BREAKING UP IS HARD TO DO:
ESTATE PLANNING FOR A DIVORCE

Written and Presented by:

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PREMARITAL AGREEMENT-FORM PROVISIONS

I. Introduction. The US Bureau of Census has reported that the average marriage in America lasts only seven years and that one out of two marriages ends in divorce. The practical reality is that a professional involved in providing estate planning work for a married couple is likely to receive notice from one or both of those individuals that the marriage is ending in divorce and assistance is needed to address the resulting estate planning issues and consequences.

The planning and action steps that affect the ownership, division, control, and beneficial interest in property owned upon the termination of a marriage can begin prior to the date of that marriage, and that does not only include the possibility that the spouses entered into a premarital agreement. Retirement plans funded, partnership and/or other business entities formed and operated, and trusts funded from whomever and whatever sources prior to marriage all impact the issues that must be addressed in estate planning through a divorce. Likewise, the manner in which assets are received (compensation, gift, inheritance, etc.), structured (in trust, partnership, corporation, retirement plan, IRA, etc.), and acquired/titled (as community property or separate property) all present issues and consequences that must be addressed during the process of the divorce. Further, the existence of a premarital agreement or a marital agreement that addresses the spouses' rights with respect to marital property will also come into consideration in the event that they were executed and administered in accordance with the laws of the State of Texas.

Still, even those considerations are not the whole of the estate planning issues that arise during a divorce. Existing wills, trusts (both irrevocable and revocable), beneficiary designations, gifting, and other factors all play into the consequences and planning issues presented upon divorce.

To understand the estate planning issues upon a divorce and to fully address the client's needs at that time require an understanding of Texas marital property law as pertains to marital property characterization, but also an understanding and working knowledge of specific rules pertaining to, amongst other matters, residences, rights of reimbursement between the marital estates, trust law, business entity law, and the complicated rules and regulations from both the federal and state level pertaining to retirement plans and IRAs. The focus of this outline is to address and establish a practical understanding of those issues as they apply to fully assisting a client through the complicated issues that arise in the context of a divorce.

II. Short Course In Estate and Gift Tax Principles. The following is a brief overview of several concepts integral to the estate and gift tax system.

A. General Nature of Estate and Gift Tax System. The federal tax laws impose a tax on the lifetime and testamentary transfer of assets.

To the extent an individual makes taxable gifts (described below) over the course of his/her lifetime collectively in excess of his/her lifetime gift tax exemption amount, gift tax will be due. The donor is responsible for paying any gift tax due.

At death, the executor of an estate is required to (i) aggregate and value all assets owned by the decedent as of the date of death (or otherwise included in the decedent's estate under the IRC pursuant to Sections 2031-2044), (ii) subtract all debts and expenses, (iii) deduct amounts passing to the decedent's spouse, a qualified charity, or to a qualifying trust for either (for a qualifying charitable trust, limited to the charitable interest in the trust), (iv) combine that net amount with all taxable gifts made by the decedent during life (even if collectively within the gift tax exemption amount), and (v) pay estate taxes on the balance to the extent it exceeds the applicable estate tax exemption amount (described below).

B. Applicable Exemptions For Gift And Estate Taxes.

1. Gift Tax Exemption Amount. Pursuant to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act"), the IRC provides each individual with a lifetime exemption against gift taxes equal to $5,000,000 (indexed, beginning in 2012). [Note: The provisions of the 2010 Tax Act discussed in this paper are set to expire as of January 1, 2013.] As a result, each individual may make up to the lifetime exemption amount in "taxable gifts" (discussed below) during the course of his/her lifetime without having to pay any gift tax. In the event a person makes taxable gifts in excess of the exemption amount during life, the excess will be subject to gift taxes. A "taxable gift" is a gift (or a portion of a gift) that does not qualify for any of the following:

a. Unlimited marital deduction for gifts made either directly to a spouse or to a qualifying trust for the spouse's benefit (discussed below);

b.* Unlimited charitable deduction for a gift made to a qualifying charity, either directly or via a qualifying trust, such as a charitable remainder trust or charitable lead trust (as discussed below, only the charitable portion is eligible for the charitable deduction);

c.* Gift tax annual exclusion amount (currently $13,000 per donee, or $26,000 per donee if the election to "gift-split" is made by spouses pursuant to IRC 2513); or

d. Gift tax exclusion for gifts made to the provider of qualifying educational or medical care services pursuant to IRC 2503(e).

***Note**, a gift to a charitable remainder trust or a charitable lead trust may qualify in part for the charitable deduction but also result in a taxable gift with regard to the portion of the gift representing the noncharitable beneficiary's interest. Similarly, a gift to an individual may qualify in part for the gift tax annual exclusion amount, leaving the excess amount of the gift to be considered a taxable gift.

EXAMPLE: Husband and Wife made a gift of $50,000 of community property cash to their son in 2009 to assist him in buying a house. That is the only gift they made to him for that year. As the gift was community property, each spouse is treated as making a $25,000 gift to the son. After applying each spouse's $13,000 annual gift tax exclusion for 2009, each spouse has made a $12,000 taxable gift to the son.

2. Estate Tax Exemption Amount. Pursuant to the 2010 Tax Act, each individual has an exemption against estate taxes in an amount equal to $5,000,000 (indexed, beginning in 2012). However, the required aggregation of an individual's lifetime taxable gifts with his/her gross estate at death effectively causes his/her estate tax exemption amount to be reduced dollar-for-dollar by his/her use of the lifetime gift tax exemption. Under the existing estate tax system, in the event a decedent transfers at death property in excess of his or her estate tax exemption amount (taking into account any lifetime taxable gifts), such excess will be subject to the estate tax except to the extent the charitable or marital deduction applies.

C. Unlimited Marital Deduction. Congress passed the Economic Recovery Tax Act in 1981, which provided married individuals with the opportunity to transfer an unlimited amount of property to and between each other (or to a qualifying marital trust for the other spouse described in IRC 2056) without paying any gift or estate taxes on the transfer. The rationale behind the enactment of the unlimited marital deduction was to treat married individuals as one economic unit and therefore exempt transfers between them for federal wealth transfer tax purposes. For example, if one spouse dies and leaves property to the other spouse under his or her Will in excess of the estate tax exemption amount, the deceased spouse's estate would otherwise be required to pay a federal estate tax on the excess in the absence of the marital deduction. However, the unlimited marital deduction provides that to the extent property is left to the surviving spouse, outright or in a qualifying marital trust, such property will not be exposed to potential federal estate taxes until the death of the surviving spouse. Thus, with a properly designed estate plan, spouses can together exempt an amount of property equal to the combination of their respective estate tax exemptions (i.e., for 2011, $10,000,000).

D. Portability. The 2010 Tax Act introduced into law for the first time the concept of "portability"as applied to the unused estate tax exemption and gift tax exemption of a decedent spouse. Under this concept, the executor of a deceased spouse's estate may elect to transfer any of such spouse's unused estate tax exemption to the surviving spouse. The portability concept applies to the unused gift tax exemption of a deceased spouse, but does not apply to unused GST exemption (discussed below). Under the 2010 Tax Act, portability is only available for 2011 and 2012, and only applies to decedents who die after December 31, 2010.

E. Unlimited Charitable Deduction. Each individual has the opportunity to transfer property to a qualified charity described in IRC 2522 and 2055 (either directly or via a qualifying trust, such as a charitable remainder trust or charitable lead trust) and receive at least a partial charitable deduction in return. If the gift is made free of trust to a qualifying charity or to a "zeroed-out" charitable lead trust, an offsetting charitable estate or gift (as applicable) deduction will be secured and no estate/gift tax exemption will be used in the process. If a gift is made to a charitable remainder trust or to a charitable lead trust that is not "zeroed-out," the donor/decedent will receive an offsetting charitable estate or gift (as applicable) deduction equal to the actuarial value of the charitable interest and will be required to use gift/estate tax exemption on the noncharitable portion of the gift (and possibly pay gift/estate tax depending upon the size of the noncharitable portion of the gift and the amount of applicable exemption remaining at the time of the gift).

F. Generation-Skipping Transfer Tax ("GST"). Congress was concerned that wealthy individuals might seek to circumvent additional gift or estate taxes by transferring their assets in such a way so as to bypass their children for federal wealth transfer tax purposes. For example, one can transfer assets to a trust for the lifetime benefit of a child, with any remaining assets passing at the child's death to grandchildren (or trusts for them). Even though the child receives benefits from the trust during his or her lifetime, the remaining assets

passing at the child's death to grandchildren (or trusts for them) will not be subject to inclusion in the child's estate for federal estate tax purposes (i.e., it will "skip") if the trust is properly structured because the remaining assets will be owned by (and thus transferred by) the child's trust (and not the child) at death.

To curb these perceived tax "abuses," Congress enacted the current GST provisions as part of the 1986 Tax Reform Act. In addition to applicable gift or estate taxes, the GST provisions impose a flat tax on transfers which "skip" generations for federal gift and/or estate taxes equal to the highest marginal estate tax rate in effect at the time of the "skip." Fortunately, however, Congress likewise provided each person with a GST exemption wherein assets can still be "skipped" through successive generations without being subject to such additional GST taxes. The GST exemption matches the estate tax exemption amount (i.e., $5,000,000 for 2011, with an index adjustment for 2012) and can be allocated to gifts made directly to grandchildren (or individuals deemed to occupy the grandchildren's generational level pursuant to IRC 2613), or to trusts for which a grandchild (or a member of a grandchild's generational assignment) is either currently a beneficiary or will ultimately become a beneficiary (subject to the inability to allocate GST exemption during an "ETIP" period, described in IRC 2642(f)).

III. Short Course on Marital Property Law. Generally, the law of the state where spouses reside at the time either of them acquires title to an asset will control the nature of the ownership of that asset. Generally, the character of property follows spouses as they move from state to state (see an exception to this rule discussed below referred to as "quasi-community property"). Texas is one of ten states (including New Mexico and Louisiana) which follow the "community property" system. The community property system manifests the social and legal belief that property acquired by spouses during marriage should be construed as one total "community" of property. With certain exceptions, regardless of how title to community property is taken, it belongs to the marital partnership in the absence of a written agreement to the contrary. In the non-community property states ("common law" states), for most purposes, property acquired during marriage is deemed to be the separate property of the spouse who acquired it.

In Texas, all property owned by spouses is either "community property" or the "separate property" of one of the spouses. A spouse's separate property is his or her own, but community property is owned one-half by the husband and one-half by the wife during the marriage and divided accordingly at death (but not necessarily upon divorce, as discussed below). The character of property is important in the estate planning context because of the many legal consequences that derive from property being either community or separate. For instance, the character of property determines: (i) how it is managed and controlled by the respective spouses during marriage and following the death of a spouse; (ii) what liabilities it is subject to; (iii) various tax aspects of the property; and (iv) how it is divided and distributed at the termination of the marriage by death or divorce.

A. Definition of Separate Property. The Texas Constitution, the Texas Family Code, and the Texas Courts define a spouse's "separate property" as (although spouses can agree otherwise in writing) -

1. Property owned or claimed by the spouse before marriage,
2. Property acquired during the marriage by gift, devise or inheritance,
3. Amounts recovered for personal injuries sustained by the spouse (except for money paid for loss of earning capacity, which is community property),
4. All income or property arising from a gift of property from one spouse to the other,
5. Assets acquired during marriage with separate funds, or with the proceeds of the sale of separate assets (an increase in the value of separate property is still separate property),
6. Bonuses and royalties from separate property minerals,
7. A gift of property from a third party to both spouses [in this case, one-half of the property would be held by each spouse as tenants in common (i.e., a gift cannot be made to the community)].

The owner-spouse retains full ownership of his/her separate property in the event of a divorce and retains full discretion to dispose of such property in any manner he/she deems fit upon death, unless a different distribution of the separate property is otherwise required under a marital property agreement.

As a caveat, the surviving spouse has an absolute right in Texas (the "homestead right") to continue residing rent-free (but with responsibility for certain expenses) in the property the spouses shared during their joint lifetime as their primary residence. The homestead right applies even if the residence was the deceased spouse's separate property and ownership of the residence passed at his/her death to his/her children. In that event, the deceased spouse's children will not be able to sell the residence so long as the surviving spouse wishes to continue living there. The surviving spouse will even retain this right to reside rent-free in the residence if he/she remarries.

If the surviving spouse exercises his/her homestead right, he/she will be responsible for paying maintenance costs, property taxes, and mortgage interest (but not principal). The actual owner of the residence will be responsible for paying the mortgage principal payments and casualty insurance premiums ("owner costs"). If the spouses owned the residence as community property but the deceased spouse's children from a prior marriage receive his/her one-half community property interest at death, the surviving spouse will bear one-half of the owner costs and the children will bear the other one-half.

Other "spousal" rights exist under state law, but are outside the scope of this presentation.

B. Definition of Community Property. The Texas Family Code defines "community property" to be all property acquired during marriage that is not "separate property." TFC § 3.002. Some examples of community property include (although spouses can agree otherwise in writing) -

1. Income of either spouse's separate property and income from community property,
2. Income acquired by either spouse as compensation for services,
3. Offspring from separate property animals.

Community property is owned equally by spouses during the marriage (e.g., a gift of community property is deemed a gift of one-half of the property by each spouse). Upon the death of the first spouse to die, the deceased spouse may dispose of his/her one-half of the community estate in whatever manner he/she chooses, and the surviving spouse takes his/her one-half of the community.

However, community property is subject to a "just and right" division in the event of a divorce, with the court giving "due regard for the rights of each party and any children of the marriage." In other words, community property is not automatically divided equally between the spouses in the event of a divorce.

Note, the spouses can choose to override these results in a marital property agreement.

C. Presumption of Community Property. In Texas, all assets possessed by either spouse during or at dissolution of the marriage (i.e., upon divorce or the death of the first of the spouses to die) are presumed to be community property.

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

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

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

A spouse's interest in an asset is determined according to the laws of the state in which the couple was domiciled at the time the asset was acquired. That original character is not altered when the couple thereafter moves to a community property state. For example, in a common law state, property acquired from a husband's efforts during marriage is "his" property, and if the couple thereafter moves to Texas, it remains his "separate property." However, see the discussion below regarding "quasi-community property" for an exception to this rule.

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

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

F. Planning For New Texas Residents and Couples Planning Marriage. The laws of the State of Texas regarding community and separate property apply to married persons while domiciled in the State of Texas. Accordingly, when spouses move to Texas from a common law jurisdiction, all of their assets become subject to the rules regarding marital property characterization. As indicated previously, the general rule is that property acquired in a common law state will maintain its character as determined by the laws of the state in which the property was acquired (subject to the quasi-community property rule). However, once the spouses become domiciled in Texas, all income and earnings on all property is the community property of the spouses. Most people moving into a community property jurisdiction are unfamiliar with the property characterization laws.

Those rules have a similar application to Texas couples who are planning to be married. The law provides that the property they each own at the time of the marriage is his/her separate property. However, once they are married the community property system applies to determine the character of their property. This reality is particularly important in situations where one spouse-to-be has significantly more money than the other or where one (or both) prospective spouse(s) has (have) children from a prior marriage (i.e., where they are forming a blended family). Accordingly, at a minimum, couples in these situations should be advised as to the community property system (as discussed above) and its impact on their respective ownership rights with respect to marital property, and advised to take one of the following action steps.

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

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

3. Keep The Income And Corpus Separate. In order to facilitate the requisite recordkeeping, the clients may wish to arrange their financial affairs so that each spouse's separate property is held in a separate revocable management trust created solely for that spouse's benefit and then provide for any community property income earned by those assets (e.g., interest and dividends) to be segregated (or "swept out") periodically into a separate community property account or joint revocable management trust.

4. Marital Property Agreement. The final alternative (and often the recommended alternative) for the clients is to enter into a marital agreement which clarifies the character of the property and the income generated by the property. A marital property agreement can accomplish the following -

- Provide for specific assets (e.g., a bank account) to be considered one spouse's separate property (even if it would not be so classified in the absence of the agreement) and provide that all income generated by that asset will be separate property. This avoids any need to "sweep out" what would otherwise be community property income earned by a separate property asset to avoid the commingling that could otherwise occur. To be effective, such agreements must meet all the requirements of TFC § 4.101, et. seq.
- Alternatively, provide for either spouse's separate property (or specific separate property assets) to be considered community property, thus avoiding a need to trace the origin of assets at the time of death and qualifying the asset for a full "step up" in basis at the death of the first spouse to die (regardless of whether that spouse was the original owner). As a caveat, converting separate property into community property will subject the converted asset to a "just and right" division in the event of a divorce and will give each spouse the right to dispose of one-half of the asset at death (and generally the entire asset during life if it is a spouse's sole management community property), whereas the asset would have been unconditionally retained by the original owner-spouse in either event had he/she retained the asset as his/her separate property. Converting a spouse's

separate property into community property may also alter the original owner-spouse's management rights with regard to the property (unless otherwise retained in the marital property agreement) and may subject the converted property to the other spouse's creditors when the property would have been exempt from those claims if it had retained its separate property character. To be effective, such agreements must meet all the requirements of TFC § 4.201, et. seq.

- Provide for the manner in which property is to be divided in the event of death or divorce. To be effective, such agreements must meet all the requirements of TFC § 4.101, et. seq.

5. Summary Of Planning. Regardless of which action step the clients decide to take, it is important that they (i) understand the basics of the community property regime and (ii) understand the consequences of the characterization of property as it relates to distribution upon death, division upon divorce, management during the marriage, creditor claims, and the issues related to taxation of such assets. Note that the marital property characterization of interests in trusts, partnerships, life insurance, and retirement benefits involve many complicated factors, the discussion of which (except as otherwise provided in parts of this outline) is beyond the scope of this presentation.

G. Marital Property Agreements. Section 4 of the Family Code governs "premarital and marital property agreements." The law provides an exhaustive checklist of requirements that must be met if a premarital or marital agreement is to be enforced as a matter of law.[1] The required elements of Chapter 4 of the Family Code will be strictly construed. Therefore, to be enforceable under Texas law, a premarital or marital agreement must strictly comply with the requirements. It is common for each party's legal counsel to execute the agreement to further evidence the informed consent of the parties entering into the agreement. The many requirements of the Family Code nevertheless make premarital and marital agreements subject to attack well after they are executed.

1. Premarital Agreements. Premarital agreements are agreements between prospective spouses made in contemplation of marriage and to be effective upon marriage. Prior to 1980, premarital agreements were ineffective to the extent that they purported to change the character of property to be acquired after marriage. The 1980 amendments to the Constitution make it possible for persons about to marry, by written instrument to partition between themselves all or part of their property then existing or to be acquired, or to exchange between themselves the community interest of a future spouse in any property for the community property then existing or to be acquired.

2. Marital Property Agreements. At any time, spouses may enter into effective marital property agreements to partition or exchange between themselves all or party of their community property, then existing or to be acquired., as the spouses may desire. Property or a property interest transferred to a spouse by a partition or exchange agreement becomes that spouse's separate property. The partition or exchange of property may also provide that future earnings arising from the transferred property shall be the separate property of the owning spouse.

At any time, spouses may agree that all or part of their separate property owned by either or both spouses is converted to community property. Typically this is done with an Agreement to Convert Separate Property to Community Property. To be effective, such agreements must meet all the requirements of TFC § 4.203. These agreements are often filed in deed records of the county in which a spouse resides and of the county where any real property is located.

3. Revocation or Amendment. Marital property agreements, including premarital property agreements, may be changed or revoked, but it must be done in writing.

4. A marital property agreement can accomplish the following -

- Provide for specific assets (e.g., a bank account) to be considered one spouse's separate property (even if it would not be so classified in the absence of the agreement) and provide that all income generated by that asset will be separate property. This avoids any need to "sweep out" what would otherwise be community property income earned by a separate property asset to avoid the commingling that could otherwise occur. To be effective, such agreements must meet all the requirements of TFC § 4.101, et. seq.
- Alternatively, provide for either spouse's separate property (or specific separate property assets) to be considered community property, thus avoiding a need to trace the origin of assets at the time of death and qualifying the asset for a full "step up" in basis at the death of the first spouse to die (regardless of whether that spouse was the original owner). As a caveat, converting

[1] *See* TEXAS FAMILY CODE § 4.006 for required elements.

separate property into community property will subject the converted asset to a 'just and right" division in the event of a divorce and will give each spouse the right to dispose of one-half of the asset at death (and generally the entire asset during life if it is a spouse's sole management community property), whereas the asset would have been unconditionally retained by the original owner-spouse in either event had he/she retained the asset as his/her separate property. Converting a spouse's separate property into community property may also alter the original owner-spouse's management rights with regard to the property (unless otherwise retained in the marital property agreement) and may subject the converted property to the other spouse's creditors when the property would have been exempt from those claims if it had retained its separate property character. To be effective, such agreements must meet all the requirements of TFC § 4.201, et. seq.

- Provide for the manner in which property is to be divided in the event of death or divorce. To be effective, such agreements must meet all the requirements of TFC § 4.101, et. seq.

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

A. Distribution Of Marital Property Upon Death. Upon the death of a spouse, his or her interest in probate property may pass by a Will (or via a Pour Over Will directing the probate estate into a revocable management trust becoming irrevocable at death). In the absence of such an arrangement, the laws of descent and distribution (i.e., intestate distribution) will apply with regard to the distribution of the probate estate. On the other hand, nonprobate property passes in accordance with a beneficiary designation (e.g., an insurance policy or retirement account), in accordance with the titling on an account (e.g., an account or other asset held in a joint tenancy with rights of survivorship format or in a "P.O.D." format), or in accordance with the terms of a management trust (if the property is titled in the name of the trust during the decedent's lifetime).

1. Intestate Distribution. The laws of descent and distribution in the Texas Probate Code determine the distribution of the decedent's probate property in the absence of a Will. Specifically, § 38 of the Texas Probate Code deals with the distribution of separate property and § 45 of the Texas Probate Code deals with the distribution of the community property assets. It is important to note that the concept of quasi-community property is not applicable to the distribution of assets upon the death of a spouse.

a. Separate Property Intestate Distribution. Section 38(b) of the Texas Probate Code provides that if a person dies leaving a spouse, then the surviving spouse will take ⅓ of the personal estate and the balance of the personal estate shall go to the children and the descendants of the deceased. In addition, the surviving spouse will be entitled to an estate for life in ⅓ of the land, with remainder to the children and descendants of the deceased spouse. If there are no children, then the surviving spouse shall be entitled to all of the personal estate and to one-half of the land, and the other half of the land will pass to the decedent's heirs at law (unless the deceased spouse has no living parent, sibling, or issue of a sibling, in which event the surviving spouse will receive the entire estate).

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

2. Testate Distribution. Under the laws of Texas, a decedent has the right to dispose of his or her interest in all property. Therefore, a decedent's Will typically disposes of 100% of his or her separate property and his or her one-half interest in the community property (or, if a Pour Over Will directs the probate estate into a revocable management trust becoming irrevocable at death, the trust will provide for that result).

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

B. Management Of Assets During Marriage.

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

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

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

C. Rules of Marital Property Liability.

1. The Texas Family Code provides that each spouse has a duty to support his or her minor children and the other spouse when the other spouse is unable to support himself or herself. A spouse who fails to discharge this obligation is liable to any person who provides such support.

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

a. A spouse's separate property is not subject to liabilities of the other spouse unless both spouses are liable by other rules of law.

b. Community property subject to a spouse's sole management (special) is not subject to non-tortious liabilities of the other spouse (i.e., bank debt) incurred during the marriage or any liabilities of the other spouse incurred before marriage unless both spouses are liable by other rules of law.

c. All community property is subject to tortious liabilities of either spouse incurred during marriage.

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

The chart below illustrates the application of these rules.

PROPERTY SUBJECT TO LIABILITY (UNLESS BOTH SPOUSES ARE LIABLE BY OTHER RULES OF LAW)

	Type of Liability	Joint Management Community Property	Sole Management Community Property	Separate Property
1.	Contracts of Other Spouse Before Marriage	X		
2.	Contracts of Other Spouse During Marriage	X		
3.	Torts of Other Spouse Before Marriage	X		
4.	Torts of Other Spouse During Marriage	X	X	
5.	Debts Incurred by Other Spouse for Necessities	X	X	X
6.	Own Contracts (Before or During Marriage)	X	X	X
7.	Own Torts (Before or During Marriage)	X	X	X

D. Planning For The Residence. Particular care should be taken in addressing the ownership and use of the spouses' residence since it is often the most valuable asset involved and is often the asset with the most "emotional" importance. The following discussion

highlights the issues to be addressed with respect to the ownership and use of the residence both during and after the marriage (whether that should occur due to divorce or the death of the first spouse) and potential solutions for resolving those issues.

1. State Law Provides Default Rules. If spouses do not provide otherwise in a marital property agreement, Texas law will dictate how their residence will be disposed of upon the termination of their marriage by divorce or by the death of the first of them to die. As discussed below, the deceased spouse can, to a certain extent, override those provisions applicable at death via a Will/Revocable Trust, but not entirely.

a. Divorce.

i. If the Residence is a Spouse's Separate Property. If one spouse owned the residence prior to the marriage (or acquired it as separate property during the marriage), that spouse will continue to own it as his/her separate property and will retain it in the event of a divorce. If community property funds, or the separate property funds of the nonowner-spouse, are expended to benefit the residence, the nonowner-spouse may have a claim for reimbursement under Texas Family Code Section 3.402 against the owner-spouse's separate property estate (see E. below). However, the nonowner-spouse will have no claim to the residence itself.

ii. If the Residence is Community Property. If the spouses own the residence as community property, the ownership of the residence will be resolved either by the spouses in a marital property settlement or (if the spouses cannot agree) by the judge. Either spouse could have a claim for reimbursement against the community property estate if that spouse's separate property funds had been expended to benefit the residence (see E. below).

b. Death. For purposes of the following discussion (and for general ease of reference), assume the first spouse to die has a Will providing for his/her entire estate to pass to that spouse's children from a prior marriage and that all of such spouse's ownership interest in the residence passes pursuant to that Will.

i. If the Residence is a Spouse's Separate Property. If one spouse owned the residence prior to the marriage (or acquired it as separate property during the marriage), that spouse will continue to own it as his/her separate property and will have testamentary control over who will become the owner of the residence at the owner-spouse's death. The nonowner-spouse (or that spouse's estate) may have a claim for reimbursement against the owner-spouse's separate property estate to the extent community property funds (or the nonowner-spouse's separate property funds) were used to benefit the residence, but the separate property nature of the residence will not be altered.

However, as noted in III.A above, Texas provides the surviving spouse with a "homestead right" (see Texas Probate Code Section 283), which entitles the surviving spouse to continue residing in the residence rent-free for the remainder of his/her lifetime **regardless of whether the surviving spouse owns any interest in the residence and regardless of whether the surviving spouse remarries.** In other words, even if the owner-spouse leaves the residence (his/her separate property) to his/her children, the children will take title to the residence subject to the nonowner-spouse's right of occupancy. The children cannot sell the residence as long as the nonowner-spouse wishes to assert that spouse's homestead occupancy rights. This will be the case, even if the nonowner-spouse retained ownership of his/her prior residence and could move back into it.

A surviving spouse asserting his/her right of homestead occupancy is responsible for paying property taxes, mortgage interest, and other maintenance expenses typically imposed on the owner of a legal life estate. The actual owners of the residence (the deceased spouse's children) will be responsible for paying casualty insurance premiums and mortgage principal payments.

Caution: The Tax Court has ruled that the surviving spouse's homestead right is a nonqualified terminable interest and therefore does not qualify for the federal estate tax marital deduction in the deceased spouse's estate. See *Estate of Kyle v. Commissioner*, 94 TC 829 (1990).

ii. If the Residence is Community Property. If the spouses own the residence as community property, each spouse will have testamentary control over who is to receive his/her community share in the residence at death. Either spouse (or that spouse's estate) may have a claim for reimbursement against the community estate if that spouse's separate property funds had been expended to benefit the residence.

To the extent the deceased spouse elects to leave his/her share of the residence to that spouse's children, the surviving spouse will have two different "claims" to the residence. The surviving spouse will own one-half of the residence, representing his/her community share. The surviving spouse will also have a homestead occupancy right in the other one-half of the residence, even though title to the deceased spouse's one-half of the residence passed to his/her children at death. In that

event, the surviving spouse will be responsible for paying all of the maintenance costs, mortgage interest and property taxes plus one-half of the mortgage principal and casualty insurance premiums (as owner of one-half of the residence).

Note, if the surviving spouse remarries and predeceases the new spouse, the new spouse will have a homestead occupancy right in the surviving spouse's one-half of the residence but will have no such right in the other one-half that previously belonged to the deceased spouse.

iii. Potential Issues Created. Obviously, less than ideal situations can result under the aforementioned scenarios if the surviving spouse wants to assert the homestead right:

- Tensions can develop between the deceased spouse's children and the surviving spouse over the use of the residence. For example, if the children were living in the house they could be forced to move out, unless the surviving spouse decides to be accommodating and permits them to stay.
- The children may lack sufficient funds to pay the insurance and mortgage principal payments (unless the deceased spouse provides them with those funds) and may therefore prefer to sell the residence to avoid continuing to incur those expenses. The surviving spouse may wish to remain in the residence and elect not to accommodate the children's desire to sell it.
- The surviving spouse may endure hardships in paying the maintenance costs, mortgage interest and property taxes, if the deceased spouse leaves little else to the surviving spouse and the surviving spouse does not have sufficient resources of his/her own.
- The surviving spouse may be unable to make the modifications/improvements to the residence he/she would like, if the children do not approve of the proposed alterations. Query, if certain modifications are necessary in order to provide the surviving spouse with the ability to continue living in the residence (e.g., a wheelchair ramp or widening door frames to accommodate a wheelchair), would the deceased spouse's children be able to "veto" those modifications?
- The surviving spouse may wish to "downsize" and move into a smaller, less expensive home. However, the homestead occupancy right only applies for the residence the spouses shared during their joint lifetime. So, unless the children decide to be accommodating, the surviving spouse might not be able to relocate to a residence he/she might find more suitable.

2. Recommended Approach: Specifically Address Ownership/Use of the Residence in Will and (As Necessary) a Marital Property Agreement. Spouses should seriously consider addressing (either prior to or early on in the marriage) how the residence is to pass upon the termination of the marriage, whether due to divorce or death. The agreed upon arrangements should be formalized in the owner's(s') Will(s). The arrangements should also be incorporated in a marital property agreement, if the spouses want to make the agreed upon arrangements legally binding. As a result, spouses will help to avoid the potential tensions and disagreements between the surviving spouse and the deceased spouse's children discussed above. Discussed below are different scenarios that may apply with regard to the ownership/use of a residence, along with suggested ways of balancing the interests involved.

a. Divorce.

i. If the Residence is Owned By One Spouse as Separate Property. As explained above, if the residence the spouses will share was owned by one of them prior to their marriage (or is acquired by one spouse during the marriage as his/her separate property), that spouse will retain ownership of the residence upon divorce. The nonowner-spouse may want an assurance that he/she will have a place to live if the spouses divorce. This may be of particular concern for the nonowner-spouse if that spouse sells his/her residence prior to the marriage and/or may otherwise lack the financial means to purchase a new residence in the event of a divorce. Given those concerns, the nonowner-spouse may suggest that the spouses enter into a marital property agreement providing in the event of a divorce for the owner-spouse to provide the nonowner-spouse with sufficient funds to acquire a suitable residence or other housing. Of course, the owner-spouse may not be receptive to such a suggestion. See Section III.F.4 of this outline for a more detailed discussion of marital property agreements.

ii. If the Residence Is/Will Be Community Property. If the residence is or will be owned as community property, it may be prudent for the spouses to address ahead of time how the residence should be distributed upon divorce in order to avoid a judge making that decision for them. This will require addressing several issues:

- Should either spouse receive the residence in the settlement of the community estate? If so, what (if any) accommodations should be made for the other spouse from the community estate?

• Alternatively, should the residence simply be sold and the proceeds divided between the spouses? If so, in what proportions?

• If the residence is to be sold in the event of a divorce, should either spouse be permitted to continue living in the residence prior to its sale (and if so, for how long)? Should that spouse be required to pay rent in return? If so, how will that rent be determined (e.g., predetermined in the marital property agreement or based upon comparable rentals at the time of the use)? Who will be responsible for listing the residence for sale? Who will determine the list price?

b. Death.

i. If the Residence is Owned By One Spouse as Separate Property. Again, if the residence the spouses will share was owned by one of them prior to their marriage (or is acquired by one spouse during the marriage as his/her separate property), that spouse will retain ownership of the residence and will have the ability to direct how it passes at that spouse's death, subject to the surviving spouse's homestead right. Of course, the nonowner-spouse may not have a strong desire to remain in the residence if he/she is the surviving spouse, particularly if the nonowner-spouse plans to retain his/her prior residence or would just as soon receive a cash bequest instead for use in purchasing a replacement residence. In that event, the owner-spouse might want to consider asking the nonowner-spouse to waive the homestead right, possibly in a marital property agreement in which the owner-spouse commits to leaving the nonowner-spouse sufficient funds to find a replacement residence. In doing so, the owner-spouse will achieve the peace of mind that will come in knowing that this otherwise potentially contentious issue is resolved. He/she will now also be free to pursue lifetime planning techniques for the residence (e.g., transfer to a Qualified Personal Residence Trust, or "QPRT") without having to obtain the nonowner-spouse's consent, which would otherwise be required due to the surviving spouse's homestead right.

If, instead, the nonowner-spouse wants the ability to continue living in the residence for as long after the deceased spouse's death as the surviving spouse desires, it may be prudent to formalize those arrangements rather than rely on the homestead provision provided by state law (particularly if a marital deduction is desired and/or if the surviving spouse may not otherwise have the financial resources to pay the expenses required in order to assert the homestead right). In that event, the owner-spouse should consider incorporating in his/her Will the desired arrangement for the nonowner-spouse's use of the residence. It may also be appropriate to incorporate those arrangements in a marital property agreement as well (if a legally binding arrangement is particularly important to either or both of the spouses). The following discussion offers suggested applications of these principles.

• **Alternative #1: Provide the Surviving Spouse Outright Ownership of the Residence.** Under certain circumstances, it may be just as well for the owner-spouse (if the first to die) to leave the residence to the nonowner- spouse (along with funds necessary for its upkeep, if appropriate). This may be an acceptable solution, particularly if the owner- spouse has sufficient other wealth to leave to his/her children and the children have no particular sentimental attachment to the residence. As a result, the owner-spouse's children and the surviving spouse can all "go their separate ways."

The surviving spouse will be free to make whatever improvements/modifications to the residence he/she desires (and can afford). Alternatively, the surviving spouse can "downsize" as appropriate by selling the house and purchasing a smaller residence (perhaps using the excess proceeds to cover future maintenance expenses and property taxes). As a bonus, the deceased spouse's estate will receive an offsetting estate tax marital deduction for the gift of the residence (and any additional funds) to the surviving spouse. (Again, the deceased spouse's estate would not be entitled to an estate tax marital deduction if the surviving spouse were simply provided with his/her homestead right.)

• **Alternative #2: Provide the Owner- Spouse's Children With Ownership of the Residence and Make Alternative Provision for the Nonowner-Spouse.** If the owner-spouse's children are minors and the owner-spouse wants to provide his/her children with the option of continuing to use the residence (or if the owner-spouse's adult children have a particular sentimental attachment to the residence), it may be appropriate to leave the residence to the children. The owner-spouse can then provide the nonowner-spouse with a lump sum designed to provide him/her with the means to acquire a replacement residence. An offsetting estate tax marital deduction would be available for the funds left to the nonowner-spouse.

• **Alternative #3: Leave the Residence to a Trust (Possibly a "QTIP").** If the owner-spouse wants to provide the nonowner-spouse with continued use of the residence but ultimately provide for it to pass to the owner-spouse's children at the nonowner-spouse's death, it may be preferable to leave the residence to a Trust. The nonowner-spouse would be granted the right to live rent-free in the residence, which will pass upon his/her death to the owner-spouse's children. The Trust could

also be funded with funds sufficient to cover any future mortgage payments/property taxes/other associated expenses. In funding the Trust with funds sufficient to cover all expenses relating to the residence, the owner-spouse can avoid the issues that might otherwise arise with the shared responsibility for expenses that would be imposed on the nonowner-spouse and the owner-spouse's children if the homestead provisions were applicable.

If desired, the Trust can be structured as a QTIP so that assets left to it by the owner-spouse will qualify for the federal estate tax marital deduction, which defers any estate taxes otherwise due on those assets until the nonowner-spouse's death. (Typically, the QTIP bears whatever estate taxes are caused by its inclusion in the surviving spouse's estate, although spouses can make alternative arrangements in that regard.)

As a caveat, in order to qualify the Trust for the marital deduction, the nonowner-spouse must be given certain rights:

- The nonowner-spouse has to be given the ability to force the Trustee to sell the residence, invest the proceeds in income producing assets, and receive distributions (at least annually) of the resulting income. Consequently, if the owner-spouse wants to ensure that the residence will be retained for his/her children's ultimate use, the owner-spouse may be forced to forgo the estate tax marital deduction.
- The nonowner-spouse's right to the continued use of the residence (and the ability to force its sale) must be unconditional, meaning that the owner-spouse cannot provide for those rights to be extinguished in the event the nonowner-spouse remarries. (Of course, the homestead right provides the nonowner-spouse with a similar ability to retain use of the residence after the owner-spouse's death, even in the event the nonowner-spouse remarries.)

If the owner-spouse finds these conditions for securing the estate tax marital deduction to be unacceptable, it may be preferable to forgo the deduction and instead structure the Trust in whatever manner the owner-spouse (and the nonowner-spouse, if the owner-spouse is feeling accommodating) finds more acceptable.

Note, a legal life estate for the nonowner-spouse may also be an appropriate alternative, provided the drafting of such contains the elements necessary to qualify the provisions made for the nonowner-spouse for the estate tax marital deduction (if desired).

ii. If the Residence is Owned By the Spouses as Community Property. Many of the same concerns discussed above will apply (and offered solutions may be appropriate) if the residence is held by the spouses as community property. Of course, in that event the surviving spouse will own one-half of the residence and thus will have an equal say in how the residence will ultimately pass once both of the spouses are deceased (unless the spouses provide otherwise in a marital property agreement).

Note, the spouses may wish to convert the residence from one spouse's separate property into community property. See Section III.F.4 of this outline for factors that might affect the spouses' decision in this regard.

3. Ensure Titling of Residence Is Consistent with the Objectives and Intent. The titling of the residence should be consistent with whatever plans the spouses have made for it. For example, if one spouse intends to purchase a new residence using separate property funds and wishes to have the residence correspondingly considered his/her separate property, title should be taken in that spouse's name only. Otherwise, if the spouse providing the funds for the acquisition takes title in both spouses' names, the Texas Courts have held that such spouse has made a gift to the non-contributing spouse and they each own a one-half separate property interest in the residence. See *Long v. Long*, 234 S.W.3d 34 (Tex. App.- El Paso 2007, pet. denied).

Also, keep in mind that even if the residence is to be held as community property, it should not be titled with survivorship rights (unless the spouses and their attorney(s) have chosen to do so for specific reasons). Survivorship rights will cause the residence to pass upon the deceased spouse's death directly to the surviving spouse. As a result, any tax and/or marital property planning provided for the residence in the deceased spouse's Will/Revocable Trust will not apply with regard to the residence. In addition, titling the residence with survivorship rights could be deemed an amendment to a previously executed marital property agreement and thus could defeat any planning for the residence contained in that agreement. In effect, the titling of the residence with survivorship rights could potentially reintroduce the sorts of conflicts that the spouses intended to avoid through specific planning in their testamentary documents and/or a marital property agreement.

Also use caution when titling an out-of-state vacation or rental property for your clients. In a recent case, Husband and Wife (both Texas residents and the second marriage for each) planned to buy a vacation home in another state and, upon the death of the second spouse to die, leave that home to Husband's siblings, nieces, and nephews who lived in that state. Wife did not know (had never met) those relatives of Husband. The house was purchased with community property. Husband and Wife engaged an attorney in the state in which the property was located to handle their purchase of the real estate.

The resulting deed listed both Husband and Wife as the owners of the real estate.

Husband died, leaving Wife surviving. Husband's Will was probated in Texas and his son was appointed Executor of the Estate. The Will transferred Husband's interest in the out-of-state real estate to his relatives, but, in working to accomplish that transfer, son was stunned to find that -

under the laws of the state where the vacation home was located, by titling the real estate in the names of Husband and Wife, with no other language, title to the property was taken in a survivorship mode and, upon Husband's death, by law, a 100% ownership interest in the property passed to Wife.

That's the end of this story, except to note that Wife's children and grandchildren sure did like that vacation home.

E. Claims for Economic Reimbursement.

1. Background. It is often the case that community property funds will be used to pay down a debt that is the responsibility of only one spouse (e.g., a mortgage) and/or to improve a spouse's separate property (e.g., the residence). The reverse also commonly occurs when a spouse uses separate property to improve a community property asset or to pay down debt for which both spouses are responsible. Under the Inception of Title Rule, the ownership of the benefitted property will not change, regardless of the benefit received from the other marital estate's contribution of funds. Consequently, the Texas Legislature has attempted over the year to enact laws intended to alleviate the "unfairness" often produced by that result.

Until recently, Section 3.402 of the Texas Family Code ("TFC") was the governing law in that respect and provided the contributing marital estate with a claim for "economic contribution."[2] A claim for economic contribution was calculated under TFC Section 3.403 using a complex statutory formula that "divided" up the equity associated with the benefitted property upon the termination of the marriage between the owner marital estate and the other contributing marital estate based upon their relative contributions towards payment of debt secured by the property and/or capital improvements to it. Claims not falling within that category were still pursuable under Section 3.408, which provided for a "Claim for Reimbursement" based upon equitable principles developed by case law spanning over a century.

However, practitioners and judges found the economic contribution rules to be complicated and confusing. In particular, there was a good deal of confusion regarding when an economic contribution claim pursuant to Section 3.402 was appropriate, as opposed to an equitable reimbursement claim pursuant to Section 3.408. Additionally, some attorneys were concerned that the statutory formula mandated by Section 3.403 could cause a conversion of separate property into community property via a means not authorized by the Texas Constitution.

2. Current Law. Consequently, in 2009, the Texas Legislature repealed TFC Section 3.403 and Section 3.408 and modified TFC Section 3.402 and the remaining Sections of Chapter 3 of the TFC to provide for a return to the broader "Claim for Reimbursement" approach. In doing so, TFC Section 3.402 provides the contributing marital estate with a claim against the benefitted estate that matures on the dissolution of the marriage (but not an ownership interest in the benefitted property). Specifically, TFC Section 3.402 provides that a "Claim for Reimbursement" includes

a. payment by one marital estate of the unsecured liabilities of another marital estate;

b. inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse;

c. the reduction of the principal amount of a debt secured by a lien on property owned before marriage, to the extent the debt existed at the time the property was received;

d. the reduction of the principal amount of a debt secured by a lien on property received by a spouse by gift, devise, or descent during a marriage, to the extent the debt existed at the time of the marriage;

e. the reduction of the principal amount of that part of a debt (including a home equity loan) (i) incurred during a marriage, (ii) secured by a lien on property; and (iii) incurred for the acquisition of, or for capital improvements to, property;

f. the reduction of the principal amount of that part of a debt (i) incurred during a marriage, (ii) secured by a lien on property owned by a spouse, (iii) incurred for the acquisition of, or for capital improvements to, property,

[2] The three "marital estates" potentially in existence during the marriage are: husband's separate property estate, wife's separate property estate, and the community property estate.

and (iii) for which the creditor agreed to look for repayment solely to that spouse's separate property;

g. the refinancing of the principal amount of any previously mentioned debt, to the extent the refinancing reduces that principal amount in a manner described by the applicable description;

h. capital improvements to property other than by incurring debt; and

i. the reduction by the community property estate of an unsecured debt incurred by the separate estate of one of the spouses.

TFC Section 3.402 provides that a court is to resolve a claim for reimbursement by using equitable principles, offsetting one claim for reimbursement against another, as appropriate. For example, benefits for the use and enjoyment of property may generally be offset against a claim for reimbursement for expenditures to benefit a marital estate. However, TFC Section 3.402(d) provides that "the separate estate of a spouse may not claim an offset for use and enjoyment of a primary or secondary residence owned wholly or partly by the separate estate against contributions made by the community estate to the separate estate." The party seeking an offset to a claim for reimbursement has the burden of proof with respect to the offset.

TFC Section 3.402(d) provides that "reimbursement for funds expended by a marital estate for improvements to another marital estate are to be measured by the enhancement in value to the benefitted marital estate."

TFC Section 3.409 provides that a court cannot recognize a claim for reimbursement for (i) payment of child support, alimony, spousal maintenance, (ii) payment of a spouse's or a child's living expenses, (iii) contributions of property of a nominal value, (iv) payment of a liability of a nominal amount, or (v) a spouse's student loan.

TFC Section 3.406 provides that a court may (but is not required) to impose a lien on the property of the benefitted marital estate in the event of divorce in order to secure payment of the claim for reimbursement.

The changes to Chapter 3 of the TFC became effective September 1, 2009 and accordingly apply to claims made in a marriage dissolution suit filed on or after that date. A claim made in a suite filed before September 1, 2009 will continue to be governed by the law in effect at the time the suit was filed.

3. <u>Questions Raised With Enactment of New Chapter 3 of the TFC</u>. The 2009 legislative return to the concept of "claims for reimbursement" eliminated the uncertainties under the prior law associated with the "economic contribution" concept. However, the new legislation contains its own ambiguities and raises other questions that will need to be addressed by future legislation or the courts.

For example, TFC Section 3.402(d) provides that "the separate estate of a spouse may not claim an offset for use and enjoyment of a primary or secondary residence owned wholly or partly by the separate estate against contributions made by the community estate to the separate estate." The Legislature neglected to define what is to be considered a "primary or secondary residence." This could lead to some debates between spouses with regard to whether (for example) the condo in Colorado owned by husband, used by the family for a few weeks during the year, but rented out the remainder of the year should be considered a "secondary residence." If the condo is properly considered a "secondary residence," then the community could seek reimbursement for any community property funds used to pay the principal on a mortgage secured by the condo and/or improvements without an offsetting reduction for the benefits for the use and enjoyment of the condo. If the condo is not properly considered a "secondary residence," then the offset would be appropriate.

As another example, TFC Section 3.402(d) provides that "reimbursement for funds expended by a marital estate for improvements to another marital estate are to be measured by the enhancement in value to the benefitted marital estate." However, that Section neglects to establish when the determination of the enhancement in value is to occur – is it at the time the improvements are made or when the marriage is dissolved? Under case law predating the enactment of the prior economic contribution principles, the determination of the enhancement in value was to be established at the time of the marriage's dissolution. Anderson v. Gilliland, 684 S.W. 2d 673 (1985).

Additionally, TFC Section 3.402 creates a reimbursement claim for "inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse." However, under prior law, the reimbursement claim was only to account for time, toil, talent, and effort expended beyond a level reasonably necessary to manage the separate property, to the extent the community has not already been adequately compensated. Consequently, TFC Section 3.402 on its face suggests that a reimbursement claim could extend to <u>all</u> time, toil, talent, and effort expended (i.e., there is no offset for efforts necessary to maintain the property).

Further, TFC Section 3.402 creates a reimbursement claim relating to the lack of community compensation for

one spouse's time, toil, talent, and effort relating to a "business entity." Given that TFC Section 3.402 does not purport to provide an all-inclusive of the bases for reimbursement claims, one has to wonder if a reimbursement claim might exist for extraordinary, yet uncompensated efforts expended by one spouse on his/her separate property real estate that is not held in entity form?

These are just a few of the many questions raised by the legislative enactments to TFC Chapter in 2009. As with most legislation, the ambiguities and other uncertainties raised will be addressed over time, but create confusion and uncertainties of our own for those of us who are charged with determining how our clients will be impacted by legislation.

4. The Solution – a Premarital Agreement/Marital Property Agreement. Spouses can set their own rules in a premarital agreement or marital property agreement for what sort of claims for reimbursement (if any) are to be recognized in the event of a divorce and what sorts of offsets (if any) should be allowed. In taking this approach, the spouses can incorporate or waive in part or altogether the provisions of TFC Chapter 3.

Note, pursuant to TFC 3.410, premarital or marital property agreements executed prior to September 1, 2009 that reflect an agreement by spouses to waive, release, assign, or partition a claim for economic contribution or claim for reimbursement (or both) will continue to be effective in that regard, regardless of the terminology used.

F. Titling Bank Accounts/Investment Accounts (Holmes v. Beatty).

1. History. In 1989, Texas passed a constitutional amendment to make it easier for spouses to establish survivorship estates with respect to community property. The Texas Probate Code § 452 provides that survivorship agreements involving community property must be (1) in writing, (2) signed by both spouses, and (3) contain express survivorship language. Extrinsic evidence cannot be used to demonstrate that the parties intended to create survivorship rights. Prior to *Holmes v. Beatty*, the long established Texas law requires that the survivorship feature of a joint account be expressly stated.[3]

If an account has a survivorship feature, at the first spouses death, all of the property in the account shall pass to the surviving spouse. If the account does not have a survivorship feature, the typical community property rules will apply so that each spouse has a one-half interest in the property. In this case, the parties have a right to devise their portion of such property to anyone that they wish at their death.

2. *Holmes v. Beatty*. This case involved a second marriage for Husband and Wife (each spouse had children by a first marriage) and over $10 million in brokerage accounts and securities issued from the accounts, all of which were undisputedly community property.[4] Both Husband and Wife signed all of the agreements. The brokerage accounts were variously listed as "JT TEN", "JT TEN defined as 'joint tenants with right of survivorship and not as tenants in common,'" "JTWROS", and "Joint (WROS)." Stating that the "constitutional amendment permitting survivorship agreements in community property was intended to facilitate the creation of such agreements," the Supreme Court held that Husband and Wife's brokerage account agreements established rights of survivorship. The court explains that "[p]recedent, trade usage, and seminal treatises make clear that joint tenancies carry rights of survivorship."

The court also ruled that stock and bond certificates issued from the accounts with designations such as "JT TEN," "JT TEN-as joint tenants with right of survivorship and not as tenants in common," and "JT WROS," retained the survivorship rights established by the respective account agreements even though the certificates were not signed by Husband and Wife. The court noted that "owners do not typically sign stocks or bonds until they are ready to sell or redeem them." Thus, the securities retained the characteristics of the accounts from which they were issued. The end result was that on Wife's death, her interest in the accounts and securities passed by right of survivorship to Husband, and when Husband died nine months later all of the interests passed under Husband's Will, which left nothing to Wife's children.

Conclusion: Community property held as joint tenants can automatically have the survivorship feature even if that feature is not expressly stated or intended by the spouses.

[3] *See* Probate Code § 46(a) (survivorship in separate or individual property cannot be inferred from the mere fact that the property is held in joint ownership); Probate Code § 452 (requiring community property survivorship agreements to contain an express statement of the survivorship feature); *Stauffer v. Henderson*, 801 S.W.2d 858 (Tex. 1990) (holding that extrinsic evidence cannot be used to show a right of survivorship for joint bank accounts between non-spouses).

[4] *Holmes* v. *Beatty*, 290 S.W.3d 852 (Tex. 2009)

Question: Do you think that this was what Husband and Wife intended when drafting their estate planning documents?

G. Retirement Assets. The retirement accounts are often the most valuable assets owned by spouses. In the event of a divorce, the retirement accounts will be divided in one of two ways: pursuant to a marital property agreement (the preferred approach) or based upon the spouses' (or a court's) division of the accounts at the time of the divorce (less preferred, but more common).

The following discussion assumes that the retirement accounts will be divided in some manner between the former spouses upon divorce, rather than the participant spouse retaining the accounts and "settling up" with the nonparticipant spouse using other assets. The following discussion also assumes that any retirement account in question is either (i) a traditional IRA (or Roth) or (ii) an employer-sponsored retirement plan that is a pension plan, 401(k), or stock bonus plan (the most common types of plans). Specific planning may be appropriate for less common types of benefit plans (e.g., non-qualified plans benefitting highly-compensated executives and state or federal government retirement plans), but a discussion in that regard is beyond the scope of this presentation.

In the following discussion, the term "participant spouse" is used as a reference to the spouse who is the participant in the subject employer-sponsored retirement plan or the spouse who is the contributor to the subject IRA, as applicable. Accordingly, the term "nonparticipant spouse" refers to the spouse who is not the plan participant or the IRA contributor.

1. The "Basics" of Community Property With Regard to Retirement Assets. The balance in a spouse's employee benefit plan/IRA at the time of the marriage and any attributable capital appreciation remains that spouse's separate property. However, the account will also ultimately hold community property in the form of: (i) post-marriage earnings in the account (including on the pre-marriage balance), (ii) all post-marriage contributions to an employer-sponsored retirement plan (excepting rollovers of separate property from other employer-sponsored retirement plans/IRAs), and (iii) all post-marriage contributions to an IRA consisting of community property. Obviously, commingling of an account can easily occur and ultimately make dividing the account into separate property/community property upon divorce a difficult task.

Pursuant to Texas Family Code Section 3.007(c), the separate property interest in a "defined contribution retirement plan" (e.g., a 401(k)) may be traced using the same tracing and characterization principles commonly applicable with nonretirement assets. Presumably, the same would apply with respect to establishing the community/separate property portions of IRAs. In effect, all benefits in a defined contribution plan (and presumably an IRA) are assumed to be community property, subject to a spouse's establishing the separate property character of a portion of the account using the inception-of-title and tracing rules. This approach represents a legislative overturning of case law that had determined (i) the balance of an account as of the date of the marriage to be the participant spouse's separate property and (ii) any subsequent increase in the balance of the account to be community property. Those decisions were duly criticized as failing to acknowledge that some portion of the capital appreciation occurring in the account during the marriage was solely attributable to the date of marriage balance of the account (i.e., the participant spouse's separate property).

The now repealed Sections 3.007(a) and (b) of the Texas Family Code previously provided formulas for defining the separate property and community property portions of a defined benefit plan (e.g., pensions). The Texas Legislature repealed those provisions in 2009 due to their having contained a mathematical error. Consequently, the separate and community shares of a defined benefit plan must be resolved in accordance with principles developed in prior case law. Taggart v. Taggart, 552 S.W.2d 422 (Tex. 1977); Cearley v. Cearley, 544 S.W.2d 661 (Tex. 1976); Berry v. Berry, 647 S.W.2d 945 (Tex. 1983); May v. May, 716 S.W.2d 705 (Tex. Civ. App.–Corpus Christi 1986). A discussion of the methodology for establishing the value of a defined benefit plan prescribed by the applicable case law is beyond the scope of this presentation.

2. Employer-Sponsored Retirement Plans.

a. ERISA/REA Generally, the Employee Retirement Income Security Act of 1974 ("ERISA") applies to pension plans, profit-sharing plans (including 401(k)s), 403(b) plans, and stock bonus plans. ERISA does not apply to IRAs.

The Retirement Equity Act of 1984 ("REA") provides nonparticipant spouses with certain rights in plans subject to ERISA (most notably certain survivor annuities) and imposes strict requirements on the manner in which nonparticipant spouses are permitted to waive those rights. The circumstances in which spouses might want to consider having the nonparticipant spouse waive those rights and the mechanics of doing so are topics beyond the scope of this presentation.

However, neither ERISA nor REA creates any substantive rights for the nonparticipant spouse in the event of a divorce. Consequently, spouses are free at any time to address the manner in which an employer-sponsored retirement account is to be distributed in the event of divorce.

b. Spouses' Planning for Division of Plan Benefits In Event of Divorce. Obviously, it is preferable for spouses to address the manner in which an employer-sponsored retirement account is to be distributed in the event of divorce in either a premarital agreement or a marital property agreement executed during the marriage, rather than wait until a divorce is underway. Any waiver by the nonparticipant spouse of his/her rights in the accounts should specifically address the spouses' intentions in that regard, rather than be of a general nature intended to apply to all assets (including nonretirement assets). However, no formal paperwork is required to be filed with the plan administrator until (if ever) a divorce occurs. (In contrast, there are specific time frames for filing the nonparticipant spouse's waiver of the survivor annuities.) Note, spouses cannot voluntarily partition an employer-sponsored retirement account between them during their marriage due to the anti-alienation provisions of ERISA.

c. Division of Plan Benefits Upon Divorce. The determination of the nonparticipant spouse's interest in the participant spouse's employer-sponsored retirement account has long plagued attorneys. Prior to the enactment of REA, some participant spouses attempted to argue that their employer-sponsored retirement plans could not legally be awarded to nonparticipant spouses in a divorce based upon ERISA's anti-alienation and preemption provisions. Texas courts typically found a creative way around those arguments by imposing "constructive trusts" on the participant spouses for the portion of the benefits awarded to the nonparticipant spouses in divorce. As such, the Court ordered the participant spouse to hold and pay to the nonparticipant spouse that spouse's share of the participant spouse's benefits, subject to being held in contempt for noncompliance.

Ultimately, Congress enacted the REA, which specifically carved out an exception to the general anti-alienation and preemption provisions of ERISA for Qualified Domestic Relations Orders ("QDROs"). Pursuant to IRC 414(p)(1), a QDRO is a "domestic relations order (i) which creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan" and which meets certain criteria set out in IRC 414(p)(2) and IRC 414(p)(3). Pursuant to IRC § 414(p)(1)(B), a domestic relations order is a "judgment, decree, or order (including approval of a property settlement agreement) which (i) relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant and (ii) is made pursuant to a state domestic relations law (including a community property law)." Essentially, a QDRO creates or recognizes the nonparticipant spouse's right to part or all of the participant spouse's employer-sponsored retirement account upon divorce (whether determined by the court or by the spouses pursuant to a marital property agreement). Consequently, a divorce decree alone is not sufficient to transfer ownership of the requisite portion of the retirement account to the nonparticipant spouse unless it meets the criteria of a QDRO (including approval by the plan administrator).

The plan administrator may provide a form QDRO for the spouses' use that will suffice for some situations. However, customized drafting may be in order if the employee benefit plan is significant in size, since it will be important to ensure that the arrangements regarding the division of the account set out in the divorce decree are incorporated into the QDRO as well.

d. Resulting Taxation. Distributions from an employer-sponsored retirement account to the nonparticipant spouse pursuant to a QDRO will be taxed to the nonparticipant spouse under the annuity rules of Code Section 72 (unless rolled over), rather than the participant spouse. IRC 414(p)(12). The nonparticipant spouse may rollover distributions to his/her own IRA or employer-sponsored retirement plan (via an initial rollover to an IRA). Treas. Reg. 1.402(c)-2, Q&A-12. However, payments made to a child pursuant to a QDRO will remain taxable to the participant spouse. Code Section 72(m)(10) and 402(a)(9).

In contrast, distributions to the nonparticipant spouse pursuant to a divorce decree that was not a QDRO will be taxed to the participant spouse (even though the benefits had been community property during the marriage).[5] Robert L. Karem and Hazel W. Karem v. Commissioner, 100 T.C. 521 (1987); A. Hawkins, 102 T.C. 61 (1987). This result is in keeping with the Service's position that the participant in a nonqualified plan (not subject to a QDRO due to their exemption from ERISA) will remain taxable on distributions to the nonparticipant spouse pursuant to a divorce decree.

[5] Such a distribution will also result in the plan's disqualification.

It is also worth noting that while the participant spouse will continue to be subject to the 10% excise tax on early withdrawals for distributions before age 59.5, the nonparticipant spouse will not be subject to that excise tax on distributions he/she receives prior to age 59.5 from his/her IRA in receipt of a share of the participant spouse's account. IRC 72(t)(2)(C).

e. Importance of Changing Beneficiary Designation. Unless the participant spouse is obligated pursuant to the divorce decree to maintain the nonparticipant spouse as beneficiary of the employer-sponsored benefit plan (or the nonparticipant spouse is to receive the benefits as a fiduciary for the children), it will be important for the participant spouse to take the nonparticipant spouse off the beneficiary designation.

In 2009, the United States Supreme Court ruled that a plan administrator acted properly in paying the deceased employee's benefits to his ex-wife in accordance with the beneficiary designation on file. The ex-wife had waived any entitlement to the benefits, and her waiver had been incorporated in the divorce decree. However, the divorce decree failed to qualify as a QDRO, which the Court concluded meant the plan administrator was obligated to honor the beneficiary designation on file. In arriving at that determination, the Supreme Court noted the importance of the plan administrator being able to rely on the "plan documents," which include the beneficiary designation and a QDRO but not a divorce decree failing to meet the criteria of a QDRO. Estate of Kennedy v. Plan Administrator for DuPont Savings and Investment Plan, 129 S. Ct. 865 (2009).

The United States Supreme Court had previously ruled that a plan administrator acted properly in paying the deceased employee's benefits to his ex-wife in accordance with the beneficiary designation on file, despite the fact that a state statute similar to Texas Family Code Section 9.302 purported to divest the ex-wife of any interest in the benefits. Egelhoff v. Egelhoff, 121 S. Ct. 1322 (2001). In finding that ERISA pre-empted the state statute, the Supreme Court again noted the importance of the plan administrator being able to rely on the "plan documents," rather than being required to stay apprised of potentially contradictory state statutes.

Note, in Kennedy and Egelhoff, the Supreme Court only addressed the issue of whether the plan administrators acted properly under the given circumstances. The Court did not address whether the participant spouse's estate/heirs had other recourse for forcing the ex-spouse to relinquish the benefits received (e.g., unjust enrichment). The presenter is unaware of any rulings or case law addressing this possibility.

3. Individual Retirement Accounts ("IRAs").

a. ERISA/REA. IRAs are not subject to ERISA (and, consequently, are not subject to REA).

b. Spouses' Planning for Division of IRA In Event of Divorce. Spouses are free at any time to address the manner in which their IRAs are to be distributed in the event of divorce. Ideally, this is done in either a premarital agreement or a marital property agreement executed during the marriage, rather than at the time of the actual divorce. Any waiver by the nonparticipant spouse of his/her rights in the accounts should specifically address the spouses' intentions in that regard, rather than be of a general nature intended to apply to all assets (including nonretirement assets).

The IRS has issued conflicting private letter rulings addressing whether an IRA partitioned into separate property shares for spouses pursuant to a marital property agreement can be physically divided during the marriage between separate IRAs for the spouses. See PLR 9439020 (indicating an actual division of the account into separate IRAs can be accomplished without incurring any tax under IRC 408(d)(1)), but PLR 199937055 takes a contrary position. In any event, an IRA may be divided pursuant to a divorce on a tax-free basis, as discussed below.

c. Division of IRA Upon Divorce. An IRA will be divided in the event of divorce in the manner agreed upon by the spouses in a premarital agreement/marital property agreement, if any. In the absence of such an agreement, ownership of an IRA will likely be determined by the Court in the same manner used for determining ownership of a defined contribution retirement plan, although TFC 3.007 expressly applies to the latter but not the former. As such, the Court will likely presume the IRA to be community property, subject to a spouse's demonstrating otherwise using the same tracing and characterization principles commonly applicable with nonretirement assets.

In any event, once the proper division of the IRA is established, the divorce decree will instruct the IRA administrator to split the account accordingly between the former spouses. (QDROs are only issued with regard to employer-sponsored retirement plans.)

d. Resulting Taxation. IRC § 408(d)(6) provides that an interest in the participant spouse's IRA can be transferred to an IRA for the nonparticipant spouse in a divorce without recognition of income if done pursuant to a divorce or separation instrument described in Code Section 71(b)(2)(A). However, if funds are withdrawn

from the participant spouse's IRA and given to the nonparticipant spouse to satisfy an obligation under the divorce decree, the withdrawal will be taxable to the participant spouse. Paul D. Harris, 62 T.C.M. 406 (1991).

Any distributions taken by the nonparticipant spouse from his/her newly established IRA before age 59.5 will be subject to the 10% excise tax on early withdrawals unless an exception applies. (In other words, the exemption from the 10% excise tax set out in IRC 72(t)(2)(C) only applies if the nonparticipant spouse's IRA receives funds from the participant spouse's employer-sponsored retirement plan pursuant to a QDRO.) See IRC 72(t)(3)(A).

e. Importance of Changing Beneficiary Designation. It is preferable for the participant spouse to take the nonparticipant spouse off the beneficiary designation, unless doing so would be contrary to the divorce decree or an agreed upon fiduciary arrangement whereby the ex-spouse is to receive the benefits on behalf of the children. However, Texas Family Code Section 9.302 should divest the ex-spouse of any rights to the participant's IRA at death, if his/her designation as the "primary beneficiary" was solely due to the participant spouse's neglect to submit a new beneficiary designation.

Note, the Supreme Court's refusal to accord a similar statute such effect in Egelhoff was based upon the fact that the retirement plan in question was subject to ERISA, which the Court concluded preempted the applicable state law. However, IRAs are not subject to ERISA. Consequently, Texas Family Code Section 9.302 would appear sufficient to divest an ex-spouse of any entitlement to the IRA benefits upon the participant spouse's death, if his/her designation as the "primary beneficiary" was strictly due to the participant spouse's failure to change the beneficiary for the account. In keeping with that same logic, a divorce decree divesting an ex-spouse of any right to the IRA benefits upon the participant's death would also seem sufficient, even if the participant spouse failed to change the beneficiary designation on file naming the ex-spouse. Of course, it is always recommended that the participant spouse change the beneficiary designation in order to avoid the need to rely on a state statute.

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

A. Partnership.

1. Entity Ownership. Under the entity theory adopted under the Uniform Partnership Act, partnership property is owned by the entity and not the individual partners.[1] A partner's right in specific partnership property is subordinate to the rights of the partnership entity to own and control the property. The partner may possess the property only for carrying out the partnership purposes. Partnership property is therefore not characterized as separate or community property.

The partner does have an interest in the partnership, which can be characterized as separate or community property. This includes the partner's right to receive profits and surplus.

This concept allows for marital planning opportunities in the partnership area. If separate property is contributed to the partnership, it would appear that the partnership interest received in return for such contribution constitutes the contributing spouse's separate property. Any different conclusion would allow a spouse to convert separate property to community property without meeting the requirements of the Texas Constitution and Family Code. Likewise, the partnership interest received as a result of a contribution of community property to a partnership should constitute the community property of the contributing spouses.[2]

2. Characterization of Partnership Income.

a. Federal Income Tax Treatment. Most partnerships elect for the partnership income to flow through to the partner's individual income tax return and for the related income tax to be paid by the partner. Each partner is then required to report their pro rata portion of the income or loss, regardless of whether that income was distributed to the partners or not. This can cause some inequalities on a joint income tax return if the tax is paid with community property funds.

b. Distribution of Partnership Funds. Regardless of whether the partnership interests themselves are community or separate property, distributions of

[1] TEX. REV. CIV. STAT. ANN. Art. 6132B; *See Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App. – Dallas 1987).

[2] Section 154.001(b) of the TBOC states "a partner's partnership interest may be community property under applicable law" and section 154.001(a) states "a partner's partnership interest is personal property for all purposes."

partnership income will constitute community property (absent a marital agreement between the spouses).

c. Undistributed Partnership Income. Once again, the assets of the partnership are not considered to be owned by any individual partner. Thus, if a partnership does not distribute excess earnings to the partners, and instead retains such funds, the retained partnership earnings do not become part of the community property estate. Should community property funds be used to pay the income taxes related to partnership income that has not been distributed to the partner, the value of the separate property partnership interest is enhanced while the community accounts are depleted by the payment of the partnership taxes.

d. Right to Reimbursement. Community property states recognize that the community portion is entitled to reimbursement for the time, toil, and talent spent by one spouse for the benefit and enhancement of his or her separate property.[1] For example, Husband is a partner in a partnership that is characterized as his separate property. Husband works for the partnership forty hours a week and contributes to the partnership making substantial income. Husband does not take a salary and does not take distributions from the partnership. Without a marital property agreement that states otherwise, the community could have a reasonable claim to reimbursement from Husband for adequate compensation for the significant services provided by Husband.

e. Use of an FLP (or FLLC). Applying the entity theory to family limited partnerships (an "FLP") or family limited liability companies (an "FLLC"), the partner/owner does not have an interest in the underlying assets of the entity, so the entity can be used as a planning tool for marital property purposes (as well as for many other estate planning purposes).

Among the many benefits of holding FLP and FLLC interests include:

i. ability to protect entity assets from claims brought against a partner,

ii. ability to protect partner assets from claims brought against the entity,

iii. gift and estate tax savings from opportunities associated with valuation discounts, and

iv. the ability to consolidate management of assets owned by various family individuals that are prone to fractionalization.

B. Property In Trust. Trusts allow for beneficial ownership without legal title. The trustee holds the legal title for the use and enjoyment of the beneficiary. The characterization of income, as well as the principal of a Trust, as to the beneficiary depends upon several factors including the identity of the settlor, the intention of the settlor, the identity of the Trustee, and the terms of the Trust regarding distributions. The existence of these factors has caused a multitude of cases which struggle with the classification issue.

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

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

3. Non-Self-Settled Trust. Where the settlor is not the beneficiary, income earned on the trust assets will

[1] *Jensen v. Jensen*, 665 S.W. 2d 107, 109 (Tex. 1984).

generally be separate property if distributed to the beneficiary or not marital property at all if retained in the Trust. This general rule is supported by several Texas cases including *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex. App. – Tyler 1996, no writ), *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. App. – Ft. Worth 1967, writ dism'd.), and *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App., 1896, writ ref'd.).

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

C. The Mandatory Income Trust. If a Trust is established by a third party for the benefit of a spouse, and the Trust requires or mandates that all income be distributed to the spouse, the separate or community property character of such distribution is subject to differing theories. One theory is that if the beneficiary also has an interest in the corpus of the Trust, then the income associated with that corpus should be considered community property income. That was the holding in *Ridgell v. Ridgell*, 960 S.W.2d 17 144 (Tex. Civ. App. – Corpus Christi, 1997, no writ). Most think that Ridgell was incorrectly decided – the court followed Fifth Circuit cases from the 1930's and 1940's that would no longer be consistent with Texas law.

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

VI. After the Divorce: Effect on Property and Existing Estate Plan.

A. Reproductive Rights. The definition of "property" in the area of reproductive rights has become more problematic in a society where advances have been made in reproductive medicine such as sperm donors, egg donors, in vitro fertilization and surrogate mothers.

1. Texas Law.

a. Under Section 160.702 of the Texas Family Code (which parallels Section 702 of the Uniform Parentage Act), a donor (whether sperm or egg) is not a parent of a child conceived by means of assisted reproduction.

b. Under Section 160.703 of the Texas Family Code (which parallels Section 703 of the Uniform Parentage Act), if a husband provides sperm for or consents to assisted production of his wife, then he is the father of the resulting child. Commentary to the UPA Section 703 indicates that only the husband can file an action denying paternity through lack of consent.

c. Under Section 160.7031 of the Texas Family Code (entitled "Unmarried Man's Paternity of Child of Assisted Reproduction"), if an unmarried man, with the intent to be the father of a resulting child, provides sperm to a licensed physician and consents to the use of that sperm for assisted reproduction by an unmarried woman, he is the father of a resulting child.

d. In *In the Interest of Olivia Grace McGill*, husband and wife created an embryo, which they cryogenically preserved. After husband and wife divorced, ex-wife had the embryo implanted and then claimed the ex-husband was not the father inasmuch as the divorce nullified his parental rights. However, the court disagreed with the mother and granted paternity rights to the biological father of the child, citing the interests of the father who was not a stranger or an uninvolved sperm donor.

2. Laws of Other States.

a. California. In *Hecht v. S.C.*, 16 Cal. App. 4th 836 (Cal. Ct. App. 1993), Mr. Kane bequeathed his cryopreserved sperm to his mistress, Deborah Hecht, under the terms of his Will. After Mr. Kane's suicide, his children sought to have the preserved sperm destroyed over the objections of Hecht who sought to conceive Mr. Kane's child. The Court ruled in favor of Hecht holding that Mr. Kane's cryopreserved sperm was a property right that passed as part of his estate, and

public policy did not prohibit a posthumous artificial insemination.

b. Tennessee. In *Davis v. Davis*, 842 S.W.2d, 588 (Tenn. 1992), the Tennessee Supreme Court decided the legal status of cryopreserved embryos in a divorce. The husband in this case wanted the embryos destroyed but the wife wanted to donate the embryos to a childless couple. The Tennessee Supreme Court held that because the parties did not execute a written agreement specifying the disposition of the unused embryos and no Tennessee statute had been enacted addressing this issue, neither party had a "true property interest in the embryos".

c. Massachusetts. In *AZ v. BZ*, 725 N.E.2d 1051 (Mass. 2000), a husband and wife entered into a contract that permitted the wife to use the couple's cryopreserved embryos to bear children, but after the couple divorced, ex-husband obtained an injunction prohibiting ex-wife from using or donating the embryos. The Massachusetts court concluded that it was against public policy to enforce a contract that would compel one donor to become a parent against his or her will.

B. Impact of Divorce on Existing Estate Planning Documents under Texas Law.

1. Wills. Under Section 69 of the Texas Probate Code, if, after making a Will, the testator's marriage is dissolved, whether by divorce, annulment, or declaration that the marriage is void, all provisions in the Will, including fiduciary appointments, shall be read as if the former spouse, and each relative of the former spouse who is not a relative of the testator, failed to survive the testator, unless the Will provides otherwise.

2. Revocable Living Trusts.

a. Under Section 472 of the Texas Probate Code, except as otherwise provided in (1) a court order or (2) the express terms of a trust instrument executed by a divorced individual before the individual's marriage was dissolved or (3) an express provision of a contract relating to the division of the marital estate entered into between a divorced individual and the individual's former spouse before, during, or after the marriage, the dissolution of the marriage revokes the following:

i. a revocable disposition or appointment of property made by a divorced individual to the individual's former spouse in a trust instrument executed before the dissolution of the marriage;

ii. a provision in a trust instrument executed by a divorced individual before the dissolution of the marriage that confers a general or special power of appointment on the individual's former spouse; and

iii. a nomination in a trust instrument executed by a divorced individual before the dissolution of the marriage that nominates the individual's former spouse to serve in a fiduciary or representative capacity, including as a personal representative, executor, trustee, conservator, agent, or guardian.

b. Section 472 of the Texas Probate Code further provides that after the dissolution of a marriage, an interest granted in a provision of a trust instrument that is revoked under Sections VII.B.2(a)(i) or VII.B.2(a)(ii) above passes as if the former spouse of the divorced individual who executed the trust instrument disclaimed the interest granted in the provision, and an interest granted in a provision of a trust instrument that is revoked under Section VII.B.2(a)(iii) above passes as if the former spouse died immediately before the dissolution of the marriage.

3. Financial Power of Attorney. Section 485A of the Texas Probate Code provides that a court decree dissolving marriage terminates an agent's authority under a power of attorney if the power of attorney was signed prior to the decree dissolving marriage, unless the power of attorney provides otherwise.

4. Medical Power of Attorney. Section 166.155(a)(3) of the Texas Health and Safety Code similarly provides that the divorce of principal and spouse revokes a medical power of attorney if the spouse is the principal's agent, unless the medical power of attorney provides otherwise.

5. Divorce Pending. None of the statutes listed above applies if a spouse dies during a divorce proceeding and prior to the dissolution of the marriage.

6. Documents Not Affected by Divorce.

a. Irrevocable Trusts. Texas law does not terminate a former spouse's status as a beneficiary of an irrevocable trust established by his or her spouse. Therefore, if a spouse creates an irrevocable QTIP trust or irrevocable life insurance trust as part of a comprehensive estate plan, Texas law will not prevent such former spouse from retaining his or her status as a beneficiary of such irrevocable trust after the parties' divorce.

b. Multi-party Accounts. Texas law will not prevent multi-party accounts such as joint tenancy with right of survivorship and payable on death accounts from passing to the surviving ex-spouse named on the account.

c. Life Insurance and Retirement Plans. As discussed below, life insurance and/or retirement plans governed by ERISA are not affected by Texas statutes preventing an ex-spouse from retaining the status as beneficiary of such policy or plan.

d. Annuities. An ex-spouse named as the beneficiary of an annuity is not prevented under Texas law from retaining his or her status as a beneficiary of such annuity.

e. Non-Texas IRAs. To the extent that an IRA is not governed by Texas law and the governing state has not adopted a statute similar to Section 9.302 of the Texas Family Code (as discussed below), Texas law will not prevent an ex-spouse from remaining as the beneficiary of such IRA.

C. Impact of Divorce on Life Insurance Policies and Retirement Plans.

1. Texas Law – Beneficiary Designations of Life Insurance Policies.

a. Under Section 9.301(a) of the Texas Family Code, if a decree of divorce or annulment is rendered after an insured has designated the insured's spouse as a beneficiary under a life insurance policy, a provision in the policy in favor of the insured's former spouse is not effective unless:

i. the divorce decree designates the insured's former spouse as the beneficiary;

ii. the insured redesignates the former spouse as the beneficiary after rendition of the divorce decree; or

iii. the former spouse is designated to receive the proceeds in trust for, on behalf of, or for the benefit of a child or a dependent of either former spouse.

b. If a designation under a life insurance policy is not effective under Section 9.301(a) of the Texas Family Code, the proceeds of the policy are payable to the named alternative beneficiary or, if there is not a named alternative beneficiary, to the estate of the insured. (See Section 9.301(b) of the Texas Family Code).

c. An insurer who pays the proceeds of a life insurance policy issued by the insurer to the beneficiary under a designation that is not effective under Section 9.301(a) of the Texas Family Code is liable for payment of the proceeds to the person or estate provided by Section 9.301(b) of the Texas Family Code only if:

i. before payment of the proceeds to the designated beneficiary, the insurer receives written notice at the home office of the insurer from an interested person that the designation is not effective under Section 9.301(a) of the Texas Family Code; and

ii. the insurer has not interpleaded the proceeds into the registry of a court of competent jurisdiction in accordance with the Texas Rules of Civil Procedure.

d. Notwithstanding the provisions of Section 9.301 of the Texas Family Code, the Texas Supreme Court and the U.S. Supreme Court have held that the Employee Retirement Income Security Act of 1974 ("ERISA") preempts Texas law and permits a former spouse to take as a beneficiary of a life insurance policy in the event of a divorce.

e. It is also important to note that the Texas statutes do not automatically terminate a former spouse's status as a beneficiary of an **irrevocable** life insurance trust, so it is important to revise life insurance policies accordingly.

2. Texas Law – Beneficiary Designations of Retirement Plans.

a. Section 9.302(a) of the Texas Family Code provides that if a decree of divorce or annulment is rendered after a spouse, acting in the capacity of a participant, annuitant, or account holder, has designated the other spouse as a beneficiary under an individual retirement account, employee stock option plan, stock option, or other form of savings, bonus, profit-sharing, or other employer plan or financial plan, the designating provision in the plan in favor of the other former spouse is not effective unless:

i. the decree designates the other former spouse as the beneficiary;

ii. the designating former spouse redesignates the other former spouse as the beneficiary after rendition of the decree; or

iii. the other former spouse is designated to receive the proceeds or benefits in trust for, on behalf of, or for the benefit of a child or dependent of either former spouse.

b. If a designation is not effective under Section 9.302(a) of the Texas Family Code, the benefits or proceeds are payable to the named alternative beneficiary or, if there is not a named alternative beneficiary, to the designating former spouse. (See Section 9.302(b) of the Texas Family Code).

c. A business entity, employer, pension trust, insurer, financial institution, or other person obligated to pay retirement benefits or proceeds of a financial plan covered by this section who pays the benefits or proceeds to the beneficiary under a designation that is not effective under Section 9.302(a) of the Texas Family Code is liable for payment of the benefits or proceeds to the person provided by Section 9.302(b) of the Texas Family Code only if:

i. before payment of the benefits or proceeds to the designated beneficiary, the payor receives written notice at the home office or principal office of the payor from an interested person that the designation of the beneficiary or fiduciary is not effective under Section 9.302(a) of the Texas Family Code; and

ii. the payor has not interpleaded the benefits or proceeds into the registry of a court of competent jurisdiction in accordance with the Texas Rules of Civil Procedure.

d. Section 9.302 of the Texas Family Code does not affect the right of a former spouse to assert an ownership interest in an undivided pension, retirement, annuity, or other financial plan.

e. Notwithstanding the provisions of Section 9.302 of the Texas Family Code, like the beneficiary designations of life insurance policies, to the extent that federal law conflicts with Texas law on marital property, federal law controls and permits a former spouse to take as a beneficiary of a qualified plan in the event of a divorce. Accordingly, Section 9.302 of the Texas Family Code is preempted by ERISA. Section 9.302 of the Texas Family Code is also not applicable to state retirement plans such as the Teacher Retirement System.

i. In *Kennedy v. Plan Administration for Dupont Savings and Investment Plan*, 129 S.Ct. 865 (2009), Mr. Kennedy named his wife as the beneficiary of his Dupont pension and retirement plan prior to their divorce. By operation of law, his estate was the alternate beneficiary of his retirement plan. Pursuant to the divorce, Mrs. Kennedy was divested of all right, title and interest and claim in and to any retirement plan, pension plan or like benefit program. However, Mr. Kennedy never revised the beneficiary designation on his retirement plan, and upon his death, the Dupont plan administrator paid the proceeds ($400,000) to his ex-wife, rather than to Mr. Kennedy's executor. The 5th Circuit ruled that in the absence of a Qualified Domestic Relations Order, the wife's waiver in the divorce decree violated the anti-alienation clause of ERISA and was ineffective. The U.S. Supreme Court, however, rejected this analysis and instead ruled that the anti-alienation clause of ERISA does not bar a spouse's waiver. Nevertheless, the Supreme Court held that the plan administrator fulfilled its statutory ERISA duty by paying the benefits to the named beneficiary in accordance with the plan documents. The Supreme Court reasoned that ERISA provided a bright-line rule that plan documents must be followed to distribute benefits and because the beneficiary change was not affected under the plan document, no beneficiary change was made.

ii. In *Boggs v. Boggs*, 530 U.S. 833 (1997), a case decided by the U.S. Supreme Court twelve years before *Kennedy*, the Supreme Court made it clear that ERISA preempted state community property laws where the effect of such laws is to affect a field which Congress has appropriated for a federal purpose to carry out a uniform federal scheme. In deciding whether Congress had pre-empted this field, the Court examined several provisions of ERISA and determined that the purpose of the statute is to protect the interests of participants and beneficiaries. The Court held that because community property claims are not consistent with ERISA's statutory scheme, community property laws are preempted by ERISA. In reaching its decision in Boggs, the Court stressed that the purpose of ERISA is for the living.

D. Effect on Interests in a Partnership or Corporation under Texas Law.

1. Partnership Property. Partnership property belongs to the partnership and not to the individual partners. Therefore, upon a divorce, the assets in a partnership should remain in the partnership (assuming the partnership is not dissolved) and the partnership interest will be divided. Pursuant to Section 152.406(a)(1) of the Texas Business and Organizations Code, on the divorce of a partner, the partner's spouse, to the extent of the spouse's partnership interest, is a transferee of the partnership interest from the partner.

2. Assets of the Corporation. Like a partnership, a corporation's assets belong to the corporation. Additionally, a corporation is protected by a corporate shell, which generally can only be pierced in extreme circumstances. In the context of a divorce, this is known as "reverse piercing".

a. Piercing the corporate veil in a divorce case allows the divorce court to characterize assets in a spouse's corporation as community property corporate assets that would otherwise be the separate property of one spouse. *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App. – Fort Worth 1985).

b. To properly pierce the corporate structure in a divorce case, the trial court must find something more than "dominance of the corporation" by the spouse. *Zisblatt*, 693 S.W.2d at 955. At a minimum, a finding of alter ego sufficient to justify piercing in the divorce context requires (i) unity between the separate property corporation and the spouse such that the separateness of the corporation has ceased to exist, and (ii) the spouse's improper use of the corporation damaged the community estate beyond that which might be remedied by reimbursement. *Id*.

3. Buy/Sell Agreements.

a. A Company's buy/sell agreement or shareholder agreement can provide some certainty to a business owner in the event of a divorce. A buy/sell agreement defines the procedure for any change of ownership in the company, including divorce. Most business owners are resistant to any ownership interest being transferred outside of the core group of initial investors. A buy/sell agreement gives the owners in the initial group rights of first refusal to purchase an owner's interest in the event such owner's interest is transferred to someone other than the initial group of investors, such as upon a divorce.

b. Texas law does not impair an agreement for the purchase or sale of a partnership interest or shareholder's interest at any time, which would include the divorce of an owner.

c. Tax Consequences.

i. The tax consequences of property transfers incident to a divorce are governed by I.R.C. Section 1041, which holds that transfers of property between spouses incident to divorce are generally not taxable. This rule follows the general concept in the Internal Revenue Code that property dealings between spouses should be free of income tax consequences.

ii. A transfer of property is presumed to be "incident to divorce" if the transfer is related to the cessation of the marriage. Transfers occurring within one year after the cessation of the marriage are presumed to be incident to divorce. Transfers outside the one-year time-frame are presumed to be incident to divorce if the transfer is documented in the divorce decree or other written agreement incident to divorce. Transfers occurring more than six years after the date of the cessation of the marriage are presumed to not be incident to divorce.

iii. Notwithstanding the foregoing, care must be taken when structuring the transfer of interests in closely held corporations and business entities so as to avoid unintended tax consequences. Consider the situation where spouse A has the option of either acquiring spouse B's stock for a note in a divorce or having the closely held corporation redeem it. If the corporation redeems the stock, the apparent treatment of the redemption would be to tax B on the gain realized with respect to the receipt of the redemption proceeds (assuming it is a complete termination of spouse B's interest in the corporation). However, some courts have interpreted such a redemption as involving a constructive distribution from the corporation to A (usually resulting in a constructive dividend to A), followed by a transfer from A to B of the redemption proceeds, which is tax-free under Section 1041.

iv. In 2003, Treasury Regulation 1.1014-2 was issued and it provides that the parties may specify the nature of the transaction (redemption by the redeeming spouse or constructive distribution to non-redeeming spouse), which in turn drives the character of the income as either dividend income or capital gain. Accordingly, the parties should agree to the tax treatment of a stock redemption pursuant to an agreement in accordance with Treas. Reg. 1.1014-2.

VII. Checklist of Things to Do After Divorce.

A. Remove Former Spouse and Relatives From the Estate Plan. Texas law *may* accomplish the desired result of removing the ex-spouse and his or her relatives from the client's estate plan, but it should *not* be relied upon to do so.

1. The client's Will should be revised to remove ex-spouse (including fiduciary appointments).

2. The client's revocable trust should be restated or amended to remove the ex-spouse as a beneficiary and as a fiduciary.

3. Multi-party accounts should be retitled to exclude the ex-spouse.

4. Beneficiary designations on life insurance, annuities and retirement plans should be revised.

B. Ensure Client Complies with Support Obligation Owed to Prior Spouse and/or Children From Prior Marriage and Marital Property Agreements.

1. It is common for estate planning attorneys to neglect to incorporate a client's obligation to a former spouse and/or children under a settlement agreement or final divorce decree into the client's estate plan. Similarly, a client's estate plan should also incorporate any obligation assumed under a marital property agreement (e.g., a bequest to spouse of a specified amount or specific asset).

2. As a caveat, prospective spouses will commonly agree in a prenuptial agreement for one of them to waive his/her rights in the other's retirement plan. Federal law requires that a spouse waive such right, making the spouses' post-marriage ratification of a prenuptial agreement containing that waiver necessary. The post-marriage waiver should be filed with the plan administrator as well.

C. In the Event of a Remarriage, Pay Close Attention to Tax Apportionment. It is important to ensure any estate tax due on gifts made to children from a prior marriage will not be borne by any gifts made to the current spouse.

1. For example, a typical estate plan will provide for any debts, expenses, and taxes due at the first spouse's death to be borne by the residuary estate (commonly, the QTIP). Since a typical estate plan will consist of a bequest by the deceased spouse of his/her estate tax exemption amount to the Bypass Trust and a bequest of the residuary estate to the QTIP, there will obviously be no estate tax due. However, if a sizeable bequest (i.e., in excess of the deceased spouse's estate tax exemption amount) is provided for children from a prior marriage (e.g., the deceased spouse's business), then the typical tax apportionment would cause the portion of the estate set aside for the surviving spouse (the QTIP) to bear the estate tax due on the children's gift of the decedent's business.

2. Not only will this apportionment of the estate taxes commonly be against the deceased spouse's wishes, but it will cause the overall estate tax ultimately due to be greater than would be the case if the estate tax were borne by the children's share of the estate due to the interrelation calculation required to account for the marital deduction's reduction by the estate tax.

PREMARITAL AGREEMENT—FORM PROVISIONS

1. EACH RETAINS SEPARATE RESIDENCE/COMMUNITY PROPERTY RESIDENCE

Residences. It is the Parties' intention that the residences owned prior to their marriage will be maintained as their respective separate property ("Separate Property Residences"). It is the Parties' further intention to purchase a new residence ("New Residence") to use as their homestead during marriage. The New Residence will be paid for with Groom's separate property funds, but it is the Parties' intention to treat the New Residence as community property ("Community Property Residence"). The Parties intend that this Community Property Residence will be owned with right of survivorship, so that upon the first Party's death, his or her interest will pass to the surviving Party. Notwithstanding anything to the contrary in this Section _____, if the Parties' marriage should terminate by divorce, then the Community Property Residence will be divided equally between the Parties in accordance with Section _____.

Personal Effects, Household Furniture, Furnishings, Etc. Any separate property personal effects, household furniture, furnishings or other similar items that either Party brings into the Community Property Residence shall remain the separate property of that Party. Any personal effects, household furniture, furnishings or other similar items purchased for use in the Community Property Residence shall be deemed to be a community property asset, and will be deemed to be owned with right of survivorship, so that upon the first Party's death, his or her interest will pass to the surviving Party. Notwithstanding anything to the contrary in this Section _____, if the Parties' marriage should terminate by divorce, then any community property personal effects, household furniture, furnishings, etc. will be divided equally between the Parties in accordance with Section _____.

Homestead. In is anticipated that at the date of their marriage, Groom and Bride will each have residential real property which will remain their respective Separate Property. At this time, they do not intend to reside in either Separate Property Residence, but rather to purchase a Community Property Residence (as provided in Section _____). Since they anticipate having both Separate Property Residences and a Community Property Residence, and whereas the

Community Property Residence will pass by right of survivorship in accordance with Section _____, Groom and Bride agree to the following with respect to "homestead" rights pertaining to their respective Separate Property Residences: In the event of a Party's death, the surviving Party irrevocably waives any right he or she might otherwise have under the provisions of any "homestead" rights, now or hereafter in force under the Constitution or the laws of Texas or any other state or foreign nation, as well as all rights he or she might have under the provisions of the Texas Probate Code, as amended, relating to the right to have a life estate in such homestead if that homestead is the Separate Property of the deceased Party. Notwithstanding the foregoing, if the Parties were using the Separate Property residence as their homestead at the time of a Party's death, then the surviving Party shall have the right to remain in the Separate Property homestead residence for a period not to exceed ____ days/months following the death of the other Party. During this period of time, the surviving Party shall have the same responsibilities, liabilities and duties of care as a homestead claimant towards the real property in which he or she continues to reside.

2. PRIMARY RESIDENCE/ NO WAIVER OF HOMESTEAD AT DEATH

No Waiver of Homestead With Respect to Primary Residence. Notwithstanding what may otherwise be provided in this Agreement, in the event of Groom's death, Bride does not waive any rights she may have under the provisions of any "homestead" rights, now or hereafter in force under the Constitution or the laws of Texas or any other state or foreign nation, nor any rights she may have under the provisions of the Texas Probate Code, as amended, relating to the right to have a life estate in the primary residence in which she and Groom are living at the time of Groom's death (or in which Groom last lived prior to his death). If there is more than one residence in which Groom and Bride reside, and it is unclear as to which is being used as their primary residence at the date of Groom's death, then Bride will be allowed to select the residence to which the homestead rights will apply. Currently, it is anticipated that Groom's separate property residence in _____, _____ County, Texas will be their primary residence. Bride waives any claim of homestead rights with respect to any other separate property of Groom.

3. WAIVER OF HOMESTEAD AT DEATH OF SPOUSE

Waiver of Homestead. In the event of a Party's death, the surviving Party irrevocably waives any right he or she might otherwise have under the provisions of any "homestead" rights, now or hereafter in force under the Constitution or the laws of Texas or any other state or foreign nation, as well as all rights he or she might have under the provisions of the Texas Probate Code, as amended, relating to the right to have a life estate in the homestead. Notwithstanding the foregoing, the surviving Party shall have the right to remain in the homestead residence for a period not to exceed _____days/months following the death of the other Party. During this period of time, the surviving Party shall have the same responsibilities, liabilities and duties of care as a homestead claimant towards the real property in which he or she continues to reside.

4. MANAGEMENT OF SEPARATE PROPERTY / GIFTING AND TAX CONSIDERATIONS

Each Party has the full, free, and unrestricted right to manage the separate property over which he or she has control under section 3.101 of the Texas Family Code or succeeding provisions of similar import and nature, including without limitation the right to convey or encumber the property, to dispose of it by sale, gift, or otherwise, and to deal with it without taking into consideration any rights or interests of the other Party. If the joinder of Groom and Bride ("Joining Party") should be required by law in connection with the execution of any document by the other Party with respect to the separate property of the other Party, on request and from time to time, the Joining Party must execute all such documents necessary to effect the desires of the other Party, including gift tax returns, but without any personal liability of the Joining Party. Neither Party has the authority to encumber or dispose of the other Party's separate property without the other Party's express written consent. Notwithstanding any of the provisions set forth in this Section _____, the parties agree that any gift made by a Party that would be applied to the other Party's federal annual gift tax exclusion, gift tax exemption, estate tax exemption, or GST exemption must be consented to in writing by the other Party before the making of the gift.

5. WAIVER OF REIMBURSEMENT CLAIMS

The Parties specifically release and waive any rights of and claims for reimbursement now existing or arising in the future among the estates of the Parties. Specifically, both Parties waive: the right to assert any claim for reimbursement that he or she might have in the future on behalf of or against the community estate; and, the right to assert any claim for reimbursement that he or she might have in the future against the separate estate of the other Party.

6. RICH SPOUSE / POOR SPOUSE

LUMP PAYMENT OF SUPPORT UPON DEATH OF BRIDE

If Bride should die during the marriage then, notwithstanding any other provisions Bride may make for Groom, Groom shall receive monthly payments in the amount of _____Dollars ($_____), payable from Bride's estate or a trust she establishes for such purpose, for the remainder of Groom's lifetime. It is intended that the right provided to Groom hereunder following Bride's death to receive certain payments outlined above shall comply with the requirements of Section 59A(a)(1) of the Texas Probate Code, in order to supersede any conflicting provisions currently incorporated or later added to Bride's estate plan.

7. RICH SPOUSE / POOR SPOUSE

DISSOLUTION OF MARRIAGE BY DEATH

Cash Payment Upon Death of Groom. If Groom should die during the marriage then, notwithstanding any other provisions Groom may make for Bride, Bride shall receive an outright cash payment calculated as follows.

(a) For each full calendar month the Parties were married, Bride will receive _____Dollars ($_____), subject to the restrictions in Section ___(b) below.

(b) The cash payment due to Bride under this Section shall not exceed the lesser of (i)_____Dollars ($_____), and (ii) ___ percent (___%) of Groom's net worth (defined in Section _____ below).

The cash payment due to Bride under this Section shall be delivered to her on or before the thirtieth (30^{th}) day following Groom's date of death.

The duration of the Parties marriage for purposes of this Section ____ shall be calculated from the date of their marriage to the date of Groom's death. Any partial month at the beginning of the marriage or at the date of Groom's death shall not be used in calculating the cash payment, unless the partial months of both periods should add up to a full month of marriage.

DISSOLUTION OF MARRIAGE BY DIVORCE OR ANNULMENT

Property Division. The Parties are looking forward to a happy marriage for the rest of their lives and do not believe that there will ever be a separation or dissolution of their marriage during their lives. Although this Agreement is made without either Party having the intention of bringing about a subsequent dissolution through annulment or divorce, the Parties recognize that such an occurrence is within the realm of possibility, and they wish to provide for such an eventuality in the following manner.

(a) The provisions of this Agreement shall not be terminated by a divorce or annulment except as specifically provided for in this Agreement.

(b) In the event of a divorce or annulment, except as otherwise provided in this Agreement, neither Party shall have any right against the other by way of claim for support, alimony, attorney's fees, costs, or division of property in any such divorce or annulment proceeding.

(c) If the Parties' marriage is dissolved by divorce or annulment by any court, wherever located, each Party is to retain his or her separate estate determined as of the date of any such divorce or annulment as his or her Separate Property following the dissolution.

(d) Any Community Property is to be divided equally between the Parties according to its value. To effect this provision, the Parties relinquish and disclaim any right they may have to seek a division of their property other than in accordance with this paragraph and agree to indemnify the other for the value of any property that

may be awarded by a court in excess of the value that would result if division were in accordance with this paragraph.

Marital Rights. Except as specifically provided for in this Agreement, each Party hereby waives and releases any and all claims he or she may have against the other Party (or against the other Party's estate) or that may otherwise arise as described in Section _____ above; provided, however, this provision shall not prevent a Party from voluntarily making provisions for the other Party, during lifetime or at death, but neither Party is relying on the other Party having made any of such provisions.

Cash Payment Upon Divorce. Notwithstanding anything to the contrary in this Agreement, in the event of a divorce Groom agrees to make a cash payment outright to Bride calculated as follows.

(a) For each full calendar month the Parties were married, Bride will receive _____ Dollars ($_____), subject to the restrictions in Section _____(b) below.

(b) The cash payment due to Bride under this Section shall not exceed the lesser of (i) _____ Dollars ($_____), and (ii) _____ percent (__%) of Groom's net worth (defined in Section _____ below).

The cash payment due to the Bride under this Section shall be delivered to her no later than the thirtieth (30^{th}) day after the date the divorce becomes final.

The duration of the Parties marriage shall be calculated from the date of their marriage to the date either party files an initial proceeding for divorce. Any partial month at the beginning of the marriage or at the date either party files an initial proceeding for divorce shall not be used in calculating the cash payment, unless the partial months of both periods should add up to a full month of marriage.

Net Worth. In calculating _____ percent (__%) of Groom's net worth, as provided in Sections _____(b) and _____(b), values will be calculated as follows:

(a) Interests in closely held entities will be based on book value; and

(b) Interests in real estate will be based on appraised fair market value.

The Parties will mutually agree on an appraiser to determine the fair market value of the interests in real estate. If the Parties are unable to agree in good faith on an appraiser, then Groom and Bride (or his or her heirs, executor, or other legal representative, if applicable) shall each select an appraiser with at least five (5) years of experience in the valuation of real estate similar to the real estate being appraised, and the costs of each appraiser shall be borne by the Party selecting such appraiser. Each such appraiser shall, within thirty (30) days of being selected, deliver their respective appraised values of the real estate interests, and the fair market value of such interest shall be the average of the appraisers' values.

8. SEPARATE PROPERTY RESIDENCE

Property of Bride.

(a) …

(b) …

(c) The residence identified by street address _____, _____, _____ County, Texas _____ (the "Residence") is and shall remain the Separate Property of Bride. Groom, his creditors, his estate, or his heirs shall have no claim to the Residence including all mutations, changes, future cash flows, and increases in kind or in value of such Separate Property.

Notwithstanding this Section _____(c), the Parties agree to the following terms concerning the Residence.

Each Party hereby waives on behalf of his or his Separate Property Estate, and on behalf of the Community Property Estate, any claim or right to reimbursement that may arise to such Estate pursuant to Section 3.402 of the Texas Family Code or any other law with respect to funds of any such Estate applied to (i) reduce the principal amount due on a note secured by a lien on the Residence, (ii) make capital improvements to the Residence, or (iii) pay any other debt, expense, or charge with respect to the Residence.

The Parties agree that on the date that is the earlier of the date (i) either Party files for divorce or (ii) either Party dies, the Residence will remain Bride's Separate Property, but Groom

will have a claim against the Community Property Estate (or, if insufficient, from Bride's Separate Property Estate) equal to the Residence Value (as defined below), if any. For purposes of this Agreement, the Residence Value will be equal to an amount that is one-half of the following: the fair market value of the Residence as of such date (as agreed upon by the Parties in writing, or, if none, as set by a qualified real estate appraiser chosen by an agreement of the Parties), less the total amount of principal due on any note(s) secured by a lien on the Residence as of such date, less _____ Dollars ($_____). [Note outside the Form: This last dollar amount represents the owner/party's equity in the residence at the time of the marriage.]

The Parties agree that if, prior to the date that is the earlier of the date (i) either Party files for divorce or (ii) either Party dies, a transaction in which Bride sells the Residence closes, the sales proceeds from the sale will remain Bride's Separate Property, but Groom will be entitled to an amount of the sales proceeds received by Bride as his Separate Property equal to one-half of the following amount: the sales price of the Residence (less all closing costs charged to Bride per the transaction), less the total principal amount owed by Bride on any note(s) secured by a lien on the Residence, less _____ Dollars ($_____).

9. LIMITATIONS ON EXPENDITURES FOR CHILDREN FROM PRIOR MARRIAGE

PERSONAL EXPENDITURES

The Parties wish that any education expenses paid for a child of Bride's (who is not also a child of Groom) that may properly be paid from a 529 Plan without penalty and as provided under the related federal income tax law shall first be paid out of any 529 Plan(s) in such child's name that have been established for the benefit of such child. Only after such account(s) have been depleted will Community Property be used for such expenses to such children's education.

OR

PERSONAL EXPENDITURES

The Parties wish that any education expenses paid for a child of Bride's (who is not also a child of Groom) that may properly be paid from a 529 Plan without penalty and as provided under the related federal income tax law shall first be paid out of any 529 Plan(s) in such child's

name that have been established for the benefit of such child. Only after such account(s) have been depleted will Bride's Separate Property be used for such expenses related to such child's education. To the extent Bride's Separate Property is insufficient to pay for expenses related to such child's education, Community Property funds may be used to satisfy the education expenses identified in this Article provided, however, that Bride agrees to reimburse the Community Property estate, dollar-for-dollar, for any Community funds used for this purpose.