

**WILLS AND REVOCABLE TRUSTS –  
WHAT’S BEST FOR THE CLIENT?**

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# WILLS AND REVOCABLE TRUSTS - WHAT'S BEST FOR THE CLIENT?

Thomas M. Featherston, Jr.

## I. INTRODUCTION

During the past twenty years consumer demand and attorney acceptance have made the revocable trust an important tool in the planner's "tool box." Accordingly, the primary purpose of this paper is not to debate the viability of the revocable trust as a "tool," but to compare and contrast revocable trust planning with traditional testamentary planning (where the will and a well-drafted durable power of attorney remain the cornerstones of the estate plan). See Exhibit attached.

In addition, the outline addresses the creation (i.e., drafting and funding) of the revocable trust in two contexts. First and foremost, attention will be given to the *funded revocable trust* where the settlor places most, if not all, of the estate into the trust arrangement prior to the settlor's death. Second, in what will be referred to as "*stand by trust*" planning, the settlor enters into a trust agreement with the trustee; however, at the time the trust is created, the trust is only nominally funded. In addition, the settlor executes a durable power of attorney authorizing an agent to fund the trust in the event of the settlor's subsequent incapacity. If the settlor's death occurs before the settlor (or the settlor's agent) funds the trust, the decedent's assets will pass under the will and then "*pour-over*" into the revocable trust arrangement. Thereafter, the outline will address community property law issues regarding revocable trust planning.

*Now, for the answer to the question posed in the title of this presentation . . . It depends! Both traditional testamentary planning and revocable trust planning are viable, useful tools. For some clients, a*

*revocable trust may be more appropriate; for others, the will should be the key dispositive document.*

## II. THE BASICS

One noted authority describes the private express trust as ". . . a device for making dispositions of property. And no other system of law has for this purpose so flexible a tool. It is this that makes the trust unique. . . . The purposes for which trusts can be created are as unlimited as the imagination of lawyers." Scott, Trusts 3,4 (3d. Ed. 1967).

### A. Definition

A trust, when not qualified by the word "charitable," "resulting" or "constructive," is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of the intention to create the relationship. Restatement Trust (Second) § 2. Compare Tex. Prop. Code § 111.004(4).

### B. Methods

According to Section 112.002 of the Texas Trust Code, a trust may be created by: (i) *a property owner's declaration that the owner holds the property as trustee for another person;* (ii) *a property owner's inter vivos transfer of the property to another person as trustee for the transferor or a third person;* (iii) *a property owner's testamentary transfer to another person as trustee for a third person;* (iv) *an appointment under a power of appointment to another person as trustee for the donee of the power or for a third person;* or (v) *a promise to another person whose rights*

under the promise are to be held in trust for a third person.

*Note: Filipp v. Till, 230 S.W.3d 197 (Tex. App.—Houston [14<sup>th</sup> Dist.] 2006, no pet) held that an agent acting under the authority of a durable power of attorney cannot create a trust on behalf of the agent's principal because the settlor must manifest the intent to create the trust. However, an agent under a durable power of attorney does have the authority to transfer the principal's property to an existing trust. Tex. Prob. Code 499 § (6).*

### **C. Revocable and Irrevocable Trusts**

Inter vivos trusts are further divided into two categories: revocable and irrevocable. A revocable trust is one that can be amended or terminated by the settlor. An irrevocable trust, in contrast, is one which cannot be amended or terminated by the settlor for at least some period of time. The presumption regarding the revocability of inter vivos trusts varies by jurisdiction. For example, in Texas all trusts are revocable unless the trust document expressly states otherwise, while in some other states trusts are deemed irrevocable unless the trust document states otherwise. Texas Prop. Code § 112.051. See Restatement (Second) Trusts, Sec. 330; Bogert, Law of Trusts and Trustees, § 998 (1983).

### **D. Tax Consequences**

Traditional testamentary planning and revocable trust planning are subject to essentially the same tax consequences and planning opportunities. The creation and funding of the revocable trust are not taxable events for gift tax purposes because of the power of revocation. See Treas. Reg. § 25.2511-2. During the settlor's remaining lifetime, the settlor will be treated as the owner of the revocable trust assets for income tax purposes. IRC § 671-677. The

assets of the revocable trust will be included in the settlor's gross estate for transfer tax purposes upon the settlor's death. IRC § 2038. Further, due to the Taxpayer Relief Act of 1997, there remains very little difference in the post-death income tax treatment of revocable trusts and probate estates. Consequently, tax reasons are generally not good reasons, in and to themselves, to implement revocable trust planning.

### **E. Settlor's Subsequent Death/Incapacity**

Upon the death of a settlor, the revocable trust becomes irrevocable but a revocable trust is generally not deemed "irrevocable" due to the settlor's later incapacity prior to death because the settlor's guardian can petition the probate court for authority to revoke the trust. *Weatherly v. Byrd*, 566 S.W.2d (Tex. 1978). However, it would be advisable to confirm this concept in the document to negate an argument that the trust has become irrevocable unless that the settlor's original intent was for the trust to become irrevocable upon incapacity. In which event, after considering the possible consequences, the document should so state and clearly define incapacity by an objective standard.

*Note: Whether intentional or not, a revocable trust becoming irrevocable prior to the settlor's death can create potential tax, creditor and even rule against perpetuities issues. For example, if the trust becomes irrevocable prior to the settlor's death, a taxable event for gift tax purposes may be triggered if in fact a completed gift of a future interest to others occurs by reason of the trust becoming irrevocable. A transfer in fraud of creditors may occur, and the perpetuities period will begin to run when it becomes irrevocable.*

### **III. THE USES OF THE REVOCABLE TRUST**

As explained in I.D., *supra.*, revocable trusts are not needed for basic transfer tax planning since the settlor is deemed to be the owner of the revocable trust assets for tax purposes (i.e., the same tax planning opportunities exist in traditional testamentary planning). However, there are a number of non-tax reasons for considering the use of the revocable trust. The more popular, non-tax reasons include:

#### **A. Providing for Current Management of the Estate**

An individual may decide for any number of reasons (age, politics, travel, inexperience) to have all or part of his or her assets managed by someone else either for a limited period of time or for an even longer duration (such as the settlor's entire remaining lifetime).

#### **B. Providing for Current Management of Certain Assets**

While retaining the personal management of most of the estate, an individual may want certain assets to be managed separate and apart from the general estate. For example, a spouse may wish to place his or her separate assets in a trust relationship to maintain its separate status. Co-owners of real estate, oil and gas properties, and other closely held business interests may use the revocable trust as a means of managing their common property on long term, short term or transitional basis. The revocable trust could be an approach to test the managerial ability of the younger generation before the older generations irrevocably turns an asset over to the successors.

#### **C. Avoiding Possible Will Contest**

Many lawyers feel the trust is less susceptible to a successful challenge by disappointed heirs than a will. While not immune from challenge, there are obstacles to overcome which are not present in a will contest. Koenig reports that:

Perhaps the greatest obstacle in setting aside a trust is obtaining standing to sue. As no notice need be given of the creation of a funded revocable trust, many beneficiaries are not even aware that the trust exists. Even potential heirs who are aware of the trust cannot challenge it during the grantor's life as they are only heirs apparent or expectant. *Davis v. Hunter*, 323 F.Supp. 976,979 (D. Conn. 1970). Upon the grantor's death, the actual heirs may still lack standing to challenge the trust as only the duly appointed personal representative has standing to bring suit on behalf of the decedent regarding the decedent's assets. *Davis v. Hunter, Id.*; *Talley v. Talley's Estate*, 383 So.2d 1065(LaApp. 1980) writ refd 391 So.2d456.

Even if the heirs are able to get over the standing hurdle, they still face practical difficulties in successfully challenging the trust. A respectable third party, such as a bank named as trustee of a funded trust, can be a credible witness used to establish the fact that the grantor had capacity and was in control of his affairs. The grantor's continuing contacts with the trustee may constitute continuous validation of the trust and of the grantor's capacity. Thus, an attack on a trust following the grantor's death, after the trust has been in operation during the grantor's life, appears less likely to succeed than an attack on a will. Koenig "Use of Trusts in Estate

Planning," 1991 Wills and Probate Institute, Houston Bar Association.

Note: Consider the effect of *Tex. Prop. Code § 112.038* which addresses the effect of "no contest" clauses in trusts. For a good discussion on the procedural differences, see Jay Hartnett and Lisa Jamieson, "Will Contests in the 21<sup>st</sup> Century – They Aren't What They Used to Be," 2011 State Bar of Texas Advanced Estate Planning and Probate Course.

#### **D. Defeating Marital Rights**

Revocable trusts have been used by individuals in common law states with varying degrees of success to attempt to defeat the statutory shares of surviving spouses. See "The Use of the Revocable Trust for Defeat the Elective Shares." 57 Fla. Ba. J. 110(1983). Where community property is involved, the revocable trust may prove to be more effective in disposing of the entire community than "election" wills or "contractual" wills. It may even give a spouse more flexibility in planning for the spouse's separate property, including the homestead. See VI, F and X, *supra*.

#### **E. Providing for "Dead Hand" Control**

Planning with a revocable trust, as opposed to a will, can offer assurances that the dispositive plan will be carried out since the plan itself is already in effect at the settlor's death and cannot be legally overturned without the consent of the trustee and remainder beneficiaries. On the other hand, testamentary planning does not go into effect until the will is probated and can be defeated by the family's failure to probate the will.

#### **F. Avoiding Probate Administration**

The so-called "horrors of probate" have been suggested by some promoters as the major reason to fund a revocable trust rather

than having one's assets pass at death through probate administration and on to devisees under a will.

#### 1. ADVANTAGES

Fully funding the revocable trust with all of the settlor's assets will avoid the possible need for an ongoing dependent probate administration which could be time consuming and expensive. Administering the decedent's assets through the funded revocable trust would, therefore, obviate the need for a probate inventory, annual and final accountings, and court appointed appraisals. The revocable trust also offers the opportunity to eliminate or reduce court costs, the commissions of personal representatives and certain attorney's and accounting fees. Many of the transactions occurring during the administration that would otherwise need probate court approval can be accomplished by the trustee simply carrying out the powers granted to the trustee in the trust document.

#### 2. TEXAS ADMINISTRATION

However, Texas law already gives testators the option of creating an independent administration, thereby, in effect, allowing the independent executor to administer the decedent's estate similar to the way a trustee of a private express trust administers the trust. Further, if there are no debts outstanding other than those secured by real estate, the will can be admitted to probate as a muniment of title, thereby avoiding any type of administration. Texas Prob. Code § 89C.

#### 3. THE REAL QUESTION

*Accordingly, in a solvent estate situation, the real question is whether the anticipated reduction in future probate costs will be offset by the immediate cost of creating, funding and administering the*

*trust during the remainder of the settlor's lifetime.*

### **G. Segregating Certain Assets from Probate Administration**

Even where probate administration is appropriate for most of the estate, the settlor may create a trust to administer certain assets while even keeping those assets available to provide immediate liquidity for the beneficiaries or even the estate itself. Common examples of the principal of such limited use trusts include life insurance, retirement benefits and other contract type rights.

### **H. Avoiding the Publicity of Probate**

Since the creation and funding of a revocable trust is a private contractual matter between the parties, the property of the trust, the identity of the beneficiaries, and the terms of the trust are not as available to the public as matters of public record, such as wills and inventories. This traditional advantage of a revocable trust is now is tempered by a 2011 change to Texas Probate Code Section 250 which allows the waiver of the filing of an inventory in independent administrations under certain circumstances. The terms of the will would still be a public record. Of course, in some situations, the trust agreement is filed in the deed records. Also, the trust agreement will be attached to the U.S. Estate Tax Return, if required.

### **I. Avoiding Ancillary Administration**

Where an individual owns real property or mineral interests in a state other than his own state, ancillary administration following the individual's death may be avoided by the individual conveying the real property or mineral interests into a revocable trust arrangement in accordance with the other state's law.

### **J. Selecting the Situs of Certain Assets**

Zaritsky reports that: "The situs of a trust and the law governing its application may be determined by the location of the trust corpus, the residence of the trustee, and statements contained in the trust instrument. Consequently, it is normally possible to "adopt" another state's law with respect to realty located in that state and with respect to personalty held in a trust in that state, by having a local fiduciary and by stating in the trust agreement that the trust law of the desired state is to govern." Zaritsky, "The Use of the Revocable Trusts: The Debate continues. 15 Probate Notes 244 (1989).

### **K. Avoiding the Possibility of Guardianship**

Funding a revocable trust while still competent can avoid the necessity of a guardianship of the estate should the settlor subsequently become incapacitated. In this author's opinion, avoiding guardianship is perhaps the most important reason to implement funded revocable trust planning in Texas.

*Note: H. Clyde Farrell reports that the revocable trust has the following potential disadvantages as an estate planning device if the settlor or the settlor's spouse applies for Medicaid:*

*"1. The home, if there is one, may at some time in the future be found to lose its exclusion status.*

*2. A supplemental needs trust established in the revocable trust by a spouse may be counted as a resource (although it should not be if established by will.)*

*3. Withdrawals of corpus are treated as "income."*

*4. A gift from the trust is subject to a 60 month lookback period."*

"If the Medicaid planning client already has a revocable trust, consider carefully whether one or more of these considerations indicate it should be revoked and replaced with a will-based estate plan. If that is not currently necessary, be sure someone has a power of attorney giving the agent the authority to revoke the trust, in the event it becomes advisable in the future." Farrell, Disability Benefits in the Estate Plan: Passing the Means Test, S.B. O. T. *Advanced Estate Planning and Probate Course*, June, 1999.

#### L. Modifying or Eliminating Duties

Effective 2006, the Texas Trust Code was amended to clarify the default and mandatory rules related to fiduciary duties. Except for certain mandatory provisions, a settlor can override in the trust document any of the common law or statutory default rules. The relevant exceptions are set out in Sections 111.0035 (b):

(b) The terms of a trust prevail over any provision of this subtitle, except that the terms of a trust may not limit:

(1) the requirements imposed under Section 112.031 (regarding trust purposes);

(2) the applicability of Section 114.007 to an exculpation term of a trust;

(3) the periods of limitation for commencing a judicial proceeding regarding a trust;

(4) a trustee's duty:

(A) with regard to an irrevocable trust, to respond to a demand for accounting made under Section 113.151 if the demand is from a beneficiary who, at the time of the demand:

(i) is entitled or permitted to receive distributions from the trust; or

(ii) would receive a distribution from the trust if the trust

terminated at the time of the demand; and

(B) to act in good faith and in accordance with the purposes of the trust;

(5) the power of a court, in the interest of justice, to take action or exercise jurisdiction, including the power to:

(A) modify or terminate a trust or take other action under Section 112.054;

(B) remove a trustee under Section 113.082;

(C) exercise jurisdiction under Section 115.001;

(D) require, dispense with, modify, or terminate a trustee's bond; or

(E) adjust or deny a trustee's compensation if the trustee commits a breach of trust; or

(6) the applicability of Section 112.038 (regarding forfeiture clauses).

These provisions are widely regarded as allowing a settlor to modify or eliminate all of a trustee's traditional duties including but not limited to conflicts of interest, self dealing and loyalty. The exceptions are "to act in good faith and in accordance with the purposes of the trust." (Section 111.0035(b)((4)(B))

There is no similar statute regarding wills.

#### IV. IMPLEMENTATION OF THE REVOCABLE TRUST

Initially, it will be assumed that an *inter vivos transfer in trust*, as opposed to the *inter vivos declaration of trust*, is the trust method of choice. In other words, the settlor enters into a trust agreement with a third party trustee, either a corporate fiduciary, a friend or a family member. Accordingly, certain principles need to be

considered and possibly incorporated into the document.

Note: *For discussion purposes, the author assumes that (a) a client has decided to use revocable trust planning for the dual purposes of avoiding (i) the possibility of a guardianship of the estate in the event of future incapacity, and (ii) the eventuality of probate upon the client's death and (b) the client has adopted a fully funded revocable trust plan (i.e., most, if not all, of the settlor's assets will be placed into the trust upon its creation). The essential terms of the trust will typically direct the trustee to care for the settlor for the remainder of the settlor's lifetime, and upon the settlor's death, to deliver the remaining trust assets to the settlor's children (or other beneficiaries).*

#### **A. Retention of Control**

Texas law permits the settlor to retain extensive interests and powers in and to the trust estate, including a beneficial life estate, the power to revoke, the power to designate beneficiaries and the power to control the trust's administration. Tex. Prop. Code § 112.033. The statute specifically states that the retention of these powers does not make the "disposition" invalid as an attempted "testamentary disposition," if an interest in the trust property has been created in a beneficiary other than the settlor. Accordingly, following the death of the settlor, the settlor's heirs/devisees cannot successfully attack the disposition as being an attempted will which fails for the lack of testamentary formalities, if someone other than the settlor had been given a future interest in the trust.

#### **B. Expressly Revocable**

Unlike in most other states, trusts in Texas are deemed to be revocable unless expressly made irrevocable. Tex. Prop. Code

§ 112.051. One should not, however, rely on rules of construction but expressly state in the document that the trust is revocable.

#### **C. Revocation by Agent**

The trust document should address whether an agent of the settlor acting under the authority of a durable power of attorney can revoke or amend the trust while the settlor is incapacitated. While there is authority that an agent can be expressly given this power, it is possible Texas courts could eventually hold that the power of revocation is a non-delegable power. In any event, the settlor's wishes should be expressed clearly in both the trust agreement and the durable power of attorney.

#### **D. Spendthrift Trust**

Although a spendthrift provision is not effective to protect a retained interest of the settlor from the settlor's creditors, it should be effective to protect the trust estate from the creditors of the other beneficiaries. So, it is advisable to include spendthrift provisions. See Tex. Prop. Code § 112.035.

#### **E. After-Acquired Property**

Because the settlor may not fund the trust with the entire estate at the creation of the trust, or because the settlor may acquire other assets after its creation, the settlor should execute a durable power of attorney specifically authorizing the agent to fund the trust with these assets in the event the principal is unable to do so personally. See Tex. Prob. Code §36A.

#### **F. Coordination With Probate and Nonprobate Dispositions**

Because it is likely that not all of the settlor's estate will be placed in trust, care should be taken to insure that the disposition of the non-trust assets is coordinated with the trust assets. For example, the settlor can

execute a "pour-over" will as per Sec. 58A of the Texas Probate Code; beneficiary designations for life insurance and retirement benefits can be changed to the trustee of the revocable trust.

### **G. Trustee Powers and Duties**

Because the trustee of the revocable trust is a fiduciary with fiduciary obligations and duties owing to all of the trust's beneficiaries and not just the settlor, care should be taken in drafting the duties and powers provisions of the trust. See III, L, *supra*. Beneficiaries to whom fiduciary duties are owed include any person whose property interest is held in trust, "regardless of the nature of the interest." Tex. Prop. Code § 111.004. The inclusion of exculpatory provisions may also be appropriate to protect the trustee or a successor acting in good faith during the settlor's lifetime from potential liability from the remaindermen." However, if the settlor is the trustee, see VII, *infra*.

### **H. The Non-Settlor Trustee**

In situations where the settlor is not serving as the trustee of the revocable trust, or where the settlor is serving as co-trustee, difficult fiduciary problems exist for the non-settlor trustee.

#### **1. FIDUCIARY DUTY**

The non-settlor trustee owes fiduciary duties to the settlor and to the other beneficiaries of the trust. However, in a revocable trust situation, the settlor has the power to modify, amend or even revoke the trust, effectively terminating the rights of the other beneficiaries. This power of the settlor is a reality that cannot be ignored by the non-settlor trustee.

#### **2. CO-TRUSTEES**

Section 113.085 of the Texas Trust Code provides that, unless the trust

agreement provides otherwise, co-trustees are to act jointly if there are two co-trustees and by majority, if there are three or more co-trustees; however, a co-trustee cannot ignore the reality that the settlor/trustee can revoke, modify or amend the trust.

#### **3. CONFIRMATION IN WRITING**

Section 112.051 requires that any changes to written revocable trusts be in writing and that the settlor cannot enlarge the other trustee's duties without the other trustee's consent.

#### **4. THE OTHER TRUSTEE'S DILEMMA**

Thus, how does the non-settlor trustee exercise its independent judgment in the management and administration of the trust under these circumstances? How does the non-trustee protect itself when it does not agree with a decision of the settlor? Does the non-trustee owe a duty to protest the settlor's decisions? How does the non-trustee respond to the settlor's oral instructions? Other than the non-trustee's insisting on a formal, written amendment of the trust agreement, there appears to be little definitive Texas authority on point.

#### **5. CAREFUL DRAFTING**

Careful drafting of the trust agreement is needed to define the duties of the non-settlor trustee while the settlor is in "effective control." Tex. Trust Code § 114.003 protects the co-trustee from liability in the administration of the trust if the settlor "reserves or vests authority" in the settlor to the exclusion of the co-trustee. Is this reservation of authority implied in a revocable trust? Is the co-trustee still protected from liability if the settlor is making imprudent decisions or if the co-trustee knows or has reason to believe (or should have known) that the settlor is incapacitated? Again, only careful drafting can give the assurances that will satisfy the

concerns of both the settlor and the non-settlor.

## 6. SETTLOR'S INCAPACITY

The settlor's effective control will terminate upon the settlor's incapacity. Accordingly, careful attention should be given to defining "incapacity" in the trust agreement to clearly determine when the settlor's power to amend or revoke the trust is suspended, or when the settlor's co-trusteeship ceases and the sole responsibility of the other trustee begins. The document should confirm that a judicial determination of incapacity is not necessary and specifically describe the point in time for the change in the settlor's authority by an objective standard (e.g., a physician's written determination of incapacity delivered to the successor trustee). It may be advisable to confirm that the non-settlor trustee is entitled to rely upon a presumption of capacity until notice is received insofar as any liability of the non-settlor trustee is concerned. See VII.E., *infra*.

*Note: It should be noted that a settlor/trustee may no longer have the capacity to act as trustee but might still have sufficient capacity to exercise some or all of the rights and powers reserved to him as settlor including but not limited to power to revoke or amend, power to remove and replace a trustee and even the right to demand distributions.*

### **I. Debts and Taxes**

Care should be taken to prescribe in the document how the debts of settlor should be satisfied following the settlor's death and how the death taxes owing by reason of the settlor's death are to be allocated among the trust beneficiaries. Failure to do so could place the trustee in a precarious situation, particularly if the beneficiaries of the trust

estate and non-trust assets are not the same. It may be advisable to name the trustee as the executor under the settlor's will and to authorize the trustee to withhold distributions to the remaindermen until a sufficient amount of time has passed to resolve both the debt and tax issues that will arise upon the settlor's death. It may also be advisable to authorize the trustee to loan money to the estate or purchase assets from the estate or even to pay the debts for the estate. See V.I.D., *infra*.

*Note: Consider prohibiting the direct use of proceeds and retirement benefits for the direct payment of debts since those funds are exempt from the settlor's debts. See Art. 21.22 of the Texas Insurance Code and Sec. 42.0021 of the Texas Property Code.*

### **J. Rule Against Perpetuities**

Because it is likely that the revocable trust agreement will create contingent future interests (subject to divestment if the settlor revokes the trust), the rule against perpetuities is applicable. Tex. Prop. Code § 112.036. While there does not appear to be any Texas law on point, the general rule appears to be that the perpetuities time period does not begin until the trust becomes irrevocable. See Bogert, Law of Trusts and Trustees, § 213. In any event, it is advisable to include a perpetuities savings clause.

### **K. Settlor's Needs and Wishes**

The terms of the trust typically will require the trustee generally to care for the settlor during the settlor's remaining lifetime and should specifically instruct the trustee on whether distributions of income and/or principal are to be made at the discretion of the trustee, or pursuant to an ascertainable standard, or as a mandatory requirement. A different set of instructions may be appropriate during those periods of time the settlor is incapacitated. To give the

trustee further guidance in making distributions while the settlor is incapacitated, the trustee could be authorized to consider any known wishes of the settlor and even the settlor's agent acting under a health care power of attorney. Further, a facility of payment provision should be included to authorize the trustee to make distributions either to the settlor or to a third party (such as a creditor of the settlor) on behalf of the settlor, or to any guardian of the person or other person having care or custody of an incapacitated settlor. Such a provision could even exonerate the trustee, acting in good faith, from liability occurring from the subsequent misuse of the funds by the guardian or caretaker.

## V. RULES OF CONSTRUCTION

Despite perhaps a trend in some jurisdictions (particularly those states adopting the Uniform Probate Code) to hold that revocable trusts are will substitutes to be interpreted, construed and enforced in the same manner as wills, the established legal principle remains that a settlor's power of revocation over an inter vivos trust does not make the disposition testamentary in nature. Restatement (Second), Trusts, § 57. Further, during the settlor's lifetime, the beneficiaries own defeasible equitable interests in the trust property created by an inter vivos disposition, not mere expectancies like under a will prior to the testator's death. Bogert, Law of Trust and Trustees, § 104. Texas has adopted this view. See *Schmidt v. Schmidt*, 261 S.W.2d 892 (Tex.Civ.App. 1953, writ refd); *Wilkerson v. McCleary*, 647 S.W.2d 79 (Tex.App. - Beaumont 1983); *Westerfeld v. Huckaby*, 474 S.W.2d 191 (Tex. 1972); Tex. Prop. Code § 112.033.

## A. Will or Trust Law

The problems related to the interpretation and construction of the revocable trust following the settlor's death are magnified if the terms of the revocable trust call for "specific," "general," and "residuary" gifts to different parties and changes in the nature, extent and value of the trust estate, as well as the beneficiaries, occur between the creation of the trust and the settlor's death. When these changes occur to a decedent's probate estate between the date of the will and the date of death, a number of long-established and well-understood rules of construction control the dispositions under the will where the testator's intent is not clearly expressed. However, the rules of construction unique to wills do not necessarily apply to revocable trusts. For example, under Sec. 68 of the Texas Probate Code, a devise to certain beneficiaries who predecease the testator pass to the deceased beneficiaries' lineal descendants under certain circumstances; this "anti-lapse" rule does not apply to revocable trusts. Depending on the exact terms of the trust, a deceased beneficiary's interest in the revocable trust may pass to the deceased beneficiary's heirs and/or devisees. Accordingly careful drafting is necessary to make sure the settlor's intent is carried out under all possible circumstances.

## B. Common Denominators

Three important statutory "default" rules of construction found in the Texas Probate Code apply to revocable trusts, if the governing trust document does not provide to the contrary. Trust beneficiaries must survive by 120 hours if their right to succeed to any interest is conditioned on surviving another person. Tex. Prob. Code § 47(c). The settlor's subsequent divorce voids any provision in the revocable trust in favor of the former spouse or the former spouse's relatives who are not also related to

the settlor. Tex Prob. Code § 472. Estate tax liability is apportioned among the remaining beneficiaries other than the settlor's spouse, a marital deduction trust or a qualified charity or charitable trust. Tex. Prob. Code § 322A. Further, common law rules of construction related to "class gifts" apply to both trusts and wills, although the legislature has modified those rules to some extent as they apply to wills. See Tex. Prob. Code § 68.

### C. Drafting Tips

In view of the uncertainty that exits in this area and the possibility that Texas may one day adopt the Uniform Probate Code approach, Texas practitioners need to adopt the truism: *a well-drafted revocable trust, like a well-drafted will, is one that does not need the ever-changing rules of construction to determine who will eventually get what when the settlor dies.*

Accordingly, the following list of general rules are suggested for consideration by those drafting revocable trusts to help ensure that the actual dispositive intent of a settlor is carried out 10, 15, 25,35 or 50 years from the date the trust is created:

1. *Define who are the remainder beneficiaries:* For example, what does the settlor actually mean in the use of terms like "children," "grandchildren," "descendants," "issues," or "nieces or nephews"? Are step-children, non-marital children, scientifically generated descendants, pretermitted children, adopted children and adults who are adopted as adults to be included within those terms?
2. *Expressly state what happens if an individual beneficiary, fractional gift beneficiary or class member predeceases the settlor.* Does the interest pass to the beneficiary's children, spouse, estate or to another beneficiary, or does it revert to the settlor's probate estate?
3. *Define "survivorship" for the beneficiaries; 120 days, 30 days, 60 days or 90 days, etc.*
4. *Is a particular beneficiary to receive the interest out right or in trust?*
5. *Anticipate changes in the subjects of "specific" gifts.* For example, stipulate whether any specific gift is to pass "free of or "subject to" any indebtedness existing with the respect of the property at the time of the settlor's death. Further, stipulate whether any specific gifts are to include any casualty insurance policies in order to negate ademption by extinction. Anticipate which assets may undergo changes of substance or form and state whether or not any traceable mutations thereof are to pass to the intended beneficiary.
6. *Specify who gets the income generated by the trust estate following the settlor's death and prior to distribution by the trustee to the beneficiaries.*
7. *Always include a "residuary" clause and an "alternative residuary disposition" in order to avoid having property reverting to the settlor's probate estate to pass by possible intestate succession.*
8. *Clarify what type of representation is desired by the settlor, "per stirpes" or "per capita with representation."*

9. *Specify which assets are to be used by the trustee to satisfy any debts and administration expenses that are to be paid out of the trust estate.*
10. *Coordinate the trust with the settlor's will and express specifically how debts, death taxes, and administrative expenses should be paid and whether or not assets passing outside of the will and trust are to be burdened with death taxes to avoid statutory apportionment.*
11. *Include a perpetuities savings clause for any future interests created in the trust.*
12. *Include spendthrift provisions.*
13. *Stipulate whether or not any amounts owing by a beneficiary to the settlor, whether enforceable or not, and whether any advancements by the settlor to a beneficiary, are to be taken into consideration in determining the beneficiary's net share of the trust estate.*
14. *Address trustee's authority to change situs of the trust after settlor's death.*

## **VI. THE FULLY FUNDED REVOCABLE TRUST**

In order for revocable trust planning to work most effectively, it is necessary to transfer legal title of the settlor's assets to the trustee. Real property must be conveyed; stocks assigned; savings accounts retitled, etc. By its very nature, the inter vivos transfer in trust technique requires the settlor to transfer legal title to the trustee and either to retain the equitable title for the settlor and/or assign the equitable title to another beneficiary.

Note: *Failure to transfer legal/record title of all of the settlor's assets to the trustee at the time of funding could result in undue complications upon the disability or death of the settlor even if the property is sufficiently described in the trust agreement so as to constitute a conveyance of a future interest in the legal title and a transfer of the future equitable title because record title will still be in the settlor's name at the time of the settlor's death or disability and appear of record to part of the guardianship or probate process.*

### **A. Record Title**

Although the statute of frauds requires a written agreement in order for a trust of real property to be enforced against the trustee, it is not necessary that the record, legal title to the trust property reflect the names of the beneficiaries, the terms of the trust or that the trustee is even holding title to the property "as trustee." Oral trusts of personal property can be enforced against a non-settlor trustee; a writing is, however, recommended. Tex. Prop. Code § 112.004. Of course, whether title reflects the fiduciary relationship or not, the trustee of an enforceable trust is obligated to carry out the purposes of the trust. However, good faith purchasers transacting business with an undisclosed trustee can rely on the apparent authority of the legal title holder. Tex. Prop. Code § 114.082. See "Magic Wand Funding," VII, C, *infra*.

### **B. Initial and Ongoing Paperwork and Expenses**

Legal fees will be incurred in the preparation of the trust document in addition to the other documents necessary to put the plan into effect, such as deeds and other transfer documents. The trustee will be required to keep accurate records. Trust beneficiaries (the settlor and remainderman) can demand accountings. In addition, the

trustee is required to maintain separate bank accounts. In addition, there may be additional and on-going trustee fees and expenses, legal fees and accounting fees during the remainder of the settlor's lifetime.

### C. Income Tax Returns

Generally, unless the settlor or the settlor's spouse is a trustee, the trustee must obtain a taxpayer identification number, and a fiduciary income tax return, Form 1041, is required to be filed even though items of income, deductions and credits flow through to the settlor and are reported on the settlor's Form 1040. If the settlor or the settlor's spouse is the trustee, the trust uses the settlor's Social Security number and the settlor reports all items of income, deductions and credits on the settlor's own Form 1040. Since the trust is revocable, it also must have the same taxable year and use the same accounting method as the settlor. Rev. Rul. 57-390, 1957-2 C.B. 326. *The regulations under Sections 671 and 6012 address these issues and provide some alternatives.* See § 1.671-4 and § 1.6012-3.

### D. Settlor's Creditors

The creation and funding of an inter vivos trust by a settlor may or may not remove the trust assets from the reach of the settlor's creditors. If (i) the trust is irrevocable, (ii) the settlor has not retained an equitable interest in the trust estate and (iii) the transfer of assets into the trust was not in fraud of creditors, the assets of the trust belong to the beneficiaries and are not generally liable for the debts of the settlor. If the transfer of assets in order to fund the trust is found to have been in fraud of creditors, creditors can reach the assets in trust.

Most of the assets transferred by the settlor to the trustee of a Texas revocable trust will likely continue to be liable for the settlor's debts both during the settlor's

lifetime and following the settlor's death. There is authority to the contrary. (Tones v. Clifton, 101 U.S. 225 (1980); 92 A.L.R. 282 (1934); Scott, § 330.12; Bogert, § 41); however, the modern trend appears to adopt the premise, *if one can claim the assets at any time, they should be available to one's creditors.* See State Street Bank v. Reiser, 389N.E.2d 768 (Mass. 1979).

According to Section 112.035(d) of the Texas Property Code (the spendthrift statute), if a settlor retains the right to revoke, then it appears that the settlor's creditors can reach all of the assets in the trust.

*Note: In 2005 Section 112.035(f) was added to make clear that under Texas law (contrary to The Restatement (Third) of Trusts, published in 2003) a non-settlor beneficiary of a trust is not considered a settlor because he holds (either as trustee or individually) a power of appointment or a power to reach principal if that power is limited by an ascertainable standard. Nor is a non-settlor beneficiary deemed to be a settlor because of a lapse, waiver or release of certain limited powers ("Crummey powers"). Section 112.035(e).*

#### 1. U.F.T.A.

The provisions of the Uniform Fraudulent Transfer Act give creditors theories whereby assets placed in the revocable trust can be reached to satisfy the settlor's debts. See Tex. Bus. & Comm. Code §§ 24.001 through 24.0013.

#### 2. GENERAL POWER

Even if the Uniform Fraudulent Transfer Act is not violated, the Texas definition of a "general power of appointment" would seem broad enough to capture revocable trust assets within its coverage and thereby subject the property in question to the liabilities of the

settlor/donee of the power, either during the settlor's lifetime or at the settlor's death. A general power includes "the authority to alter, amend or revoke an instrument under which an estate or trust is created or held and to terminate a right or interest under a state or trust. Tex. Prop. Code § 181-001(2). The Restatement provides that "appointive assets covered by a general power . . . can be subjected to the claims of creditors of the donee or claims against the donee's estate." Restatement (Second) Property § 13.3(1984). In *Bank of Dallas v. Republic National Bank*, 540 S.W.2d 499 (Tex.Civ.App. 197, writ ref d n.r.e.), the court, adopting the general restatement approach, stated: "If the settlor reserves for his own benefit not only a life estate but also a general power . . . his creditors can reach the principal." In addition, the fact that the trust is a spendthrift trust would not afford any protection from the settlor's creditors. Tex. Prop. Code § 112.035(d).

Caveat: *In FCLT Loans, L.P. v. Estate of Bracher*, 93 S.W.3d 469 (Tex. App.—Houston [14<sup>th</sup> Dist.] 2002, no pet.), a creditor of the settlor of a revocable trust sought to satisfy the debt out of the trust assets following the settlor's death. In denying the creditor's motion for summary judgment, the Houston court noted that this was a case of first impression in Texas and offered no opinion on whether the creditor could recover from the trust property after the settlor's death.

### **E. Settlor's Homestead Protection**

A homestead exemption from the owner's general creditors can only exist in a possessory interest in land. See *Capitol Aggregates v. Walker*, 448 S.W.2d 830 (Tex.Civ.App.-Austin 1969, writ refd n.r.e.); *Texas Commerce Bank v. McCreary*, 677 S.W.2d 643 (Tex.App.-Dallas 1984, no writ). In revocable trust planning, where

legal title in the home is transferred to the trustee, the settlor usually retains the equitable title at least for the remainder of the settlor's lifetime. In addition, there is authority for the proposition that an "equitable interest" will support a homestead claim. See *Rose v. Carney's Lumber Co.*, 565 S.W.2d 571 (Tex.Civ.App.-Tyler 1978, no writ); *White v. Edwards*, 399 S.W.2d 935 (Tex.Civ.App.-Texarkana 1966, writ refd n.r.e.). In fact, one early case held that the property retained its homestead character during the settlor's lifetime notwithstanding the fact it had been conveyed to a trustee where the settlor had continued to occupy the property and the purpose of that trust was to prevent the premises from being taken by creditors. See *Archenhold v. B.C. Evans Co.*, 32 S.W. 795 (Tex.Civ.App. 1895, no writ). Thus, it appears as if the homestead continues to be exempt from most creditors so long as the settlor is alive. Tex. Prop. Code § 41.001. The same would appear to be true for exempt personal property. Tex. Prop. Code § 42.001.

Texas statutes now confirm the case law. In 2009 the Texas Legislature added Property Code Section 41.0021, that says, inter alia, the transfer of a homestead to a qualifying trust does not affect the homestead protections of the Texas Constitution Section 50, Article XVI and Property Code Section 41.001.

Note: *Amendments to the property tax code, effective January 1, 1994, guaranteed that the homestead ad valorem tax exemption remains even if the residence is placed in the revocable trust.*

### **F. Survival of the Homestead**

On the other hand, the transfer of assets to the revocable trust may result in the loss of certain probate provisions which protect the surviving members of the family from the decedent's creditors (i.e., the probate

homestead, exempt personal property, family allowance and the claims procedures followed in probate administration) following a decedent's death. The 2009 amendment to the Property Code, Section 41.0021(e), says, "This section does not affect the rights of a surviving spouse or surviving children under Section 52, Article XVI, Texas Constitution, or Part 3, Chapter VIII, Texas Probate Code" (Homestead, Family Allowance and Other Exempt Property).

### 1. PROBATE HOMESTEAD

The Texas Constitution provides that, on the death of a homestead owner, the homestead is to descend and vest in like manner as other real property of the deceased but that it shall not be partitioned among the heirs of the deceased during the lifetime of the surviving spouse for so long as the survivor elects to use or occupy the same as a homestead, or so long as the guardian of the minor children of the deceased may be permitted, under the order of the proper court having the jurisdiction, to use and occupy the same. Tex. Const. Art. XVI. § 52 (1987). The effect of this constitutional mandate is to vest a "life estate" in the surviving spouse until abandonment, or a right to receive an estate until majority for minor children. *Thompson v. Thompson*, 236 S.W.2d 779 (Tex. 1951). In addition, the Texas Probate Code provides that following the owner's death, the homestead will not be liable for any debts, except for the purchase money thereof, the taxes due thereon, or work and material used in constructing improvements thereon. Tex. Prob. Code § 270. Further, the Texas Probate Code directs the probate court to set apart for the use and benefit of the surviving spouse and minor children all such property of the estate as is exempt from execution or forced sale by the

constitution and laws of the state. Tex. Prob. Code § 271.

Note: *Prior to 2005, Texas case law appeared to grant the exemption from creditors if the owner was survived only by an unmarried child living at home. 2005 amendments to Sections 271 and 272 may have inadvertently eliminated that exemption.*

### 2. RIGHT OF OCCUPANCY

Will the surviving spouse have a right to occupy the home following the death of the owner if it was placed in a revocable trust prior to its owner's death? While there are no definitive cases on point, it appears that the surviving spouse may not have such a right unless the trust document so provides. First, whether the home was community property or not, if the home was placed in the revocable trust during marriage, both spouses would have had to join in the transaction or the conveyance would have been void. Tex.Fam.Code § 5.81. See also Tex. Prop. Code § 41.0021(c). Second, the Texas Supreme Court has approved provisions in premarital agreements that allow one to waive his/her homestead right of occupancy. However, it has also been held that such waivers must be clear and unambiguous and with full disclosure. See *Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978) and *Hunter v. Clark*, 687 S.W.2d 811 (Tex.App.-San Antonio 1985).

In addition, if the home had been placed into the revocable trust by its owner before the marriage, or if the owner places it in trust during the marriage but before it is used as the home, in either situation, the survivor's right of occupancy may never come into existence because the right may only attach to the actual property interest owned by the owner, which in the revocable trust situation is an equitable life estate that

terminates upon the settlor's death. This same rationale may even defeat the possession rights of the owner's minor children.

On the other hand, perhaps public policy in favor of the surviving spouse and minor children will lead the courts to extend the "illusory transfer" concept to such a situation to protect the rights of the surviving spouse and minor children to occupy the home like it did to protect the surviving spouse's community one-half interest unilaterally placed in a revocable trust in *Land v. Marshall*, discussed at IX, B, *infra*.

Note: *It should be noted that Section 41.0021(c) was an amendment to the exemption from creditors' section of the Texas Property Code and not intended to address "the right of occupancy" under the Texas Constitution. See Tex. Const. Art XVI, § 52 (1987).*

*This possible loss of the right of occupancy is consistent with the constitutional and statutory homestead provisions because both contemplate the homestead being a probate asset upon the death of the owner. If the home has been placed into a revocable trust, the settlor's life estate terminates and the remainder beneficiary's interest becomes possessory upon the death of the settlor instead of going through probate.*

### 3. CREDITOR'S RIGHTS

Assuming the settlor is survived by a "constituent family member" (surviving spouse, minor child and possibly unmarried adult child still at home), will the home placed in a revocable trust continue to be exempt from most creditors of the settlor upon the settlor's death? Again, there are no definitive cases and the likely result is not very clear. First, a creditor could argue that,

if the constituent family members have lost their right of occupancy, the purpose in exempting the property is frustrated and, therefore, the creditors should be able to reach the asset like any other revocable trust asset. Second, the creditors will point out that the exemption from creditors is found in the probate code and is directed at probate assets; thus, where the owner elected to take the home out of probate, its exemption is lost. On the other hand, the basic theory that supports the creditor's position, in effect, ignores the existence of the trust, thereby revesting the settlor with the property and returning it to his/her probate estate where it would have been exempt from the claims of the creditors in the first place. In other words, the creditors have essentially forced the settlor to revoke the trust thereby making the home probate property again and, therefore, entitled to probate protection. The 2009 amendment to the Texas Property Code, Section 41.0021(c), does not address this issue.

### **G. Exempt Personal Property**

Normally, certain items of tangible personal property are exempt from most of the decedent's creditors if the decedent is survived by a constituent family member. Tex. Prob. Code §§ 271 and 281. These items are described in the Texas Property Code and generally include the household furnishings, personal effects and automobiles in an amount that does not exceed \$60,000. Tex. Prop. Code § 42.002. In addition, during administration, the family members can retain possession of these items and will receive ownership of them if the decedent's estate proves to be insolvent; otherwise the decedent's interest in these items passes to his/her heirs and/or devisees when the administration terminates. Tex. Prob. Code § 278. The arguments "pro" and "con" as to whether these rights exist if these otherwise exempt

items are placed in a revocable trust would seem to parallel the above homestead discussion.

#### **H. Family Allowance**

In addition to the allowances in lieu of homestead and exempt personal property, an allowance for one year's maintenance of the surviving spouse and minor children may be established by the probate court. Tex. Prob. Code §§ 286 and 287. The allowance is paid out of the decedent's property subject to administration. *Ward v. Braun*, 417 S.W.2d 888 (Tex.Civ.App.-Corpus Christi, 1967, no writ). Thus, it appears that the family allowance would be lost if all of the decedent's assets have been placed in a revocable trust.

#### **I. Probate Claims Procedures**

The probate code also describes a very elaborate statutory scheme for the handling of secured and unsecured claims against a probate estate. These procedures afford protection and guidance to the persons charged with administering the decedent's estate and assure the creditors of fair treatment. It does not appear that these procedures would apply to a trust administration. For example, unlike in a decedent's dependent administration where the probate code prohibits a secured creditor from foreclosing on probate property during administration, a creditor with a security interest in trust property could in fact foreclose. In 2011 Section 146 of the Texas Probate Code was amended to prescribe the rights of a secured creditor in an independent administration. In particular a creditor who elects preferred debt and lien (taking collateral with no right to a deficiency) may not foreclose for 6 months. A creditor electing matured, secured status must get court (or personal representative) permission to foreclose. In addition, the probate code directs the personal

representative regarding which debts to pay but the trustee has no such guidelines in the trust code, thereby possibly exposing the trustee to personal liability if the trustee pays the wrong creditor at the wrong time.

*Note: In order to give the trustee the opportunity to invoke the procedures of the probate code following the settlor's death, consider authorizing the trustee to terminate the trust and distribute the trust assets to the personal representative of the settlor's probate estate, if (i) such action would be in the best interests of the beneficiaries and (ii) the beneficiaries of the trust are the same as the beneficiaries under the will. Alternatively, simply do not place otherwise exempt assets in the trust if possible insolvency is a concern.*

#### **J. Real Estate Issues**

The settlor planning to convey real property to the trustee of a revocable trust should consider the possible impact such a transfer could have on the property's title policy, if any. Typically, a conveyance by a general warranty deed converts the title policy into a warrantor's policy, protecting the grantee up to the amount of consideration paid by the grantee, which in the revocable trust plan is nominal, if any. Due to the settlor's retained power of revocation (defined as a general power of appointment), it is arguable that the settlor should still be deemed the owner under the title policy and that the insurance company's risk has not been affected because of the transfer, thereby maintaining the protection the title policy affords. However, upon the death of the settlor, the beneficiaries of the trust would seem to have lost any protection under either the original title policy (or its subsequent warrantor's policy). Had the property not been transferred and been a part of the deceased owner's probate estate, the

title policy's protection would have typically extended to the insured's heirs and devisees.

Further, had the property been encumbered at the time of the transfer into the revocable trust, another problem arises. Most "due on sale" and/or prepayment penalty clauses are drafted to include any voluntary inter vivos transfer of the encumbered property which would appear to include the funding of a revocable trust. See *Sonny Arnold, Inc. v. Sentry Savings Association*, 633 S.W.2d 811 (Tex. 1982); *Metropolitan Savings and Loan v. Nabonas*, 652 S.W.2d 820 (Tex. Civ. App. 1985, n.w.h.); and the Garn St. Germain Depository Institution Act of 1982, 12 U.S.C. § 1701 j-3. See Donley and Santos, *Due on Sale Clauses and Prepayment Penalties: Can They Coexist in Texas?* Newsletter, Texas State Bar Section on Real Estate, Probate and Trust Law, July, 1989.

Had the encumbered property not been transferred and remained a probate asset at the owner's death, the holder of the note could have elected "preferred debt and lien" pursuant to the original contract or "matured, secured claim" and accelerated payment during administration. However, if the encumbered property is transferred to the trust, the note holder would appear to have the ability to accelerate the note at any time up until and following the settlor's death without following prescribed probate code procedures.

*Note: Assuming that the transfer of encumbered property into the trust did not trigger the "due on sale" clause, a later refinancing of the loan may require the property to be conveyed back to the settlor because the lender may require the borrower to be an individual.*

#### **K. P.C., P.A. and P.L.L.C. Ownership**

Texas law may prohibit the transfer of ownership interests in professional

corporations, professional associations and professional limited liability companies to a trustee because it is fundamental that trust law requires that the subject of a trust be a legally recognizable property interest that is transferable. Further, professional corporations, associations and limited liability companies are authorized to issue ownership interests only to licensed professionals (or, in the case of professional corporations and professional limited liability companies, to professional organizations). Tex. Bus. Orgs. Code §§ 301.004, 301.007(a), 301.008, 301.009.

#### **L. L.L.C. and L.L.P. Ownership**

The establishment of a revocable trust to hold a membership or partnership interest sometimes may create problems. If an owner initially holds an interest in an individual capacity and then establishes a trust of which the owner is trustee, has the interest been assigned such that the trustee is merely an assignee with no management or voting rights? Similarly, if a trust or trustee is designated as a member or a partner and the trustee dies, has there been an assignment of the interest where the interest continues to be held in the same trust by a successor trustee? The company or partnership agreement needs to address these situations. See *Clark v. Kelly*, No. C.A. 16780, 1999 WL 458625 (Del. Ch. June 24, 1999); *Lusk v. Elliott*, No. Civ. A. 16326, 1999 WL 644739 (Del. Ch. Aug. 13, 1999); and *Presta v. Tepper*, 102 Cal. Rptr. 3d 12 (Cal. Ct. App. 2009).

#### **M. Accounting and Distribution**

After the death of the settlor or testator, when it is time to distribute or accountings should be provided, there are differences between independent and trust administrations.

A beneficiary under an independent administration is not entitled to demand an

accounting for 15 months (Section 149A(a)). Once demanded, the beneficiary has to wait 60 more days to find out if the accounting will be provided. If not, only then, 17 months after the administrator was appointed, can he file an action to compel an accounting (Section 149A(b)). Section 149A does not directly say a beneficiary can seek a distribution but it does say the personal representative has to show why the estate should not be closed and distributed.

Section 149B allows a beneficiary to seek an accounting and a distribution after two years from the date the first letters testamentary or letters of administration were issued to any personal representative.

In a trust under Property Code Section 113.151(a) a beneficiary may demand an accounting. If the trustee does not provide an accounting within 90 days, the beneficiary may file suit. (Consider the effect of Tex. Prop. Code § 111.0035.)

If the beneficiary is successful, the court, in its discretion may award attorneys fees and costs against the trust or the trustee individually. This section also says that the trustee does not have to account more often than annually, unless the court orders more frequent accountings.

*Note: Allocation of Receipts and Disbursements. Except as otherwise provided in a trust document Property Code Sections 116.001, et seq., control the allocation of receipts and disbursements between principal and income.*

*Similarly for decedents' estates (except as otherwise provided by the will) Probate Code Section 378B controls. But note that it incorporates Sections 116.001, et seq., as well.*

## VII. WHEN THE SETTLOR IS THE TRUSTEE

A settlor may not be ready to turn control of his or her estate over to another person. One way to solve this problem is for the initial trustee of the trust to be the settlor so that the settlor can continue to manage the trust assets for as long as the settlor is able and willing to do so. In other words, the settlor creates an *inter vivos declaration of trust*. In the event of the settlor's incapacity or death or resignation, a friend, family member or corporate fiduciary succeeds the settlor, as trustee, and continues the management of the trust assets in accordance with the settlor's wishes expressed in the trust agreement.

### A. Settlor as Trustee

Texas law permits the settlor to be the initial trustee of his own trust so long as there is a separation of legal and equitable title, which can be accomplished very easily by the settlor retaining an equitable life estate and giving the equitable remainder interest to the ultimate beneficiaries. The fact that the trust is revocable and that the interest of the equitable remaindermen can be terminated by the settlor does not affect the validity of the trust. See Tex. Prop. Code § 112.033 and *Westerfeld v. Huckaby*, 474 S.W.2d 180 (Tex. 1972).

*Note: Where the settlor's daughter, a remainder beneficiary, complained that the settlor, co-trustee breached his fiduciary duty when he sold property of the trust at a price considerably below fair market value to his son, the other co-trustee. Since the vesting of daughter's contingent interest in the trust was subject to the settlor's discretion until his death, the court held the daughter lacked standing to complain about the sale. Moon v. Lesikar, 250 SW.3d 800 (Tex. App.—Houston [14<sup>th</sup> Dist.] 2007, pet. denied).*

## **B. Title to Trust Property**

It is still advisable for the settlor to "retitle" the trust property in order to facilitate the successor's trustee's ability to step in and the later transfer of the property to the remaindermen.

## **C. Magic Wand Funding**

Where an owner declares that the owner holds property in trust for another, the owner typically (i) retains legal title subject to divestment upon the owner's death or disability and (ii) retains an equitable interest in the property that terminates upon the owner's death and gives the ultimate beneficiary an equitable remainder interest in the property subject to divestment, if the trust is amended or revoked. The future interests of the successor trustee and ultimate beneficiaries are not, however, enforceable unless the creation of their interests is evidenced by a writing. Tex. Prop. Code § 112.004. This writing requirement does not mean that the record/legal title to the property needs to be changed upon the creation of the trust. Accordingly, legal/record title to the owner's property subject to the new trust relationships can remain in the settlor/owner as if the interests of the successor trustee and remaindermen did not exist insofar as third parties are concerned. Then, upon the settlor's death or incapacity, the successors in interest under the trust document can enforce the terms of the trust against the settlor's guardian, personal representative or heirs/devisees. *Wilkerson v. McCleary*, 641 S.W.2d 79 (Tex.App.-Beaumont 1983.) However, even where the settlor's guardian, personal representative and heirs/devisees cooperate with the successor trustee and/or beneficiaries, the failure to have "retitled" the property upon the trust's creation will complicate and delay the "settlement" of the estate. In other words, the opportunity to

"pre-settle" the estate with the settlor's assistance has been lost and this may even possibly open the door to challenge by disgruntled parties. See also, Keydel, "The Magic Wand of Estate Planning: Converting Joint Property into Revocable Trust Property," *Probate and Property*, January/February 1989.

Note: *In Re Estate of Walker*, 250 S.W.3d 212 (Tex. App.—Dallas 2008, *pet. denied*), *the trust agreement described the assets of the trust as: "All properties whether real or personal or mixed we now own or will own in our names individually. . . . We include all . . . properties, such as land, . . . stock, other securities, insurance policies, art, coin collections, automobiles . . . other personal property with or without titles. . . ." The court held that an amended probate inventory, which omitted certain assets held in trust pursuant to the described property description, was neither erroneous nor unjust, suggesting that the omitted assets were part of the trust estate of the revocable trust prior to the decedent's death.*

## **D. Recordkeeping and Trust Activities**

In order to minimize "illusory trust" arguments and other challenge theories, it would appear that the trustee/settlor needs to keep accurate, on-going records for the trust administration and avoid integrating personal and trust activities. See *Fleck v. Baldwin*, 172 S.W.2d 975 (Tex. 1943). However, as long as the settlor or the settlor's spouse is the trustee, fiduciary income tax returns will not be necessary. Accurate recordkeeping could be of even more importance if a corporate fiduciary will be succeeding the settlor as trustee upon the settlor's death or disability. *It may also be a good idea to include a provision which relieves the successor/trustee of its duty to examine the records of its predecessor, the*

*settlor*. It would also be advisable to address what will constitute a revocation or a modification of the entire trust or as to specific trust assets.

### **E. Settlor/Trustee's Incapacity**

The settlor's ability to continue as the initial sole trustee of the revocable declaration of trust will terminate upon the settlor's incapacity. Tex. Prop. Code § 112.008. Accordingly, careful attention should be given to defining "incapacity" in the trust agreement to clearly determine when the settlor's trusteeship ceases and the responsibility of the successor trustee begins. The document should confirm that a judicial determination of incapacity is not necessary and specifically describe the point in time for the change in responsibility by an objective standard (e.g., a physician's written determination of incapacity delivered to the successor trustee). It also would appear advisable to confirm that the successor is entitled to rely upon a presumption of capacity until notice is received insofar as any liability of the successor is concerned. See IV.H.(6), *supra*.

*Note: These same concerns need to be addressed when the settlor is a co-trustee or otherwise retains the authority to direct a co-trustee or control the trustee of the revocable trust (i.e., in all revocable trusts). Further, in those situations, it would also be advisable to clarify whether the trustee has a duty to monitor the settlor's mental condition.*

## **VIII. THE STAND BY TRUST**

Many lawyers who still believe in the Texas independent administration as a viable, efficient and economical process for their clients offer the "stand by trust" to their clients who insist on having a revocable trust. The revocable trust agreement is executed but the trust itself is initially only nominally funded. The idea is that the trust

will not be fully funded until the settlor voluntarily funds at a later date or funding is needed either to avoid a guardianship in the event of the settlor's incapacity or to distribute the estate upon the settlor's death, thereby deferring the time, trouble and expense of funding until it is really needed. In addition to the revocable trust agreement, two other documents are an inherent part of the plan: the *durable power of attorney* and the *pour-over -will*.

*Note: Defining incapacity in order to determine when the agent should fund the trust is important.*

### **A. The Durable Power of Attorney**

In the event of the settlor's incapacity prior to the finding of this trust, the settlor's agent needs to be in the position to fund the trust under the authority of a *durable power of attorney*, one where the powers of the agent do not terminate on the principal's disability or incapacity. A power becomes a "durable" one by the addition of the words: "This power of attorney shall not terminate on the disability or incapacity of the principal." Tex. Prob. Code § 482. Although frequently executed, durable powers have not been all that effective in the past because third parties, such as title companies, banks and transfer agents, have been reluctant to rely on them. Accordingly, over the years there have been several attempts to modernize the durable power of attorney legislation to promote their more effective use. Significant changes occurred in 1993 with the enactment of Chapter XII of the Texas Probate Code.

### **B. Chapter XII, Texas Probate Code**

Two policies were followed in drafting Chapter XII. First, the law should encourage the use of the durable power of attorney in estate planning. Second, the statutory provisions applicable to the durable power

of attorney should not impose technical requirements which discourage its use and acceptance.

1. THIRD PARTY ACCEPTANCE

Instead of an indemnification provision, Chapter XII adopted the option set forth in The Uniform Durable Power of Attorney Act which allows an agent to execute an affidavit stating that, to the best of the agent's knowledge, the power had not been revoked; this provides protection for third parties relying on the affidavit in good faith. Tex. Prob. Code § 487.

2. REVOCAION

A principal can revoke a power of attorney; however, unless otherwise provided in the document, a revocation is not effective as to a third party until the third party receives actual notice. Tex. Prob. Code § 488.

3. APPOINTMENT OF GUARDIAN

Chapter XII retains the former Texas law that the appointment of a guardian of the estate terminates the durable power of attorney; the appointment of a guardian of the person should not have that effect. Tex. Prob. Code § 485.

4. SPRINGING POWERS

Chapter XII provides that the principal can have a power become effective on the principal's incapacity. Tex. Prob. Code § 482.

5. FORMALITIES

Chapter XII requires that the durable power be in a writing signed and acknowledged by the principal. Tex. Prob. Code § 482. It does not need to be recorded to be effective unless recordation is otherwise needed for a real estate transaction. Tex. Prob. Code § 489.

**C. Statutory Power of Attorney Form**

Chapter XII includes a statutory durable power of attorney form in an effort to encourage its use by the public and its acceptance by third parties. Tex. Prob. Code § 490. The form, as modified in 1997, contains a consumer warning concerning its legal consequences, lists a number of powers which can be given the agent, including a general power, offers the principal the opportunity to limit or extend the listed powers, including the power to make gifts, and allows the principal to create a power that is effective immediately or upon the principal's disability or incapacity. *It does not specifically authorize the agent to fund or create a revocable trust although there is reference to "estate, trust and other beneficiary transactions."* Chapter XII also includes a number of provisions offering constructional guidance to the form's actual use. Tex. Prob. Code §§ 491-505. These provisions can be helpful in the drafting of a customized power.

**D. Authority of Agent**

Although it is generally recognized that an agent may not execute a will for an incapacitated principal, there is authority to suggest that an agent, *if expressly authorized by the principal*, can amend or revoke existing revocable trusts or even create and fund inter vivos trusts. Stand by trust planning usually contemplates the agent funding an existing inter vivos trust at the appropriate time, such as the settlor's incapacity. See Restatement of Agency 2d, § 17 ("What acts are delegable?"). However, at least one Texas court has held that an agent cannot create a trust for the principal because the trust law requires a manifestation of intent by the settlor. See *Filipp v. Till*, 230 S.W.3d 197 (Tex. App.—Houston [14<sup>th</sup> Dist.] 2006, no pet.). Further, *federal law may not permit an agent to place U.S. Savings Bonds into a revocable trust*. See 31 C.F.R. § 353.65.

### **E. Limited Power**

While the principal can create a general, universal power in stand by trust planning, the principal may want a tailored power of attorney only allowing the agent to perform specified tasks, such as funding a revocable trust already created by the principal. In any event, it would be advisable to specifically authorize the agent to fund the trust. This authority could be a springing power (i.e., the power becomes effective on the principal's incapacity).

### **F. Pour-Over Will**

In the event neither the settlor nor the settlor's agent funds the trust prior to the settlor's death, a pour-over will is needed to devise the probate estate to be the trustee of the revocable trust who in turn distributes the estate to the intended trust beneficiaries following an independent administration by an independent executor who could be the trustee of the stand by trust. It should be noted that Section 58A of the Texas Probate Code was amended in 1993 to permit the "pour-over" of probate assets to a trustee of an inter vivos trust". .if the trust is identified in the testator's will and its terms are in a written instrument, other than a will, that is executed before, with, or after the execution of the testator's will or in another person's will if that other person has predeceased the testator, *regardless of the existence, size, or charter of the corpus of the trust.*" In other words, the "pour-over" trust no longer needs to be either in existence prior to the testator's death or at the time of the will's execution.

*Note: Notwithstanding the 1993 amendments, a well drafted stand by trust should be in existence and at least nominally funded when the will is executed.*

## **IX. COMMUNITY PROPERTY IN THE REVOCABLE TRUST**

If a married individual or couple places community property into a revocable trust, the relative marital property rights of the husband and wife could be adversely affected. For example, separate and community could be commingled; community property subject to a spouse's sole management and control could become subject to the couple's joint control. Community property may be deemed partitioned.

*Note: For a discussion of homestead related issues, see VI, E, F, G and H, supra.*

### **A. Professional Responsibility**

It is obvious, therefore, that the practitioner advising the couple should be alert for possible conflicts of interests and make sure the couple understands the effect revocable trust planning could have on their marital property rights during the remainder of the marriage and on its dissolution either by death or divorce.

### **B. Creation and Funding**

Generally, when marital property is to be placed into a revocable trust, steps should be taken to insure that the planning:

1. Is not deemed fraudulent or even "illusory" under Land v. Marshall, 426 S.W.2d 841 (Tex. 1968). (husband placed his sole management community property into a revocable trust; upon his death, the wife disrupted the plan by pulling her one-half interest out of the trust under the "illusory" transfer doctrine);
2. Is not deemed void because one spouse unilaterally attempted to transfer community property subject to joint control into the trust under Tex. Fam. Code §3.102;

3. Does not amount to a partition of community property under Section 4.102 of the Texas Family Code unless that is desired by the parties;
4. Does not work a commingling of community and separate funds as to risk losing the separate character of the separate property, unless that is desired by the parties;
5. Does not convert one spouse's retained equitable interest in his or her sole management community property into joint community property and thereby expose it to liability for the contractual debts of the other spouse; and
6. Defines which assets the trustee should use to provide for, and pay the debts of, the spouses while both are alive, and to satisfy claims of creditors upon the first spouse's death.

*Note: Texas community property law may create a unique planning opportunity when one spouse is incapacitated. Following a judicial declaration of incapacity, the other spouse, in the capacity of the community administrator, is granted the sole power of management, control and disposition of the entire community estate. Does this authority give the managing spouse the power to create and fund a revocable trust? Absent the judicial declaration, the competent spouse still retains sole authority over his/her special community property. In Land v. Marshall, the Texas Supreme Court held that the husband's creation of a revocable trust with his sole management community without his wife's joinder was not void as to the wife's one-half interest, but voidable at her election under the "illusory transfer" doctrine. Compare Filipp v. Till. At VIII, D, supra.*

### **C. Distributions**

Careful consideration should be given to the trustee's duty to support the couple while both are still surviving. Generally, the terms of the trust should specify whether trust income is to be distributed or retained and if distributed, whether distributions to the husband, wife, or both, are appropriate. It may be advisable to distribute what would otherwise be a spouse's special community income (income from separate property or existing special community property) to that particular spouse. If such income is retained, it may be advisable to hold and invest it, in trust, as "special community." When the trustee is authorized to distribute income or principal for the spouses pursuant to an ascertainable standard, the terms of the trust need to specify what sources are to be exhausted first (i.e., use separate before community, or use community before separate and which type of community is expended first—special or joint). A different set of distribution criteria may be appropriate during those periods the spouses are incapacitated.

### **D. Power of Revocation**

When a husband and wife fund a revocable trust with community property, should the power of revocation be exercised jointly or severally? If the document directs that either spouse can revoke the trust unilaterally, should the power extend to the whole community asset being withdrawn from the trust or only to the revoking spouse's undivided one-half interest therein?

#### **1. JOINT REVOCATION**

If the power to revoke is retained jointly by the couple, the couple's equitable interest in the trust would appear to be their joint community property even though some of the community assets in the trust were a spouse's special community property prior to

funding. Converting special community property into joint community property affects the relative marital property rights of the husband and wife. For example, an asset which would have been exempt from certain debts of a particular spouse would become liable. See Brooks v. Sherry Lane National Bank, 788 S.W. 2d 874 (Tex. App—Dallas 1990). See IV. A., *supra*.

## 2. UNILATERAL REVOCATION

To avoid converting special community property into joint community property, the document could be drafted to permit either spouse to withdraw from the trust that spouse's community one-half interest in any community asset placed in the trust. This approach has several problems. Such a power would, in effect, permit either spouse to unilaterally partition the couple's community property interests, a result which does not appear to be authorized by Art. XVI, Sec. 15 of the Texas Constitution. Only jointly can spouses partition community property into their respective separate estates. Even an agreement by the spouses to authorize such a unilateral partition would appear to violate the "mere agreement" rule of marital property. See Kellet v. Trice 95 Tex. 160, 66 S.W. 51 (1902); King v. Bruce, 145 Tex. 647, 201 S.W.2d 803 (1947); Hilley v. Hilley, 161 Tex. 569, 342 S.W.2d 565 (1961).

Note: *If unilateral revocation is desired, the more considered solution may be to allow one spouse, with notice to the other, to withdraw their special community and any joint community property with the joint community property being distributed in both names.*

## 3. "JOINT AND SEVERAL" REVOCATION

Accordingly, the safe harbor approach would be for the couple to retain power of revocation (i) jointly for some assets of the trust, (the joint community property assets) and (ii) unilaterally as to other assets in the trust (special community property and separate property) after giving notice to the other spouse. If the several power of revocation is exercised as to a special community asset, the withdrawn asset would remain the couple's community property, but still subject to the withdrawing spouse's sole management and control. If the couple so agrees, allowing either spouse to revoke as to a joint community asset would not appear to have any adverse consequences from a constitutional, liability or tax perspective so long as the asset in its entirety is revested as community property.

### **E. Subsequent Incapacity of a Settlor**

As with any revocable trust, the trust document should address the effect the possible incapacity of a settlor will have on the power of revocation. Can an agent under a durable power of attorney revoke on behalf of the settlor/principal? Can a guardian revoke the ward's revocable trust? Is the power of revocation a non-delegable power? See Weatherly v. Byrd, 566 S.W.2d 292 (Tex. 1972). The questions evolve even further if the settlor is married and the trust is funded with the incapacitated spouse's special community property or joint community property. Do Sec. 883 of the Texas Probate Code and Sec. 3.301 of the Texas Family Code permit the other spouse to revoke the trust on behalf of the incapacitated spouse? Texas law provides no clear answers to these questions, thus, the document should address all of them.

## **F. Effect of Divorce**

Community assets and quasi-community property held in trust where one, or both, of the spouses hold a power of revocation should be part of the "estate of the parties" subject to division by the divorce court in a just and right manner pursuant to Sec. 7.001 of the Texas Family Code.

### **1. POWERS OF APPOINTMENT**

A power of revocation is defined in the Texas Property Code as a general power of appointment, giving the holder thereof the equivalents of ownership over the assets subject to the power. See Tex. Prop. Code, § 181.001.

### **2. VOID AND VOIDABLE TRANSFERS**

If only one spouse is the settlor of a trust funded with the settlor spouse's special community property, the transfer of such community assets into the trust is deemed "illusory" as to the other spouse. See *Land v. Marshall*, IX, B, *supra*. If the sole settlor spouse attempted to transfer into the trust joint community assets without the joinder of the other spouse, the transfer should be found to be void as to the other spouse.

### **3. SEPARATE TRUST ESTATE**

If the settlor spouse transfers separate property into a revocable trust arrangement, (a) the original trust estate and its traceable mutations should retain the separate character of the separate property contributed to the trust, (b) trust income distributed to the settlor is community property and (c) any undistributed income and its mutations should be deemed to be community due to the settlor's power of revocation.

### **4. TRANSFERS TO THIRD PARTIES**

Any trust income or any other community assets held in the trust and

distributed by the trustee to a third party, such as a child of the settlor from the settlor's prior marriage, is usually deemed to be a completed gift by the settlor to the third party for tax purposes (unless the distribution satisfied the settlor's legal obligations of support) and is subject to attack by the other spouse as being a transfer in fraud of the other spouse's community property rights.

### **5. REVOCABLE TRUSTS BECOMING IRREVOCABLE**

If, during the marriage, a revocable trust becomes irrevocable due to a modification by the settlor, or due to the trust terms (e.g., the trust provides that it becomes irrevocable upon the settlor's incapacity or death), (a) the interests of the non-settlor beneficiaries may become fixed, vested and/or ascertainable, (b) the settlor may be deemed to have made a completed gift for tax purposes and (c) the now completed transfers to the non-settlor beneficiaries are subject to scrutiny as being transfers in fraud of the other spouse's community property rights.

### **6. INCOME TAXES**

The income generated by revocable trust assets is taxable to the settlor whether or not the income is distributed to the settlor, retained in the trust or distributed to another beneficiary of the trust. Because the income either retained in the trust or distributed to a third party is still reported on the settlor's individual income tax return (typically a joint return with the settlor's spouse), the payment of the consequential income tax liability with community funds could adversely affect the rights of the other spouse.

## 7. PLANNING FOR DIVORCE

While Section 472 voids provisions in favor of the former spouse and the former spouse's relatives, in the event of a subsequent divorce, other problems exist if the trust is a joint revocable trust that provides for "joint revocation" and does not address what happens to the power of revocation in the event of a divorce. Further, it is not difficult to imagine the problems trying to interpret and construe the remaining terms of the trust. In that situation, it would likely serve both settlors to address these issues in the divorce settlement.

Awkward as it might be, it would be even better to address the possibility of a subsequent divorce in the trust agreement and how it would impact the power of revocation and the other terms of the trust.

### **G. Death of First Spouse**

Upon the death of the first spouse to die, the decedent's separate property and one-half interest in the community assets are normally placed in a continuing decedent's trust or are distributed in accordance with the provisions of the trust document. For further discussion, See X, *infra*, Non-Pro Rata Distributions.

### **H. Survivor's Interests**

Upon the death of the first spouse, the surviving spouse's separate property and one-half interest in the community property generally should be delivered to the surviving spouse or segregated into a "survivor's trust" that continues to be revocable by the surviving spouse unless a different result is desired after considering the consequences of it becoming irrevocable. In addition to the substantive advantages for the surviving spouse, continuing revocability prevents an unintended taxable gift on the part of the surviving spouse. If the surviving spouse is

not a settlor of the trust (or did not otherwise agree to the terms of the trust) and does not receive the survivor's one-half interest in the community property, the settlor spouse can use the "illusory trust" argument to reclaim the survivor's one-half interests in the community trust assets. See Land v. Marshall at IX, B, *supra*.

### **I. Amending the Survivor's Trust**

Quite often these joint trusts do allow the surviving spouse to amend the "survivor's trust" after the death of the first spouse, but are silent about any unilateral amendment while both are living.

Generally no problems are encountered if both of the spouses agree to an amendment. But, what if one spouse wants to amend but other does not (or cannot). Generally, this is not permitted unless stated in the trust.

However, if the amendment only impacts the disposition of the surviving spouse's property after the first spouse's death, but the trust is silent on the point, can a spouse make those changes while both are alive? Even then, is notice necessary?

Obviously, this is an issue that should be addressed in the trust agreement. If the trust permits unilateral changes, it should include not only the dispositive provisions but any and all administrative provisions as applied to that survivor's dispositive provisions including but not limited to who could serve as trustee of any trusts that spring up after the death of one or both of the settlors.

### **J. Planning Considerations**

When drafting the trust document, separate trusts may be desirable for the husband's separate property, the wife's separate property and their community property. In fact, it may be advisable to segregate the community property further into three separate sub-trusts, one for the

husband's sole management community property, one for the wife's sole management community property, and one for their joint community property in order to maintain their relative marital property rights, to facilitate the management rules of Sections 3.101 and 3.102 of the Texas Family Code and to continue the liability exemption rules of Section 3.202 of the Family Code, otherwise the couple's relative rights are affected and the attorney is placed in a conflict of interest by trying to represent both spouses in the planning. Finally, the trustee should be instructed to pay debts and other expenses in a manner consistent with the liability rules of the Texas Family Code.

#### **K. Community Property Basis**

Because the decedent's interest in the revocable trust assets is included in the gross estate, such assets will receive a new income tax basis. However, if a married couple is creating the revocable trust and plan on placing community property in the trust, care should be taken in the drafting of the trust agreement and the other transfer documents to make sure that the funding of the trust with community property does not amount to a partition of the community property that would jeopardize the new income tax basis both halves of the community can receive upon the death of the first spouse. See Rev. Rul. 66-283, 1966-2 C.B. 297.

#### **X. Closing the Probate Estate**

Upon the death of the first spouse and while record legal title to the probate assets still reflects that some community assets are held in the decedent's name, some are held in the survivor's name and others are held in both names, the surviving spouse and the heirs and/or devisees of the deceased spouse are, in effect, tenants in common as to each and every community probate asset,

unless the surviving spouse is the sole distributee of some or all of the deceased spouse's one-half interest in such assets.

Assuming that the decedent's one-half community interest has been left to someone other than the surviving spouse, the respective ownership interests of the survivor and the decedent's distributees are subject to the possessory rights of either a court appointed personal representative or the surviving spouse for administration purposes. When probate administration is completed, the survivor and the distributees are entitled to their respective one-half interests in each and every community probate asset. Tex. Prob. Code §37.

#### **A. Non-Pro Rata Division**

Accordingly, can the survivor and the personal representative (or the decedent's distributees) agree to make a non pro rata division of the community estate so that the surviving spouse receives 100% of some of the assets and the distributees receive 100% of other community assets? The answer is an obvious yes. The authority of an executor to enter into such a transaction should depend on the powers granted to the executor in the decedent's will. Of course, even if the will purports to enable the executor to make a non pro rata division of the community, the surviving spouse's agreement is still required. However, the surviving spouse may have already agreed by accepting benefits under the will through either an express or equitable election. The real issue is whether any such agreement will be considered a taxable exchange, subjecting the parties to capital gain exposure to the extent the assets have appreciated in value since the decedent's date of death.

#### **B. I.R.S. Position**

Three private letter rulings suggest that such an exchange is not taxable. In one, PLR 8037124, 1980 WL 134564, a husband

and wife proposed to divide into two equal, but non pro rata shares, certain community assets in order to create liquidity for one to pay estate taxes upon an anticipated death; relying in part on Rev. Rul 76-85, 1976-L C.B. 215, 1976-WL 36350, the memorandum concludes that such a partition would not result in a taxable event.

In the second, PLR 8016050, 1980 WL 132102, where a husband and the executor of his wife's estate proposed an equal, but non-pro rata division, again the Service ruled the exchange was not a taxable event. In California, the ruling noted, the right of partition is to the entire community estate and not merely to some specific part, relying in part on the legal principle that the marital property interest of each spouse is an interest in the property as an entity. The legal entity principle relied on in the memorandum is, however, only mentioned in the context of Rev. Rul. 76-83, 1976-1 C.B. 213, 1976 W.L. 36350. Rev Rule. 76-83 ruled that a divorce non prorata division of community transaction was a non-taxable transaction with no gain or loss being recognized. This author has not found any definitive reference in the ruling to the community being an entity under California law. The main point of the ruling was, while a division of the community in a divorce settlement may result in a taxable event, such a division is not considered taxable when there is an equal division of the value with some assets going to the wife and other assets going to the husband. In Texas, for most purposes, community property principles do not create an entity. Community property is a form of co-ownership among a husband and wife that ceases to exist when the marriage terminates.

Note: *The 1980 private letter rulings were issue prior to the enactment of 26 U.S.C.A. Sec. 1041, which provides that*

*no gain or loss is recognized on a transfer between spouses incident to a divorce.*

In the third, PLR 9422052, 1994 WL 237304 community assets had been placed in a revocable trust arrangement prior to the first spouse's death, and the trust agreement authorized the trustee to make non pro rata distributions following the first spouse's death among the survivor's trust and the deceased spouse's marital deduction and bypass trusts.

### **C. The Revocable Trust Advantage**

Do these three rulings really support the legal conclusion that a non pro rata division of assets in Texas among the surviving spouse and the heirs and/or devisees of the deceased spouse is not a taxable event, or is Texas substantive law different enough to generate a different tax result (a topic beyond the scope of this paper)? However, PLR 9422052 suggests a possible planning advantage a revocable trust may have over a traditional testamentary plan

In a traditional testamentary plan, a safe harbor approach may be for the personal representative with appropriate authority granted in the will to enter into a partition and exchange agreement with the surviving spouse shortly after the first spouse's death and prior to any significant appreciation in value to the community assets. Care should then be taken to track the income from the partitioned assets so that the income is properly reported on the income tax returns of the survivor and the estate (or its successors).

Note: *Even if the will of the deceased spouse authorized the executor to make non-pro rata distributions, it is doubtful such mandate is binding on the surviving spouse whose agreement to the division will be necessary to complete the*

*exchange. (But, consider the effect of a “widow’s election.”) On the other hand, in a joint revocable trust situation, the husband and wife, as the settlors of the trust, have already agreed as to the disposition of the trust estate, including perhaps a non-pro rata distribution of community assets, upon the death of the first spouse.*

## **EXHIBIT**

### **PLANNING PACKAGES**

#### **Traditional Testamentary Planning**

- 1) will
- 2) no current transfer documentation, other paperwork, expenses or fees
- 3) durable power of attorney
- 4) may avoid guardianship
- 5) full probate with independent administration
- 6) future transfer documentation, paperwork, expenses and fees

#### **Revocable Trust Planning**

- 1) revocable trust—fully funded
- 2) transfer documentation
- 3) current paperwork, expenses and fees
- 4) ltd. durable power of attorney
- 5) pour-over will
- 6) avoid guardianship
- 7) limit probate
- 8) future transfer documentation, paperwork, expenses and fees

#### **Stand by Planning**

- 1) revocable trust—nominal funding
- 2) ltd. durable power of attorney
- 3) defer transfer documentation, paperwork, fees and expenses
- 4) settlor or agent funds when needed
- 5) may avoid guardianship
- 6) if funded, can limit probate
- 7) if not funded, full probate with independent administration
- 8) pour-over will
- 9) future transfer documentation, paperwork, expenses and fees

### **ADDITIONAL DOCUMENTATION**

- 1) Health Care Power of Attorney
- 2) Natural Death Act Directive
- 3) Designation of Guardian of the Estate and/or Person