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## COMMUNITY PROPERTY AND THE LAW OF TRUSTS

by

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AS the concept of the trust form evolved under the English law, there was no thought that trusts would be widely used in jurisdictions where a large part of the property would be the community property of marital partners and in which the ownership of income from property might differ from the ownership of the property itself. Similarly, the community property system developed over the centuries in the civil law countries of southern Europe and found its way to Spanish America and the southwestern United States without any provision for the separation of legal and equitable titles which trust arrangements entail. As the economies of the community property states have matured and as trusts in this area have multiplied, many questions, largely unanswered, have arisen with respect to the interplay of the two concepts.

The problems which arise are fundamental. If a husband funds a trust with community property, retaining powers such as a power of revocation, is this power held for the benefit of himself or the marital community? If community, does it survive the death, incompetency or divorce of his wife? If the husband becomes incompetent or predeceases the wife, does the wife have any such power thereafter? Where a member of the marital community is the beneficiary of a trust, are distributions to him out of the income of the trust community or separate property? Where trust income is retained and accumulated, does the community estate acquire some interest in undistributed trust assets? If not, does this income when subsequently distributed become community property? Generally, is the equitable interest of the community estate in a trust to be conceived of in terms of the beneficial rights or powers held under the trust instrument, or does it extend to include an interest in the underlying trust assets?

Delicate distinctions over control, necessary in order to determine the federal tax consequences of trust transactions, raise additional issues. Are the powers of the husband who establishes a revocable trust out of community property personal to him, as suggested by some courts, or does he hold such powers as agent for the marital

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community, as suggested by others? Is the relationship between husband and wife under such circumstances one in which the husband cannot act without acting also on behalf of his spouse? If such a power is exercised by the husband, does the property revert to the husband or to the marital community or its successors? As a practical matter, how can trust arrangements which are commonplace in separate property systems be applied to community property in a way so that the same benefits and flexibility will be attained?

### I. COMMUNITY TRUST POWERS

*The Nature of Retained Control* An informal survey of the larger banks in the Southwest discloses that the great majority of inter vivos trusts administered by such fiduciaries is revocable. Most of these trusts have probably been funded with community property. Therefore, potential legal and tax problems are undoubtedly widespread in the states in which both the community property system and the common law prevail—Texas, California, New Mexico, Nevada, Washington, Idaho, and Arizona.<sup>1</sup> The common law has never been adopted in Louisiana, and, for this reason, that state is considered beyond the scope of this Article.<sup>2</sup>

The decided cases in the common law community property states,<sup>3</sup> in the absence of statute, follow the rule prevailing elsewhere<sup>4</sup> that revocability must be expressly retained; irrevocability follows as a matter of law otherwise. More recently, some states, including Texas<sup>5</sup> and California,<sup>6</sup> have enacted statutes designed to avoid an irrevoca-

<sup>1</sup> DE FUNIAK, *COMMUNITY PROPERTY* (1st ed. 1943); MARSH, *MARITAL PROPERTY IN CONFLICT OF LAWS* (1952); JACKSON, *Community Property and Federal Taxes*, 12 SW. L.J. 1 (1958). Similar problems may arise with respect to revocable trusts in separate property states, such as the question whether a revocable trust established by the husband during marriage will effectively cut off the statutory share of such property which the wife would have had, if the property had been a part of the husband's estate. See Scott, *The Revocable Trust and the Surviving Spouse's Statutory Share in Colorado*, 36 COLO. L. REV. 464 (1964).

<sup>2</sup> In 1964 the Louisiana Legislature enacted its first comprehensive statute relating to trusts. Louisiana Trust Code, LA. REV. STAT. 9:1721-9:2252 (1964). Previously, the authority for the creation of private trusts had been limited, with no statutory authority prior to 1920.

<sup>3</sup> Gray v. Union Trust Co., 171 Cal. 637, 154 P. 306 (1916); Kopp v. Gunther, 95 Cal. 63, 30 P. 301 (1892); Monday v. Vance, 92 Tex. 428, 49 S.W. 516 (1899); Holmes v. Holmes, 65 Wash. 572, 118 P. 733 (1911). There appears to be no express authority in Arizona, New Mexico, Idaho and Nevada.

<sup>4</sup> RESTATEMENT (SECOND), TRUSTS § 330 (1965); BOGERT, TRUSTS § 1000 (2d ed. 1962).

<sup>5</sup> TEX. REV. CIV. STAT. ANN. art. 7425b-41 (1960).

<sup>6</sup> CAL. CIV. CODE § 2280, as amended by Cal. L. 1931, ch. 950, p. 1955. Oklahoma has adopted a similar statute, 60 OKLA. STAT. ANN. § 175.41. See also more limited statutes in Maryland, Md. L. 1951, ch. 312, art. 16, § 108; North Carolina, N.C. Gen. Sess. L. § 39-6 (1950); New York, N.Y. Personal Property Law § 23 (1962); Wisconsin, Wis. L. 1961, ch. 407, § 231.50.

ble commitment except where the trust expressly provides for it. Even though in such states it is not necessary to specify in the instrument itself that a power to revoke is retained,<sup>7</sup> it is the usual practice for careful draftsmen to do so if the power is desired. Therefore, in these as in other states, the existence and scope of the power may depend to a considerable extent on the language of the individual instrument.

It is significant that, for purposes of state law, a revocable trust is effective for most purposes when it is established, not when the power to revoke may subsequently lapse or terminate. It is for this reason that the trust effectively removes property from the probate estate of the donor<sup>8</sup> and may also enable the donor to remove property from his wife's estate without her joinder.<sup>9</sup> For the same reason, a revocable trust is not subject to the Statute of Wills.<sup>10</sup>

The Statute of Wills cases emphasize the significance of the contractual and fiduciary rights and duties which come into being when a revocable trust is established, and which distinguish true trust from transfers to a "trustee" which are legally treated as agency arrangements. Although a tentative<sup>11</sup> or illusory trust<sup>12</sup> is no trust at all and terminates in any event at death or incompetency under the familiar rules of agency, the retention of a power of revocation is insufficient to create an agency arrangement unless accompanied by extensive other powers.<sup>13</sup> For this reason, a revocable trust may continue after the death of the settlor, although his power to revoke will ordinarily not survive him, and is non-assignable while in force.<sup>14</sup> Thus, in trust terminology, a power to revoke is a "personal" power,<sup>15</sup> even

<sup>7</sup> *McCauley v. Simmer*, 336 S.W.2d 872 (Tex. Civ. App. 1960) *error dismissed*, holding that irrevocability will not be implied from the terms of the instrument.

<sup>8</sup> RESTATEMENT (SECOND), TRUSTS § 330 (1965).

<sup>9</sup> *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959) (construing Texas law).

<sup>10</sup> *Ibid.*; *Marine Midland Trust Co. v. Stanford*, 256 App. Div. 26, 9 N.Y.S.2d 648 (1939), *aff'd mem.*, 281 N.Y. 760, 24 N.E.2d 20 (1939); RESTATEMENT (SECOND), TRUSTS § 57 (1965); 1 SCOTT, TRUSTS § 57 (2d ed. 1956); BOGERT, TRUSTS § 104 (2d ed. 1956); Scott, *The Effects of a Power To Revoke a Trust*, 57 HARV. L. REV. 362 (1944).

<sup>11</sup> *Fleck v. Baldwin*, 141 Tex. 340, 172 S.W.2d 957 (1943); 1 SCOTT, TRUSTS § 58.3 (2d ed. 1956).

<sup>12</sup> *Newman v. Dore*, 275 N.Y. 371, 9 N.E.2d 966 (1937); 1 SCOTT, TRUSTS § 57.5 (2d ed. 1956); 1 NOSSAMAN, TRUST ADMINISTRATION AND TAXATION 63 (2d ed. 1965).

<sup>13</sup> *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959); *Marine Midland Trust Co. v. Stanford*, 256 App. Div. 26, 9 N.Y.S.2d 648 (1939), *aff'd mem.*, 281 N.Y. 760, 24 N.E.2d 20 (1939); *Beirne v. Continental Equitable Trust Co.*, 307 Pa. 570, 161 A. 721 (1932); 1 SCOTT, TRUSTS § 57.1 (2d ed. 1956); BOGERT, TRUSTS § 104 (2d ed. 1965); RESTATEMENT (SECOND), TRUSTS § 57 (1965); Scott, *The Effects of a Power To Revoke a Trust*, 57 HARV. L. REV. 362 (1944).

<sup>14</sup> *Grove v. Payne*, 47 Wash. 2d 461, 288 P.2d 424 (1955). *Jones v. Clifton*, 101 U.S. 225 (1879); BOGERT, TRUSTS § 1001 (2d ed. 1962).

<sup>15</sup> BOGERT, TRUSTS § 1000 (2d ed. 1962).

though from the standpoint of community property law the holder of the power may or may not hold it in a "personal," as compared with a community property, capacity.<sup>16</sup>

The effectiveness of a conveyance to a trustee, even though revocable, does not mean that the revocation power is without significance. For example, the period within which vesting is required under the rule against perpetuities probably begins when the power to revoke terminates, rather than at the date the trust is originally established.<sup>17</sup> More importantly, the retention of a power to revoke completely alters the federal tax consequences of a trust. Since the property held in a trust which is revocable is regarded for federal income,<sup>18</sup> gift<sup>19</sup> and estate<sup>20</sup> tax purposes as the property of the person holding the power, at least when exercisable by a single settlor competent to act without the consent of an adverse party, it is the termination of the power to revoke which is the effective date of the trust transaction for such purposes.<sup>21</sup>

*Revocable Trusts with Dual Settlers—Community Property* The application of these rules of substantive and federal tax law becomes much more difficult where two settlors are involved, as where husband and wife establish a trust out of community property. It is recognized in separate property states that where two persons join in establishing a trust, retaining a power to revoke, it is ordinarily not intended that either will have the power to revoke without the consent of the other.<sup>22</sup> From this it usually follows, in the absence of provisions to the con-

<sup>16</sup> Compare *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958), cert. denied, 359 U.S. 913 (1959) with *Katz v. United States*, 66-1 U.S. Tax Cas. § 12,384 (S.D. Cal. 1966).

<sup>17</sup> RESTATEMENT, PROPERTY §§ 373, 441(2) (1944); cf. *Schmidt v. Schmidt*, 261 S.W.2d 892 (Tex. Civ. App. 1953) error ref.

<sup>18</sup> INT. REV. CODE OF 1954, §§ 676, 671 (trustee not required to file fiduciary return form 1041); Treas. Reg. §§ 1.641(a)-0(b), 1.641-4, 1.641(b)-2 (1956); Rev. Rul. 57-51, 1957-1 CUM. BULL. 171 (subchapter J. of INT. REV. CODE OF 1954 not applicable to revocable trusts).

<sup>19</sup> Treas. Reg. § 25.2511-2(c) (1961); *Stiffel v. Commissioner*, 197 F.2d 107 (2d Cir. 1952).

<sup>20</sup> INT. REV. CODE OF 1954, § 2038; property acquires a new basis at death, even if it is acquired after the trust is established. Rev. Rul. 58-395, 1958-2 CUM. BULL. 398 (step up in basis applicable to community property revocable trusts, Rev. Rul. 66-283, 1966 INT. REV. BULL. No. 39, at 17). However, the holding period probably runs from the date of acquisition, and not from the date of death of a party with power to revoke. Cf. Rev. Rul. 59-86, 1959-1, CUM. BULL. 209 (no new holding period, gifts in contemplation of death); Rev. Rul. 59-220, 1959-1 CUM. BULL. 210 (no new holding period, surviving spouse, community property). *Contra*, *Brewster v. Gage*, 280 U.S. 327 (1930). INT. REV. CODE OF 1954, § 2053 (estate debts and administration expenses deductible for estate tax purposes if paid with reasonable promptness); INT. REV. CODE OF 1954, § 6324(a)(2) (trust liable for estate taxes if not paid when due).

<sup>21</sup> *Commissioner v. Soloman*, 124 F.2d 86 (3d Cir. 1941).

<sup>22</sup> *Noble v. Rogan*, 49 F. Supp. 370 (S.D. Cal. 1943); *Crocker v. Crocker*, 192 N.Y. Supp. 666 (1921); RESTATEMENT (SECOND), TRUSTS § 330 (1965); *BOGERT, TRUSTS* § 1001 (2d ed. 1962).

trary, that since joint action is required, the trust will become irrevocable upon the death or incapacity of either; and the trust is never "revocable" in the sense that one individual has the unilateral power to vest trust property in himself at will.<sup>23</sup>

The position of the spouses in a community property state is similar but is not identical. Since the husband possesses powers under laws of all community property states to make gifts of community property without his wife's signature, subject to varying limitations,<sup>24</sup> revocable trusts of community property may be established by the husband acting alone in many instances. Furthermore, a husband's power to manage the community will ordinarily enable him to revoke the trust with respect to community contributions, if powers of revocation exist under the instrument or by statute. On the other hand, where a general power of revocation is granted in a trust or by statute, the wife ordinarily cannot exercise it during marriage.<sup>25</sup>

A basic distinction is drawn between such powers held by the husband on behalf of the community, and exercisable only for the benefit of the community, and powers held individually to revoke in favor of himself alone. In the leading case in the area, *Commissioner v. Chase Manhattan Bank*,<sup>26</sup> the Court of Appeals for the Fifth Circuit held that a power to revoke created by a transfer of community property to a trust in Texas was a community power, even though retained in the name of the husband alone. It is clear that if the power had been exercised during marriage, the property received would have reverted to the community. Since the wife's position in such a trust is

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<sup>23</sup> Note 22 *supra*.

<sup>24</sup> In California, the husband is deprived of all power to give community property to third persons unless the wife consents in writing. CAL. CIV. CODE § 172 (Deering 1960). In Idaho, New Mexico, and Washington there are statutory requirements for the wife's joinder in transfers of community realty. IDAHO CODE § 32-912 (1963); N.M. STAT. ANN. § 57-4-3 (1962); REV. CODE WASH. ANN. § 26.16.040 (1961). If the husband does make such a transfer to a third party without the wife's joinder, the New Mexico statute provides that such transfer is void, and this may also be the result in Idaho. N.M. STAT. ANN. § 57-4-3 (1962); *Wits-Keets-Poo v. Rowton*, 28 Idaho 193, 152 P. 1064 (1915). If the husband does have the authority to "give away" portions of the community without the wife's joinder, this power is generally limited by his incapacity to act in fraud of the wife's rights. *La Tourette v. La Tourette*, 15 Ariz. 200, 137 P. 426 (1914); *Kohny v. Dunbar*, 21 Idaho 258, 121 P. 544 (1912); *Nixon v. Brown*, 46 Nev. 439, 214 P. 524 (1923); *Beals v. Ceres*, 25 N.M. 459, 185 P. 780 (1919); *Occidental Life Ins. Co. v. Powers*, 192 Wash. 475, 74 P.2d 27, 114 A.L.R. 531 (1937); *Stewart v. Bank of Endicott*, 82 Wash. 106, 143 P. 458 (1914).

<sup>25</sup> TEX. REV. CIV. STAT. ANN. art. 4619 (1959); note 24 *supra*.

<sup>26</sup> 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959).

not adverse to that of the husband in the federal tax sense,<sup>27</sup> the income of the trust, so long as it is revocable, is taxed to the marital community.<sup>28</sup>

It is possible in some jurisdictions for a wife to make a gift to the husband of her interest in community property,<sup>29</sup> and in all jurisdictions for the husband to make a gift to the wife.<sup>30</sup> In such instances, the revocation power may be vested exclusively in a spouse individually, as in *Katz v. United States*,<sup>31</sup> decided under California law. The holder of such a power is, therefore, the sole owner of the property if the trust is revoked. In these circumstances, a taxable gift of the wife's community interest occurs when the trust is set up, and thereafter the trust is treated for tax and other legal purposes as if it had been funded with separate property.

*Prior Death of the Husband* Problems with respect to the revocability of community property trusts become critical at the deaths of the spouses. The legal consequences of the prior death of the husband are more easily ascertained than the consequences of the prior death of the wife. In the *Chase Manhattan* case, the court held that the trust became irrevocable in its entirety upon the prior death of the husband on the ground that, although the trust had been created with property belonging to the community and was held for the benefit of both, nevertheless the right to revoke was exercisable only by the husband; and therefore it lapsed upon his death when the community ceased to exist.

In the *Chase Manhattan* decision, the court recognized the well established rule in Texas that a husband may dispose of community property as he sees fit, absent fraud on his wife or creditors.<sup>32</sup> There-

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<sup>27</sup> *DeAmodio v. Commissioner*, 299 F.2d 623 (3d Cir. 1962). In order to establish an adverse interest, the power to revoke must be exercisable only with the consent of a beneficiary or holder of a general power of appointment. INT. REV. CODE OF 1954, §§ 676, 672(a). *Commisisoner v. Makransky*, 321 F.2d 598 (3d Cir. 1963); *Laganas v. Commissioner*, 281 F.2d 731 (1st Cir. 1960). If, upon termination of the trust, the property would vest solely in the husband, a power exercisable only with the consent of the wife would not make the trust taxable to the husband, to the extent of the wife's beneficial interest in the trust. However, where two individuals are co-donors and co-holders of the power to re-vest the property in themselves jointly, no taxable adverse interest exists. *DeAmodio v. Commissioner*, *supra*. The gift tax rules are substantially the same. *Camp v. Commissioner*, 195 F.2d 999 (1st Cir. 1952); *Skouras v. Commissioner*, 188 F.2d 831 (2d Cir. 1951).

<sup>28</sup> Note 18 *supra*.

<sup>29</sup> N.M. STAT. ANN. § 57-4-3 (1962); REV. CODE WASH. ANN. § 26.16.050 (1961); NEV. REV. STAT. § 123.070 (1957); CAL. CIV. CODE § 158 (Deering 1960); IDAHO CODE § 32-906 (1963). Dealing with real property, the case law of Arizona makes clear that a wife may make a gift of her interest in community realty to her husband. *Schofield v. Gold*, 26 Ariz. 296, 225 P. 71 (1924).

<sup>30</sup> *Huie, Community Property as Applied to Life Insurance*, 17 TEXAS L. REV. 121 (1939).

<sup>31</sup> 66-1 U.S. Tax Cas. ¶ 12,384 (S.D. Cal. 1966).

<sup>32</sup> *Aaron v. Aaron*, 173 S.W.2d 310 (Tex. Civ. App. 1943) *error ref.*

fore, the court reasoned, where the husband predeceased the wife, it was obvious that any capacity he had to change his mind had terminated, and the disposition of the property had become fixed. It would follow that the wife's rights to question the trust transaction or to participate in the exercise of the power were limited to the opportunity to seek relief in the courts, if the transfer to the trust had been a fraud on her,<sup>33</sup> and did not include any succession to her husband's power to revoke.

From a federal tax point of view, the court held that at the death of the husband, one-half of the trust was taxable in the husband's estate, and the other one-half became, at the same time, the subject of a taxable gift from the wife. Since she was entitled to the income from the trust for her life under the terms of the instrument, the amount of the gift was reduced for tax purposes by the value of the income rights retained by her out of her interest in the community.<sup>34</sup>

In the *Chase Manhattan* case, the power to revoke was retained by express provisions in a trust established in 1928, prior to the enactment of the Texas Trust Act. Does the same result follow where revocability is a creature of statute, reserved to the "trustor" of the trust, in absence of trust provisions otherwise? Certainly, the wife, even if unnamed in the instrument, is a trustor in the economic sense. It is clear she would also be recognized as such for federal tax purposes<sup>35</sup> and for many purposes under state law.<sup>36</sup> Nevertheless, it appears probable that courts will tend to follow the literal language of the statute and limit the power to the husband, especially since, with exceptions, he has the power of management, control, and disposition of his wife's interest in the community as a matter of state law.<sup>37</sup>

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<sup>33</sup> In Texas, the heirs of a wife can also sue to set aside a gift by the husband out of the community during the wife's life, on the grounds of fraud. *Stramler v. Coe*, 15 Tex. 211 (1855). However, there appears to be no authority whether the wife's heirs could seek to set aside the exercise, subsequent to the wife's death, of a power of revocation on the ground that it was a fraud upon the wife's estate. Whether, during coverture, the wife could obtain a personal judgment against the husband for her loss is not clear. See *Irwin v. Irwin*, 110 S.W. 1011 (Tex. Civ. App. 1908). See also SPEER, *MARITAL RIGHTS IN TEXAS* § 187 (4th ed. 1961).

<sup>34</sup> Presumably, the same property would be taxed again thereafter in the estate of the widow, in the absence of some intervening transaction. INT. REV. CODE OF 1954, § 2036.

<sup>35</sup> *Poe v. Seaborn*, 282 U.S. 101 (1930); *Goodell v. Koch*, 282 U.S. 118 (1930); *Hopkins v. Bacon*, 282 U.S. 122 (1930); *Mim* 3853, X-1 CUM. BULL. 139 (1930); X-1 CUM. BULL. 140 (1930).

<sup>36</sup> For example, the wife's joinder in a conveyance of community property is not necessary in Texas and adds no force to the instrument. *Griffin v. Troup*, Ind. School Dist., 163 S.W.2d 412 (Tex. Civ. App. 1942) *error ref.*

<sup>37</sup> IDAHO CODE § 32-906 (1963); N.M. STAT. ANN. § 57-4-3 (1953); REV. CODE WASH. ANN. § 26.16.030-040 (1961); TEX. REV. CIV. STAT. ANN. art. 4616 (1957). See also MARSH, *MARITAL PROPERTY IN CONFLICT OF LAWS* (1952).



A different result may follow under such a statute if the wife's name appears in the trust instrument as a "trustor." Although "the trustor" is referred to in the singular in the statutes of both Texas and California, it should probably be interpreted as applying to both spouses where both are designated as trustors in the instrument. A California case has by dicta so indicated.<sup>38</sup> In such an instance, the joint consent of both spouses is presumably required in order to revoke, unless the power so conferred on the wife is regarded as an invalid attempt by the husband to delegate a part of his statutory authority to manage the community.

In the *Katz* case, the husband also predeceased the wife. Since, however, under California law the wife could and, in this case, did divest herself of any interest in the trust property by express provisions in the trust, to which she consented in writing, the court concluded that the trust had effected a "transmutation" of the wife's one-half interest in the community, which thereafter became exclusively subject to the personal dominion and control of the husband. Consequently, in the *Katz* case, the entire trust was held to be within the husband's estate for estate tax purposes.<sup>39</sup> In all community property states, the husband ordinarily has dominion and control over the wife's community property. The court in *Katz* clearly rejected this as a basis for its decision and predicated its conclusion upon the language of the trust instrument and the capacity of the wife to divest herself of her interest under California law.

The community property states differ on the capacity of the wife to make an effective gift of her interest in the community to the husband,<sup>40</sup> and the issue seems far from settled in Texas.<sup>41</sup> However, even if it is ultimately held that the wife has the power to make an outright inter-spousal gift in this state, it would not necessarily follow that the courts would sustain the exercise by a husband of such a personal power to revoke if he uses the power to thwart the original trust

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<sup>38</sup> Hill v. Conover, 12 Cal. Rep. 522 (1961).

<sup>39</sup> In the *Katz* case, the inclusion of the property within the estate of the husband was predicated upon §§ 2036 and 2038. This would appear to be erroneous, insofar as it applied to the property contributed to the trust by the wife, as such sections apply only to prior transfers by the decedent. However, the same result would appear to follow under § 2041, dealing with powers of appointment, which applies to other powers of equal comprehensiveness, and includes powers of revocation. Treas. Reg. § 20.2041-1(b) (1961).

<sup>40</sup> Note 29 *supra*.

<sup>41</sup> In one court of civil appeals opinion, the court held without discussion that a gift by the wife of her community interest in land to the husband was effective to make the property the husband's separate property. Stratton v. Robinson, 67 S.W. 539 (Tex. Civ. App. 1902) *error ref.* In another court of civil appeals opinion, the court stated in dictum that the wife has such power. Collett v. Houston & T.C.R.R., 186 S.W. 232 (Tex. Civ. App. 1916) *error ref.* See also SPEER, MARITAL RIGHTS IN TEXAS (4th ed. 1961); Huie, *Community Property as Applied to Life Insurance*, 17 TEXAS L. REV. 121 (1939).

objectives by vesting title to trust property in himself, individually. Ordinarily, therefore, it is contemplated that the courts of most community property states will tend to treat a power to revoke a trust created with community property as a power exercisable in favor of the community upon the prior death of the husband.

*Prior Death of the Wife* If the husband, as manager of the community, establishes a revocable trust with community funds and the wife predeceases him, the problem becomes more difficult; and direct judicial authority on the legal result is lacking. There are several possibilities. First, it could be argued that the prior death of the wife has no effect on the revocability of the trust and that the husband, during his lifetime, continues to have such power of revocation. Second, it is possible that the prior death of the wife would result in irrevocability with respect to one-half of the property in the trust. Finally, it could be argued that at the prior death of the wife, the trust becomes irrevocable in its entirety.

The result will depend in part upon state law. The statutes in New Mexico deprive the wife of any power of testamentary disposition over her community property, and such property belongs to the husband at her death without the necessity of administration upon her estate.<sup>42</sup> Therefore her prior death should have no effect on the power of the husband to revoke a trust, except possibly where there is a specific trust provision to the contrary. The law of Nevada<sup>43</sup> is also subject to special provisions in the event the wife predeceases the husband.

In other community property states if a husband establishes a revocable community property trust, it would seem that if the wife predeceases the husband, the husband should not have the power to revoke the entire trust. As pointed out above, the husband is acting for the community when he establishes the trust, and the right of revocation is reserved on behalf of the community. The power to revoke the trust with respect to his wife's interest exists only because of the marital relationship. Upon the death of the wife, this relationship terminates, and the husband's authority to act on behalf of the com-

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<sup>42</sup> N.M. STAT. ANN. § 29-1-8 (1953). See also *In re Chavez's Estate*, 34 N.M. 258, 280 P. 241 (1929); MARSH, MARITAL PROPERTY IN CONFLICT OF LAWS (1952); Clark, *Management and Control of Community Property in New Mexico*, 26 TUL. L. REV. 324 (1952). *Hernandez v. Becker*, 54 F.2d 542 (10th Cir. 1931). If the husband predeceases, all of the husband's estate is subject to administration, and at least one-half, and probably all of it, is subject to tax. *Hurley v. Hartley*, 66-1 U.S. Tax Cas. ¶ 12,403 (D.N.M. 1966). See also Swihart, *Federal Taxation of New Mexico Community Property*, 3 NATURAL RESOURCES JOURNAL 104 (1963).

<sup>43</sup> NEV. REV. STAT. § 123.260 (1957). See also MARSH, MARITAL PROPERTY IN CONFLICT OF LAWS (1952).

munity ceases. It should follow that the power to revoke the trust in its entirety also ceases.

Could a continued power to revoke the entire trust be based upon the premise that the power was a personal one in the husband? Unless the wife joins in establishing the trust, and makes an effective gift to her husband in so doing, such a holding would, in effect, be that the husband has the power to make a gift to himself of his wife's property. This he cannot do.<sup>44</sup> Even though he can give community property to others, he cannot give it to himself.

If, after the death of the wife, the husband lacks the authority to revoke the entire trust as agent of the community or in his own personal right, the literal language of the statute or trust provision creating the power to revoke might provide support for such a power, especially if he is designated in the instrument as "trustor" or by some equivalent term. However, such a construction would permit the husband to exercise, after the wife's death, a power that he previously held over her property only in a community property capacity. Such an interpretation would, therefore, be inconsistent with the basic concept of the husband's authority over his wife's community property.

Assuming, therefore, that the husband's authority to revoke the entire trust cannot continue after the death of the wife, in the absence of an effective gift or peculiarities of state law, does the husband's power to revoke continue with respect to one-half of the trust? This also appears to be an unlikely result. A trust may be established to achieve objectives which may be prejudiced by the removal of one-half of the trust corpus. It has been recognized that where there are two unrelated settlors, the death of one terminates the power of both.<sup>45</sup> Under some circumstances, it would appear to be a matter of bad faith for the husband to fund a trust with property belonging to his wife and himself for some legitimate objective of the marital partnership and, after her death, to withdraw his contribution.

There is an additional problem to partial revocation. Although a power to revoke may be legally construed to include a power of partial revocation,<sup>46</sup> there is no basis for creating two trusts out of a single trust at the death of one of the spouses, each trust having differing terms with respect to revocability, unless the trust instru-

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<sup>44</sup> *Martin v. Moran*, 32 S.W. 904 (Tex. Civ. App. 1895).

<sup>45</sup> BOGERT, TRUSTS § 1001 (2d ed. 1962).

<sup>46</sup> 3 SCOTT, TRUSTS § 330.11 (2d ed. 1956).

ment so provides. To do so would be a legal novelty which seems unlikely to be adopted by the courts.

The most reasonable conclusion appears to be that unless the trust instrument specifically provides otherwise, the entire trust becomes irrevocable when the wife predeceases the husband. Since it has been previously shown that such a trust becomes irrevocable if the husband dies first, such a construction would result in the same rule being applied, regardless of which spouse predeceased the other.

*Incompetency or Divorce of a Spouse* Since a power to revoke a trust is usually construed as a personal one in the sense that it is not assignable or transferable, the authorities<sup>47</sup> as well as the courts<sup>48</sup> are in general agreement that incompetency ordinarily suspends a power to revoke so long as incompetency continues. There is substantial authority in the federal tax field that a trust will still be treated as revocable by an incompetent where, under the trust instrument, the trust is revocable by such person or his guardian,<sup>49</sup> except, perhaps, where no guardian has been appointed.<sup>50</sup> The weight of authority outside of the tax area appears to hold that a guardian has no such power.<sup>51</sup> There is, however, the possibility that a court of competent jurisdiction may be able to exercise the power if the circumstances of the particular case require it to do so.<sup>52</sup>

The existence of a community property trust may result in the application of a different rule. To varying degrees, the community property states,<sup>53</sup> including Texas,<sup>54</sup> provide that when a spouse is ju-

<sup>47</sup> BOGERT, TRUSTS § 1000 (2d ed. 1962); 3 SCOTT, TRUSTS § 330 (2d ed. 1966 supp.).

<sup>48</sup> First Nat'l Bank v. Oppenheimer, 92 Ohio L. Abs. 233, 190 N.E.2d 70 (Prob. 1963); Kemmerer v. Kemmerer, 74 Ohio L. Abs. 65, 139 N.E.2d 84 (App. 1956); Nat'l Commercial Bank & Trust Co., 50 N.Y.S.2d 274 (Sup. 1944); Chase Nat'l Bank v. Ginnel, 50 N.Y.S.2d 345 (Sup. 1944); the same result would probably occur under the Texas Probate Code § 230(b).

<sup>49</sup> Trust No. 3 v. Commissioner, 285 F.2d 102 (7th Cir. 1960) (income taxes); Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954); Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951); Griffith v. United States, 63-1 U.S. Tax Cas. ¶ 12,124 (S.D. Tex. 1962).

<sup>50</sup> Rev. Rul. 54-91, 1954-1 CUM. BULL. 207; Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952); George W. Perkins, 27 T.C. 601 (1956); W. H. Pope, CCH Tax. Ct. Mem. 646 (1953).

<sup>51</sup> See Chase Nat'l Bank v. Ginnel, 50 N.Y.S.2d 345 (Sup. 1944); BOGERT, TRUSTS § 1000 (2d ed. 1962).

<sup>52</sup> Thus, when the other assets of the incompetent have been exhausted and the property subject to the trust is needed for his care and support, the court will exercise such power of revocation. Rickel v. Peck, 211 Minn. 576, 2 N.W.2d 140 (1942); 138 A.L.R. 1375; cf., TEX. REV. CIV. STAT. ANN. art. 7425b-24 (1960).

<sup>53</sup> N.M. STAT. ANN. § 57-4-8 (1962); IDAHO CODE §§ 15-2001, 15-2011 (1948). In New Mexico, if the husband has been declared incompetent, the wife still cannot convey or transfer community realty. Frkovich v. Petranovich, 48 N.M. 382, 151 P.2d 337, 155 A.L.R. 295 (1944). In California, if the wife has been adjudged incompetent, the husband cannot convey her interest in community realty. Cullen v. Spremo, 142 Cal. App. 2d 225, 298 P.2d 579 (1956).

<sup>54</sup> TEX. PROB. CODE ANN. § 157 (1956). In a recent case, the husband conveyed the homestead without his wife's joinder. The court held that if the wife is in fact incompetent,

ditionally declared incompetent, the other spouse acquires power to manage, control, and dispose of the entire community estate. In such a situation, it would appear that upon incompetency of the husband, the wife might have the authority to exercise the power of revocation on behalf of an incompetent husband.

In the event of divorce, the possibility of judicial revocation of the trust would vary with the laws of a particular jurisdiction; but, in most, the court's authority over property matters would undoubtedly be sufficient to reach the trust assets.<sup>55</sup> If the divorce decree does not deal with the revocability issue, a more difficult problem would be presented. However, it would appear that the considerations which suggest irrevocability when the wife predeceases the husband would also suggest irrevocability when the marital relationship is severed by divorce.

*Drafting of Community Property Trusts* The impetus which the revocable trust has recently received from both responsible<sup>56</sup> and irresponsible<sup>57</sup> sources has increased the importance of developing satisfactory solutions to these problems. Two basic patterns appear to be emerging. One is based on the assumption that the usual intent of the parties is for the husband to have the power to revoke for the remainder of his life even if his wife predeceases him, after which the trust is to become irrevocable. This pattern is especially common for trusts funded with insurance on the husband's life, which are frequently made revocable during the husband's life in order to eliminate gift taxes on premium payments. After his death, the trust continues on an irrevocable basis in order to assure the availability of the proceeds of the insurance for the support of the wife, if she survives, and for the children in any event.

Notwithstanding the disadvantageous tax consequences of such an arrangement, it may best meet family needs in many cases, provided such a trust can be validly established under the law of the applicable state. In most states, if this result can be attained at all, it would require, as we have seen, that the wife give up her interest in the trust property, making an effective gift to the husband with respect to the original trust corpus and any amounts subsequently added to

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even though she has not been judicially declared so, then § 157 of the Texas Probate Code does not preclude the husband's conveyance of such homestead. *Schmidt v. Schmidt*, 403 S.W.2d 531 (Tex. Civ. App. 1966). For a complete analysis of this area of the law see in this issue, Comment, *Conveying the Homestead Without Joinder of Both Spouses*.

<sup>55</sup> TEX. REV. CIV. STAT. ANN. art. 4638 (1960).

<sup>56</sup> Casner, *Estate Planning—Avoidance of Probate*, 60 COLUM. L. REV. 108 (1960).

<sup>57</sup> DACY, *HOW TO AVOID PROBATE* (1966); cf., *Avoiding Probate*, 52 A.B.A.J. 938 (1966). Bush, *Do-It-Yourself Guide to Mis-Planned Estates*, Harpers, p. 108, Sept. 1966; *The Mess in Our Probate Courts*, Readers Digest, p. 102, Oct. 1966.

it, including premiums paid to maintain trust insurance policies. From a tax standpoint, the trust property is then equivalent to the husband's separate property, fully includable in his estate.<sup>58</sup>

An alternate approach is to provide for the division of the trust into two halves, one reflecting contributions of each. Upon the death of the first spouse, the trust attributable to his interest in the community takes the form of a conventional testamentary trust; while the other continues to be revocable (or irrevocable with a retained general power of appointment) for the remainder of the life of the surviving spouse.<sup>59</sup>

Practice varies concerning the time at which the two trusts should come into being. When a single trust is divided into two trusts at the death of the first spouse, there are conceptual problems to the identification of each trust as representing the property contributed by a particular spouse. In addition, such an arrangement is not easily used in the case of insurance trusts unless the insured spouse predeceases the other, as otherwise each trust will own an undivided one-half interest in an insurance policy or policies on a living person. In some cases, arrangements are made in advance to separate the policies at the time of the wife's prior death into two halves, or for one of the trusts to acquire the interest of the other on some acceptable basis.

An alternate approach is to divide the property into two trusts when the trusts are first established. In some states the spouses may be aided in identifying each trust as reflecting the separate contributions of each by statutes authorizing the partition of property divisible in kind between the spouses by contract.<sup>60</sup> The consequences of the two-share approach, if utilized from the inception of the trusts is, in effect, to create two trusts, one of which will be treated for tax purposes as the separate property of each spouse.

In any event, the contingency of incompetency, and possibly divorce, must be provided for unless the risk is to be taken that such an event would produce irrevocability and result in a taxable gift at that time.

There are, of course, many other powers which a spouse can retain in the establishment of a community property trust. If the power is broad enough to permit the trust corpus to be withdrawn from the trust, utilized to defray the legal obligations of the settlor of the trust, or used for the personal benefit of the settlor, it would appear that a husband who holds the power should be under a duty to exercise it

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<sup>58</sup> Note 20 *supra*.

<sup>59</sup> Polasky, "Pour Over Wills": Use with *Inter-Vivos* Trusts, 17 Sw. L.J. 410 (1963).

<sup>60</sup> TEX. REV. CIV. STAT. ANN. art. 4624a (1960).

for the benefit of community, in the absence of a transfer between the spouses as in the *Katz* case. Powers which might fall into this category would include general powers of appointment, the power to withdraw trust assets at will, and unrestricted powers to alter and amend.

In the event of the death of the wife, where the husband is the holder of such a power, two results are possible. One would be to hold that the power continues so long as the holder is living, but that if exercised, it must be utilized for the joint benefit of the husband and the wife's estate or heirs. This would result in a variety of problems if the power is exercised many years later, with anomalous results in some circumstances. The alternative would be to construe such powers as subject to the same restrictions on exercise as powers of revocation. Since the powers are similar in effect, this would appear to be the more appropriate result.

It is to be noted that powers to withdraw assets and similar powers benefit either the holder of the power or the community estate which he represents. The same considerations would not apply to powers held in a fiduciary capacity, the exercise of which is governed by the best interests of the beneficiaries of the trust. It is well recognized, of course, that fiduciary trust powers are ordinarily not personal but inherent in the office of the trustee and will not terminate at the death of the holder, even if it is necessary for a court to appoint a successor trustee to exercise them.<sup>61</sup> It is undoubtedly possible to grant to an individual a power which will terminate at his death but which he is required to exercise in a fiduciary capacity.<sup>62</sup> The considerations which suggest the termination of nonfiduciary powers upon the death of either spouse of a community property trust should not be applicable to fiduciary powers.

## II. TRUST INCOME AS COMMUNITY PROPERTY

*Distributed Income* The interplay of community property concepts and the equitable principles of trust law also becomes significant where beneficial interests are involved. The most difficult area is that of determining the ownership of distributed and undistributed trust income in the two states, Texas and Idaho, in which income from separate property is community property.<sup>63</sup>

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<sup>61</sup> TEX. REV. CIV. STAT. ANN. art. 7425b-17 (1960); BOGERT, TRUSTS § 553 (2d ed. 1960).

<sup>62</sup> BOGERT, TRUSTS § 553 (2d ed. 1960).

<sup>63</sup> TEX. REV. CIV. STAT. ANN. art. 4614 (Supp. 1966); IDAHO CODE § 32-903 (1963); *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925). In New Mexico, Washington,

For example, consider the common situation in which a parent creates a trust for the benefit of his child, either before or after the child's marriage. The Court of Appeals for the Fifth Circuit has held in a number of tax cases<sup>64</sup> that the income of such a trust, when distributed, is community property of the beneficiary and his spouse, if the income is derived from dividends, rents, or other sources which would normally be considered community when earned by a married person from his separate property. *Mercantile Nat'l Bank v. Wilson*, the only recent state court decision in the area, reaches the same result,<sup>65</sup> although there are a number of earlier decisions<sup>66</sup> discussed later in this article which take a different approach.

The principal contention which was made before the circuit court to avoid the characterization of trust distributions as community was that the income itself was the gift which the beneficiary had received from the settlor, and hence was separate property. The refusal of the court to accept this argument apparently stemmed primarily from the leading Supreme Court decision of *Irwin v. Gavit*,<sup>67</sup> in which Justice Holmes concluded that trust distributions were not gifts for federal tax purposes on the ground that "a gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund."<sup>68</sup> The court held, therefore, that the equitable interest in the trust was itself the subject matter of the gift. Using this approach, the circuit court decisions reason that the equitable interest of a married beneficiary of a trust is also property for purposes of the community property laws, and that the income derived from it in the form of trust distributions is, therefore, community property.

The equitable interest theory is more easily accepted where distributions from the trust are mandatory. For example, if a trust provides that "the trustee shall distribute to the beneficiary all of the income of the trust," or "\$100 per month out of the income of the trust," it is apparent that the married beneficiary has substantial property rights under the trust instrument which may be appropri-

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Nevada, California and Arizona, income from the wife's separate property remains her separate property. N.M. STAT. ANN. § 75-3-4 (1953); REV. CODE WASH. ANN. § 26.16.020 (1961). See also MARSH, MARITAL PROPERTY IN CONFLICT OF LAWS (1952).

<sup>64</sup> *Commissioner v. Sims*, 148 F.2d 754 (5th Cir. 1945); *McFaddin v. Commissioner*, 148 F.2d 570 (5th Cir. 1945); *Commissioner v. Snowden*, 148 F.2d 569 (5th Cir. 1945); *Commissioner v. Porter*, 148 F.2d 566 (5th Cir. 1945); *Commissioner v. Wilson*, 76 F.2d 766 (5th Cir. 1935); *Commissioner v. Terry*, 69 F.2d 969 (5th Cir. 1934).

<sup>65</sup> 279 S.W.2d 650 (Tex. Civ. App. 1955) *error ref. n.r.e.*

<sup>66</sup> *Sullivan v. Skinner*, 66 S.W. 680 (Tex. Civ. App. 1902) *error ref.*; *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896) *error ref.*; *Monday v. Vance*, 11 Tex. Civ. App. 374, 32 S.W. 559 (1895); *Shefflin v. Small*, 4 Tex. Civ. App. 493, 23 S.W. 432 (1893); *Hutcheson v. Mitchell*, 39 Tex. 488 (1873).

<sup>67</sup> 268 U.S. 161 (1925).

<sup>68</sup> *Id.* at 167.



ately characterized as the property from which the income is derived. On the other hand, if the power of the trustee to make distributions is completely discretionary, it may be more difficult to find that the beneficiary owns a vested "equitable interest" in the corpus of the trust, since he is entitled to nothing which the corpus produces unless the trustee decides to distribute such income to him.

Even in the case of a wholly discretionary trust, however, the beneficiary, under some circumstances, can compel distributions.<sup>69</sup> His interest is also sufficient to permit him to bring suit to prevent the trustee from mismanaging the trust.<sup>70</sup> Thus, even in such circumstances, it would not appear unreasonable to conclude that the beneficiary has a sufficient interest in the trust so that distributions, if made to him while married, will be community property. Any other approach would create the difficult problem of determining in each particular case whether the degree of discretion over distributions is sufficient to preclude a community character for the distributions. *The Conduit Principle* There is, in addition, a definite conduit concept incorporated in these decisions. For example, in *Commissioner v. Wilson*,<sup>71</sup> a married man residing in Texas was the income beneficiary of a trust which consisted of oil and gas interests and other properties. After reviewing the Texas authorities, the court held that so much of the trust income distributed to the married beneficiary as could be shown to have been derived from royalties, including bonus, was the separate property of such beneficiary, on the basis of the familiar rule in that state that royalties and bonuses from separate property are separate property. In *McFaddin v. Commissioner*<sup>72</sup> the character of trust income in the hands of the beneficiary was also determined as if it had been received directly by the beneficiary without the intervention of the trust. Under both decisions distributions from sources other than royalties, such as rents, retained their community character, since they would have been community if received directly by the beneficiary.

The conduit principle is unnecessary to the conclusion that distributed trust income is community property, once it is accepted that the beneficial interest from which the income is derived is susceptible of being considered property in itself. Furthermore, the use of the conduit principle may occasion serious legal and administrative problems, since the rules for computing income for purposes of fiduciary

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<sup>69</sup> See, e.g., *In re Lachmann's Estate*, 156 Cal. App. 2d 674, 320 P.2d 186 (1958). See also BOGERT, TRUSTS § 560 (2d ed. 1960).

<sup>70</sup> See BOGERT, TRUSTS § 560 (2d ed. 1960).

<sup>71</sup> 76 F.2d 766 (5th Cir. 1935).

<sup>72</sup> 148 F.2d 570 (5th Cir. 1945).

accounting may differ substantially from the rules applicable to determining income in order to distinguish community from separate property.

An obvious example is that trustees subject to the Texas Trust Act calculate depletion on oil and gas income in a different manner<sup>73</sup> from the way in which oil income is divided between principal and income for common law life estates.<sup>74</sup> The latter rule is utilized for community property purposes<sup>75</sup> and was followed in the *Wilson* case.

Another example of the difference between trust and community property accounting is that, in the former, trustees may be given discretion to distinguish between income and principal.<sup>76</sup> On the other hand, the parties have no power to alter, by agreement, the rules under which income is to be identified for purposes of segregating community and separate property in a state such as Texas.<sup>77</sup>

Under present law, trustees compute income for federal tax purposes under different rules from those which apply for fiduciary accounting purposes, although the federal regulations rely on state law to determine corpus and income in many respects.<sup>78</sup> It is conceivable that one set of rules might be used to determine how much money the fiduciary should distribute, another to determine how much of each distribution is community property, and a third to determine the taxable income of the trust.<sup>79</sup> In a substantial trust, however, even if the trustee is willing to operate under three accounting systems, the computation of income and principal based strictly on the source of the funds distributed becomes extremely difficult.

These problems are illustrated by the *McFaddin* case. There the corpus of the trust included two cattle ranches, several farms, and large amounts of rental property. The trustee had also executed an oil and gas lease on one of the ranches. Throughout the operation of the trust, large sums of money from rents, cattle operations, sales of properties, and royalties had been deposited in a common bank account from which operating expenses were paid, indebtedness discharged, and new purchases of cattle and additional lands made. An amount equivalent to the net income of the trust, as computed by the trustees, was also distributed to the beneficiaries annually from the same account.

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<sup>73</sup> TEX. REV. CIV. STAT. ANN. art. 7425b-33 (1960).

<sup>74</sup> *Youngman v. Shular*, 281 S.W.2d 373 (Tex. Civ. App. 1955), *aff'd*, 155 Tex. 437, 288 S.W.2d 495 (1956).

<sup>75</sup> *Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676 (1953).

<sup>76</sup> TEX. REV. CIV. STAT. ANN. art. 7425b-26 (1960).

<sup>77</sup> *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902).

<sup>78</sup> *E.g.*, Treas. Reg. §§ 1.661(b)-1, 1.661(a)-2(e), 1.661(b)-2 (1956).

<sup>79</sup> *Browning, Problems of Fiduciary Accounting*, 26 N.Y.U.L. REV. 931 (1961).

The Tax Court in *McFaddin* had proceeded on the theory that the problem of commingled trust income was not present since the court concluded that the undistributed income of the trust was not community property of the beneficiaries. In rejecting this theory, the Fifth Circuit stated that:

[T]he taxpayers were the beneficial owners of the trust properties, *and every part and parcel of them*, including income from them, belonged beneficially to them, either as separate or as community property *in the same way that it would have belonged to them had the property been deeded to the taxpayers* and operated by themselves. The greater part of the normal income from the property during the years preceding the tax years in question was community income. When it was commingled in a common bank account with other funds of the trust so that the constituents had lost their identity, the whole fund became community, and, when it was used by the trustees to purchase additional properties, those properties, taking the character of the funds which bought them, were community property.<sup>80</sup>

However, the appellate court did conclude that "the oil royalties and bonuses derived from, and the profits from sales of, the properties originally conveyed in trust to the separate beneficial interests of the taxpayers came to them as separate property and are taxable as separate income"<sup>81</sup> and remanded the case with directions to determine how much of the claimed separate income came from the original and how much from the after-acquired property.

The *McFaddin* decision specifically rejects the idea that the beneficial interest in the trust itself is the property which produces the income and attempts to distinguish between distributions of community and separate funds by viewing the properties held in trust as if owned by the beneficiary. Even here, where all of the net income was distributable annually, and the beneficiaries upon termination were the same persons as the income beneficiaries, tracing became impractical and the court was forced to apply the presumption that commingling creates community, although it was unwilling to follow the presumption entirely. An attempt to segregate corpus and income by tracing where diverse assets are held in trust would present even more difficulty where irregular distributions are made to multiple beneficiaries under discretionary distribution provisions.

In the ordinary case of community property where no trust is involved, the commingling principle, which is relied on so strictly in

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<sup>80</sup> Note 72 *supra*, at 573. (Emphasis added.)

<sup>81</sup> Note 72 *supra*, at 572-73.

the earlier cases,<sup>82</sup> is being applied with a less heavy hand today,<sup>83</sup> influenced undoubtedly by the fact that detailed accounting records are now usually available to overcome the presumption which commingling creates.<sup>84</sup> More is required than accounting records to divide commingled separate and community property, however. Guide lines which have developed include the concept that a separate estate is entitled to be reimbursed for advances to the community, at least to the extent that the community estate has benefited by the advances,<sup>85</sup> and the principle that community expenses are to be considered as coming first out of community income.<sup>86</sup> While these principals do not make accounting for community and separate property simple, even if complete accounting data is available, they at least make it possible.

The use of basic concepts of trust accounting, in lieu of community property concepts, to distinguish between community and separate property when distributed to the beneficiary of a trust finds support in *Mercantile Nat'l Bank v. Wilson*. In this case, the contention was made that the original corpus had become so commingled with the trust income during the marriage that a large portion of the trust corpus had become community property. The court concluded as follows:

[P]roperly considered, the trustees under such instrument were bound to first pay out or expend the income from the trust before paying out or expending the corpus of the trust, and in our opinion there is a presumption that the trustee and substitute trustee did, as was his duty, first pay out or expend such income before paying out or expending the corpus of the trust. . . . It follows that they were, therefore, required to pay out income first, and even if such income was commingled with corpus funds, it will be presumed that the first moneys paid out, until all income was exhausted, was in fact income.<sup>87</sup>

Therefore, the *Mercantile* decision rejects the application of the com-

<sup>82</sup> *Gaulding v. Gaulding*, 256 S.W.2d 684 (Tex. Civ. App. 1953); *Moore v. Moore*, 192 S.W.2d 929 (Tex. Civ. App. 1946); *Ervin v. Ervin*, 128 S.W. 1139 (Tex. Civ. App. 1910) *error disp.*; *Moor v. Moor*, 255 S.W. 231 (Tex. Civ. App. 1900).

<sup>83</sup> *Blumer v. Kallison*, 297 S.W.2d 898 (Tex. Civ. App. 1956) *error ref. n.r.e.*; *Hartman v. Hartman*, 253 S.W.2d 480 (Tex. Civ. App. 1952); *Hudspeth v. Hudspeth*, 198 S.W.2d 768 (Tex. Civ. App. 1946) *error ref. n.r.e.*

<sup>84</sup> *Pearce, Presumption of Community Ownership in Texas Commingling Cases*, 36 TEXAS L. REV. 196 (1957).

<sup>85</sup> *Dakan v. Dakan*, 125 Tex. 305, 83 S.W.2d 620 (1935); *Snodgrass v. Robertson*, 167 S.W.2d 534 (Tex. Civ. App. 1942) *error ref. w.m.*; *Lamar Life Ins. Co. v. Jordan*, 163 S.W.2d 215 (Tex. Civ. App. 1940) *error ref. w.m.*; SPEER, MARITAL RIGHTS IN TEXAS § 343 (4th ed. 1961).

<sup>86</sup> *Barrington v. Barrington*, 290 S.W.2d 297 (Tex. Civ. App. 1956); *Sibley v. Sibley*, 286 S.W.2d 657 (Tex. Civ. App. 1955) *error disp.*

<sup>87</sup> *Mercantile Nat'l Bank v. Wilson*, 279 S.W.2d 650, 658-60 (Tex. Civ. App. 1955) *error ref. n.r.e.*

munity property commingling concept at the trust level and accepts general principles of trust accounting—aided, in this case, by provisions of the trust instrument—as an appropriate guide, not only to determine income and corpus for trust accounting purposes, but also to determine the community and separate property character of distributions.

Such an approach is consistent with community property law, if it is accepted that trust property is neither community nor separate, but property of the trust. From this point of view, the collective rights of the beneficiary, viewed as an abstraction, are considered as the “property” from which the income flows, and distributions are classified as community income when made out of income of the trust, as determined for trust accounting purposes, much as corporate dividends are community income when declared in cash or property out of accumulated corporate profits.<sup>88</sup> Similarly, under this approach, corpus distributions from a trust are treated as separate property just as dividends paid by a corporation out of capital are separate<sup>89</sup> property where the stock itself is separate.

*Undistributed Income* A final difficulty with the conduit principle is that it tends to suggest that a community estate might have an interest in undistributed income of a trust established for the benefit of one of the spouses by gift. Such an approach would undoubtedly be inconsistent with the intent of the settlor in most cases. In addition it would cause endless problems in the administration of trusts, requiring fiduciaries to maintain a record of the marital status of the spouses and to account for the equity of the silent partner of the beneficiary.

There appear to be have been only two cases actually decided on the community property status of undistributed trust income. In the earlier, *McClelland v. McClelland*,<sup>90</sup> the testator devised to his son, in trust, all of the residue of his estate. The trustee was to distribute only \$150 per month to the son; and, except for these monthly distributions, all other rents, profits, etc., arising from the residue were to be accumulated.

In a divorce suit, the son's wife alleged that the rents from such realty had been accumulating since the marriage of herself with the son, and that such accumulated rents constituted their community

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<sup>88</sup> *Scofield v. Weiss*, 131 F.2d 631 (5th Cir. 1942); *Fain v. Fain*, 93 S.W.2d 1226 (Tex. Civ. App. 1936) *error dismissed*.

<sup>89</sup> *Scofield v. Weiss*, 131 F.2d 631 (5th Cir. 1942); SPEER, MARITAL RIGHTS IN TEXAS § 428 (4th ed. 1961).

<sup>90</sup> 37 S.W. 350 (Tex. Civ. App. 1896) *error ref.*

property. In holding that the wife had no claim to such accumulated rents in the hands of the trustee, the court stated:

The will, with the codicil, in effect is what is technically understood to be a spendthrift trust. The power of a testator at this date to make such a disposition of his property cannot be questioned. . . . It is apparent that the scheme of the testator was to place all of his estate, together with the revenues and income that should arise from it, in the possession and keeping of the trustees named in the will, to be held by them during the lifetime of [the son] subject only to a liability in his favor for the amount stated as set apart for his support. Those of his creditors or others who should seek an interest in the estate through him will have no greater right than he would have, and the limitation upon his right thus imposed would extend to a claim asserted by his wife, who was seeking to recover an interest in this estate. If the income arising from the estate was not available to [the son] and could not be reached by him, the right of his wife would be no greater than his. . . . Our conclusion is that [the wife] had no interest in the property conveyed by the will that she could reach.<sup>91</sup>

Such an approach seems necessary if the trust device is to serve in a community property state as a means by which properties may be placed in safe hands until a designated future date when distributions will be made. Certainly, it could not be said that the son would have had one-half of the undistributed trust income as an asset of his estate had he died prior to the time he was entitled to receive such income. It should follow, as the court held, that the community estate of the beneficiary and his spouse could have no greater claim to such income.

Again, the corporate analogy suggests itself. It is clear that corporate stock owned by a husband prior to his marriage or given to him during his marriage is his separate property, regardless of increases in value due to retained corporate earnings.<sup>92</sup> The wife, in a divorce suit, cannot claim any interest in undistributed corporate earnings, nor force a distribution, even though a distribution, if made, would be community property.<sup>93</sup> Furthermore, although the directors of a corporation have a broad measure of discretion in determining the amount of dividend distributions, as do the trustees of a discretionary trust, the discretion of both is subject to equitable limitations.<sup>94</sup>

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<sup>91</sup> Note 90 *supra*, at 358-59. See also *Hoffman v. Rose*, 217 S.W. 424 (Tex. Civ. App. 1920) *error ref.*

<sup>92</sup> SPEER, MARITAL RIGHTS IN TEXAS § 427 (4th ed. 1961).

<sup>93</sup> *Ibid.*

<sup>94</sup> *In re Lachmann's Estate*, 320 P.2d 186, 156 Cal. App. 2d 674 (1958); *Moroney v. Moroney*, 286 S.W. 167 (Tex. Comm. App. 1926); BOGERT, TRUSTS § 560 (2d ed. 1960).

Nevertheless, the *Mercantile Nat'l Bank*<sup>95</sup> case, which was decided in 1955, casts some doubt on the status of undistributed income. In this case, a suit was brought by a community creditor against the wife after her husband's death. Subsequent to the death of the husband, the wife had received distributions from a trust of which she had been the beneficiary, and which had been established prior to her marriage. The terminating distributions included income accumulated in the trust during marriage.

The daughter contended that such income was not liable for community indebtedness since "undistributed income of the trust is not community property."<sup>96</sup> During the course of its opinion, the court stated that:

[T]he first and preliminary material question, in our opinion, is whether or not the *undistributed* profits or income from the trust in the hands of the trustee is community property. We must answer that the income on the trust corpus was community property from the date of the marriage of appellee to George O. Wilson, now deceased, until the time of the death of George O. Wilson.<sup>97</sup>

In spite of this statement, the court of civil appeals reached the conclusion that Mr. Wilson's creditors had no claim to the undistributed income of the trust on the grounds that it was part of his wife's "special community" under applicable Texas statutes.<sup>98</sup> When an application for writ of error was filed with the Supreme Court, it was refused on the grounds that "no reversible error" was present. Perhaps we may assume that the Supreme Court doubted the correctness of the court of civil appeals' views on undistributed income but regarded them as dicta, since a holding that the undistributed funds were not the property of either spouse, but rather of the trust, would have produced the same result.<sup>99</sup>

*The Significance of Spendthrift Clauses* One way in which the *Wilson* case and the *McClelland* case might be distinguished is that the trust in *McClelland* contained a valid spendthrift trust clause which prevented the son from reaching prospective trust distributions until actually distributed to him. In the *Wilson* case, on the other

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<sup>95</sup> 279 S.W.2d 650 (Tex. Civ. App. 1955) *error ref. n.r.e.*

<sup>96</sup> *Id.* at 652.

<sup>97</sup> Note 95 *supra*, at 653-54. (Emphasis added.)

<sup>98</sup> The special community concept may relieve the trustee from liability for distributing the husband's community share of trust income to the wife, under a trust established by gift or devise for her benefit. However, the concept does not provide a basis for ignoring the husband's interest in such income for other purposes, such as division of property at death or divorce.

<sup>99</sup> *Glass v. Carpenter*, 330 S.W.2d 530 (Tex. Civ. App. 1959) *error ref. n.r.e.*; *McFaddin v. Commissioner*, 148 F.2d 570 (5th Cir. 1945). *Contra*, *Booth v. Chadwick*, 154 S.W.2d 268 (Tex. Civ. App. 1941) *error ref. w.m.*

hand, the spendthrift trust clause appears to have been invalid, since the settlor was also the sole beneficiary.<sup>100</sup>

The presence of a spendthrift trust clause, though emphasized in the *McClelland* case, does not provide a very satisfactory basis for determining whether undistributed trust income is subject to the community property claims of the spouse of a beneficiary. A leading recent decision supports the view that this issue should turn upon more fundamental and generally applicable criteria.

In *Herring v. Blakeley*,<sup>101</sup> the Texas Supreme Court was called upon to decide whether or not an interest under a profit sharing trust, together with rights under a retirement annuity agreement, were "property" and, if so, whether such property was community property. The husband's participation in both commenced during marriage and the contributions by the employer for the husband's account, as well as by the husband himself, had been made during the marriage. The benefits under both plans were payable only upon the husband's death or termination of employment by retirement or otherwise. Although anticipation was forbidden by spendthrift provisions<sup>102</sup> and clauses forbidding assignment, the rights of the husband under both agreements were "vested" in the sense that the employee had participated for a long enough period so that under the provisions of the agreements his beneficial interests were not subject to reduction in the event of termination of employment.

Prior to the husband's death, he and his wife were divorced. Upon the death of the husband, the wife claimed that she was entitled to one-half of the value of the husband's interest under the profit-sharing trust, as well as the annuity plan, determined as of the date of divorce, on the grounds that the rights of the husband under both plans were community property. The supreme court, in sustaining her position, found that "the ownership of this account was unconditional"<sup>103</sup> and that "the employee's vested interest in the plan has all the attributes of property, and we hold that it was property at the time of the divorce."<sup>104</sup> The court then concluded that both

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<sup>100</sup> The validity of the spendthrift provision might be sustained by the particular circumstances under which the trust was created. Although the settlor was also sole beneficiary, the trust corpus had been a gift from the settlor's parents immediately prior to the establishment of the trust, apparently with a pre-existing understanding that the trust would be established. It may be possible, therefore, to treat the parents as the real settlors, in which event the spendthrift trust clause would presumably be valid.

<sup>101</sup> 385 S.W.2d 843 (Tex. 1965).

<sup>102</sup> Since the husband's "interest" under the trust was received as compensation for services, there is some doubt as to the validity of the spendthrift trust clause. *Cf.*, *McFaddin v. Commissioner*, 148 F.2d 566 (5th Cir. 1945).

<sup>103</sup> Note 101 *supra*, at 845.

<sup>104</sup> Note 101 *supra*, at 845-46.



were community property even though neither spouse could compel distributions at the time of divorce. In reaching this result, the court held that "there is no requirement in Texas that community property must be reducible to immediate possession before a divorce court can take jurisdiction to determine the parties' rights therein. Community rights may exist in interests that cannot be reduced to possession, such as remainder or reversion rights."<sup>105</sup>

*Herring v. Blakely* does not hold that undistributed income in a trust established for the benefit of one spouse is subject to the community property claims of the other in the event of a divorce. As shown by the decision, a trust in which both members of the community will have property rights can be created not only by transfers of community property to a trustee retaining income or other rights under the trust for the benefit of the community, but also by the performance of services during marriage in consideration of which a trust is established. Mrs. Herring was, at the time of divorce, just as much an owner of the beneficial rights under the profit sharing trust as was her husband. On the other hand, had the trust been established as a gift by a relative for Mr. Herring's personal benefit, the equitable interest of the beneficiary would have been his separate property. Distributed income would still have been community, but undistributed income would not have been reflected in the value of the community estate unless the conduit approach were used.

*Herring v. Blakeley* leaves undecided the obvious question of how the interest of the wife would have been satisfied and liquidated had the property settlement occurred while Herring was living and employed.<sup>106</sup> The fact that the court recognizes that the right to benefits under a trust do not have to be possessory to be "property" does not mean that a beneficial interest in a trust will change from separate property to community property because benefits are accruing at the trust level. The emphasis in *Herring v. Blakeley* that the beneficial interest under the profit sharing trust was property itself appears to strengthen the concept of *Irwin v. Gavit* in Texas.

<sup>105</sup> Note 101 *supra*, at 847.

<sup>106</sup> Brief of Amicus Curiae, *Herring v. Blakely*, 385 S.W.2d 843 (Tex. 1965); The Committee on Community Property Problems Having Significant Tax Implications, Tax Section, State Bar of Texas. The decision also leaves unanswered whether the interest of a beneficiary under a profit sharing trust is "property" for community property purposes where his rights are unvested or only partially vested. If the approach of *Irwin v. Gavit* is used, such beneficial rights may be regarded as community property, but as having no value, or as being incapable of valuation, under such circumstances. The theory of *Irwin v. Gavit* would provide a basis for valuing the interest of the beneficiary without specific reference to the value of the underlying assets. This approach might provide a practical basis for avoiding the difficulties which would arise if the courts should hold that the spouse of the beneficiary of a profit sharing trust has a recognizable interest in the trust under all circumstances.

### III. CAPACITY OF SETTLOR TO CONTROL CHARACTER OF DISTRIBUTED INCOME

Although two of the legal theories discussed above support the conclusion that distributions from the income of a trust to a married beneficiary should be treated as community property during his marriage, there are several earlier Texas cases which suggest that it may be possible to change this result if sufficiently clear provisions are inserted in the trust instrument. For example, two court of civil appeals decisions<sup>107</sup> have held that where the husband and wife conveyed the wife's separate property to a trustee with a provision that the proceeds from the separate property were to be paid for the support of the wife and her children, such a conveyance successfully withdrew the rent from the community estate, thereby resulting in such income being the wife's separate property.

It has been pointed out<sup>108</sup> that this concept of making trust income a beneficiary's separate property simply by having the trustor show that this is his intent in "clear and unmistakable language" is difficult to reconcile with the decisions of the Texas Supreme Court<sup>109</sup> to the effect that the community or separate character of property is determined by the constitution and applicable statutes and not by the intent of the parties, however clearly such intent may be stated.

It may be possible to explain these cases on a gift theory. It is clear in Texas that a person cannot make a gift or community which is not yet in being.<sup>110</sup> However, it has also been held that:

[T]his rule has no reference to the well recognized right of the husband to make to his wife a gift of his interest in the community property then in esse, when it can be done without injury to the rights of others . . . this is simply doing with his property what he has the right to do. Hence, while it may be conceded that the community status of rents collected was not affected by the mere agreement between [the husband] and his wife, made when he conveyed the property to her, yet if this agreement was thereafter observed and actually carried out, and the rents delivered into the possession of the wife, as the evidence discloses and the jury has found, then the collected rents became the separate property of [the wife] unless the gift was in fraud of the rights of creditors.<sup>111</sup>

Thus, it might be argued that when the instrument makes it clear

<sup>107</sup> *Monday v. Vance*, 11 Tex. Civ. App. 374, 32 S.W. 599 (1895); *Shepflin v. Small*, 4 Tex. Civ. App. 493, 23 S.W. 432 (1893).

<sup>108</sup> HUIE, *COMMUNITY PROPERTY LAW OF TEXAS* (rev. ed. 1960).

<sup>109</sup> *Tittle v. Tittle*, 148 Tex. 102, 220 S.W.2d 637 (1949); *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902).

<sup>110</sup> See, e.g., *Chandler v. Alamo Mfg. Co.*, 140 S.W.2d 918 (Tex. Civ. App. 1940).

<sup>111</sup> *Armstrong v. Turbeville*, 216 S.W. 1101, 1106 (Tex. Civ. App. 1919) *error disp.* See also *Cadwell v. Dabney*, 208 S.W.2d 127 (Tex. Civ. App. 1948) *error ref. n.r.e.*

that the income is to belong to the wife, and any such income is thereafter actually distributed to her, then the husband has made an effective gift of his interest in such income to his wife, and converted it into her separate property. If the courts continue to so hold, it may be possible to control the character of distributed income in the case of such trusts by the way the trust is drafted.

Some of the cases which recognize the effectiveness of trust language to control the classification of distributions as community or separate property involve trusts established by third parties. For example, in *Sullivan v. Skinner*,<sup>112</sup> a father had devised certain property to his daughter for her sole and separate use during her lifetime, with the corpus passing to her children upon death. In holding that the rents derived from such property were the daughter's separate property and not subject to her husband's creditors, the court placed great emphasis upon the provisions of the will which stated that the property was given to the daughter "for the term of her natural life, with full power to receive *for her sole and separate use, and no other*, with rents and profits of the same, and on her death the same to belong to any child or children of the said [wife]."<sup>113</sup> The court held that such language of the will meant that the rents and profits the wife was empowered to receive "excluded the right of her husband to any interest in the rents and profits, and made them her separate property."<sup>114</sup>

The doubtful nature of this concept has been noted by the federal courts. Thus, as stated in the decision of *Commissioner v. Porter*:

[W]e are not prepared to go as far as the taxpayers do in their claim, that under the laws of Texas, a trust could not be validly created upon terms giving income to a wife or a husband, for life, as their separate property. . . . [B]ut in view of the generally prevailing rule in Texas, that income from separate property falls when received into the community, it is certainly true that if by a use of a trust instrument this general rule can be departed from, the instrument must, in the most precise and definite way, and by the use of language of unmistakable intent, make that desire and intention clear.<sup>115</sup>

In the *McClelland* case, as discussed earlier, the married son's father had established a testamentary trust under which the son was to receive \$150 per month during his lifetime. Such distributions were made to the son and, in a divorce suit, the court held that the wife had no interest in such distributed income. The court apparently

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<sup>112</sup> 66 S.W. 680 (Tex. Civ. App. 1902) *error ref.*

<sup>113</sup> *Id.* at 681. (Emphasis added.)

<sup>114</sup> Note 112 *supra*, at 681.

<sup>115</sup> 148 F.2d 566, 568 (5th Cir. 1945). See also *Commissioner v. Hinds*, 180 F.2d 930 (5th Cir. 1950) (concurring opinion).

concluded that such distributed income was the son's separate property because he had received it by will. Unless there is a distinction between an inter vivos gift to a trust beneficiary and a testamentary gift devised to him, this holding would appear to be in conflict with the cases discussed earlier holding that the gift to an income beneficiary of a trust is not a gift of the income itself but a gift of an equitable interest in the corpus of the trust. Apparently, the court in the McClelland case did not view the bequest to the son as an equitable interest in the corpus but as the income itself.<sup>116</sup> There appears to be no way in which to justify such a conversion into separate property of income which would otherwise be community, by a third party settlor, without such a rejection of the doctrine of *Irwin v. Gavit*.

#### IV. CONCLUSION

Additional precedent will be required before it is clear in which direction the decisions on trust income will go. The concept that, for community property purposes, the property which the beneficiary owns is his equitable interest in the trust, is an approach which appears consistent with the fundamental legal concepts in the area, and which would provide a uniform and workable guide for identifying the ownership of trust income in community situations. The cases treating the beneficiary as if he owned an interest in the underlying properties, at one extreme, or as if he had received by gift only the actual trust distributions themselves, at the other, may result in a satisfactory result in a particular case, but do not appear to provide the basis for a practical and uniform over-all development of the law of trusts as applied to community property.

The concept of *Irwin v. Gavit* that the collective rights and benefits of the beneficiary is property in itself is also more consistent with the law as it is developing in the revocable trust area. It is reasonably clear that community and separate property states agree that even a revocable trust is a distinct property-owning entity. Where revocation or equivalent trust powers are held for the benefit of a marital community, it appears that with the exception of one or two states in which the community principle is not carried through consistently to the estates of the spouses, the consequences of death, incapacity and divorce will conform with the generally applicable rules in other states, provided it is recognized that such powers are owned by partners whose authority to act for one another varies with individual circumstances and individual states.

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<sup>116</sup> *Cf.*, *Lucas v. Lucas*, 365 S.W.2d 372 (Tex. Civ. App. 1962).