separate property of the beneficiary spouse so long as the spouse has not either (1) actually acquired such income or (2) constructively acquired it because of a right to require that it be distributed.[282] H presumably could have demanded distribution at any time of the aggregate amount that was distributable to him at the age of twenty-five, along with income subsequently earned on that amount; H would thus be treated as having constructively acquired such income.[283] But the court does not explain why the accumulated income distributable to H at the age of twenty-five is also not community property.[284] That portion of the court's holding appears to conflict with the *Burns* line of cases.[285] In *Long*, H had the right at the age of twenty-five to distribution of the income that accumulated

278. *Id.* at 718.

279. *Id.*

280. *Id. See* Mercantile Nat'l Bank at Dallas v. Wilson, 279 S.W.2d 650, 654 (Tex. App.—Dallas 1955, writ ref'd n.r.e.).

281. *Long*, 542 S.W.2d at 718. *See also* Sharma v. Routh, 302 S.W.3d 355, 362 (Tex. App.—Houston [14th Dist.] 2009, no writ) (citing approvingly to *Long* for this holding); Cleaver v. Cleaver, 935 S.W.2d 491, 494 (Tex. App.—Tyler 1996, no writ) (holding that wife had a present possessory interest in trust funds that should have, but had not, been timely distributed to her by the trust, and any income earned on them is properly characterized as community property).

282. *In re* Marriage of Burns, 573 S.W.2d 555, 557 (Tex. App.—Texarkana 1978, writ dism'd).

283. *See id.*

284. *Long*, 542 S.W.2d at 717.

285. *Compare Burns*, 573 S.W.2d at 557 (holding that constructively acquired property is community property), *with Long*, 542 S.W.2d at 718 (holding that the accumulated income distributable to H at the age of twenty-five was separate property).

prior to that time.[286] It seems that those rules would characterize such income earned during the marriage as community property based on H's constructive acquisition of the income.[287]

As to trust income that remained undistributed at the time of H's death, the decision in *Wilmington* coincides with the reasoning in the *Burns* line of cases.[288] As to the distributed income, the court in *Wilmington* held that such income is separate property if the trust was created either *inter vivos* or by testamentary gift because property received by gift is separate property, as the state constitution defines that term.[289] Presumably, the court would hold that income distributed from a trust created by the beneficiary spouse would not be separate property of such spouse because a spouse cannot make a gift to herself.[290] This portion of the holding in *Wilmington* conflicts with the *Burns* line of cases.[291] Again, according to *Burns*, if a trust is funded during marriage with separate property, undistributed trust income will be separate property of the beneficiary spouse so long as the spouse has not either (1) actually acquired such income or (2) constructively acquired it because of a right to require that it be distributed.[292] Actual or constructive distribution of the income would cause it to be acquired by the beneficiary and thus be characterized as community property under those rules.[293] The *Wilmington* court's reasoning that distributed trust income is separate property because it is received by gift is weak and unprecedented.[294] In no other context has a Texas court held that receipt of a stream of income is separate property simply because the right to such income stream originated as a result of a gift. The usual context in which this would occur is a gift of income-producing property. The property would be characterized as separate property, but the income from such property would be community property.[295]

In *Rigdell v. Rigdell*, a divorce case decided in 1997, the court attempted to apply a number of the cases discussed above but ended up making a complete mess of its analysis.[296] The wife (W) in this case was the beneficiary of two testamentary trusts created by her parents' wills.[297] The trusts provided

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286. *Long*, 542 S.W.2d at 715.
287. *Burns*, 573 S.W.2d at 557.
288. Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 14 (1983).
289. *See id.* at 11.
290. *See* Sharma v. Routh, 302 S.W.3d 355, 366 (Tex. App.—Houston [14th Dist.] 2009, no pet.).
291. *See Wilmington Trust*, 4 Cl. Ct. at 14.
292. *See Burns*, 573 S.W.2d at 557.
293. *See id.*
294. *Wilmington Trust*, 4 Cl. Ct. at 6.
295. *See* Colden v. Alexander, 171 S.W.2d 328, 334 (Tex. 1943). The lone exception to this rule applies when the income-producing property was received by the owner spouse as a gift from the other spouse. *See* Rigdell v. Rigdell, 960 S.W.2d 144, 148 (Tex. App.—Corpus Christi 1997, no pet. h.). In that event, in addition to the income-producing property being characterized as separate property because it was acquired by gift, the income from such property is presumed to be separate property as well. *See* TEX. FAM. CODE ANN. § 3.005 (West 2006).
296. *Rigdell*, 960 S.W.2d at 144.
297. *Id.* at 146.

that W receive mandatory distributions of the entire net income of the trusts and that she receive distributions from the corpus of the trusts in the complete discretion of the trustees.[298] In addition, the trusts provided that W receive mandatory distributions of corpus in specified amounts each year beginning with the year she turns forty and ending with the year she turns fifty.[299] The trusts contained spendthrift clauses stipulating that W may not "transfer, assign, convey, sell, pledge, mortgage, alienate, or encumber any part of the corpus or income of the trusts."[300] Her husband argued that income distributed to W from the trusts was community property.[301] The court cited to a number of the cases discussed above, including *Cleaver*, *Long*, *Currie*, *Burns*, *Mercantile National Bank,* and *Wilmington*, and made a woefully inadequate attempt to apply them to the facts presented.[302] The court concluded that because of W's right to mandatory distributions of corpus beginning with the year she reaches the age of forty, the trusts granted to W "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."[303] Accordingly, because W received the income from the trusts and had expectancy interests in the corpus of the trusts, the income distributed from the trusts was community property.[304] It is unclear how W's right to distributions from corpus affects in any way the characterization of the income distributed to W from the trusts. Applying the cases discussed above, such income was either community property when W actually or constructively acquired it under the *Burns* line of cases, or it was separate property under *Wilmington* because the trusts were created by testamentary gift.[305]

The most recent appellate decision dealing with the marital property characterization of income distributed from irrevocable trusts is *Sharma v. Routh*, decided in 2009.[306] *Sharma* is a divorce case in which the husband (H) was a beneficiary of two testamentary trusts (designated as the Marital Trust and the Family Trust) created by the will of a former spouse.[307] Additionally, H was the trustee of both trusts.[308] The trusts provided that H receive mandatory quarterly distributions of the entire net income of the Marital Trust and that he receive distributions from the corpus of both trusts at the substantial discretion

298. *Id.* at 149.
299. *Id.*
300. *Id.*
301. *Id.* at 147.
302. *Id.* at 148.
303. *Id.*
304. *Id.*
305. Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 14 (1983); *In re* Marriage of Burns, 573 S.W.2d 555, 557 (Tex. App.—Texarkana 1978, writ dism'd).
306. *See generally* Sharma v. Routh, 302 S.W.3d 355 (Tex. App.—Houston [14th Dist.] 2009, no pet. h.).
307. *Id.* at 357.
308. *Id.* The court held that the fact that H was trustee bore no relevance to the marital property characterization of the trust income. *Id.* at 366.

of the trustees.[309] During the marriage, H received distributions of income from both trusts but received no distributions of trust corpus from either trust.[310] H argued that the income distributions from the trusts were his separate property.[311] The court cited to and discussed many of the cases identified above but appeared to be mostly influenced by the decisions in *Wilmington* and *Rigdell*.[312] The court posited four possible rules that it could adopt for characterizing income distributions from trusts; all four rules were premised on the beneficiary who received the distributions having sufficient rights to the trust corpus to make such beneficiary the effective owner of such corpus.[313] The court concluded that the appropriate rule for characterizing distributions of trust income during marriage from an irrevocable trust is that such 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."[314] This conclusion was apparently inspired by the court's illogical decision in *Rigdell*.[315] The court then held that H acquired the income distributions from both trusts by devise or gift because both trusts were created by the will of his former spouse.[316] That analysis was apparently inspired by the decision in *Wilmington*.[317] The court then held that based on the provisions of the will creating the trusts, H did not have a present possessory right to receive distributions of corpus from either trust; H was thus not effectively an owner of the trust corpus, and the income distributions from the trusts were thus not community property.[318]

V. PROPOSAL FOR ADOPTION OF STANDARD RULES

As illustrated in Section IV, the rules for marital property characterization of interests in and distributions from irrevocable trusts are inconsistent, messy, and at times irrational. Perhaps more importantly, those rules are not logically consistent with the marital property rules generally applicable to characterization of similar types of property. Section II described the marital property rules for characterizing income-producing property and the income produced by such property. Further, Section II provides the rules for

309. *Id.* at 357–67. The trustees of both trusts were required to distribute trust principal to H to provide for his health, support, and maintenance "in order to maintain him, to the extent reasonably possible, in accordance with the standard of living to which [he] is accustomed." *Id.*

310. *Id.* at 358.

311. *Id.* at 359–60.

312. *See* Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 14 (1983). *See generally* Rigdell v. Rigdell, 960 S.W.2d 144 (Tex. App.—Corpus Christi 1997, no pet. h.).

313. *Sharma*, 302 S.W.3d at 362.

314. *Id.* at 364.

315. *See Rigdell*, 960 S.W.2d at 144.

316. *Sharma*, 302 S.W.3d at 365, 367.

317. *See Wilmington Trust*, 4 Cl. Ct. at 6.

318. *Sharma*, 302 S.W.3d at 365, 367–68.

characterizing ownership interests in and distributions from separate entities other than trusts, such as corporations and partnerships. As explained in Section III, in some jurisdictions a trust is a legal entity separate from the owners of the beneficial interests in the trust.[319] If that is true under Texas law, at least with respect to characterizing marital property, then the rules for characterizing beneficial interests in and distributions from trusts should be consistent with the rules for characterizing ownership interests in and distributions from other separate entities, such as corporations and partnerships. There is no such consistency under current Texas law, as explained in Section IV. Section III explains that the Supreme Court of Texas has ruled that, at least for certain purposes, trusts are not legal entities at all but rather constitute a fiduciary relationship between the trustee and the trust property.[320] If that is also true for purposes of marital property characterization of beneficial interests in and distributions from trusts, then the property interest owned by a trust beneficiary is simply an equitable interest in the trust property. If the property interest is an equitable interest in the trust property, then the rules for characterizing beneficial interests in and distributions from trusts should be consistent with the rules for characterizing ownership interests in and income earned by other types of income-producing property. As explained in Section IV, no consistency currently exists under Texas law.

This article proposes adoption of specific rules for characterization of interests in and distributions from trusts that will harmonize the various approaches and rules currently used. These new rules provide a predictable result desperately needed by litigants and trial courts. Most importantly, these proposed rules are consistent with those rules applicable to the characterization of similar types of property regardless of whether a trust is treated for marital property characterization purposes as a separate legal entity.

As explained in Section II, income-producing property is characterized as separate or community property pursuant to the normal rules for characterizing marital property, including the doctrine of inception of title. The income produced by such property is characterized as community property without regard to whether the property that produced such income is characterized as community property or separate property.[321] Section II also explains that when a spouse owns an interest in a corporation or partnership, the income-producing property is the corporate stock or partnership interest.[322] Distributions from the

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319. *See, e.g.*, United States v. Harrison, 653 F.2d 359, 361 (8th Cir. 1981) (holding that under Missouri law, a trust is a formally organized entity legally distinct from its trustees); Leone Hall Price Found. v. Baker, 577 S.E.2d 779, 781 (Ga. 2003) (stating that it is a generally accepted principle that a trust is a legal entity separate from its beneficiaries).

320. *See* Ditta v. Conte, 298 S.W.3d 187, 191–92 (Tex. 2009); Ray Malooly Trust v. Juhl, 186 S.W.3d 568, 570 (Tex. 2006); Huie v. DeShazo, 922 S.W.2d 920, 926 (Tex. 1996).

321. Colden v. Alexander, 171 S.W.2d 328, 334 (Tex. 1943).

322. *See, e.g.*, Thomas v. Thomas, 738 S.W.2d 342, 343 (Tex. App.—Houston [1st Dist.] 1987, writ denied) (holding that in a divorce, the court may award shares of stock but not corporate assets); McKnight v.

corporation or partnership constitute income to the owner of such stock or partnership interest and are thus characterized as community property regardless of whether the stock or partnership interest is community or separate property.[323]

The conceptual problem with applying the usual rules for characterizing income-producing property and the income produced by such property to distributions of trust income is identifying the property interest that is producing the income. The trustee owns the legal title to the property that actually produces the income.[324] What is the income-producing property when a spouse is an income beneficiary of a trust? The answer depends on whether a trust is a legal entity separate from the owners of its beneficial interests for marital property characterization purposes, as discussed in Section III. If a trust is a separate legal entity for such purposes under Texas law, then the income-producing property owned by the trust beneficiary is clearly not the property actually producing the income because that is owned by the trust. When a spouse owns an interest in a corporation or partnership, the entity owns the property or business that actually produces the income; the income-producing property owned by the spouse in those situations is the corporate stock or partnership interest. Thus, if a trust is a separate entity for these purposes under Texas law, the income-producing property owned by the trust beneficiary is the beneficial interest in the trust. If this is true, then treating trusts the same as corporations and partnerships would simply require recognition that the property actually producing income is owned by the trust and the income-producing property owned by the spouse is the beneficial interest in the trust. When the trust distributes trust income to a beneficiary, those distributions then constitute income to such beneficiary, and they are characterized as community property regardless of whether the beneficial interest in the trust is community or separate property. That is the same result that occurs with distributions to an owner of stock or a partnership interest.

But what if a trust is not a separate legal entity under Texas law for marital property characterization purposes? What then is the income-producing property when a spouse is an income beneficiary of a trust? Does an income beneficiary of a trust own property at all?

The United States Supreme Court answered the above question in 1937 in *Blair v. Commissioner of Internal Revenue*, a case dealing with an issue that arose not long after the genesis of the federal income tax.[325] The federal

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McKnight, 543 S.W.2d 863, 867 (Tex. 1976) (holding that the rights of a divorcing spouse can only attach to a partnership interest and not to specific partnership property).

323. *See* LeGrand-Brock v. Brock, 246 S.W.3d 318, 322 (Tex. App.—Beaumont 2008, pet. denied) (stating that cash dividends from stock are treated as income); Marshall v. Marshall, 735 S.W.2d 587, 594 (Tex. App.—Dallas 1987, writ ref'd n.r.e) (holding that distributions from a partnership to a partner were distributions of income).

324. *See* Hallmark v. Port/Cooper–T. Smith Stevedoring Co., 907 S.W.2d 586, 589 (Tex. App.—Corpus Christi 1995).

325. *See generally* Blair v. Comm'r, 300 U.S. 5 (1937).

income tax is, and has always been, a "graduated" or "progressive" tax on income—higher levels of taxable income are taxed at higher rates.[326] To circumvent these higher tax rates, taxpayers began assigning some of their income to family members with much lower taxable income because the family members would pay taxes on that assigned income at much lower rates than would the taxpayer assigning it.[327] Early schemes of assigning income involved attempts to assign the right to receive income from personal services.[328] The United States Supreme Court invalidated those schemes by establishing a rule that "tax could not be escaped by anticipatory arrangements and contracts however skil[l]fully devised to prevent the salary when paid from vesting even for a second in the man who earned it."[329] In a subsequent line of cases, taxpayers' schemes consisted of attempts to assign income from property.[330] In those cases, the Court established a rule that income earned from property was taxable to the person who owned the property at the time the income was earned.[331] These schemes would thus be effective if a taxpayer assigned his right to the income-producing property. The assignee would then be taxed on any income subsequently earned by such property.[332]

In *Blair*, the taxpayer was the beneficiary of a testamentary trust that provided that he receive one-half the net income of the trust for the duration of his life and, upon the death of the donor's widow, the entire net income of the trust for the duration of his life.[333] After the donor's widow died, the taxpayer assigned several interests to his children in fixed amounts "in each calendar year thereafter, in the net income which the [taxpayer] was then or might thereafter be entitled to receive during his life."[334] "The trustees accepted th[ose] assignments and distributed" such income directly to the children.[335] The IRS relied on early cases dealing with assignment of income from personal services, arguing that in spite of the assignments, the income was all taxable to the taxpayer.[336] The Court explained that those cases were not applicable because the taxpayer in this case did not assign his right to income from personal services; rather, this case involved "income as to which . . . the tax liability attaches to ownership."[337] The Court's primary concern was who actually owned the beneficial interest in the trust; specifically, the Court stated that "[t]he one who is to receive the income as the owner of the beneficial

326. *See* Leo P. Martinez, *"To Lay and Collect Taxes": The Constitutional Case for Progressive Taxation*, 18 YALE L. & POL'Y REV. 111, 111–12 (1999).
327. *See, e.g.*, Lucas v. Earl, 281 U.S. 111, 114–15 (1930).
328. *See, e.g.*, *id.*
329. *Id.* at 115.
330. *See, e.g.*, *Blair*, 300 U.S. at 11–13.
331. *See id. See also* Helvering v. Horst, 311 U.S. 112, 118–19 (1940).
332. *See Blair*, 300 U.S. at 12.
333. *Id.* at 7.
334. *Id.*
335. *Id.*
336. *Id.* at 11–12.
337. *Id.*

interest is to pay the tax."[338] The Court then focused on the nature of the interest that the taxpayer assigned.[339] The court of appeals previously decided that the taxpayer "had no interest in the corpus of the estate and could not dispose of the income until he received it."[340] With this, the IRS argued "that the assignments 'dealt only with a right to receive the income' and that 'no attempt was made to assign any equitable right, title or interest in the trust itself.'"[341] The Court disagreed and held that the taxpayer's right to receive the net income of the trust property for his life made him "the owner of an equitable interest in the corpus of the property."[342]

> By virtue of that interest he was entitled to enforce the trust, to have a breach of trust enjoined and to obtain redress in case of breach. The interest was present property alienable like any other, in the absence of a valid restraint upon alienation. . . . The assignment of the beneficial interest is not the assignment of a chose in action but of the 'right, title, and estate in and to property.'[343]

One of the cases used by the Court as authority for its holding was *Merchants' Loan & Trust Company v. Patterson*.[344] In that case, the Supreme Court of Illinois explained the distinctions between the legal and equitable interests in a trust estate:[345]

> In a court of law the legal estate of the trustee, as a general rule, has the same properties, characteristics, and incidents as if the trustee were the absolute, beneficial owner, and he may so deal with it. In equity, on the other hand, the [beneficiary] may deal with his equitable estate as property. He is the beneficial and substantial owner, and if under no disability may sell and dispose of his estate, and any legal conveyance will have the same operation upon the equitable estate as a similar conveyance of the legal estate would have at law upon the legal estate.[346]

The principal issue in *Blair* involved a taxpayer's right to assign or alienate his beneficial interest in a trust, and the Court determined that a taxpayer's interest was alienable because it was an interest in property.[347] Spendthrift trusts, as explained earlier, do not allow the beneficial interests to be transferred or alienated prior to payment of such interest to the beneficiary by the trustee.[348]

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338. *Id.* at 12.
339. *Id.*
340. *Id.*
341. *Id.* at 13.
342. *Id.*
343. *Id.* at 13–14 (emphasis added).
344. Merchants' Loan & Trust Co. v. Patterson, 139 N.E. 912 (1923).
345. *Id.* at 916.
346. *Id.* (alteration in original).
347. *See Blair*, 300 U.S. at 13.
348. *In re* Marriage of Burns, 573 S.W.2d 555, 556 (Tex. App.—Texarkana 1978, no writ).

Does that mean that beneficial interests in spendthrift trusts are not property? The bankruptcy court in *Internal Revenue Service v. Orr* dealt with that issue in a case in which the IRS asserted pre-petition tax liens in property that a debtor owned prior to filing his bankruptcy petition.[349] The debtor was a beneficiary of a spendthrift trust created by his grandmother, which stipulated that the debtor receive all of the trust income for his life.[350] The debtor "failed to file his federal income tax returns" for years prior to filing his bankruptcy petition, and the IRS acquired tax liens on all of the debtor's property.[351] State laws protecting spendthrift trusts from attachment by creditors do not apply to federal tax liens.[352] Federal tax liens attach to all interests in property owned by the taxpayer at the time the lien attaches or acquired thereafter during the life of the lien, but they may not attach to property obtained after a bankruptcy petition is filed.[353] Thus, a primary issue in the case was whether the debtor's beneficial interest in the trust constituted a property interest owned by the debtor prior to the filing of his bankruptcy petition. If it did, the federal tax liens remain attached to the property interests that the debtor owned prior to filing for bankruptcy.[354] The court defined "property" generally "as an aggregate of rights; 'the right to dispose of a thing in every legal way, to [possess] it, to use it, and to exclude everyone else from interfering with it.'"[355] The court stated that "it is left to state law to determine whether a taxpayer has a property interest to which a federal lien may attach."[356] The court reviewed Texas law and determined that "Texas courts have long upheld and enforced spendthrift trust provisions," but in doing so the courts do "not deny that the beneficiary holds an 'ownership interest' in the trust."[357] The court thus concluded that, "while the trustee holds bare legal title and the right to possession of spendthrift trust assets, it is 'the beneficiary [who] is considered the real owner of the property, holding equitable or beneficial title.'"[358] The debtor cited a case decided by the Fifth Circuit Court of Appeals, *United States v. Dallas National Bank*, and interpreted the holding to mean that an income beneficiary of a trust has no property interest in such income until she receives it from the trustee.[359] The court stated that the debtor's interpretation of that case is incorrect because it "conflicts with fundamental principles of property law which allow for a 'bundle of rights' in any particular piece of property."[360] Further, in later

349. Internal Revenue Serv. v. Orr, 239 B.R. 130, 133 (Bankr. S.D. Tex. 1998).
350. *Id.* at 132–33.
351. *Id.* at 133.
352. *See id.* at 134.
353. *See id.*
354. *See id.*
355. *Id.* at 134–35 (alteration in original).
356. *Id.* at 135.
357. *Id.*
358. *Id.*
359. *See id.* at 136 (citing United States v. Dallas Nat'l Bank, 152 F.2d 582 (5th Cir. 1945), *modified*, 164 F.2d 489 (5th Cir. 1947), *modified*, 167 F.2d 468 (5th Cir. 1948)).
360. *Id.* at 136–37.

rehearings of the case, the Fifth Circuit made it clear that "the [debtor] had an interest in the trust property, [albeit] not an interest that could be sold" because of the spendthrift provisions.[361]

It is quite clear from the foregoing discussion that a beneficial interest in a trust is a property interest.[362] If a trust is not a legal entity separate from the owners of its beneficial interests within the context of Texas marital property law then, as determined by the United States Supreme Court, an income beneficiary is "the owner of an equitable interest in the corpus of the property."[363] The beneficiary is thus the owner of income-producing property.[364] Distributions of trust income from the trustee to the beneficiary are thus income from such property at the time they are made. These distributions cannot be treated as income to the beneficiary prior to distribution unless such beneficiary has a legal right to demand them; if so, they should be treated as having been constructively received as several Texas cases have held.[365] If the beneficiary is married, then the beneficial interest in the trust should be characterized as separate or community property under the inception of title doctrine, depending on when and how such interest was acquired.[366] For example, beneficial interests owned prior to marriage, or received during marriage by gift or inheritance, should be characterized as separate property.[367] Trust income received during the marriage should be characterized as community property regardless of whether the beneficial interest in the trust is community or separate property—the same result as with ownership interests in and income produced by other types of income-producing property.

Based on the foregoing discussion and consistent with Texas law, this article proposes a very simple set of rules for the marital property characterization of interests in and distributions from trusts, regardless of whether a trust is treated as a separate legal entity for marital property characterization purposes. To review, if a trust is a legal entity separate from the owners of its beneficial interests under Texas law, at least for purposes of characterizing marital property, then the property owned by a spouse who is an income beneficiary of a trust is the beneficial interest in the trust. In addition, actual or constructive distributions of income from the trustee to such beneficiary are community property regardless of whether the beneficial interest in the trust is community or separate property. The beneficial interest in the trust is property that is characterized under the normal rules for characterizing marital property, including the doctrine of inception of title. These rules are identical to those applicable to marital property characterization of ownership

361. *Id.* at 137.
362. *See id.*
363. Blair v. Comm'r, 300 U.S. 5, 13–14 (1937).
364. *Id.*
365. *See, e.g.*, *In re* Marriage of Burns, 573 S.W. 2d 555, 557–58 (Tex. App.—Texarkana 1978, no writ).
366. *See* Pace v. Pace, 160 S.W.3d 706, 711 (Tex. App.—Dallas 2005, pet. denied).
367. *See* Hardin v. Hardin, 681 S.W.2d 241, 242 (Tex. App.—San Antonio 1984, no pet. h.).

interests in other separate legal entities, such as corporations and partnerships, as should be the case (i.e., when a spouse owns an interest in a corporation or partnership, the stock or partnership interest is characterized as separate or community property under the normal characterization rules, including the inception of title doctrine, and income actually or constructively distributed to such spouse from such corporation or partnership is characterized as community property regardless of whether the stock or partnership interest is community or separate property).[368]

But even if a trust is not treated as a legal entity separate from the owners of its beneficial interests under Texas law for purposes of characterizing marital property, a spouse who is an income beneficiary of a trust owns a beneficial property interest in the trust property; actual or constructive distributions of income from the trustee to such beneficiary are thus community property regardless of whether the beneficial interest in the trust property is community or separate property. The beneficial interest in the trust property is itself property that is characterized under the normal rules for characterizing marital property, including the doctrine of inception of title. These rules are identical to those applicable to marital property characterization of ownership interests in and income produced by other types of income-producing property, as should be the case.

This article thus proposes that in all cases in which a spouse is an income beneficiary of an irrevocable trust, the beneficial interest in the trust should be treated as property and characterized under the normal rules for characterizing marital property, including the doctrine of inception of title, and actual or constructive distributions of income from the trustee to such beneficiary spouse should be characterized as community property regardless of whether the beneficial interest in the trust is community or separate property. These rules are simple to apply, are rational and consistent with Texas law, are logically consistent with the marital property rules applicable to characterization of similar types of property, and produce consistent and predictable results.

VI. CONCLUSION

The marital property rules currently used in Texas for characterizing beneficial interests in and distributions from trusts have not been formulated and applied consistently by the circuit courts, and the Supreme Court of Texas has thus far not resolved this inconsistency.[369] In addition, none of the rules currently in use by the circuit courts are logically consistent with the marital property rules generally applicable to characterization of similar types of

368. *See* LeGrand-Brock v. Brock, 246 S.W.3d 318, 322 (Tex. App.—Beaumont 2008, pet. denied) (stating that cash dividends from stock are treated as income); Marshall v. Marshall, 735 S.W.2d 587, 594 (Tex. App.—Dallas 1987, writ ref'd n.r.e) (holding that distributions from a partnership to a partner were distributions of income).

369. *See supra* Part IV.

property.[370] Much of the blame for this inconsistency stems from the fact that trusts are often structured in a complex manner, and courts have struggled to understand them and to consistently apply marital property characterization rules to them.[371] The result is a hodgepodge of different approaches and rules applied by the various circuit courts.[372] The problem is confusion for litigants and trial courts attempting to determine applicable rules for characterizing interests in and distributions from trusts. A logical and consistent set of rules needs to be set forth. This article proposes the adoption of specific rules for characterization of interests in and distributions from trusts that will harmonize the various approaches and rules currently used and provide a predictable result desperately needed by litigants and trial courts. Most importantly, these proposed rules are consistent with those applicable to characterization of similar types of property.

Under Texas law, income-producing property is characterized as separate or community property pursuant to the normal rules for characterizing marital property, including the doctrine of inception of title, and the income produced by such property is characterized as community property without regard to whether the property that produced such income is characterized as community property or separate property.[373] If a spouse owns an interest in a legal entity, the income-producing property is the ownership interest in such entity.[374] Distributions from the entity constitute income to the owner of such interest and are thus characterized as community property regardless of whether the ownership interest is community or separate property.[375]

If under Texas law a trust is a legal entity separate from the owners of its beneficial interests for marital property characterization purposes, the income-producing property owned by the trust beneficiary is not the property actually producing the income but rather the beneficial interest in the trust. When the trust actually or constructively distributes trust income to a beneficiary, those distributions constitute income to the beneficiary—the same result as with distributions by a corporation or partnership to an owner of stock or a partnership interest—and are thus characterized as community property regardless of whether the beneficial interest in the trust is community or separate property. If a trust is not a separate legal entity under Texas law for marital property characterization purposes, a spouse who is an income beneficiary of a trust owns a beneficial property interest in the trust property;[376]

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370. *See supra* Part IV.

371. *See supra* Part IV.

372. *See supra* Part IV.

373. *See* McClary v. Thompson, 65 S.W.3d 829, 834 (Tex. App.—Fort Worth 2002, pet. denied).

374. *See* Harris v. Harris, 765 S.W.2d 798, 802–04 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

375. *See* LeGrand-Brock v. Brock, 246 S.W.3d 318, 322 (Tex. App.—Beaumont 2008, pet. denied) (stating that cash dividends from stock are treated as income); Marshall v. Marshall, 735 S.W.2d 587, 594 (Tex. App.—Dallas 1987, writ ref'd n.r.e) (holding that distributions from a partnership to a partner were distributions of income).

376. *See* Blair v. Comm'r, 300 U.S. 5, 14 (1937).

actual or constructive distributions of income from the trustee to such beneficiary are thus community property regardless of whether the beneficial interest in the trust property is community or separate property, which is the same characterization given to income produced by other types of income-producing property.

This article thus proposes that, in all cases in which a spouse is an income beneficiary of an irrevocable trust, the beneficial interest in the trust should be treated as property and characterized under the normal rules for characterizing marital property, including the doctrine of inception of title, and that actual or constructive distributions of income from the trustee to such beneficiary spouse should be characterized as community property regardless of whether the beneficial interest in the trust is community or separate property. These rules are simple to apply, are rational and consistent with Texas law, are logically consistent with the marital property rules applicable to characterization of similar types of property, and produce consistent and predictable results.