MARITAL PROPERTY AGREEMENTS: FAMILY LAW ATTORNEYS' AND ESTATE PLANNING ATTORNEYS' TOP TIPS FOR EACH OTHER

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I. INTRODUCTION

Regarding premarital agreements and postmarital agreements, family law attorneys think, "Those are within my domain. Those are documents I prepare."[1] Likewise, estate planning attorneys think, "Those are in my bailiwick. Those are documents that I prepare."[2] The truth is that premarital agreements and postmarital agreements are property agreements where family law attorneys and estate planners alike utilize their unique skill sets to assist clients.[3] Often, family law attorneys and estate planners best serve their clients when they work together by bringing the best of each of their skill sets to the negotiating table.[4]

Ideally, every client would hire a family law attorney and an estate planning attorney to work on the client's marital property agreements.[5] However, that is not feasible for every client.[6] Short of collaboration on a case-by-case basis, these practitioners can learn from each other's top tips in premarital and postmarital agreements.[7] Furthermore, while divorce settlements are squarely in the family law attorney's purview, there are some insights and tips from estate planners that family lawyers can incorporate into their divorce practice, especially when trusts are involved.[8]

II. BACKGROUND: ESTATE PLANNING AND ESTATE ADMINISTRATION

A. Trusts

1. What Constitutes a Trust?

A trust is a fiduciary relationship in which one or more persons (i.e., trustee or trustees) holds an interest in property (i.e., trust property or res) for the benefit of one or more persons (i.e., beneficiaries).[9] The trust's

1. Author's original thought.
2. Author's original thought.
3. *See* Joseph W. McNight, *Family Law: Husband and Wife*, 56 S. METHODIST UNIV. L. REV. 1659, 1691 (2003).
4. *Id.*
5. *Id.*
6. *See* Paula M. Young, *A Connecticut Mediator in a Kangaroo Court?: Successfully Communicating the "Authorized Practice of Mediation" Paradigm to "Unauthorized Practice of Law" Disciplinary Bodies*, 49 S. TEX. L. REV. 1047, 1183 (2008).
7. Author's original thought.
8. *See Can a Trust or Estate Plan Protect Your Assets During a Divorce?*, JEANNE M. BROWN FAM. L. ATT'Y MEDIATOR, https://jeannebrowne.com/can-a-trust-or-estate-plan-protect-your-assets-during-a-divorce/ (last visited Apr. 3, 2022) [https://perma.cc/U5LW-WQE6].
9. *See* TEX. PROP. CODE. ANN. § 111.004(4).

beneficiaries hold equitable title to the trust property, and the trustee holds legal title to the trust assets.[10] The trustee's obligation to hold trust property subject to the trust beneficiaries' equitable rights can be imposed by a court (i.e., in a constructive trust) or by a trustee's voluntary agreement to serve under the terms set forth in a written agreement as supplemented by the Texas Trust Code (i.e., an express trust).[11] While trustees often have significant discretion to invest and distribute trust property, the trustee's discretion is not limitless.[12] The governing instrument for the trust (e.g., a trust agreement or sometimes a will) and the Texas Trust Code provide the rules by which the trustee must operate.[13] Subject to certain exceptions, the trust creator who contributes property to the trust (i.e., the grantor, settlor, trustor, or trust-maker) decides the rules for the trust agreement.[14]

2. What Does Not Constitute a Trust?

For purposes of Texas law, a trust is not an entity.[15] Instead, for state law purposes, a trust is a fiduciary relationship governing the trustee.[16] That means trusts cannot hold title to real property or enter into contracts.[17] A trustee must take legal title to trust property in the trustee's capacity as trustee of the trust.[18] Lawsuits may not be brought against a trust because trusts are not legal entities and must be brought against a trustee instead.[19]

Despite the fact that Texas law does not treat trusts as entities, a trust may nevertheless be treated as a separate legal entity for federal income tax purposes.[20] For example, certain irrevocable non-grantor trusts are required to obtain their own federal tax identification numbers and are treated as distinct legal entities.[21] In contrast, revocable trusts and certain irrevocable trusts that qualify as "grantor trusts" are typically taxed to the trust's settlor.[22]

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10. *See id.*

11. KCM Fin. LLC v. Bradshaw, 457 S.W.3d 70, 87 (Tex. 2015); *id.* All references in this Article to trusts are to express written trusts governed by a written instrument and applicable governing law unless the text references a constructive trust explicitly. This Article assumes the applicable governing law for a trust is Texas law.

12. *In re* Wilson, 140 B.R. 400, 404 (Bankr. N.D. Tex. 1992).

13. *See* PROP. §§ 101.001–124.002.

14. *Id.* § 111.035 (setting forth six items for which the Texas Trust Code must prevail over the terms of the trust instrument). For example, the terms of the trust may not require the trustee to commit a criminal or tortious act or an act that is contrary to public policy. *Id.* § 111.035(b)(1).

15. *In re* Guetersloh, 326 S.W.3d 737, 739 (Tex. App.—Amarillo 2010, no pet.); 72 TEX. JUR.3D. TRS. § 214.

16. PROP. § 111.004(4).

17. *Id.*

18. *See id.* §§ 111.004(17)–111.004(18).

19. Ray Malooly Tr. v. Juhl, 186 S.W.3d 568, 570 (Tex. 2006).

20. *See* I.R.C. §§ 641–46.

21. *See* Treas. Reg. § 301.6109-1(a)(1)(ii)(C).

22. *See id.* A federal tax identification number is typically not needed for revocable trusts during the lifetime of the Settlor or funder of the trust. *Id.* However, upon the settlor's death, an identification number

In certain narrow circumstances, the beneficiary of an irrevocable trust will be taxed as the owner of the trust for federal income tax purposes, instead of the settlor of the trust or the trust itself.[23]

3. What Are Trusts Used for?

It is important to understand the varying purposes of trusts.[24] Purposes of trusts include, but are not limited to, privacy, coordination of assets, asset protection from third party creditors (including potential ex-spouses), transfer tax savings, protecting beneficiaries from irresponsible spending habits, shifting income among taxpayers, avoiding or minimizing the cost and administrative burden of probate in the state of domicile (i.e., where the settlor resides), avoiding the cost and administrative burden of probate in foreign jurisdictions (e.g., transferring title of the decedent's out-of-state vacation house), and planning for special needs and elderly individuals to avoid jeopardizing eligibility for means-tested public assistance benefits.[25]

Trusts can be wonderful tools to accomplish one or more of the above planning objectives.[26] Unfortunately, however, trusts vary in their benefits.[27] For example, a revocable trust is often considered a beneficial planning tool because it offers the settlor the flexibility to change the settlor's own mind about the provisions of the trust daily, and to the extent the settlor retitles the settlor's assets prior to death, such a trust can help the settlor's estate avoid probate.[28] However, unlike irrevocable trusts, a revocable trust typically offers no asset protection for the trust beneficiaries during the settlor's lifetime.[29] No trust does it all.[30]

Whether a lawyer practices in the trusts and estates world or not, a lawyer may not be able to look at a trust agreement and immediately decipher the purpose of the trust.[31] Clients often are not much help.[32] After signing a trust agreement, clients' memories are often short.[33] Sometimes they have difficulty recalling the purpose of the trust or basic details like whether they

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must be obtained if the trust will continue. *Id.* § 301.6109-1(a)(3)(i)(A); *see* I.R.C. §§ 671–78; Treas. Reg. § 301.6109-1(a)(2)(i)(B).

23. *See, e.g.*, I.R.C. §§ 678, 1361(d)(1)(B).

24. Author's original thought.

25. *See* RESTATEMENT (THIRD) OF TRS. § 27 (AM. L. INST. 2003).

26. Author's original thought.

27. *See* RESTATEMENT (THIRD) OF TRS. § 25 (AM. L. INST. 2003).

28. *See id.*

29. *See* Dennis M. Sandoval, *Drafting Trusts for Maximum Protection from Creditors*, 30 EST. PLAN. 290, 297 (2003).

30. Author's original thought.

31. *See* Thomas E. Simmons, *A Will for Willa Cather*, 83 MO. L. REV. 641, 671 (2018).

32. Author's original thought.

33. *What is Short-term Memory?*, COGNIFIT, https://www.cognifit.com/science/cognitive-skills/shortterm-memory#:~:text=Short%2Dterm%20memory%20is%20the,the%20brain%20forgets%20the%20words (last visited Feb. 26, 2022) [https://perma.cc/H2ME-9PXZ].

are a trustee, whether the trust is revocable or irrevocable by them, and who is considered the trust's settlor.[34] And if understanding the basic trust provisions is difficult for many clients, then understanding the tax attributes of a trust is even trickier for clients to understand, recall, and repeat.[35] The tax attributes of a trust are usually not obvious on the face of a trust agreement and require an understanding of external facts and knowledge of how the trust's terms operate in the context of the vast and confusing Internal Revenue Code (I.R.C.) and Treasury Regulations (Treas. Reg.).[36]

4. Practical Tips When a Trust Is Involved in a Divorce

a. Who Is Currently Obligated to Pay the Income Tax for the Trust?

As a general rule, it makes sense to consult with a competent certified public accountant or trust and estates lawyer knowledgeable about the income taxation of trusts whenever a party to a divorce is a settlor, trustee, or beneficiary of a trust.[37] This is of particular importance with a trust that was jointly created by both spouses during their marriage either directly (e.g., both spouses are settlors of the trust) or indirectly (e.g., only one spouse is the settlor of the trust, but it was funded with community property, and therefore deemed by federal tax law to be settled one-half by each spouse).[38]

> **Example**:[39] Husband and Wife are getting divorced. Husband's attorney asks Husband about the purpose of the ABC Family Trust. Husband shrugs and says, "It's a trust I set up for the kids." Husband tells his attorney he has been managing this trust, so he does not see any reason why Wife would not allow his administration to continue post-divorce. However, he wants her non-involvement to become official. Husband's attorney also takes Husband's word for it that the trust pays its own tax. Husband's attorney takes a quick glance at the trust agreement but does not think much about it, as he assumes this is a trust for the kids and not considered a marital asset about which he should be concerned.
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> **Outcome**:[40] The trust agreement actually states that Husband and Wife are both settlors and co-trustees of the trust and must jointly appoint a successor trustee. Furthermore, the trust agreement

34. Author's original thought.
35. Author's original thought.
36. *See* RESTATEMENT (THIRD) OF TRS. § 12.2 (AM. L. INST. 2003).
37. *See* Pangea Capital Mgmt., LLC v. Lakian, 906 F.3d 1, 9–10 (2d Cir. 2018).
38. *2021 Instructions for Form 709*, IRS (Aug. 26, 2021), https://www.irs.gov/pub/irs-pdf/i709.pdf [https://perma.cc/8LQB-LGRE] ("If a gift is of community property, it is considered made one-half by each spouse.").
39. Author's original hypothetical.
40. Author's original thought.

contains a seemingly benign "power to substitute assets in a non-fiduciary capacity" and gives Husband alone the power to release the power to substitute assets.

Post-divorce, Husband and Wife each hire new trusts and estates counsel to update their estate plan. Husband's counsel explains that Husband remains co-trustee with Wife, and she must sign off on every investment, distribution, and future trustee appointment. Furthermore, if Husband passes away first, Wife controls the trust completely and can appoint her successors. Further, the provision authorizing a settlor to substitute assets means Husband and Wife are personally liable for the trust's income since inception under Internal Revenue Code Section 675(4). Wife's counsel similarly explains that she is responsible for half the income tax liability incurred in the past and future. Wife has an ongoing obligation to pay half the federal income tax incurred with respect to this trust, and only Husband has the power to release such obligation. Both Husband and Wife are furious with their attorneys for failing to address the trust's income tax liability in the divorce.

What Should Have Happened:[41] Wife and Husband should have hired separate trusts and estates counsel to advise them with respect to the trust before the divorce decree was signed. Husband's lawyer should have counseled him that he needed to have Wife resign as a trustee (in her fiduciary capacity), disclaim her right to participate in the appointment of successors (in her individual capacity), and disclaim any other powers that might be granted to her with respect to the trust. Husband's lawyer also should have pointed out before the divorce was finalized that the trust was a "grantor trust" so that the parties could deal with the income tax liability in connection with the divorce. In addition, Wife's attorney should have pointed out to her the problem that could arise as a result of Husband's retained power to substitute assets in his individual capacity. This power, which is Husband's power alone to control, dictates Wife's responsibility to pay half of the income tax liability for the trust. If Wife did not want this unknown and ongoing income tax liability, she should have negotiated for Husband to release the power to substitute assets in connection with the divorce.

b. Trusts Owning Interests in S Corporations: Will a Divorce Change Any Tax Attributes of the Trust?

A trust jointly created by a married couple who later divorces could also trigger other significant income tax consequences if such trust holds shares

41. Author's original analysis.

of an S corporation.[42] This is because only certain trusts are permitted shareholders of interests in S corporations.[43] If an ineligible trust becomes an S corporation shareholder or an eligible trust shareholder later becomes an ineligible trust shareholder, then the corporation's S election will automatically and involuntarily terminate for federal income tax purposes.[44] Immediately upon termination of a corporation's S election, the corporation will be deemed a C corporation and become subject to corporate-level tax.[45]

One such eligible trust S corporation shareholder is a grantor trust, which is treated as wholly owned by an individual who is a U.S. citizen or resident.[46] Such a trust will remain an eligible shareholder during the deemed owner's lifetime and for two years following the deemed owner's death.[47] Notably, if a grantor trust is treated as owned exclusively by both a husband and wife who are either United States citizens or residents, then such trust is also a permitted S shareholder during the marriage.[48] Therefore, grantor trusts for which a husband and wife are co-settlors (or deemed co-settlors by virtue of community property laws) are eligible S corporation shareholders while the husband and wife are married.[49]

However, a trust treated as a partial grantor trust as to a husband and a partial grantor trust as to a wife will cease to be an eligible S corporation shareholder if the marriage terminates for any reason other than death, meaning divorce.[50] The trust must make an affirmative, written election with the Internal Revenue Service (IRS) within two months and sixteen days after the trust ceases to be a grantor trust to elect to become another type of eligible S corporation shareholder, or else the trust will become an ineligible S corporation shareholder going forward.[51]

As explained above, in such an event, the corporation's S election will be revoked automatically and the corporation will be deemed a C corporation subject to an additional layer of tax at the corporate level.[52] This could have far-reaching implications not only for the divorcing parties but also for the company and its other shareholders.[53] Unfortunately, these significant tax consequences might occur without any knowledge of the issue or notice of the default to the affected parties.[54] Until someone figures out the mistake,

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42. *See* I.R.C. § 1361(c)(2)(A).
43. *Id.*
44. *Id.* §§ 1362(d)(2)–(f).
45. *Id.* § 1362(d)(2).
46. *Id.* § 1361(c)(2)(A).
47. *Id.* §§ 1361(c)(2)(A)(i)–(ii).
48. *See* Treas. Reg. § 1.1361-1.
49. *Id.*
50. *See id.* § 1.1361-1(e)(2).
51. *See id.* §§ 1.1361-1(m)(2)(iii), 1.1361-1(j)(6)(iii).
52. I.R.C. §§ 1362(d)(2)-(f), 11, 301.
53. *See id.*
54. *See id.* §§ 6601, 6651, 6655, 6662.

remedies it, and successfully requests relief from the IRS through a private letter ruling process, interest and penalties may accrue on back taxes owed.[55]

> **Example**:[56] In 2012, Husband and Wife, both United States citizens and residents of Texas, create an irrevocable trust for the benefit of their Child. The trust authorizes distributions to Child for health, education, maintenance, and support at the trustee's discretion. The terms of the trust allow Husband and Wife to substitute assets of equivalent value in a non-fiduciary capacity. Husband and Wife gift a community property interest in XYZ, Inc. to the trust. XYZ, Inc. is a Texas S corporation. Husband and Wife's estate planning counsel advises them that there is no need to file an "Electing Small Business Trust" (ESBT) election for the trust because, as a wholly-owned grantor trust, the trust is an eligible S corporation shareholder. On June 12, 2018, Husband and Wife divorce. They failed to consult their tax attorney or estate planning attorney about their divorce.
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> **Outcome**:[57] XYZ, Inc. ceased to be an S corporation on June 12, 2018, when the grantor trust for the Child ceased to be treated as owned by individuals who are Husband and Wife.
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> **What Should Have Happened**:[58] Counsel for Husband or Wife should have asked if the trust owned any S corporation stock. Upon learning that it did, they should have consulted with a qualified CPA or trusts and estates counsel to make an appropriate election to convert the trust to a trust that would be an eligible S corporation shareholder post-divorce. They should have filed such election with the IRS within two months and sixteen days of the date of the divorce decree.

c. When Dealing with Trusts, Make Sure You Have Sign Off from the Correct Party in the Correct Capacity

If a document in a family law matter creates rights or obligations related to a trust, it is important to remember the rule that a trust is not an entity.[59] A cautious lawyer should (1) identify who has the power in question with respect to the trust; (2) understand and note the capacity in which such person has the power; and (3) make sure that the right person signs off on the desired action related to the trust in the proper capacity.[60] The trustee of the trust(s) in question should agree to the right or liability in the trustee's capacity as

55. *See id.*
56. Author's original hypothetical.
57. Author's original thoughts.
58. Author's original analysis.
59. TEX. PROP. CODE ANN. § 101.001.
60. *See id.*

trustee.[61] Otherwise, one may argue that one is not bound to the arrangement in the capacity in which one has the proper legal authority and thus are not bound at all.[62] This may be even more likely with respect to a trust involved in a divorce in which a third party is the trustee of the trust but the spouses are personally affected by the trust's administration (e.g., if they are personally liable for the income taxes of the trust under I.R.C. Section 675(4)).[63] For example, Husband and Wife might divorce after creating a joint irrevocable trust for their children and naming a third party as trustee but maintaining the power to substitute assets in a non-fiduciary capacity.[64] This trust may be out of sight and out of mind because Husband and Wife do not control the assets.[65] One or both spouses might be surprised to learn of their ongoing income tax obligation.[66]

> **Example**: [67] Husband and Wife are getting divorced. Husband comes from a wealthy family, and he set up a spendthrift trust for their daughter and appointed Husband's sister as trustee four years ago. As part of their divorce, Husband and Wife agreed (at Wife's insistence) that the trust pay for Daughter's expensive summer camp each year. Post-divorce, Wife reaches out to Sister to request disbursement to pay for summer camp. Sister denies the request on the grounds that she has the sole discretion to determine how trust assets are spent for Daughter's benefit.
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> **Outcome**:[68] Wife is livid and argues that Husband agreed that the trust would pay this expense. Husband argues that he asked his sister to pay the expense. However, Husband is not the trustee of the trust, and he cannot force the trustee to exercise her discretion.
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> **What Should Have Happened**:[69] Wife's lawyers should have advised her that in a spendthrift trust, the income or principal of the trust may not be voluntarily or involuntarily transferred by any person before payment or delivery of the interest in the trust made by the trustee to the beneficiary.[70] Furthermore, Wife should have been advised that Sister was not a party to the divorce and is the sole party with legal authority to direct distributions of trust assets. To ensure Husband was responsible for paying for Daughter's summer camp, either (1) the obligation should have been included as Husband's

61. *Id.* § 114.001.
62. *See id.*
63. I.R.C. § 675(4).
64. *See id.*
65. *Id.*
66. *Id.*
67. Author's original hypothetical.
68. Author's original thoughts.
69. Author's original analysis.
70. TEX. PROP. CODE ANN. § 112.035(a).

personal obligation in the divorce decree or (2) Wife's attorney should have ensured that Sister, in her capacity as trustee, signed a binding instrument agreeing to make the requested annual distribution for the benefit of Daughter. Even though the funds are connected with Husband, in the eyes of the law, he has no legal control over the assets in Daughter's trust, and this provision in the divorce decree is unenforceable.

5. How Are Distributions from Trusts Characterized?

One of the most common areas of potential dispute regarding trusts in divorce cases involves the characterization of trust income.[71] When one party has inherited, been gifted, or came into the marriage with a beneficial interest in a trust, the interest in the underlying trust corpus is the separate property of the beneficiary.[72] However, whether the income from the trust is the beneficiary's separate property or whether it is community is not always so clear cut.[73]

a. When the Beneficiary Is Not Entitled to Trust Corpus

When a beneficiary is entitled only to distributions of trust income and has no right to the corpus of the trust, Texas courts have consistently held that the income itself is the separate property of the beneficiary.[74] Courts have said that income from separate property is community property.[75] However, because there is no underlying ownership interest in the corpus of a trust that only authorizes distributions of income, the income that the beneficiary receives must be considered the gift, given that income is the only asset the beneficiary receives.[76]

b. When the Beneficiary Is Entitled to Trust Corpus

In a clear-cut situation where a beneficiary has a clear and present right to receive some or all of a corpus of a trust, that corpus is generally treated as the beneficiary's separate property, with income generated by the corpus subject to the traditional rules governing the community nature of income

71. *See* TEX. FAM. CODE ANN. § 3.001.

72. *See* TEX. CONST. art. XVI, § 15; *id.* § 3.001(2).

73. *See* FAM. § 3.001(2).

74. *See* Ridgell v. Ridgell, 960 S.W.2d 144, 145–48 (Tex. App.—Corpus Christi–Edinburg1997, no pet.); Sharma v. Routh, 302 S.W.3d 355, 372–73 (Tex. App.—Houston [14th Dist.] 2009, no pet.); Cleaver v. Cleaver, 935 S.W.2d 491, 495 (Tex. App.—Tyler 1996, no writ).

75. *See Ridgell*, 960 S.W.2d at 145–48; *Sharma*, 302 S.W.3d at 372–73; *Cleaver*, 935 S.W.2d at 495.

76. *See Ridgell*, 960 S.W.2d at 145–48; *Sharma*, 302 S.W.3d at 372–73; *Cleaver*, 935 S.W.2d at 495.

generated by separate property.[77] This oftentimes arises in a scenario where a beneficiary is also the trustee of a trust, with no meaningful restrictions on the trustee-beneficiary's ability to access or distribute to such trustee-beneficiary the income or corpus of the trust.[78] There are also scenarios in which a beneficiary may not also be the trustee of a trust, but under the terms of the trust, the beneficiary can compel, with no meaningful restrictions, the distribution of the assets of the trust.[79] In such a scenario, there is a merger in the ownership of the trust assets—the legal ownership and the beneficial ownership of the assets are effectively held by the same person, with unfettered rights to the trust assets.[80] In such a case, the trust form itself can be disregarded for marital asset characterization purposes, with the character of any income generated by the underlying assets being characterized in the same way it would be characterized if the assets were owned in the beneficiary's individual name.[81]

For example, if a party is the sole beneficiary of a trust that provides that, at age thirty-five, the party may elect to be the sole trustee of the trust and may elect to distribute any or all of the trust corpus and income as he may, at his sole discretion, deem appropriate, then for characterization purposes, it would be reasonable to treat the assets of the underlying trust as being, effective on the party's thirty-fifth birthday, owned solely by the beneficiary, even if the trust has not formally distributed the trust assets to such beneficiary.[82] In such a situation, the beneficiary's potential ability to control the corpus is absolute, whether the beneficiary opted to exercise such control or not.[83] The income's character would thus be governed by the rules that would govern the character of the income generated by the underlying asset if it were not held in a trust.[84] This merger concept sometimes also comes into play when a trust, under the terms of the trust instrument, is supposed to have been terminated but the trustee has not formally distributed the trust assets and dissolved the trust.[85] A beneficiary cannot shield income from being treated as community property by continuing to maintain a trust beyond the time that the trust is required to terminate pursuant to the specific

77. *See Ridgell*, 960 S.W.2d at 145–48; *Sharma*, 302 S.W.3d at 372–73; *Cleaver*, 935 S.W.2d at 495.

78. *See* TEX. PROP. CODE ANN. § 112.034.

79. *See id.*

80. *See id.*

81. *See Ridgell*, 960 S.W.2d at 149 (citing *In re* Marriage of Long, 542 S.W.2d 712, 718 (Tex. App.—Texarkana, no writ)).

82. *See generally*, Mercantile Nat'l Bank Dallas v. Wilson, 279 S.W.2d 650, 653–54 (Tex. App.—Dallas 1955, writ ref'd n.r.e.) (discussing the characterization of income on the trust corpus from the marriage of defendant's husband until his death).

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

84. *See* PROP. § 112.034.

85. *Sharma*, 302 S.W.2d at 368.

terms of the trust or by opting not to terminate a trust where the trustee/beneficiary can do so.[86]

c. When the Beneficiary May or May Not Be Entitled to Trust Corpus

i. Sharma v. Routh

The most contentious area of disagreement in Texas divorce law relating to the characterization of trust income arises when there is no clarity as to the beneficiaries' ongoing right to trust corpus.[87] The rule formalized in *Sharma v. Routh*—the seminal Texas case regarding the characterization of distributions of trust income as separate or community property—governs the characterization of distributions of income during marriage from a trust to a party who has a beneficial interest in the trust that is such party's separate property.[88]

The Fourteenth Court of Appeals' opinion in *Sharma*, discussed in detail below, had its basis in a series of decisions by Texas courts that characterized trust income as community property only when the beneficiary-spouse had some present possessory right to trust corpus.[89] The reasoning in *Sharma* also stemmed from a series of decisions by Texas courts holding more broadly that community property cannot arise without a spouse having some right to acquire such property.[90]

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86. *See id.*

87. *See id.* at 363.

88. *See id.* at 371 (Hedges, C.J., concurring).

89. *See, e.g.*, McClelland v. McClelland, 1896 Tex. App. LEXIS 643 at *40, 37 S.W. 350, 359 (Waco 1896, writ ref'd) (holding a husband had no possessory right to trust income, and therefore trust income was the husband's separate property); Currie v. Currie, 518 S.W.2d 386, 390 (Tex. App.—San Antonio 1974, writ dism'd) (holding that where a husband had no present interest in trust corpus and only a future expectancy interest, the community estate had no interest and undistributed trust income should not be treated as community property); *In re* Marriage of Long, 542 S.W.2d 712, 719 (Tex. App.—Texarkana 1976, no writ) (finding that a husband's right to receive half of trust corpus during marriage was a present possessory interest in one half of trust corpus, and trust income from that half of trust corpus should be characterized as community property); Cleaver v. Cleaver, 935 S.W.2d 491, 497 (Tex. App.—Tyler 1996, no writ) (finding that where a wife could not receive distributions of trust corpus but had a right to receive trust income, trust income was the wife's separate property; however, because the wife had a present possessory right to that trust income, if the wife chose to leave that trust income in trust, additional trust income arising from the trust income left in trust should be characterized as community property); Ridgell v. Ridgell, 960 S.W.2d 144, 151 (Tex. App.—Corpus Christi–Edinburg 1997, no pet.) (finding that where a wife received mandatory trust income distributions for life and mandatory trust corpus distributions for eleven years, the wife had possessory right to trust income and "expectancy" interest in trust corpus; therefore, trust income should be characterized as community property); Dickinson v. Dickinson, 324 S.W.3d 653, 659 (Tex. App.—Fort Worth 2010, no pet.) (finding that remainder interest in trust could not be characterized as community property where beneficiary-spouse had no right to distributions of trust corpus).

90. *See, e.g.*, *In re* Marriage of Burns, 573 S.W.2d 555, 557–58 (Tex. App.—Texarkana 1978, writ dism'd) (finding that undistributed trust income was neither actually nor constructively acquired by a husband and not community property where the husband was beneficiary of certain trusts that allowed for distributions in discretion of trustee and one trust that directed mandatory distribution on a future date);

Sharma was decided on October 8, 2009, after a rehearing by the Fourteenth District of the Court of Appeals of Texas (the fourteenth Court of Appeals or the *Sharma* Court).[91] In *Sharma*, the husband (Dr. Sharma) filed for divorce from his wife.[92] During the marriage, Dr. Sharma was the beneficiary of two testamentary trusts established under the will of his former wife: the marital trust and the family trust.[93] Dr. Sharma was the sole trustee of both trusts.[94] Under the terms of the marital trust, the trustee was required to distribute all trust income to Dr. Sharma at least quarterly and was required to distribute trust corpus to him as needed to provide for his health, support, and maintenance in the standard of living to which he was accustomed at the time of his first wife's death.[95] Under the terms of the family trust, the trustee was required to distribute trust income and trust corpus to Dr. Sharma based on substantially similar support needs.[96]

From time to time, Dr. Sharma received trust income from both the marital trust and the family trust; however, Dr. Sharma, as trustee, never made a specific determination based on a support need that he was entitled to distributions of (i) corpus from the marital trust or (ii) income or corpus from the family trust.[97] Further, Dr. Sharma, as trustee, did not open separate trust bank accounts; instead, moneys owed to the trusts were deposited directly into his personal accounts.[98] Dr. Sharma, as trustee, also failed to properly maintain trust books—he erroneously deposited all trust receipts, including receipts of trust corpus, into his personal account until an informal accounting was prepared and he repaid the erroneous deposits of trust corpus.[99] No evidence was submitted that Dr. Sharma otherwise received corpus from either trust.[100]

Dr. Sharma and Mrs. Sharma disagreed over whether he should be treated as the owner of trust corpus and, therefore, whether trust income was community property.[101] Mrs. Sharma argued that Dr. Sharma should be considered the owner of trust corpus (i.e., that trust corpus should be characterized as his separate property) and that distributions of trust income should be characterized as community property.[102] Dr. Sharma argued that he

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Lemke v. Lemke, 929 S.W.2d 662, 664 (Tex. App.—Fort Worth 1996, writ denied) (affirming judgment that undistributed trust income was not community property where a husband was a beneficiary of a trust created by him prior to marriage that allowed for distributions in discretion of trustee).

91. *Sharma*, 302 S.W.3d at 355.
92. *Id.* at 357.
93. *Id.* at 357–58.
94. *See id.* at 358.
95. *Id.* at 364.
96. *Id.* at 365.
97. *Id.* at 358, 365.
98. *Id.* at 372 (Hedges, C.J., concurring).
99. *Id.* at 358 n. 5.
100. *Id.*
101. *See id.* at 365.
102. *Id.* at 365–66.

should not be considered the owner of trust corpus (i.e., that trust corpus belonged to the trustee) and that distributions of trust income should be characterized as his separate property.[103] The *Sharma* Court found that there were no Supreme Court of Texas decisions that specifically addressed this issue, and the Court adopted the following rule with respect to distributions of trust income during marriage from an *inter vivos* or testamentary trust settled by a third party for the benefit of a beneficiary-spouse (referred to therein as the "recipient"): 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. Under these circumstances, the recipient's possessory right to access the corpus means that the recipient is effectively an owner of the trust corpus."[104]

The *Sharma* Court reasoned that this rule produced a result that was within the definition of separate property of the Constitution of the State of Texas and the Texas Family Code, which generally provide that property owned or claimed before the marriage, as well as property received during the marriage by gift, devise, or descent, is separate property, and all other property, including income on separate property, is community property.[105] If the beneficiary-spouse had no present possessory right to part of the trust corpus, then the distribution of trust income to the beneficiary-spouse is in the nature of a gift or devise.[106] In contrast, if a beneficiary-spouse has a present possessory right to part of the trust corpus, then the distribution of trust income to the beneficiary-spouse is similar to an owner's receipt of income from property that the owner owns.[107]

Applying this logic to the facts in *Sharma*, the Fourteenth Court of Appeals found that Dr. Sharma had no present possessory right to the corpus of either the marital trust or the family trust.[108] The *Sharma* Court reasoned that Dr. Sharma would have had a present possessory right to the trust corpus if, in his capacity as trustee, he had determined that distributions of corpus were necessary for his maintenance under the support provisions.[109]

In support of its ruling, the *Sharma* Court noted that (i) Dr. Sharma's right to access trust corpus only arose if he had a specific support need and (ii) Dr. Sharma, as trustee, made no determination that he had a specific support need or that he was entitled to distributions of trust corpus due to his having a specific support need.[110] The *Sharma* Court made this ruling even though Dr. Sharma received income distributions from the family trust

103. *Id.* at 365.
104. *Id.* at 368.
105. *See id*. at 360–61 (citing TEX. CONST. art. XVI, § 15; TEX. FAM. CODE ANN. §§ 3.001–.002).
106. *Id.* at 364.
107. *See* Ridgell v. Ridgell, 960 S.W.2d 144, 145–48 (Tex. App.—Corpus Christi–Edinburg 1997, no writ); *Sharma*, 302 S.W.3d at 372–73.
108. *Sharma*, 302 S.W.3d at 365, 368.
109. *Id.* at 365.
110. *Id.* at 365–66.

without determining his support needs, which suggests that the *Sharma* Court declined to find that the trustee had implicitly made such a determination of his own support needs.[111]

The *Sharma* Court also noted that, in the case of both the marital trust and the family trust, (i) Dr. Sharma had "no interest in the remainder of the trusts and (ii) he had not received any distributions of any part of the corpus of the [trusts]."[112]

Notably, the *Sharma* Court found that the mere right to act as trustee where discretionary corpus distributions were permitted did not give Dr. Sharma a present possessory right to the trust corpus sufficient to cause the trust income to be community property.[113] The *Sharma* Court rejected Mrs. Sharma's argument that Dr. Sharma had such a present possessory right based on his being the sole trustee, stating "the fact that an income beneficiary also holds legal title to the corpus in his capacity as trustee should not be a controlling factor in the marital-property characterization of trust income."[114]

Because the *Sharma* Court found that Dr. Sharma did not have a present possessory right to the corpus of the marital trust or the family trust, the Court concluded that he acquired trust income from the marital trust and the family trust by gift or devise, rather than as receipt of income from property that he was considered to own; therefore, distributions of trust income were not community property but rather Dr. Sharma's separate property.[115]

Sharma established:

> [I]n the context of a distribution of trust income under an irrevocable trust during marriage, income distributions are community property only if the recipient has a present possessory right to part of the corpus, even if the recipient has chosen not to exercise that right, [because] the recipient's possessory right to access the corpus means that the recipient is effectively an owner of the trust corpus.[116]

Thus, when the dust finally settled, *Sharma* stated that whether trust income distributed to a beneficiary is community property or separate property ultimately depends on the rights the beneficiary has to the trust corpus and whether the beneficiary has a present possessory interest in the corpus at the time of the distribution of income.[117]

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111. *Id.* at 366 n. 26.
112. *Id.* at 364, 367.
113. *Id.* at 365.
114. *Id.* at 366.
115. *Id.* at 368.
116. *Id.*
117. *See generally id.* at 368 (finding for Dr. Sharma on the grounds that he elected to not exercise his rights to the trust; therefore, he had no present possessory interest in such trust).

ii. What Constitutes a Present Possessory Interest?

Sharma also clarifies that any distributions of income from a trust to a party are separate property if, at the time the distribution was made, the beneficiary did not have a present possessory interest in the underlying trust corpus.[118] The question then becomes, what does it mean for a beneficiary to have a "present possessory interest" in the corpus of a trust, and how do we determine whether a party had such an interest when a distribution was made?[119]

Sharma does make clear that restrictions on a trustee's ability to make distributions, even if the trustee is also the beneficiary, do matter, and that the rules that the trust sets out for whether distributions are to be made, in what amount, and from where must be factored into the analysis.[120] The initial fork in that road is whether the trust is a mandatory distribution trust or a discretionary distribution trust.[121]

Under a mandatory distribution trust, the trustee must distribute income and principal from the trust pursuant to a set schedule or a defined set of provisions as set out in the trust instrument itself.[122] For example, a mandatory trust may require that the trustee distribute income to the beneficiaries quarterly or require that the trustee distribute all accumulated income and principal to a beneficiary on a certain date.[123]

In analyzing a mandatory distribution trust, the analysis would seem to be relatively straightforward—is there a requirement that corpus also be distributed at the time of the income distribution?[124] If so, the beneficiary would, under the *Sharma* analysis, have a present possessory interest in the corpus (or at least a portion of the corpus), and thus the income would be community property.[125] If not, the income would be separate.[126]

With a discretionary trust, in contrast, the analysis is more complex.[127] If distribution of trust property is at the discretion of the trustee, then whether or not the beneficiary has a present possessory interest in the trust corpus depends on who the trustee is, the degree of discretion that the trustee has in distributing the trust property, and how that discretion is exercised.[128]

One of the most common trust discretionary standards is the standard present in the *Sharma* trusts—the ability to distribute trust income or

118. *Id.*
119. *See id.*
120. *Id.* at 357.
121. *See id.* at 363.
122. *Id.*
123. *Id.*
124. *Id.*
125. *See id.*
126. *See id.*
127. *See id.*
128. *See* TEX. PROP. CODE ANN. § 116.006.

principal to a beneficiary to the extent necessary for the beneficiary's health, education, support, and maintenance (HEMS).[129] This standard comes from the I.R.C, which specifically states that "[a] power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decent shall not be deemed a general power of appointment."[130] This is a critical determination, as for federal estate tax purposes, someone with a "general power of appointment" is viewed as being the owner of the property in question, regardless of whether the person exercises that power.[131] The I.R.C.'s use of the phrase has resulted in the phrase's incorporation in trust instruments as a common distributive standard, and it is intended to be an ascertainable standard for trustees to apply.[132]

One could argue that a trustee has broad discretion in determining whether to distribute under the HEMS standard.[133] For example, the way the *Sharma* trusts were worded—allowing Husband, as trustee and beneficiary, to make distributions to maintain the standard of living to which he was accustomed—arguably gave Husband a blank checkbook and the ability to accustom himself to any lifestyle he chose.[134]

Estate planners, however—and the IRS—would say otherwise, noting that the HEMS standard is viewed as an ascertainable standard that can be objectively evaluated and applied such that the beneficiary does not have full ownership of the underlying trust property, even if the beneficiary is also the trustee.[135] Because the HEMS provision is viewed by the federal government as being sufficient to keep a beneficiary from having absolute ownership of the property in question, it stands to reason that the Texas courts would find that a beneficiary of a trust with a HEMS provision would not automatically have sufficient control over the trust assets to give him a present possessory interest in the trust, even if he is also the trustee.[136]

The argument that a beneficiary has absolute control over a trust seems even more attenuated when the beneficiary is not also the trustee or if he has a co-trustee with whom he shares power.[137] The HEMS standard generally

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129. *See Sharma*, 302 S.W.3d at 355.

130. I.R.C. § 2041(b)(1)(A).

131. *See id.* §§ 2041(a), (b)(1).

132. *See id.* § 2041(a)(1).

133. *See What is HEMS and Should it Be in My Trust?*, SAN DIEGO LEGACY L., https://www.sdlegacylaw.com/blog/what-is-hems-and-should-it-be-in-my-trust-.cfm (last visited Jan. 26, 2022) [https://perma.cc/J6DM-NA9V].

134. *See Sharma*, 302 S.W.3d at 364–65; author's original example.

135. *See What is HEMS and Should it Be in My Trust?*, *supra* note 133.

136. *See id.*

137. *See What's the Difference Between a Beneficiary and a Trustee?*, ALBERTSON & DAVIDSON, LLP (Sept. 25, 2021) https://www.aldavlaw.com/blog/whats-the-difference-between-beneficiary-and-trustee/#:~:text=The%20law%20places%20duties%20on,to%20treat%20the%20beneficiaries%20fairly.

gives a significant amount of discretion to a trustee as to whether to make a distribution, and unless the beneficiary is also a sole trustee, the standard ensures that the beneficiary's access to the trust funds depends upon the decision of a third party.[138]

While the HEMS standard is the most common distributive standard in Texas divorce cases, other distribution standards are employed in trusts.[139] It is also possible for a trust instrument to provide for distributions that may be made in the sole discretion of the trustees.[140] Generally speaking, however, settlors tend to place restrictions on distributions that the trustee must follow.[141]

Similar to the distribution standards discussed above, spendthrift provisions impose additional restrictions on a beneficiary's ability to access trust assets.[142] A spendthrift provision is a mechanism that prevents a beneficiary of a trust from conveying the beneficiary's interest in the trust assets directly.[143] A trust beneficiary cannot alienate or encumber the future expectancy prior to actual receipt.[144] This also ensures that the trust assets can be protected from a beneficiary's creditors.[145]

Spendthrift provisions are extremely common in irrevocable trusts.[146] In Texas, in order for a trust to qualify as a spendthrift trust, all the Texas Trust Code requires is language in the trust document showing that the grantor intended the trust property to "be held subject to a spendthrift trust."[147] Below is an example of spendthrift provision:

> Prior to the actual receipt of such property by any beneficiary, no property (income or principal) distributable under any trust created by this trust instrument shall be subject to anticipation of (sic) assignment by any beneficiary, or to attachment by or to the interference or control of any creditor or assignee of any beneficiary, or be taken or reached by any legal or equitable process in satisfaction of any debt or liability of any beneficiary, and any attempted transfer or encumbrance of any interest in such property by any beneficiary hereunder prior to distribution shall be

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&text=The%20bottom%20line%3A%20Beneficiaries%20enjoy,control%20or%20manage%20those%20assets [https://perma.cc/F7NN-B3AP].

138. *See What is HEMS and Should it Be in My Trust?*, *supra* note 133.

139. *See id.*

140. *See id.*

141. *See generally* TEX. PROP. CODE ANN. § 112 (listing various provisions restricting trustee's powers).

142. *See What Is a Texas Spendthrift Trust?*, MCCULLOCH & MILLER, PLLC (Apr. 5, 2021), https://blog.mcmfirm.com/what-is-a-texas-spendthrift-trust/ [https://perma.cc/ES99-7GXJ].

143. *See id.*

144. *See* PROP. § 112.035(b).

145. *See* Rania Combs, *What is a Spendthrift Trust?*, RANIA COMBS L., PLLC (May 18, 2021), https://raniacombslaw.com/resources/what-is-a-spendthrift-trust [https://perma.cc/DN3G-VXPE].

146. *See* PROP. § 112.035.

147. *Id.* § 112.035(b).

> absolutely and wholly void. The trusts arising under this trust instrument are intended to be and shall be spendthrift trusts.[148]

While there is no "magic language" required for a trust to qualify as a spendthrift trust, the trust document should nevertheless include spendthrift language that limits the beneficiary's right to access the trust corpus and prohibits the beneficiary from voluntarily or involuntarily transferring trust property before payment or delivery of such property to the beneficiary by the trustee.[149] In a divorce, such language will help prove that the beneficiary has no present possessory interest in the trust corpus; thus, making any income from the trust separate.[150]

Ultimately, the question of whether a beneficiary has a "present possessory interest" in the corpus of a trust, and thus whether the income distributed from the trust is community or separate property, will involve an analysis of both the degree of control that the beneficiary has over the trust assets, particularly if the beneficiary is also a sole trustee, as well as the extent that the trustee complied with the distribution standard of the trust instrument.[151]

iii. Distributions from Business Entities Owned by Trusts

It is common for grantors or settlors to transfer their ownership interests in closely held businesses to a trust.[152] This allows entrepreneurs to ensure that the family business stays in the family going forward and that the family business is properly managed in the future.[153] Often, the entity interests will be placed in a trust, or in multiple trusts, which will be managed by trustees who must govern the trust per the trust document.[154] The entity is usually structured as a limited liability entity, and entity interests are transferred to the trusts during the settlor's lifetime, at the settlor's death, or a combination thereof.[155]

From time to time, underlying entities owned by trusts may make cash distributions directly to the beneficiaries, even though the trusts were

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148. Author's original example.

149. *See* Barron, Rosenberg, Mayoras & Mayoras, *What Is a Spendthrift Clause in a Trust?*, BARRON, ROSENBERG, MAYORAS & MAYORAS P.C., (July 10, 2017), https://www.brmmlaw.com/blog/2017/july/what-is-a-spendthrift-clause-in-a-trust-/#:~:text=With%20a%20spendthrift%20clause%2C%20the,needs%20or%20making%20limited%20payments [https://perma.cc/4P9Z-BXH8].

150. *See id.*

151. *See* Sharma v. Routh, 302 S.W.2d 355, 362 (Tex. App.—Houston [14th Dist.] 2009, no pet.).

152. *See Estate Planning for Closely Held Business Owners*, SHERMAN SILVERSTEIN ATTY'S LAW, https://www.sskrplaw.com/estate-planning-for-closely-held-business-owners.html (last visited Feb. 26, 2022) [https://perma.cc/6FKD-M64A].

153. *See id.*

154. *See id.*

155. *See id.*

technically entitled to such distributions as partners or shareholders.[156] This is particularly commonplace when the trusts in question have mandatory distribution provisions or when the entities only make distributions to the trusts when it is intended to pass those distributions directly to the beneficiaries as a trust distribution.[157] While trustees generally establish bank accounts for the trusts they oversee, if a trust only owns interests in closely-held businesses and it is anticipated that any distributions from those entities to the shareholding trusts will be immediately distributed to the beneficiaries of the trust, such accounts may be deemed unnecessary.[158] Therefore, when distributions of cash are ready to be made, in lieu of payment into separate accounts for the trusts, they may be paid directly to the primary beneficiary of the trusts as trust distributions, cutting out the middle step of having the entity write a check to the trust, which would deposit the check into a trust account only to turn around and write an identical check to the beneficiary.[159]

While cutting out the middleman may not be the best practice in terms of recordkeeping, it does not alter the fact that the trust, not the beneficiaries, are the owners of the underlying entities, and the entity distributions are distributions to the trust, the legal owner of the entity, not distributions to the beneficiaries, who have only a beneficial ownership interest in the entity.[160]

Whether moneys received by a trust from an underlying entity is considered corpus or income is governed by the Texas Property Code.[161] Generally, trust receipts from a partnership or corporation are classified as trust income.[162] However, such receipts are instead classified as trust corpus in situations where (i) the trust receives property other than money; (ii) the trust receives money in exchange for its interest in the entity; or (iii) the trust receives money in partial liquidation of the entity.[163] Money is received in partial liquidation of an entity when either (i) the entity indicates that the money is a distribution in partial liquidation of the entity or (ii) when the

156. *See* Akhilesh Ganti, *Trust Fund: What Is a Trust Fund?*, INVESTOPEDIA, https://www.investopedia.com/terms/t/trust-fund.asp (Aug. 31, 2020) [https://perma.cc/GU8C-32E3].

157. *See What Are Discretionary and Mandatory Trust Distributions?*, L. OFF. ANDREW SZOCKA, P.C., https://www.szocka.com/what-are-discretionary-and-mandatory-trust-distributions/#:~:text=Some%20trusts%20require%20trustees%20to,or%20property%20to%20be%20distributed (last visited Jan. 31, 2022) [https://perma.cc/4Z5J-8GBE].

158. *See generally How to Properly Distribute Trust Assets to Beneficiaries*, ALBERTSON & DAVIDSON, LLP (Aug. 18, 2021), https://www.aldavlaw.com/blog/how-to-distribute-trust-assets-to-beneficiaries/ [https://perma.cc/7A5H-DWXL] (discussing methods of distribution such as a new stock certificate).

159. *See Revocable Trusts*, CUMMINGS & LOCKWOOD, L.L.C., https://www.cl-law.com/uploads/1460582423_14.pdf (last visited Feb. 26, 2022) [https://perma.cc/6MQE-9CUH].

160. *See* Rebecca Klock Schroer, *Considerations for Administering Closely Held Business Assets in Trust*, HOLLAND & HART LLP (Aug. 2021), https://www.hollandhart.com/considerations-for-administering-closely-held-business-assets-in-trust [https://perma.cc/GY5N-GLCU].

161. *See* TEX. PROP. CODE ANN. § 116.002(4).

162. *Id.* § 116.151(b).

163. *See id.* § 116.151(c).

distribution or series of distributions from the entity is greater than 20% of the entity's gross assets immediately prior to the distribution.[164]

Barring one of these three exceptions, a distribution from an entity owned by a trust is considered trust income, and thus if and when those funds are distributed to the beneficiaries, it would be treated as a distribution of income, rather than of corpus.[165]

If a trust that owns interests in a closely-held business does not hold entity distributions but immediately distributes any such funds it receives from the entity to the beneficiaries, the classification of the distribution as income or corpus is likely moot.[166] If it is a distribution of trust income, then it is likely separate property because the beneficiary, under the terms of the trust instrument, almost certainly does not have a present possessory right to the underlying ownership interest in the entity itself if the beneficiary is not entitled to control the entity, to sell it, or compel its distribution.[167] If it is a distribution of trust corpus, on the other hand, then the entirety of the distribution is the separate property of the beneficiary because it is a distribution of corpus, and there is no income at issue that would be subject to the present possessory interest rule.[168]

B. Estate Administration and Probate

The worlds of an estate planner and a family law attorney might also collide if a party to a divorce, premarital agreement, or postmarital agreement dies while the party has obligations outstanding with respect to those property agreements.[169]

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164. *See id.* § 116.151(d).

165. *See* Thomas E. Bazley, *Trusts Owning Partnership Interests*, TAX ADVISER (Sept. 1, 2009), https://www.thetaxadviser.com/issues/2009/sep/trustsowningpartnershipinterests.html [https://perma.cc/Z45C-XZAM].

166. *See How to Properly Distribute Trust Assets to Beneficiaries*, *supra* note 158.

167. *See* Rania Combs, *Is Married Beneficiary's Interest in a Trust Separate or Community Property?*, RANIA COMBS L., PLLC (Nov. 26, 2019), https://raniacombslaw.com/resources/is-married-beneficiarys-interest-in-a-trust-separate-or-community-property#:~:text=Texas%20defines%20separate%20property%20as,acquired%20by%20gift%20or%20inheritance.&text=In%20general%2C%20principal%20distributions%20from,acquired%20by%20gift%20or%20inheritance [https://perma.cc/D9XE-C66S].

168. *Are Trusts Considered Marital Property?*, WALTERS GILBREATH, PLLC, https://www.waltersgilbreath.com/blog/are-trusts-considered-marital-property (last visited Feb. 26, 2022) [https://perma.cc/J5QS-UFXL].

169. *See* Pasternak & Fidis, *Enforcing Death Provisions in Premarital and Postmarital Agreements*, Pasternak & Fidis (Feb. 12, 2016), https://www.pasternakfidis.com/enforcing-death-provisions-in-premarital-and-postmarital-agreements/ [https://perma.cc/7FBB-U5D9].

1. What's the Difference Between Probate and Estate Administration?

A square is a rectangle, but a rectangle is not necessarily a square.[170] Likewise, probate is considered part of estate administration, but not all estate administrations involve probate.[171]

Estate administration is the settlement of a decedent's estate at the decedent's death.[172] It often involves the collection of the decedent's assets, payments of last debts, expenses, claims, and taxes, and the distribution of the remainder of the estate to those entitled to it.[173]

"Nonprobate assets" are assets that were owned by the decedent during the decedent's lifetime, but which pass by contract (e.g., beneficiary designation for a retirement account, life insurance, and non-qualified annuity), titling in a way that identifies passage at death (e.g., "with rights of survivorship," "payable on death," or "transfer on death"), or titling assets in a trust that provides for disposition other than to the decedent's estate.[174]

"Probate assets" are all assets owned by a decedent at death other than "nonprobate assets."[175] This means that the decedent did not sign any contract or paperwork transferring title to such assets effective upon death.[176] Likewise, the decedent did not title the property in the name of a trust during the decedent's lifetime that instructs any remaining trust assets to be distributed in a manner other than the decedent's estate.[177] Instead, if the decedent had a will, the probate assets will pass under the terms of the decedent's will after the court has validated the will through the probate process.[178] If the decedent died without a will, an applicant may petition a court to determine the decedent's heirs pursuant to Texas's intestate succession statutes and administer the decedent's estate.[179]

Some modest estates avoid the need for probate if there are no significant assets.[180] Furthermore, some more significant estates avoid probate by thoughtfully engaging in lifetime nonprobate transfers to reduce the burden of estate administration on their loved ones.[181]

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170. Author's original thought.

171. *See What's the Difference Between a Probate and Non-Probate Asset?*, ROMANO & SUMNER, https://romanosumner.com/blog/difference-between-probate-non-probate-asset/ (last visited Jan. 31, 2022) [https://perma.cc/BJJ4-JJ6W].

172. *See id.*

173. *Id.*

174. *Id.*

175. *See id.*

176. *See id.*

177. *See id.*

178. *Id.*

179. *See* TEX. EST. CODE §§ 201.001–.003.

180. *See What's the Difference Between a Probate and Non-Probate Asset?*, *supra* note 171.

181. *Non-Probate Transfers,* BOLLINGER L. FIRM, https://bolingerlawstl.com/estate-planning/non-probate-transfers/ (last visited Jan. 31, 2022) [https://perma.cc/RW26-U85N].

2. How Does an Estate Tax Return Affect Estate Administration?

Estates of decedents required to file estate tax returns or that opt to file an optional "portability" estate tax return typically take longer to administer than estates that do not file federal estate tax returns.[182] In 2022, only decedents who have estates exceeding $12.06 million (considering lifetime taxable gifts) must file an estate tax return.[183] An executor has nine months from the decedent's date of death to file an estate tax return.[184] Often executors opt to take advantage of the optional six-month extension to file an estate tax return, effectively allowing fifteen months from the decedent's date of death to file the decedent's estate tax return.[185]

To the extent the decedent's taxable estate exceeds the estate deductions (e.g., marital deduction, charitable deduction, and deduction for expenses of funeral, last illness, and estate administration) and the available gift and estate tax exemption, the estate will owe a 40% tax nine months from the decedent's date of death.[186] When a decedent's estate includes an interest in a closely-held business that has a value that equals at least 35% of the value of the decedent's estate for federal transfer tax purposes, the estate may elect to pay the estate tax in installments.[187] Interest-only payments may be made in the first year, and principal and interest payments can be made in the remaining year(s) for up to fourteen years total.[188] The Internal Revenue Code imposes a general lien under I.R.C. Section 6321 and a special lien under I.R.C. Section 6324 until estate taxes are paid, for which an executor can face personal liability in certain circumstances.[189]

Practically speaking, estates that must file or elect to file a federal estate tax return often take much longer to administer than estates that do not.[190] Therefore, claims that a current or former spouse may have against a decedent's estate and beneficiary distributions that a surviving spouse may be entitled to under a decedent's estate plan might be paid out only after the federal estate tax return has been filed and the executor of the estate has

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182. *See Portability of the Estate Tax Exemption*, DRONBY L. OFF., https://www.drobnylaw.com/articles/portability-of-the-estate-tax-exemption (last visited Feb. 26. 2022) [https://perma.cc/7UNF-JT2W].

183. *See* I.R.C. § 6018(a)(1).

184. *Id.* § 6075(a).

185. *See* Treas. Reg. § 1.6081-1(a).

186. *See* I.R.C. § 2001.

187. *See id.* § 6166(a).

188. *Id.*

189. *See* Matthew S. Beard, *Addressing Tax Liens in Estate Administration*, MEADOWS COLLIER ATTY'S LAW (Aug. 9, 2019), https://www.collincountybar.org/assets/Councils/McKinney-TX/library/Matt%20Beard%20August%209%202019%20Handout%201%20of%202.pdf [https://perma.cc/FM72-C9BK].

190. *See Portability of the Estate Tax Exemption*, *supra* note 182.

received an estate tax closing letter.[191] This may be years after the decedent's death.[192]

3. How Do You Make a Claim Against a Decedent's Estate If You Are Owed Something Under a Marital Property Agreement or Divorce Decree?

What if your client's former spouse owed child support and dies without otherwise providing for his or her minor children?[193] What happens if a client was guaranteed a certain amount of money upon the death of the client's spouse in a premarital agreement, but the deceased spouse failed to update the deceased spouse's will to account for the deceased spouse's obligations under the premarital agreement?[194] Under the Texas Estates Code, an aggrieved spouse or a former spouse must file a claim with the executor of the decedent's estate.[195]

The applicable rules for presentment, acceptance or rejection of a claim by an executor, and filing suit to enforce a claim depend on whether the decedent's estate is subject to an "Independent Administration" (where the executor or administrator largely operates without court oversight) or a "Dependent Administration" (where the executor or administrator operates with heavy court supervision).[196] In Texas, most estate administrations that involve probate of a will are independent administrations.[197] Intestate estates (i.e., where the decedent died without a will) are typically subject to dependent administrations.[198] However, regardless of whether an estate administration is an "Independent Administration" or a "Dependent Administration," the priority of payment of claims is the same.[199] Claims must be classified and paid in order of priority.[200]

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191. *See* Julie Garber, *The Estate Tax Closing Letter*, BALANCE (Oct. 31, 2021), https://www.thebalance.com/estate-tax-closing-letter-3505520 [https://perma.cc/M7VB-XXAC].

192. *See id.*

193. Author's original hypothetical.

194. *Id.*

195. TEX. EST. CODE ANN. § 355.001.

196. *See* Keith Branyon, *Claims Process Options for Creditors in Independent Administrations*, ST. BAR TEX., https://www.texasbar.com/AM/Template.cfm?Section=articles&Template=/CM/HTMLDisplay.cfm&ContentID=39385 (last visited Feb. 26, 2022) [https://perma.cc/B36P-D4PK].

197. *See* EST. §§ 401.001–002.

198. *See Intestate Succession: Administration Without a Will*, L. OFF. IAN MICHAEL KUECKER, PLLC, https://www.lawofficeimk.com/passing-of-a-loved-one-intestate-succession-without-a-will (last visited Jan. 31, 2022) [https://perma.cc/V4AC-TFB9].

199. EST. § 355.102.

200. *See* Branyon, *supra* note 196. Under the Texas Estates Code, Class 1 claims are composed of funeral expenses and expenses of the decedent's last illness, including claims for reimbursement of those expenses, for a reasonable amount approved by the court, not to exceed $15,000 for funeral expenses and $15,000 for expenses of the decedent's last illness. Any excess shall be classified and paid as other unsecured claims.

Class 2 claims are composed of expenses of administration; expenses incurred in preserving, safekeeping, and managing the estate, including fees and expenses awarded under Section 352.052; unpaid expenses of administration awarded in a guardianship of the decedent; and for an estate with respect to

Interestingly, the Texas Estates Code makes no mention of debts owed to the United States government.[201] Courts have ruled that claims by the United States government do not trump funeral expenses, estate administration expenses, and payment of the family allowance in order of priority of payments from the decedent's estates because those expenses are not debts of the decedent.[202] However, debts owed by the decedent to the United States government take priority over all other claims listed in Texas Estates Code Section 355.102.[203]

Class 4 regulates claims for child support.[204] Under the Texas Family Code, a deceased parent's duty to support the deceased parent's child does not end upon the decedent's death, even if the divorce decree does not explicitly state the obligation to pay child support survives the decedent's death.[205] Instead, a parent's duty of support does not survive death only if agreed in writing among the parties or expressly provided in the order.[206]

Claims to satisfy the terms of a marital property agreement (other than child support claims) are most likely to be relegated to Class 8, the lowest priority claim for payment with respect to a decedent's estate.[207]

For an executor who is resistant or slow to act, the earliest a client with a claim could obtain a court order to be paid is one year after the letters testamentary (i.e., the official authorization from a court that an executor or

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which a public probate administrator has taken any action under Chapter 455, court costs and commissions to which the administrator is entitled under Subchapter A, Chapter 352.

Class 3 claims are composed of each secured claim for money under Section 355.151(a)(1), including a tax lien, to the extent the claim can be paid out of the proceeds of the property subject to the mortgage or other lien. If more than one mortgage, lien, or security interest exists on the same property, the claims shall be paid in order of priority of the mortgage, lien, or security interest securing the debt.

Class 4 claims are composed of claims (1) for the principal amount of and accrued interest on delinquent child support and child support arrearages that have been: (A) confirmed as a judgment or a determination of arrearages by a court under Title 5, Family Code; or (B) administratively determined by the Title IV-D agency, as defined by Section 101.033, Family Code, in a Title IV-D case, as defined by Section 101.034, Family Code., and (2) for unpaid child support obligations under Section 154.015, Family Code.

Class 5 claims are composed of claims for taxes, penalties, and interest due under Title 2, Tax Code, Chapter 2153, Occupations Code, former Section 81.111, Natural Resources Code, the Municipal Sales and Use Tax Act (Chapter 321, Tax Code), Section 451.404, Transportation Code, or Subchapter I, Chapter 452, Transportation Code.

Class 6 claims are composed of claims for the cost of confinement established by the Texas Department of Criminal Justice under Section 501.017, Government Code.

Class 7 claims are composed of claims for repayment of medical assistance payments made by the state under Chapter 32, Human Resources Code, to or for the benefit of the decedent.

Class 8 claims are composed of any other claims not described by Subsections (b)–(h).

201. *See generally* EST. (in its entirety, the Texas Estates Code has nothing to say regarding debts owed to the United States government).

202. United States v. Weisburn, 48 F. Supp. 393, 397 (E.D. Pa. 1943); Rev. Rul. 80-112, 1980 C.B. 306.

203. *See* EST. § 355.102.

204. *Id.*

205. *See* TEX. FAM. CODE ANN. § 154.006.

206. *Id.* § 154.005(a).

207. *See* EST. § 355.102.

administrator is court authorized to act on behalf of the estate).[208] Letters testamentary are only issued after an application for probate or estate administration has been filed and a court hearing has occurred where a judge has signed an order appointing an executor or administrator.[209] Because the proponent of a will has four years to file an application to probate a will, it could take several years for a judge to order a valid claimant to be paid following a spouse or former spouse's death.[210]

Technically, if a creditor wants to expedite the process, the creditor could file an application to administer the decedent's estate.[211] Texas Estates Code Sections 304.001(a) provides that:

> [T]he court shall grant letters testamentary or of administration to persons qualified to act, in the following order: (1) the person named as executor in the decedent's will; (1-a) the person designated as administrator as authorized under Section 254.006; (2) the decedent's surviving spouse; (3) the principal devisee of the decedent; (4) any devisee of the decedent; (5) the next of kin of the decedent; (6) a creditor of the decedent; (7) any person of good character residing in the county who applies for the letters; (8) any other person who is not disqualified under Section 304.003; and (9) any appointed public probate administrator.[212]

To avoid the significant burdens of administering a debtor's estate, most non-spouse creditors are nevertheless advised to be patient and wait until an application for probate has been initiated.[213] However, a surviving spouse's creditor might be inclined to file an application to initiate probate or estate administration (even if he or she is not named in the decedent's will as executor) to move along an estate administration process.[214] The act of filing the application might force the hand of the person nominated as executor in the decedent's will.[215]

208. *Id.* § 355.107.
209. *See id.* §§ 306.001–007.
210. *Id.* § 256.151(2).
211. *Id.* §§ 22.018, 256.181, 301.051.
212. *Id.* § 304.001(a)(1)–(9).
213. *See* Branyon, *supra* note 196.
214. *See id.*
215. *See id.*

III. PREMARITAL AGREEMENTS

A. What Estate Planners May Not Know

1. Retirement Benefit

Although retirement benefits earned prior to marriage are considered a party's separate property, income from separate property is considered community property during the marriage.[216] Many marital agreements state that income from separate property remains separate property, eliminating burdensome tracing during a divorce.[217] Lawyers drafting a marital agreement that calls for the creation of a community estate should also address future contributions to a retirement plan.[218] If the parties want all income during the marriage to be community, contributions to a retirement plan will likely come from community funds and, therefore, will be community retirement, including the income from those future contributions[219] This can again require the task of tracing, which is time-consuming and costly.[220] If clients insist on creating community retirement, practitioners should consider a clause that states that the parties will open new retirement plans after the marriage and only contribute to those new plans during the marriage, or a clause that money contributed to retirement during the marriage are exempt from being categorized as community property income so that there is no comingling of separate and community property.[221] This will make the division of retirement much simpler in a divorce.[222]

2. Standing Orders/Injunction

Many counties in Texas have automatic standing orders and injunctions that go into effect automatically when a petition for divorce is filed.[223] Therefore, such orders and injunctions should be addressed in a premarital, postmarital, or partition agreement if the terms award either party assets as

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216. *See* TEX. FAM. CODE ANN. §§ 3.001–3.003, 3.007.

217. *See* Kathryn J. Murphey, *Marital Property Agreements*, ST. BAR TEX., 4–5 (Oct. 11, 2018), https://www.gbfamilylaw.com/wp-content/uploads/2019/02/Marital-Property-Agreements.New-Frontiers.2018.pdf [https://perma.cc/3778-JSJP].

218. *See id.* at 7.

219. *See id.*

220. *See* Thomas L. Ausley, *What is Needed to Prone Separate Property at Time of Divorce*, GORANSOR, BAIN, AUSLEY FAM. L. (Dec. 17, 2018), https://www.gbfamilylaw.com/blogs/what-is-needed-to-prove-separate-property-at-time-of-divorce/ [https://perma.cc/2GQ4-44UU].

221. *See* Murphey*, supra* note 217, at 7–8.

222. *See id.*

223. *See Standing Orders*, TEX. L. HELP.ORG, https://texaslawhelp.org/article/standing-orders (Oct. 25, 2021) [https://perma.cc/D4NS-ZAZS].

separate property.[224] Otherwise, the standing orders and injunctions may impede a client's ability to manage the client's separate property during the pendency of a divorce.[225] Below is an example of a clause to consider adding to a marital agreement to address the standing orders or any other injunctions that a court may impose:

> **Injunctions and Other Court Orders**. [226] If either party files a dissolution proceeding, the parties agree that during the pendency of the action neither party will request or seek to enforce any restraining order or injunction that could have the effect of inhibiting or prohibiting a party from making decisions concerning or disposing of the party's separate property. Further, neither party will have the right to the temporary use or possession of any separate property owned solely by the other party, either real or personal. Nothing in this section affects the ability of either party to request or seek to enforce any order for the benefit of a child of both parties.
>
> Additionally, both parties agree that the unrestricted right of a party to manage his separate property shall not be limited or hindered in any way by a court order or injunction, including but not limited to any standing order of a court that seeks to limit use or assignment of property or debt during the pendency of a divorce action, save and except for any express rights afforded to a party or the parties under the terms of this Agreement. Both parties agree that they will not seek to enforce any order of the court, including a standing order of a court imposed in divorce cases, that attempts to inhibit or prohibit a party from making decisions concerning or disposing of his separate property, save and except for any express rights afforded to a party or the parties under the terms of this Agreement, and further agree to sign all documents or court orders necessary to lift any provisions of a standing order of a court that attempt to inhibit or prohibit a party from making decisions concerning or disposing of his separate property.

3. Altering the Burden of Proof in Characterizing Property

Lawyers should consider changing the community property presumption to a separate property presumption in a premarital, postmarital, or partition agreement.[227] That is, eliminating the presumption that all assets acquired during the marriage are community property.[228] Instead, the presumption is altered to reflect a presumption that property held in the name

224. *See* Murphey, *supra* note 217, at 17–18.
225. *See Standing Orders*, *supra* note 223.
226. Author's original example.
227. *See* TEX. FAM. CODE ANN. § 3.003.
228. *Id.*

of only one spouse is that party's separate property.[229] The marital property agreement alone can be clear and convincing evidence of separate property.[230] However, if a client intends to change the burden in favor of a separate property presumption, it is wise to include a clause in the marital agreement for clarity, such as:

> **Presumption of Separate Property**. [231] Any property held in Husband's individual name is presumed to be the separate property of Husband. Any property held in Wife's individual name is presumed to be the separate property of Wife. Any property or liability inadvertently omitted from the schedules attached to this Agreement is the separate property or liability of the party to whom it belongs or by whom it was incurred. The parties specifically intend to eliminate any statutory or common law presumption of community property in favor of a separate property presumption.

4. Addressing Pre-Existing and Future Children

The parties to a premarital agreement may have children from a prior relationship.[232] Although the parties have no obligation to provide for the other party's previous children unless they obligate themselves contractually, estate planners should recognize this and address the existing children of the parties in the premarital agreement.[233] For instance, add a clause stating Party A has two existing children from a previous relationship at the time of the marriage, child A and child B.[234] By entering into this agreement, Party B is not obligating him or herself to financially support Party A's existing children unless Party B adopts Party A's existing children at some point in the future.[235]

Parties to a premarital agreement can also address future children of the marriage as long as it does not affect a party's right to child support.[236] Parties have likewise contracted regarding possession and access to future children as long as it is not against public policy.[237] However, the parties should know this will likely be seen as an intention statement, and the terms are not likely to be enforceable depending on the circumstances of the parties and the future

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229. *See id.*
230. Ausley, *supra* note 220.
231. Author's original example.
232. *See What Can and Cannot Be Included in Prenuptial Agreements*, FINDLAW, https://www.findlaw.com/family/marriage/what-can-and-cannot-be-included-in-prenuptial-agreements.html (Sept. 12, 2018) [https://perma.cc/37U5-Y84F].
233. *Id.*
234. Author's original hypothetical.
235. *See What Can and Cannot Be Included in Prenuptial Agreements*, *supra* note 232.
236. TEX. FAM. CODE ANN. § 4.003.
237. *Id.* § 4.003(a)(8).

children at the time of a dissolution proceeding.[238] The court will retain its ability to make orders for conservatorship and create a possession schedule that is in the best interest of the children considering all factors at the time of the divorce proceedings.[239]

Further, if the premarital agreement calls for lump-sum payments at the time of a divorce, the parties can determine the amount of the payment based on the number of children born during the marriage.[240] For example, the parties may agree that if there is one child born of the marriage at the dissolution proceeding, Party A will pay Party B $50,000 as a lump sum payment.[241] If there are two children born of the marriage at the dissolution proceeding, Party A will pay Party B $75,000 as a lump sum payment.[242] Such an arrangement is not necessarily a substitution for child support.[243]

B. What Family Law Attorneys May Not Know

1. Background Law

a. Gifts and Gift Tax[244]

The gift tax is a tax on the privilege of transferring property during one's lifetime.[245] Current law coordinates the gift tax with the estate tax, so that each individual has $12.06 million (referred to herein as the Basic Exclusion Amount or the Exemption Amount) "in exclusion that can be applied to that individual's lifetime transfers, post mortem transfers, or some combination of lifetime and post mortem transfers to shield gift tax and estate tax."[246] For the first time beginning in 2012 and every year after, the Basic Exclusion Amount is indexed for inflation.[247] The Basic Exclusion Amount increased to $5,120,000 in 2012.[248] It increased to $5,250,000 in 2013, $5,340,000 in 2014, $5,430,000 in 2015, $5,450,000 in 2016, $5,490,000 in 2017, $11,180,000 in 2018, $11,400,000 in 2019, $11,580,000 in 2020,

238. *See id.*
239. *See id.* § 153.002.
240. *See* Murphey, *supra* note 217, at 24.
241. Author's original hypothetical.
242. Author's original thought.
243. *See* FAM. § 4.003(b).
244. Portions of this text appear (with permission of the authors) from Lora G. Davis & Christine S. Wakeman, *GRRR (Gift Return Reporting Requirements) - Taming the Wild 709 Tiger*, METROPLEX PRAC. MGMT. GRP. (July 22, 2014), https://theblumfirm.com/wp-content/uploads/2014/07/July_22_2014_GRRR_Taming_the_Wild_709_Tiger_Outline.pdf [https://perma.cc/9FFG-GZVZ].
245. *See* I.R.C. §§ 2501–2505.
246. *See id.* §§ 2010(c), 2505(a).
247. *Id.* § 2010(c)(3)(B).
248. *See id.*

$11,700,000 in 2021, and $12,060,000 in 2022.[249] The Tax Cuts and Jobs Act doubled the Basic Exclusion Amount for tax years 2018 through 2025.[250] For gift transfers in excess of the unified credit amount in 2013 and beyond, the top gift tax rate is 40%.[251]

i. What Is a Gift?

The short answer is that many transfers qualify as "gifts" under the federal gift tax rules.[252] "Any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift."[253] Generally, a gratuitous transfer is subject to the gift tax rules whether the transfer is in trust or not in trust, "whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."[254] Donative intent on the part of the transferor is not an essential element for the gift tax rules to be applicable.[255] It has been accepted as a nearly universal truth that Congress intended a very broad definition of "gift" for federal gift tax purposes.[256]

ii. What Does Not Seem Like a Gift but May Be a Gift (in Whole or in Part)?

As noted above, donative intent is not an essential element of making a gift for federal gift tax purposes.[257] Transfers reached by the gift tax include sales, exchanges, and other property dispositions for consideration to the extent that the fair market value of the property transferred by the donor exceeds the value of money or property received.[258] The following transactions may also qualify as gifts: forgiving a debt, making an interest-free or below market rate loan, transferring the benefits of an insurance policy, making certain property settlements in divorce cases, giving up some amount of an annuity in exchange for the creation of a survivor annuity, and making certain disclaimers that are not qualified.[259] Clients may therefore have a gift tax return filing requirement even if, in their minds, no money or property has changed hands.

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249. *What's New – Estate and Gift Tax*, IRS, https://www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax (Nov. 15, 2021) [https://perma.cc/8W45-TXHT].
250. I.R.C. § 2010(c)(3)(C).
251. *Id.* §§ 2001(c), 2502.
252. *See* Treas. Reg. § 25.2511-1(c)(1).
253. *Id.*
254. *Id.* § 25.2511-1(a).
255. *Id.* § 25.2511-1(g)(1).
256. *Id.* § 25.25.2511-1(g)-(h).
257. *Id.*§ 25.2511-1(g)(1).
258. *Id.* § 25.2511-1(h).
259. *Id.;* I.R.C. § 2516.

> **Example**:[260] Dad buys his thirty-year-old son a car that costs $50,000, and they agree that Son will pay Dad back with interest. On Christmas day that same year, Dad tells Son that, as his Christmas gift, Son will not have to pay Dad back for the car. This forgiveness of debt is a gift that would trigger a gift tax return filing requirement under federal law.

Interestingly, some transfers between spouses and former spouses can be deemed gifts for income tax purposes.[261] Generally, outright transfers between spouses are subject to an unlimited marital deduction for gift tax purposes.[262] However, there is not an unlimited marital deduction available when the donor's spouse is not a United States citizen.[263] Instead, a transfer to a non-citizen spouse is subject to a limitation described in I.R.C. Section 2523(i)(2).[264] This amount is indexed for inflation annually.[265] In 2022, a spouse may transfer assets with a cumulative value equal to $164,000 before making a taxable gift.[266] When preparing marital property agreements where the spouse of lesser means is a non-citizen, it is important to know that transfers to such spouse could cause the citizen spouse to be required to use the citizen spouse's exemption amount to the extent the citizen spouse exceeds the non-citizen spouse's annual exclusion available in such year.[267]

When spouses divorce, transfers between spouses are often not considered gifts, provided they meet three requirements: (1) the transfer is pursuant to a written agreement relative to the parties' marital and property rights; (2) a final divorce decree occurs within the three years beginning one year before and ending two years after the agreement is entered into; and (3) the property transfer is in settlement of marital property rights or provides a reasonable allowance for the support of the parties' children of the marriage.[268]

Thus, for example, if an agreement incident to divorce was signed twenty-seven months after a divorce decree was issued, the transfers that occur among former spouses pursuant to that agreement would not fall under the purview of I.R.C. Section 2516.[269] If a transfer does not fall within the purview of I.R.C. Section 2516, two other exceptions would allow the

260. Author's original hypothetical.
261. 26 U.S.C. § 1041.
262. I.R.C. § 2523(a).
263. *Id.* § 2503(i).
264. *Id.* § 2523(i)(2).
265. *See id.* §§ 2503(b)(2), 2523(i)(2).
266. Rev. Proc. 2021-45, I.R.B. 764.
267. *See* I.R.C. §§ 2056, 2503; *see also* Treas. Reg. §§ 20.2056-5, 20.2056-7 (noting that transfers to trusts and life estates must be structured to meet certain requirements in order to qualify for the unlimited marital deduction).
268. I.R.C. § 2516.
269. *Id.*

transfer not to be considered taxable for gift tax purposes.[270] First, transfers among former spouses might not be considered taxable gifts if they meet the requirements of the *Harris* doctrine.[271] In the *Harris* case, the Supreme Court ruled that marital property settlement between the husband and wife, operative by its terms only on entry of divorce to decree, is exempt from gift tax.[272] Per this doctrine, transfers among former spouses ordered pursuant to a divorce decree might not incur gift tax even if they fall outside of the timing set forth in I.R.C. Section 2516.[273]

However, some courts have limited the application of the *Harris* doctrine.[274] In *Rosenthal v. Commissioner*, the court ruled that the *Harris* doctrine did not apply when the court was ordering payments to or for the benefit of adult offspring of the parties or to minors beyond their needs for support.[275] It might be easy to see how "you said you would reimburse me for paying for that expensive summer camp" or "you promised you would reimburse me for half the cost of the car for our child's twenty-first birthday" would seem incident to a divorce but might actually be taxable transfers if not specifically incorporated into a written agreement by the parties within the period described in I.R.C. Section 2516.[276]

If neither I.R.C. Section 2516 nor the *Harris* doctrine applies, the only way a client can avoid the imposition of the gift tax with respect to a transfer to a former spouse is to prove that the transfer is one made for consideration in money or money's worth.[277] In this case, the critical point to prove is that the transferee spouse released support-type rights in exchange for the property transferred.[278] Ongoing alimony and child support payments are generally exempt from gift tax under the "support" consideration exclusion.[279] However, non-support type payments (e.g., payments for the benefit of adult children) may not fall within the exception.[280]

Practitioners should do whatever it takes to fall under the exclusion in I.R.C. Section 2516.[281] If a client signs an agreement incident to divorce agreeing to terms more than one year before the divorce decree is signed, then the parties should ratify the agreement in a separate written agreement that will fall within the requirements of I.R.C. Section 2516.

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270. Harris v. Comm'r, 340 U.S. 106, 108 (1950).
271. *Id.*
272. *See id.*
273. *See id.*
274. Rosenthal v. Comm'r, 205 F.2d 505, 519–21 (2d Cir. 1953).
275. *Id.*
276. *See id.*; I.R.C. § 2516.
277. I.R.C. § 2512(b).
278. *See* JOSEPH M. DODGE, WENDY C. GERZOG, BRIDGET J. CRAWFORD, FEDERAL TAXES ON GRATUITOUS TRANSFERS: LAW AND PLANNING 78 (2011).
279. *Id.*
280. *See Rosenthal*, 205 F.2d at 505.
281. Author's original thought.

iii. What Seems Like a Gift but Is Not a Gift?

There are three types of transfers that may seem like gifts under the general rule but are specifically exempted from the gift tax system by statute.[282] A taxpayer need not file a Form 709 to report these types of transfers and should not report these transfers even if the taxpayer is otherwise required to file a Form 709 to report gifts.[283]

First, transfers to I.R.C. Section 527 political organizations are not considered gifts.[284] Such organizations, including political action committees, are designed to influence the selection, nomination, election, appointment, or defeat of candidates to federal, state, or local public office.[285] Despite this narrow carve-out from the gift tax regime, there is no comparable statutory exception for transfers to I.R.C. Section 501(c)(3) organizations (public charities) and I.R.C. Section 501(c)(4) organizations (e.g., civic leagues and other corporations operated for the promotion of "social welfare").[286]

As discussed below, a charitable deduction is available for transfers to I.R.C. Section 501(c)(3) organizations.[287] Prior to the passage of the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) on December 18, 2015, there was neither a deduction nor an exclusion available for transfers to I.R.C. Section 501(c)(4) organizations.[288] However, the PATH Act provides that the gift tax will not apply to transfers to I.R.C. Section 501(c)(4) organizations after enacting such Act.[289] Interestingly, the PATH Act specifically states that the Act should in no way be construed to create any inference with respect to whether any transfer made before, on, or after the date of enactment is a transfer of property by gift for purposes of Chapter 12 of the I.R.C.[290] This seems to create three categories related to transfers to entities: (1) statutory non-gifts (e.g., transfers to I.R.C. Section 527 organizations), (2) transfers to organizations that are gifts but for which a deduction is available (e.g., transfers to I.R.C. Section 501(c)(3) organizations), and (3) transfers to organizations that may or may not constitute a gift but for which the gift tax statutorily does not apply (e.g., transfers to I.R.C. Section 501(c)(4) organizations).[291] The 2015 Instructions

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282. *See* I.R.C. §§ 2501(a)(4), 2503(e)(2)(A), 2503(e)(2)(B).
283. *See id.*
284. *Id.* § 2501(a)(4).
285. *Id.* § 527.
286. *See id.* §§ 501(a)(3), 501(c)(4).
287. *Id.* § 501(c)(3).
288. *See Section-by-Section Summary of the Proposed "Protecting Americans From Tax Hikes Act of 2015,"* SENATE FIN. COMM., 17–18, https://www.finance.senate.gov/imo/media/doc/Summary%20of%20the%20Protecting%20Americans%20from%20Tax%20Hikes%20PATH%20Act%20of%202015.pdf (last visited Feb. 26, 2022) [https://perma.cc/2PT5-ZCML].
289. *See id.*
290. *See id.*
291. *See id.*

for Form 709 were not updated to indicate whether this new category must be reported on Form 709 if a transfer was made prior to December 18, 2015.[292] As such, transfers to I.R.C. Section 501(c)(4) organizations prior to December 18, 2015 may still be reportable and taxable.[293] However, page two of the Form 709 instructions for tax years 2016 and beyond states:

> [T]he gift tax does not apply to a transfer to any civic league or other organization described in I.R.C. Section 501(c)(4), any labor, agricultural, or horticultural organization described in I.R.C. Section 501(c)(5), or any business league or other organization described in I.R.C. Section 501(c)(6) for the use of such organization provided that such organization is exempt from tax under I.R.C. Section 501(a).[294]

Furthermore, the instructions state "you need not file a Form 709 to report these transfers and should not list them on Schedule A of Form 709."[295]

Second, the gift tax does not apply to an amount a taxpayer paid on behalf of another individual directly to a qualifying domestic or foreign educational organization as tuition for the education or training of the individual.[296] A qualifying educational organization normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.[297] This term includes institutions such as primary, secondary, preparatory and high schools, colleges, and universities.[298] The definition includes organizations engaged in both educational and noneducational activities, but only if the noneducational activities are merely incidental to the educational activities.[299] For example, a university that incidentally operates a museum or offers concerts to the public is a qualifying educational organization.[300] However, a museum that operates a school would most likely not be a qualifying educational organization.[301] Payments

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292. *See id.*

293. *See id.*

294. *2016 Instructions for Form 709*, IRS, https://www.irs.gov/pub/irs-prior/i709--2016.pdf (last visited Feb. 26, 2022) [https://perma.cc/KS6W-RZF8]; *2017 Instructions for From 709*, IRS, https://www.irs.gov/pub/irs-prior/i709--2017.pdf (last visited Mar. 21, 2022) [https://perma.cc/VKR3-AR2L]; *2018 Instructions for Form 709*, IRS, https://www.irs.gov/pub/irs-prior/i709--2018.pdf (last visited Mar. 21, 2022) [https://perma.cc/XP4P-246F]; *2019 Instructions for Form 709*, IRS, https://www.irs.gov/pub/irs-prior/i709--2019.pdf (last visited Mar. 21, 2022) [https://perma.cc/54QN-5FJS]; *2021 Instructions for Form 709*, IRS, https://www.irs.gov/pub/irs-pdf/i709.pdf (last visited Mar. 21, 2022) [https://perma.cc/5NGH-B8BM].

295. *See supra* note 294 and accompanying text.

296. I.R.C.§ 2503(e)(2)(A).

297. Treas. Reg. § 25.2503-6(b)(2).

298. *Id.* § 1.501(c)(3)-1(d)(3)(ii).

299. *See id.*

300. Erika K. Lunder, *501(C)(3) Organizations: What Qualifies as "Educational?"*, CONG. RSCH. SERV. (Aug. 21, 2012), https://sgp.fas.org/crs/misc/R42673.pdf [https://perma.cc/KBD8-RGA7].

301. *See id*.

to specialized teachers, such as violin teachers, generally do not qualify.[302] However, tuition payments to the private school that brings in a violin teacher for private lessons for its students would generally be deemed a payment to a qualifying education organization if the school builds the cost into tuition.[303] The gift tax exclusion for qualifying educational organization expenses only applies to tuition payments and explicitly does not apply to payments for room and board, books, fraternities, sororities, transportation to school, computers, and similar expenses.[304] Furthermore, the taxpayer must have *directly* paid to the qualified educational organization.[305] The donor cannot pay the student, who in turn pays tuition, nor can the donor pay off student loans in order to qualify for this exclusion from federal gift tax.[306] Generally, payments to trusts to be used for educational expenses and payments to Qualified Tuition Programs (such as I.R.C. Section 529 plans) do not qualify for this exclusion.[307] However, the IRS has ruled that a grandmother's prepaid tuition payments on behalf of her grandchildren were qualified transfers for purposes of Section 2503(e).[308] Also, it is worth noting that tuition payments to a qualified education institution on behalf of another individual are not gifts, regardless of the individual's relationship (or lack of relationship) to the donor.[309]

Third, payments made by a donor exclusively for qualifying medical expenses of another person are not considered gifts for federal gift tax purposes.[310] Such expenses include medical care expenses (e.g., expenses incurred in connection with diagnosis, cure, mitigation, or prevention of disease), transportation expenses, certain lodging expenses necessary for such care, and health insurance.[311] However, the inapplicability of the gift tax rules do not extend to items covered by the beneficiary's health insurance or elective cosmetic surgery.[312] Similar to the requirements for qualified educational expenses, qualified medical expenses must be paid directly to the health care provider (instead of to the patient who in turn pays the medical provider).[313]

Interestingly, IRS Form 709 directs taxpayers not to report outright gifts to spouses on gift tax returns, even though they are technically reportable

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302. *See id.*
303. *See id*.
304. *Instructions for Form 709 (2021)*, IRS, https://www.irs.gov/instructions/i709 (Nov. 17, 2022). [https://perma.cc/P4EY-BJ5U].
305. *Id.*
306. *See* Treas. Reg. § 25.2503-6(c).
307. *See Instructions for Form 709 (2021)*, *supra* note 304.
308. I.R.S. Tech. Adv. Mem. 199941013 (July 9, 1999).
309. Treas. Reg. § 25.2503-6(a).
310. I.R.C. § 2503(e)(2)(B).
311. Treas. Reg. § 25.2503-6(b)(3).
312. *Id.*
313. *See id.* § 25.2503-6(c).

gifts subject to a marital deduction.[314] Per the instructions, the only reportable gifts for the benefit of the spouse are gifts of terminable interests (such as gifts to QTIP trusts), gifts to charitable remainder trusts where the donor's spouse is the only non-charitable beneficiary, certain gifts of future interests benefitting a spouse, and gifts to spouses who are not U.S. citizens in excess of the annual exclusion for non-citizen spouses.[315]

iv. Who Is the Deemed Recipient of a Gift?

When a donor transfers assets to an entity, the underlying owners of such entities are often deemed to be the recipients of the gift.[316] For federal gift tax purposes, a gift to a trust is regarded as a gift to the trust's beneficiary or beneficiaries, not the trustee.[317] A gift to a partnership is deemed a gift to its partners, and a gratuitous transfer to a corporation is treated as a gift to the corporation's shareholders in proportion to their ownership interest in the company.[318] A gift to a charitable, public, or political organization may fall under an exception.[319] For example, the IRS has taken the position that a gift to a nonprofit social club was considered a gift to the entity (instead of a gift to the entity's members) because the nonprofit corporation was not operated for the members' economic benefit.[320]

b. Demystifying Gift Splitting

One concept often alluded to in premarital agreements but which family law attorneys may not have a great deal of background is gift splitting. A married donor may elect to split gifts made to any beneficiary (other than such donor's spouse) during the calendar year so that one-half of the transfers in the calendar year are deemed as made by each spouse for purposes of federal gift tax regardless of who owned the property before the transfer.[321] This can be a great way to take advantage of both spouses' exemption amounts and annual exclusion amounts even if one spouse has significantly fewer means.[322] Of course, the parties must be married at the time of the gift to split the gift.[323] Only those gifts made after the wedding date can be split in the first year of the marriage.[324] Similarly, in any year that the parties

314. *Instructions for Form 709 (2021)*, *supra* note 304.
315. *Id.*
316. *See* Shepherd v. Comm'r, 283 F.3d 1258, 1261 (11th Cir. 2002).
317. *See* Crummey v. Comm'r, 397 F.2d 82, 83 (9th Cir. 1968).
318. *See* Treas. Reg. § 25.2511-1(h)(1).
319. *Id.*
320. I.R.S. Priv. Ltr. Rul. 9818042 (Jan. 28, 1998); I.R.S. Priv. Ltr. Rul. 200533001 (May 9, 2005).
321. I.R.C. § 2513.
322. *Id.*
323. *See id.*
324. *Id.* § 2513(a).

divorce or one spouse dies, those gifts made prior to the divorce or death may be split.[325] If, however, a party remarries during a year in which the party made gifts with the former spouse, gift splitting cannot be elected even if no gifts were made with the new spouse.[326]

There are a few tricky aspects of gift splitting.[327] First, gift splitting can only be done with spousal consent on a gift tax return (also known as an IRS Form 709) filed no later than the earliest of (1) April 15th (or October 15th if properly extended) following the calendar year in which the gifts were made unless neither spouse files a gift tax return by that date, (2) the date on which a return is filed by either spouse if this occurs after this deadline, or (3) when a notice of deficiency is sent to either spouse.[328] Practically speaking, this means you need to remember to make the election on the initial gift tax return filed by either spouse in a particular year, or else the option to gift split will be lost absent some sort of extraordinary relief.[329] Gift splitting on an amended return is not permitted.[330] Consent to gift splitting is given by checking "Yes" on Line 12 of Part 1 (General Information) on IRS Form 709 and filling in Lines 13–18 where applicable, including having the taxpayer's spouse sign Line 18.[331] In limited circumstances, only one spouse is required to file a return.[332] If the spouse making the gifts to be split does not make gifts that exceed twice the annual exclusion amount to any donee, the consenting spouse does not make gifts that exceed the annual exclusion amount or gifts to any of the donees of the filing spouse, and all gifts made are present interest gifts, then only the spouse who made the gifts to be split will be required to file a return.[333] However, as discussed below, two returns may be required to properly report any GST tax consequences concerning the gifts or opt out of the automatic allocation rules.[334] Due to the very limited application of this exception, it may be prudent to always file both gift tax returns to ensure the GST issues are not overlooked.[335]

Second, it is important to keep in mind that spouses cannot cherry pick which gifts to third parties they split during the calendar year.[336] If they want to split one gift, they must split all gifts made during the part of the year that they were married.[337] Furthermore, gifts to third parties that are gift split must

325. Treas. Reg. § 25.2513-1(b)(1).
326. *Id.*
327. *See id.*
328. *Id.* § 2513(b)(2).
329. *See id.*
330. *See id.* § 2513(b)(2)(A).
331. *Instructions for Form 709 (2021)*, *supra* note 304.
332. *See id.*
333. Treas. Reg. § 25.2513-1(c).
334. *Id.* § 26.2632-1(c).
335. *See id.*
336. *Id.* § 25.2513-1(b).
337. *Id.*

be split in half by spouses.[338] Spouses cannot agree to divide gifts in some other proportion, such as 75% and 25%.[339]

Third, spouses can only split gifts to third parties.[340] Gifts by one spouse to the other spouse may qualify for the marital deduction or the annual exclusion, but they do not qualify for the gift-splitting election.[341] A gift to a trust for the benefit of the donor's spouse and third parties cannot be split if the portion of the gift to the donor's spouse is not ascertainable.[342] However, a portion of a gift to a trust established for the benefit of the donor's spouse and third parties may qualify as a gift permitted to be split, but only if the amount of the gift allocable to the donor's spouse is ascertainable so that it can be severed from the gift he or she intends to split.[343] The distribution standard of health, education, maintenance, and support is an ascertainable standard.[344]

c. Portability

Portability was introduced in January of 2011 thanks to legislation enacted as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010).[345] Portability was only implemented for two years initially under TRA 2010, but the concept was made permanent by the American Taxpayer Relief Act of 2012.[346]

The portability law represents a major paradigm shift in how a taxpayer's exemption amount is calculated.[347] Prior law employed a "use it or lose it" approach to each individual's exemption amount.[348] But portability allows a deceased spouse's unused exclusion amount (DSUE amount) (i.e., that portion of the deceased spouse's unused exemption amount, which for 2022 is $12.06 million) to be transferred to the deceased spouse's surviving spouse.[349] Now taxpayers do not just have an exclusion amount; they have an applicable exclusion amount calculated as follows: applicable exclusion amount equals the Basic Exclusion Amount (in 2022, this is the remaining amount of donor's personal $12.06 million exclusion amount) plus the DSUE amount.[350]

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338. *Id.*
339. *Id.*
340. *Id.* § 25.2513-1(a).
341. *Id.*
342. *Id.*
343. *Id.*
344. *Id.*
345. Tax Relief, Unemployment Insurance Reauthorization, Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296.
346. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2373.
347. *Id.*; I.R.C. § 2010.
348. I.R.C. § 2070.
349. *Id.* § 2010(c)(4).
350. *Id.*

There are several requirements in order to take advantage of portability.[351] The DSUE election may only be made by the executor of the deceased spouse's estate timely filing a federal estate tax return (called IRS Form 706)—that is, an estate tax return that would not otherwise be required to be filed except to take advantage of portability.[352] The IRS reserves the right to examine the deceased spouse's estate tax return until the end of the statute of limitations for the surviving spouse's estate.[353]

Another caveat to the DSUE amount is that a surviving spouse may only use the DSUE amount of the surviving spouse's "last deceased spouse."[354] This means that it is technically possible for a surviving spouse's DSUE amount to change throughout the surviving spouse's life depending on whether the surviving spouse marries a successive spouse who also predeceases the surviving spouse, whether the surviving spouse uses DSUE amounts of a previously deceased spouse before a successive spouse dies, and how many predeceased spouses the surviving spouse has during the surviving spouse's lifetime.[355] Note that portability only applies to a spouse's remaining exclusion amount for gift and estate tax purposes.[356] Portability of deceased spouse's unused GST tax exclusion amount is not permitted.[357] The surviving spouse may use the DSUE amount during life or upon death.[358] If a taxpayer has acquired a DSUE amount from one or more predeceased spouses, the taxpayer's DSUE amount is applied prior to the taxpayer's Basic Exclusion Amount with respect to lifetime gifts.[359]

d. Beware of How Courts in Other States Have Used Trusts

Texas courts have historically recognized that trusts do not constitute separate property; it might be easy for the Texas lawyer to be lulled into a false sense of security regarding how trusts are addressed in their standard premarital agreement forms.[360] However, it may be tempting for judges to set aside established legal principles relating to trusts and marital property rules when they have a sympathetic non-beneficiary spouse in a divorce case.[361] In the Massachusetts case, *Pfannenstiehl v. Pfannenstiehl*, the issue was whether the husband's interest in an irrevocable trust, which was also a spendthrift trust for which the husband's sister served as trustee and had

351. *Id.*
352. *Id.* § 2010(c)(5).
353. *Id.* §§ 20.2010-2T(d), 20.2010-3T(d), 25.2505-2T(e).
354. *Id.* § 2010(c)(4).
355. *See id.*
356. *See id.*
357. *See id.* § 2010(c)(4); Treas. Reg. § 25.2505-2(a).
358. Treas. Reg. § 25.2505-2.
359. *Id.* § 25.2502-2(b).
360. *See* Pfannenstiehl v. Pfannenstiehl, 37 N.E. 3d 15, 20–21 (Mass. App. Ct. 2015).
361. *See id.*

discretion in determining trust distributions, could be considered akin to an interest capable of division as part of the marital estate during the husband and wife's divorce case.[362] In *Pfannenstiehl*, the husband, Curt Pfannenstiehl, was one of eleven current beneficiaries of a trust for which he had no control over distributions.[363] The lower court found the trust was worth $24,8920,217 and that Curt's one-eleventh interest in this fully discretionary trust was worth $2,265,474.[364] The judge awarded 60% of Curt's interest in the trust, or $1,133,047, to Curt's wife to be paid in twenty-four monthly installments in connection with the divorce.[365] The appellate court affirmed the decision.[366] Practitioners widely criticized the lower and appellate court decisions for the decisions' focus on prior distributions from the trust to Curt instead of the nature of his interest as outlined in the trust agreement governing the trust.[367]

The *Pfannenstiehl* case was filled with Hollywood-worthy drama.[368] After the lower court issued the judgment, Diane's attorneys filed a contempt of court claim when Curt failed to make a monthly payment.[369] Curt claimed he had no means of making the court-ordered payments independent of the trust; he had written the trustee requesting a distribution but had been denied distributions that could be used to satisfy the judgment.[370] Curt was shackled and sentenced to jail for sixty days for contempt of court for missing a payment to Diane.[371]

In arriving at their decisions, both the lower court and the appellate court quoted from *D.L. v. G.L.*, in which the court wrote:

> Separate from the division of assets within the estate is the question whether certain assets properly are considered a part of the estate. In making the determination . . . "the judge is not bound by traditional concepts of title or property. Instead, we have held a number of intangible interests (even those not within the complete possession or control of their holders) to be part of a spouse's estate. "[372]

This passage sounds troublingly like, "Judges need not be bothered with legal title or other legal formalities and can do whatever they think is fair."[373] Court

362. *Id.*
363. *Id.* at 18.
364. *Id.* (suggesting that the class of beneficiaries for the trust could have expanded in the future as additional descendants were born—a very real possibility).
365. *Id.* at 19.
366. *Id.*
367. *Id.*
368. *Id.*
369. *Id.*
370. *Id.*
371. *Id.*
372. D.L. v. G.L., 811 N.E. 2d 1013, 1020 (Mass. App. Ct. 2004).
373. *Id.*

rulings in other states, like Colorado, have also caused concern about including third-party spendthrift trusts in the marital estate when a beneficiary served as trustee of a trust or when the court found that the trust was not a fully discretionary trust.[374]

The appellate court decision in *Pfannenstiehl* was ultimately overturned by the Massachusetts Supreme Court because (1) the terms of the trust authorized unequal distribution amounts to beneficiaries, (2) the number of beneficiaries of the trust could potentially expand if future descendants were born, and (3) Curt's right to receive any distributions from the trust were in the trustees' discretion, not within his control.[375] The opinion for the court wisely stated, "Whether a trust may be included in the divisible marital estate requires close examination of the particular trust instrument to determine whether the interest is 'fixed and ascertainable.'"[376]

2. Tips When Representing Spouses of Greater Means in Premarital Agreements

Family law attorneys frequently include some common terms when representing a spouse of greater means. Such terms often provide that each party retains the right to manage such party's own separate property and sole management community property and that trust assets either are not marital property capable of division or should be deemed the separate property of the beneficiary spouse.

When representing a spouse of greater means, practitioners should consider lobbying for a few estate and gift tax concepts in a premarital agreement.[377]

a. Rights Regarding Gifts

Each party retains the right to make gifts of such party's separate property (including all thereof), without the other party's consent and without regard to blood or other relationship of the donee party, and no fraud on the spouse claim may be brought by virtue of a party gifting the party's separate property to any person of the party's choosing.[378] This should give the spouse of greater means the ability to spend such spouse's separate property assets

374. *See* United States v. Delano, 182 F. Supp. 2d 1020, 1023 (D. Colo. 2001).

375. *Pfannenstiehl*, 55 N.E. 3d at 933.

376. *Id.* at 939.

377. *See* Sharon L. Klein, *What Family Lawyers Must Know About Pre-Marital Estate Planning*, FAM. LAW. MAG., https://familylawyermagazine.com/articles/what-family-lawyers-must-know-about-pre-marital-estate-planning/#:~:text=The%20federal%20estate%20and%20gift,to%20transfers%20between%20US%20spouses.&text=In%202019%2C%20each%20person%20can,%2C%20estate%2C%20and%20GST%20taxes (last updated Feb. 05, 2020) [https://perma.cc/YM6T-AQFQ].

378. *See* TEX. FAM. CODE ANN. § 3.001.

with the greatest latitude with the lowest risk of reprisal in the event of divorce.[379]

b. Cooperation with Gift Splitting that Will Not Use Exemption Amount

Each party may deem the other as the "donor" of one-half of the gift for federal gift tax reporting purposes to the extent all gifts for the year do not exceed twice the amount of the federal gift tax annual exclusion amount, and the party who is not actually gifting such party's separate property shall consent to any such gift splitting. This should allow the spouse of greater means to leverage the annual exclusion gifting power of the spouse of lesser means.[380] If done carefully and correctly, it should not impact the exemption amount available to the spouse of lesser means.[381]

c. Portability of Unused Exemption Amount

If the surviving spouse is not already serving as executor of the deceased spouse's estate, the surviving spouse should be allowed to direct the executor of the deceased spouse's estate to make the portability election.[382] The exemption amount that a spouse of lesser means can "port" to the surviving spouse can be a tremendous advantage to a spouse of greater means. This will provide the spouse of greater means the opportunity to shield additional assets from gift tax or estate tax.[383] The spouse of lesser means often feels like he or she is not giving anything up—if he or she cannot use the remaining exemption amount, his or her surviving spouse might as well use it.[384] While this type of provision can offer several advantages to the spouse of greater means at low or no cost to the spouse of lesser means, it is important to address several topics related to portability to avoid confusion and prevent surprises and administrative headaches.[385]

Each spouse will direct such spouse's executor to file an estate tax return unless the surviving spouse instructs the deceased spouse's executor not to do so in writing (e.g., if the surviving spouse does not find the election to be valuable).[386] The portability provision should address who will pay the expenses of a portability estate tax return.[387] Often, agreements will say the

379. *See id.*
380. Author's original thought.
381. Author's original thought.
382. *See* I.R.C. § 2010(c)(5).
383. *See id.*
384. *See id.*
385. *See Instructions for Form 706 (09/2021)*, IRS, https://www.irs.gov/instructions/i706 (Sept. 21, 2021) [https://perma.cc/TR8V-N5HM].
386. *See id.*
387. *See id.*

spouse of greater means shall be responsible for all preparation costs.[388] However, sometimes there is a cap on those expenses.[389] In other cases, the spouse of lesser means considers the preparation fees like a "gift" to the surviving spouse and agrees they should be expenses borne by their estate.[390] This is potentially the most contentious portability feature, and every premarital agreement dealing with portability should address it. The portability provision should also address the cooperation and sharing of information and documentation required of the executor in preparing the portability estate tax return if the surviving spouse is not the executor of the deceased spouse's estate.

d. Rights to Use, Occupy, and Sell Separate Property Residences

For protection in the event of the death of the spouse of greater means, a well-drafted premarital agreement should expressly address whether the homestead right (or the right to occupy any secondary residences) will or will not apply to any property which constitutes the separate property of a spouse.[391]

This is of particular importance when the parties have children from a prior relationship who are the primary beneficiaries of the deceased spouse's estate.[392] For example, assume Step-Mom and Dad live together in Dad's house.[393] If Dad passes away and leaves most of his estate to his kids (including the house), suddenly, in the kids' eyes, the house is now "their house," and Step-Mom is now trespassing.[394] Even default statutory law does not comfort the kids.[395] It is most helpful when the parties make a deliberate and explicit decision that clarifies what is supposed to happen with respect to any separate property residences of the spouse of greater means.

For protection during the life of the spouse of greater means, practitioners should consider adding a provision in a premarital agreement that addresses the homestead.[396] Family Code Section 5.001 provides that neither spouse may sell, convey, or encumber the homestead without the joinder of the other spouse, regardless of whether the homestead is separate or community property.[397] If the marital homestead is the separate property of one spouse, the premarital agreement should provide that the non-owner spouse will take all action necessary to join in the sale of the separate property

388. *See id.*
389. *See id.*
390. *See id.*; *Instructions for Form 709 (2021)*, *supra* note 304.
391. *See* TEX. FAM. CODE ANN. §§ 3.001, 4.002.
392. *See id.*
393. Author's original hypothetical.
394. Author's original hypothetical.
395. *See* FAM. §§ 3.001, 4.002.
396. *Id.* § 5.001.
397. *Id.*

residence as required under Family Code Section 5.001 immediately upon request of the owner spouse.[398] If a marriage is rocky and this is not addressed in a premarital agreement, the non-owner spouse could dig in his or her heels, refuse to sign paperwork, and use this statutory right as leverage to further his or her financial position in a divorce.[399]

e. Statutory Rights for Spouses

A premarital agreement should address whether any other statutory or other rights a spouse might have upon death apply.[400] This may include any and all rights to exempt personal property, allowance in lieu of exempt personal property, family allowance, widow's allowance, dower, courtesy, statutory election against any will of the other party executed prior or subsequent to the execution of this Agreement, reasonable share, forced heirship, forced share and other rights a party might have or acquire as the surviving spouse of the other or in the property of the other, if any, under any statutes now or hereafter in force, of the State of Texas or any other state or foreign nation in which the parties may have property at the time of death or in which the parties or either of them may then reside, including, without limitation, the right to be an administrator or other personal representative of the other party's estate if such other party dies without a valid will.[401]

f. Guard Against Pfannenstiehl

A premarital agreement should expressly provide that no separate property asset or the assets of any trust for which a party is a beneficiary will be taken into consideration in dividing assets upon divorce and for purposes of calculating or awarding spousal support or alimony.[402]

As the *Pfannenstiehl* case demonstrates, even where state law provides that trust and other separate property assets are not included in the marital estate, a judge still might consider those assets in determining how marital assets are divided between spouses, either because state law allows it or an uninformed judge thinks that failing to consider trust or other separate property assets is inequitable for the non-beneficiary spouse. If a client is seeking to obtain a marital property agreement and a lawyer represents the spouse of greater means, the lawyer should be as clear and as detailed as possible that trust assets (and other separate property assets) can never be awarded to the non-owner/non-beneficiary and should not be used for

398. *Id.*
399. *See id.*
400. *See id.* § 4.003.
401. *See id.*
402. Pfannenstiehl v. Pfannenstiehl, 37 N.E.3d 15, 26–27 (Mass. App. Ct. 2015).

purposes of calculating the amounts the non-owner/non-beneficiary spouse receives in a divorce (e.g., the amount of alimony or spousal support).[403]

3. Tips When Representing a Spouse of Lesser Means

a. Build in Protections with Respect to Gifts of Community Property or Gift Splitting

Practitioners should consider drafting the premarital agreement to provide that the spouse of greater means is responsible for paying for tax return preparation and legal consultation fees for a spouse of lesser means if the spouse of lesser means agrees to gift split at the request of the spouse of greater means.[404] This is fair because gift splitting typically provides benefits to the spouse of greater means.[405] If there is a burden to the spouse of lesser means associated with gift splitting, then the spouse of greater means should bear that financial burden.[406]

It may be wise to put guardrails around community property gifts, given that gifts of community property are deemed to be made one-half by each spouse.[407] The spouse of lesser means should consider requiring that the spouse of greater means provide notice of gifts in any amount that exceeds twice the annual exclusion amount.[408] This will give the spouse of lesser means the opportunity to review the gift and determine whether it will or will not trigger a gift tax filing requirement for the spouse of lesser means.

In addition to notice requirements, a spouse of lesser means should consider adding a provision in a premarital agreement stating that gifts of community property in excess of twice the annual exclusion amount require the consent of the spouse of lesser means.[409] This provision is fair given that the spouse of lesser means will be deemed to make one-half of the community property gift, will use a portion of such spouse's exemption amount, and will be required to file a gift tax return.[410]

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403. *Id.* at 29.

404. *Instructions for Form 709 (2021)*, *supra* note 304.

405. *See id.*

406. *See* Debra Kamin, *One Spouse Can Work from Anywhere. The Other Can't. So They Live Apart.*, WALL ST. J. https://www.wsj.com/articles/living-apart-for-work-11635531558 (Oct. 31, 2021 5:30 AM) [https://perma.cc/C3QT-KLEF].

407. *See id.*

408. *See id.*

409. MODEL RULES OF PROF. CONDUCT r. 1.3, 1.4 (AM. BAR ASS'N 2019).

410. TEX. FAM. CODE ANN. § 4.003(a)(3).

b. Come Up with Compensation Scheme When Spouse of Greater Means Works in or Is Otherwise Supported by Separate Property or a Trust-Owned Business

Often the spouse of lesser means will not work outside of the home.[411] The spouse of greater means may work in a family business, meaning that such spouse's family may (directly or indirectly) determine his or her salary.[412] Alternatively, the spouse of greater means may not work but may support themselves using family assets held as separate property or originating from trusts. The premarital agreement will almost assuredly be drafted to protect the separate property and trusts for the benefit of the spouse of greater means. A lawyer has a duty to communicate to the spouse of lesser means the "parade of horribles" that could happen in the event the marriage dissolves by means of death or divorce. For example, when the marriage is on the rocks, the salary which a premarital agreement labels as community property might stop and instead trust distributions, which are separate property under the premarital agreement, kick in to support the spouse of greater means. The spouse of lesser means, who felt comfortable when he or she signed the premarital agreement that there would be some community property, might be penniless when the spouse of greater means stops receiving a salary from the family business. Alternatively, at the death of a spouse of greater means, all trust distributions the spouse of greater means used to support the couple may stop, leaving the spouse of lesser means with nothing.

Drafting provisions in a premarital agreement to take effect at the death of the spouse of greater means tends to be a relatively simple conversation. The agreement should provide that some amount of assets should be left to the surviving spouse. Flexibility in funding a gift to the surviving spouse will inevitably be necessary. The spouse of greater means may not have the liquidity to satisfy a large cash bequest to the surviving spouse. However, the premarital agreement should address more than a minimum amount that the spouse of greater means should leave for the spouse of lesser means.[413]

In a premarital agreement, the attorney representing a spouse of lesser means should also consider requesting that nonprobate transfers be used to transfer some or all assets to the spouse of lesser means to expedite the transfer and address the income tax basis of assets the spouse of lesser means receives.[414] Nonprobate transfers taking effect at death (e.g., life insurance, payable on death bank accounts, and retirement plan beneficiary designations) can often be paid out more expeditiously than probate transfers because these are contractually based transactions; most such transfers do not

411. *Id.* § 4.003(a)(4).
412. *Id.* §§ 4.003(a)(3)–(4).
413. *See* Rev. Rul. 66-283, 1966-2 C.B. 297, at 1; I.R.C. § 1014(b).
414. *See* Rev. Rul. 66-283, 1966-2 C.B. 297, at 1; I.R.C. § 1014(b).

require probate court intervention.[415] Such assets are frequently paid out shortly after the financial institution receives a certified copy of the death certificate.[416]

With respect to timing, the spouse of lesser means will likely not want to wait years after his or her spouse's death to receive his or her bequest, as can be the case with assets passing under a will.[417] Instead, counsel for the spouse of lesser means should lobby for a minimum amount for the surviving spouse to receive through nonprobate transfers like life insurance, annuities, accounts titled as joint tenants with rights of survivorship, and payable on death accounts that can be funded upon provision of a death certificate instead of incurring the delay of probate.[418]

Also, practitioners should consider providing that (i) the assets the spouse of lesser means receives should have an income tax basis equal to the amount received or (ii) there will be a gross-up amount awarded to the surviving spouse to account for taxes on built-in gains.[419] The net amount a surviving spouse receives from a deceased spouse will depend, in part, on the income tax character of the property received. If a premarital agreement simply obligates the spouse of greater means to leave the spouse of lesser means assets worth $1,000,000, then the spouse of greater means will have discretion to determine how to fund that gift. Many premarital agreements are silent with respect to the basis of those assets.[420] If the spouse of greater means has the flexibility to fund an amount to his or her surviving spouse, he or she could choose to satisfy that amount in cash (which will have an equivalent income tax basis) or with an IRA (which is considered income in respect of a decedent, does not receive a basis adjustment at death under current law, and will likely have a built-in income tax gain).[421] The net amount a spouse of greater means leaves a spouse of lesser means after taxes could vary significantly depending on how that obligation is funded. Careful drafting focused on the basis of assets the spouse of greater means is required to transfer can be incredibly beneficial to the spouse of lesser means.

In the worst-case scenario, the spouse of lesser means can be left with nothing upon divorce, especially if the spouse of lesser means does not work outside the home. Discussions about awarding the spouse of lesser means a certain amount of money during the marriage or in the event of divorce can quickly be translated to "they just want me for my money" in the head of the spouse of greater means. However, it is important to remind all parties

415. I.R.C. § 1014(b)(2).

416. *See id.*

417. *See* Brian R. Greenstein, *Prenuptial Agreements: What They Can and Cannot Accomplish*, CPA J. ONLINE (Sept. 1992), https://archives.cpajournal.com/old/13606725.htm [https://perma.cc/ENK8-2CSF].

418. *Id.*

419. *Id.*

420. *See* TEX. EST. CODE ANN. §§ 201.002–.003.

421. *Id.*

involved that the spouse of greater means is requesting that the spouse of lesser means give up default rights under Texas law (e.g., the right to have income from separate property characterized as community property and/or the right for wages to be considered community property). In many ways, the spouse of greater means is asking the spouse of lesser means to give up protections under the law, so he or she should be compensated in some equitable fashion for what he or she is forfeiting.

c. Personal Residences that Are the Separate Property of the Spouse of Greater Means

Practitioners representing the spouse of lesser means often lobby for the primary personal residence to be granted to their client if the spouse of lesser means does not work outside of the home, regardless of whether the marriage terminates by death or divorce.[422] In the event of death, if the spouse of greater means is insistent that he or she not be required to leave the surviving spouse the primary personal residence, practitioners should lobby for rent-free occupancy for a reasonable period of time. When an individual's spouse dies, that person almost invariably goes through a traumatic and emotional period. The person does not need to add (constructive or actual) eviction to the person's stressful lives shortly after the person's spouse dies.[423] While addressing the surviving spouse's access to personal residences upon death, it is also prudent to address tangible personal property.[424] It would be a shame to remember to give the surviving spouse a one-year right to occupy the residence, only to have the step kids come clean out the house of every sofa, fork, and spoon that constituted the separate property of the deceased spouse.[425]

d. Narrow Provisions Related to Trusts

When some community property will exist in a marriage or when the parties will have a joint account that either can access without the permission of the other, then the attorney negotiating a premarital agreement for the spouse of lesser means should make sure that provisions in the premarital agreement classifying trusts as separate property (or akin to separate property) for marital property classification purposes are not overreaching. For example, only irrevocable trusts that are spendthrift trusts created and funded by third parties for the benefit of the beneficiary-spouse should be considered separate property or non-marital assets.[426] It may make sense for

422. *See* TEX. FAM. CODE ANN. § 4.006(a)(2)(A)–(C).
423. *See supra* Section II.A.3.
424. *See* FAM. § 4.203(b).
425. *See id.* §§ 4.204, 4.203(b).
426. *See id.* § 4.006(a)(2)(A).

revocable trust assets not to be protected to as great a degree for the spouse of greater means.[427]

As discussed at the beginning of this Article, trusts can have varying purposes, creators, and funders.[428] A creative (and devious) spouse could exploit a provision in a premarital agreement classifying trust assets as the separate property of the beneficiary spouse by creating a revocable trust for such spouse's benefit and transferring assets into that revocable trust.[429] Suddenly that devious spouse has a means of converting community/joint assets to such spouse's separate property in a manner authorized (or at least not prohibited) under the premarital agreement.[430] Instead, the lawyer for the spouse of lesser means should make sure trust protections in a premarital agreement related to community property or joint assets only apply to assets that are clearly traced to third-party gifts over which the spouse of greater means does not have unilateral control.[431]

e. Do Not Underestimate the Power of Powers of Appointment

When there are trusts for the benefit of a spouse of greater means and the practitioner represents a spouse of lesser means, the practitioner should ask opposing counsel for a copy of the trust agreements, including amendments or modifications.[432] The trust agreement should be reviewed for "powers of appointment" that the spouse of greater means may possess during life or at death.[433] A power of appointment is:

> [T]he authority to appoint or designate the recipient of property, to invade or consume property, to alter, amend, or revoke an instrument under which an estate or trust is created or held, and to terminate a right or interest under an estate or trust, and any authority remaining after a partial release of a power.[434]

Under Texas law, the "object of the power of appointment" is "a person to whom the donee is given the power to appoint" property.[435]

Some trust agreements include powers of appointment and some do not.[436] Some powers of appointment include a spouse as a permissible "object of a power of appointment" and some do not.[437] It is extremely important to

427. *Id.*
428. TEX. PROP. CODE ANN. § 181.001(2).
429. *Id.* § 181.001(1-a).
430. *See id.*
431. *See id.*
432. *See id.*
433. *See id.*
434. *Id.*
435. *Id.*
436. *See id.* § 181.081.
437. *Id.* § 181.083.

know if a spouse of lesser means could be considered a permissible "object of the power of appointment."[438] If the spouse of lesser means is a permissible object of the power appointment, then the spouse of greater means cannot use the "my hands are tied" excuse to try to argue that those assets cannot be given to the spouse of lesser means upon divorce because they are family assets not subject to the control of the spouse of greater means.[439] Practitioners will often try to get the spouse of greater means to contractually agree to exercise a power of appointment for which a spouse is an object at the spouse's death in the premarital agreement.[440] Alternatively, the power of appointment can be used as leverage for calculating the minimum amount the spouse of lesser means should receive if he or she survives the spouse of greater means.[441]

IV. POSTMARITAL AGREEMENTS

A. The Friendly Postmarital Agreement

Many family law attorneys might be shocked to learn that estate planning attorneys routinely act as a scrivener representing both spouses in preparing postmarital partition agreements to further estate planning objectives. Often, but not always, estate planners will limit this joint representation partition agreement planning to partitioning assets in half, with one-half of each partitioned asset becoming the separate property of the husband and one-half becoming the wife's separate property.[442] Estate planners know that there could still be a disadvantaged party with these equal partition agreements because the spouses give up their right to a "just and right" division upon divorce.[443] However, they often reason that the expense of obtaining separate counsel for each party outweighs the benefit in an estate planning transaction everyone agrees about and in which everyone receives the initial benefit.[444] Family law attorneys should not assume that clients who have contributed assets to irrevocable trusts during their marriage do not have postmarital agreements.[445] There is a significant chance they do have a postmarital agreement.[446] The clients may not realize they have them.[447]

438. *See id.*
439. *See id.* § 112.102.
440. *See id.* § 112.103.
441. *See id.* § 112.102(a)(2).
442. *See id.*
443. *See id.*
444. *See id.*
445. *See* TEX. FAM. CODE ANN. § 4.104.
446. *See id.*
447. *See id.*

B. In Lieu of Divorce

There are times that the parties may decide to enter into a postmarital or partition agreement in lieu of proceeding with a divorce.[448] The practitioner, whether an estate planning attorney or a family law attorney, should not represent both parties in this instance, as this is typically a negotiation between parties who want to work on the marriage but are preparing for divorce as a worst-case scenario and are not entering into an agreement merely for estate planning purposes.

V. PARTING WISDOM: TRUST AND ESTATES ISSUES CAN BE THE PROBLEM OR A COMPONENT OF THE SOLUTION

A. Trust Appointments

Just as control over trusts can be a lightning rod when negotiating a divorce, it can also be a bargaining chip to exchange another contested aspect of the divorce. When a client is named as a potential trustee or holds some other power concerning a trust created by the other spouse's family, clients may consider walking away from that trust through a combination of resignations and disclaimers in exchange for something else the client wants. Often the trust in question does not benefit the spouse anyway, so the spouse is not giving away a personal benefit. It can be a win-win situation.

B. Using Donor-Advised Funds

Often spouses get extremely close to the finish line in negotiating their divorce but have a few lingering items about which they cannot agree. They simply will not budge about who is responsible for those last few credit card expenses or medical bills relating to the children. At the bitter end, creative attorneys sometimes incorporate a donor-advised fund as part of the solution.[449] A donor-advised fund is a separately identified fund or account maintained by an I.R.C. Section 501(c)(3) charitable organization, called a sponsoring organization.[450] The donor gifts property to the fund, at which point the sponsoring organization" (e.g., Communities Foundation of Texas, Dallas Foundation, Schwab Charitable, etc.) has legal control over it.[451] However, the donor or a person appointed by the donor (an advisor) retains

448. *Id.* § 7.006.

449. *See* Annie L. Vanover, *Unwinding or Restructuring the Corporate Family Foundation*, 26 OHIO PROB. L.J., no. 2, 2015 at 8.

450. *Donor-Advised Funds*, IRS, https://www.irs.gov/charities-non-profits/charitable-organizations/donor-advised-funds#:~:text=Generally%2C%20a%20donor%20advised%20fund,contributions%20made%20by%20individual%20donors (Jan. 21, 2022) [https://perma.cc/DX5P-VQ8C].

451. *Id.*

advisory privileges regarding distribution of funds in the account to public charities.[452] Generally, sponsoring organizations will honor the direction of an advisor to qualifying charities.[453] The donor typically gets an upfront tax deduction in the year of the contribution to the fund, even if assets sit in the fund account and are not distributed to public charities for some time.[454]

When one spouse says, "I'm not giving her another red cent," and the other says, "I'm not settling until he pays me back for this expense," sometimes a donor-advised fund can be the answer. The donor spouse agrees to contribute assets to the donor-advised fund, and the recipient spouse could be the advisor on the fund. The donor has not given "a red cent" to the donor's spouse—the donor has given it to charity and received a current year income tax deduction (subject to certain limitations applicable to charitable deductions). The recipient spouse takes satisfaction that the donor spouse does not get to retain those last few dollars, and instead, the recipient spouse can direct those funds to a charity of the recipient spouse's choice when the recipient spouse finds a worthy cause in the future. This can be another win-win tool in a divorce.

VI. CONCLUSION

When it comes to marital property agreements, family law attorneys and estate planners alike have strengths and weaknesses based upon their respective areas of expertise.[455] The weaknesses forge blind spots unless such practitioners work together and learn from one another.[456] Practitioners and clients will both benefit from such attorney collaboration.[457] However, when formal collaboration is not practical for a particular client, it is helpful to draw from general rules and principles estate planning attorneys have learned from family law attorneys and the lessons family law attorneys have learned from estate planning attorneys.[458]

452. I.R.C. § 4966(d)(2)(C)(iii).
453. *Id.*
454. *See id.* § 170(f)(18).
455. *See supra* Part III.
456. *See supra* Part III.
457. *See supra* Part III.
458. *See supra* Part III.