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Interspousal Transfers

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INTERSPOUSAL TRANSFERS*

by

Regis W. Campfield**

It is indeed a privilege to participate in this tribute to Charles O'Neill Galvin on the occasion of his return to full time teaching after fifteen years as Dean of Southern Methodist University School of Law. Thirty years ago Dean Galvin began his distinguished career as a teacher and scholar. Throughout his time as dean and professor he has been a leader in tax reform and tax simplification efforts. My hope is that this Article, which considers elements of reform, simplification, and tax justice at both the state and federal levels, will contribute to these efforts.

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Inasmuch as this Article discusses pending litigation it is appropriate to note that the author has no financial interest in the outcome of this litigation, nor does he have any professional or other association with or connection to the taxpayers, their attorneys, the Department of Justice, or the Internal Revenue Service.

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I. INTRODUCTION

On August 8, 1977, the Tax Court of the United States in *Estate of Castleberry v. Commissioner*,¹ reached a decision affecting all Texans, and which, if consistently applied, will affect taxpayers in other states as well. The court, in effect, held that Texas domiciliaries can never make gifts² to their spouses without having one-half of the gift³ subsequently included in the donor spouse's gross estate for federal estate tax purposes under section

1. 68 T.C. 682 (1977), *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978), *nonacq.* 1979-1 I.R.B. 7.

2. It has even been suggested that "[i]f the logic . . . [of *Castleberry*] withstands attack, marriage in Texas results in an instantaneous gift to each spouse of a one-half life estate in the other spouse's separate property, a gift that is subject to the gift tax." Note, *Gift Tax Liability Resulting From Marriage In Texas*, 55 TEXAS L. REV. 1427, 1427 (1977).

3. See text accompanying notes 378-93 *infra*.

2036 of the Internal Revenue Code of 1954,⁴ which provides:

- (a) GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
- (1) the possession or enjoyment of, or the right to the income from, the property

In a subsequent decision, *Estate of McKee v. Commissioner*,⁵ the Tax Court said that this principle applies to all transfers between husband and wife of both income and nonincome producing property, including, in that case, birthday and anniversary presents. Moreover, in a slightly different context, in *Estate of Wyly v. Commissioner*⁶ the Tax Court held that a transfer of community property to an irrevocable trust by one Texas spouse for the benefit of the other spouse would require the inclusion of one-half of the trust property in the donor's gross estate.

In Texas,⁷ Louisiana,⁸ and Idaho,⁹ unlike the other community property

4. I.R.C. § 2036. Henceforth textual references to "§ —" or "section —" will be to sections of the Internal Revenue Code of 1954, unless the context otherwise declares.

5. 37 T.C.M. (CCH) Dec. 35,049 (1978).

6. 69 T.C. 227 (1977), *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978).

7. The Texas Family Code defines community property as "property, other than separate property, acquired by either spouse during marriage." TEX. FAM. CODE ANN. § 5.01(b) (Vernon 1975). While the Texas Constitution does not define community property, it defines separate property as "[a]ll property, both real and personal, of the wife, owned or claimed by her before marriage, and that acquired afterward by gift, devise or descent." TEX. CONST. art. XVI, § 15; *accord*, TEX. FAM. CODE ANN. § 5.01(a) (Vernon 1975). From this constitutional definition of separate property, the Texas Supreme Court has determined that income from separate property is community and that the legislature is powerless to expand the definition of separate property. *Moss v. Gibbs*, 370 S.W.2d 452 (Tex. 1963); *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925). *See also* 3 L. SIMPKINS, TEXAS FAMILY LAW § 15:39 (Speer's 5th ed. 1976). The Texas Supreme Court has also held that the legislature is powerless to transform one type of constitutionally defined property into another type of property, *Williams v. McKnight*, 402 S.W.2d 505 (Tex. 1966) (legislature powerless to authorize spouses to create joint tenancy with right to survivorship in community property without first partitioning such community property), and that the courts are powerless in a divorce proceeding to divest one spouse of his or her separate real property and transfer title to the other spouse. *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977). So too, to maintain the integrity of separate property, the Texas Supreme Court has held that gains in the nature of a change in the form of, or appreciation in, capital constituting separate property, including mineral rights and stock dividends, are not deemed revenue or income for marital property purposes and thus remain separate property. *See, e.g.*, *Scotfield v. Weiss*, 131 F.2d 631 (5th Cir. 1942); *Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676 (1953). *See note 281 infra* and accompanying text.

Despite the reaffirmation of the rule of implied exclusion in the *Eggemeyer* decision in 1977 and in *Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978), *discussed at notes 449-51 infra*, the 1972 decision in *Graham v. Franco*, 488 S.W.2d 390 (Tex. 1972), suggests that the Texas Supreme Court may recognize an additional test for classifying property as community or separate. The test of *Graham* would appear to constitute an indirect expansion of the constitutional definition of separate property in some cases. In *Graham* the supreme court was confronted by a constitutional challenge to § 5.01(a) of the Texas Family Code, which provides that "recovery for personal injuries sustained by the spouse during marriage" shall be separate property. In upholding the validity of § 5.01(a)'s classification of personal injuries recoveries as separate property, the court reasoned that such receipts must be separate property since community property, to be such, must be acquired by the joint efforts of the

jurisdictions, income from separate property is community property. In *Castleberry* and its progeny, *McKee* and *Wyly*, the Commissioner seized upon this principle to reason that the income from the transferred property will be community income, and, therefore, that the donor spouse has made a transfer of property and retained a life estate in the transferred property requiring inclusion of a portion of the transferred property in the transferor's gross estate pursuant to section 2036(a).¹⁰

The fundamental issue in *Castleberry* and *McKee*, seemingly never addressed by the Tax Court, is whether the nexus or connection between the transfer and the income interest of the donor spouse is broken since, after the transfer, the donee spouse has an absolutely unfettered right to cut off the income interest of the donor by (1) merely dissipating or otherwise disposing of the transferred property, (2) moving to a separate property jurisdiction, (3) divorcing the donor, or (4) dying.¹¹ Alternatively, the

spouses. Chief Justice Greenhill said that a definition of community property existed in Spanish law, and "in adopting the provisions of Section 15 of Article 16 of our constitution, the people did not intend to change the common law or the Spanish law under which Texas operated." He concluded, therefore, that it was appropriate to use the Spanish definition of community property:

A much later case of this Court reverted to a test more akin to that prevailing under the Spanish and Mexican law, and several early opinions of this Court, dealing with community property. It applied an affirmative test; i.e., that property is community which is acquired by the work, efforts or labor of the spouses or their agents, as income from their property, or as a gift to the community. Such property acquired by the joint efforts of the spouses, was regarded as acquired by "onerous title" and belonged to the community. *Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676 (1953); *DeBlane v. Lynch*, 23 Tex. 25 (1859); *Smith v. Strahan*, 16 Tex. 314 (1856); *Epperson v. Jones*, 65 Tex. 425 (1886); *De Funiak*, Principles of Community Property (1971) § 62; *Moynihan*, Community Property, 2 American Law of Property (1952) § 7.16

.....
 In light of the foregoing, it is our conclusion that, in adopting the provisions of Section 15 of Article 16 of our constitution, the people did not intend to change the common law or the Spanish law under which Texas operated

.....
Graham v. Franco, 488 S.W.2d at 392, 393 & 395.

Continued use of the test of *Graham* would likely result in an increase in the number of items of property that are classified as separate, whereas under *Arnold's* rule of implied exclusion, the balance would be weighted in favor of community classification.

8. LA. CIV. CODE ANN. art. 2334 (West 1971). *But see* text accompanying notes 85-86 *infra*.

9. IDAHO CODE § 32-906 (income can be declared separate property of donee if such designation appears in the instrument of transfer).

10. Texas law prevents Texas spouses from frustrating this analysis by agreeing between themselves that all income to be realized from the transferred property will be the separate property of the donee spouse. *See Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978), *discussed at* notes 449-51 *infra*; *Gorman v. Gause*, 56 S.W.2d 855 (Tex. Comm'n App. 1933, judgment adopted), *discussed at* note 451 *infra*. *See generally* 3 L. SIMPKINS, *supra* note 7, § 16:3. Only after such income comes into existence can the spouses convert it into separate property by interspousal gift, written partition agreement, or dissolution of the community. *See id.* §§ 22:5, :13. Nonetheless, it appears that the settlor of a trust can earmark the trust income as the separate property of the donee beneficiary. *See* notes 309-15 *infra* and accompanying text.

11. TEX. FAM. CODE ANN. § 5.21 (Vernon 1975) provides that: "Each spouse has the sole management, control, and disposition of his or her separate property." The right of a

question is whether the transferor can be deemed to have retained an interest in the transferred property within the meaning of section 2036(a) if the transferor has no means by which to compel the production of income or otherwise control the enjoyment of the transferred property.¹² This is not to say, however, that the income produced by the transferred property is not taxable to the transferor as community property. It is submitted that the correct analysis in *Castleberry* and *McKee* would cause (1) the exclusion of the transferred property from the transferor's gross estate when the transferred property becomes the donee's separate property; and (2) the inclusion in the transferor's gross estate of his portion of the community income produced prior to his death that is then identifiable.¹³ Perhaps the validity of this proposition can be demonstrated by noting the tax consequences if the donee spouse died first. In such a case the entire value of the transferred property would be included in her gross estate for federal estate tax purposes,¹⁴ and the property itself would be disposed of under her will, or in absence of a will,¹⁵ under the applicable intestate statutes.¹⁶

In *Wyly* the issues are slightly different. There was, for example, no possibility that the donor's spouse could alter the terms of the trust or control the trustee's exercise of discretion in administering the trust and thereby deprive the donor of any rights in the trust that he had by virtue of its terms or by virtue of applicable law. In point of fact, the irrevocable trust made no provision whatsoever for the donor, and, accordingly, it is clear that he expressly retained no interest whatsoever in the property transferred to the trust. The question remains, however, whether the decedent retained any interest in the property transferred to the trust by operation of state law.¹⁷ In particular, the issues are:

- (1) Whether trust income is separate or community property.¹⁸
- (2) If trust income is community property, does the donor spouse who has a community interest in the income produced by the trust have any ability to compel the production and distribution of such income?¹⁹ If he does not, can it still be said, as the court

spouse to dispose of his or her separate property is, with the exception of homestead property, unlimited. TEX. FAM. CODE ANN. § 5.81 (Vernon 1975); 3 L. SIMPKINS, *supra* note 7, § 17:4. Furthermore, by statute, a married person has full power to contract and may enter into contracts, including contracts to sell real property, mortgage such property, or lease such property by such spouse's separate deed and act. TEX. FAM. CODE ANN. § 4.03 (Vernon 1975); 3 L. SIMPKINS, *supra* note 7, § 19:4; see *Allen v. Monk*, 505 S.W.2d 523, 526 (Tex. 1974); *Broadway Drug Store of Galveston, Inc. v. Trowbridge*, 435 S.W.2d 268 (Tex. Civ. App.—Houston [14th Dist.] 1968, no writ).

12. See notes 368-69 *infra* and accompanying text.

13. The Government did not expressly attempt to include in Mr. *Castleberry's* gross estate any portion of the community income realized from the bonds he transferred to his wife, probably because the taxpayer had voluntarily included this property inasmuch as it had already been reduced to possession as community property.

14. I.R.C. § 2033; see notes 394-400 *infra* and accompanying text.

15. TEX. PROB. CODE ANN. § 58 (Vernon 1975).

16. *Id.* § 45.

17. See text accompanying notes 151-93 *infra*.

18. See text accompanying notes 195-327 *infra*.

19. See text accompanying notes 231-33 *infra*; cf. *Estate of Uhl v. Commissioner*, 241 F.2d 867 (7th Cir. 1957), discussed at text accompanying notes 368-69 *infra*.

did in *Wyly*, that the donor spouse retained an interest in the transferred property within the meaning of section 2036(a) even though he had no legally enforceable right to compel the production of income or the distribution of such income?

- (3) What significance should be attached to Mrs. Wyly's right to withdraw \$5,000 per annum from the trust corpus? To her right to divorce Mr. Wyly or the possibility that she might remove herself from Texas? Does the outcome in *Wyly* then turn on the same factors as the outcome in *Castleberry* and *McKee*?²⁰

Had the Tax Court in *Castleberry* and *McKee* recognized the basic issue in those cases, it might have found *Estate of Allen D. Gutchess*²¹ and *Estate of Uhl v. Commissioner*²² persuasive and dismissed the Commissioner's claim. Unfortunately, the Tax Court apparently believed that the donee spouse did not have the unrestricted right to cut off the income interest of the donor spouse despite the fact that it was her separate property. The court simply and erroneously confused the income from the transferred property, the fruit, which could not be frittered away, with the property itself, the tree, which could be frittered away by the surviving spouse.

If the Fifth Circuit makes the same mistake, Texas will either have to change its local law, which apparently means changing the state constitution,²³ or work to have Congress expressly carve out a special exception in federal law.²⁴ This is because it seems clear that Congress did not intend to deny residents of Texas the right to make interspousal gifts by causing them to be specially taxed on those gifts when residents of other states could make such gifts without such special tax consequences.²⁵

As outlined above, the questions in *Wyly* are more complex and no easy solution seems apparent. Not to be overlooked is the point that Mr. Wyly could have transferred the property in trust ostensibly for the benefit of his wife, relying on the widely held belief that trust income is community property to give him an interest in that which he appeared to have trans-

20. See text accompanying notes 190-91 *infra*.

21. 46 T.C. 554 (1966), *acq.* 1967-1 C.B. 2, *discussed at text accompanying notes 62-63 infra*.

22. 241 F.2d 867 (7th Cir. 1957), *rev'g* 25 T.C. 22 (1955), *discussed at text accompanying notes 368-69 infra*.

23. See note 7 *supra*.

24. See notes 371-73 *infra* and accompanying text.

25. *But see* *Freedman v. United States*, 382 F.2d 742 (5th Cir. 1967), a case involving the application of I.R.C. § 2042. In *Freedman* the Fifth Circuit recognized the difference in the tax impact of various sections of the Internal Revenue Code on community property states versus noncommunity property states. The court stated in response to an assertion by the taxpayer that the affirmance of the Commissioner's position would frustrate the national policy of tax equalization, that "[w]hile this point . . . seems persuasive, the simple answer is that a different result under community-property law is compelled because Mrs. Freedman had a property interest in Texas which she would not have had in a non-community property state." *Id.* at 748. Congress has recognized that an equal tax result is not possible in every case because of differences in property rights held by citizens of community and non-community property states, see S. REP. NO. 1013, 80th Cong., 2d Sess. 27 (1948), *reprinted in* 1948-1 C.B. 305, but, again in 1976, it made an effort "to provide substantial parity between common law states and community property law states." JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 532 n.1 (1976).

ferred. While the facts seem to suggest no such connivance on Mr. Wyly's part, it is possible that in another case the donor may have established such a trust with a tax avoidance purpose in mind.

Two other significant issues in *Castleberry*, *Wyly*, and *McKee* are:

- (1) Whether section 2036 contemplates retention by operation of law.²⁶
- (2) Whether the Texas concept of sole management community property²⁷ so limits the transferor's community interest in the income from the transferred property that such income is not deemed "possessed or enjoyed" or does not constitute a "right to income" as contemplated by section 2036, even though that community income is in his gross estate for federal estate tax purposes.²⁸

This Article considers the validity of the respective positions asserted in *Castleberry*, *Wyly*, and *McKee*. While it also suggests means of making interspousal transfers without *Castleberry*-like results,²⁹ it attempts to demonstrate that there is little federal tax law or state property law incentive for such transfers.³⁰

II. THE CASTLEBERRY, WYLY, AND MCKEE DECISIONS

A. Background

The principle at issue in *Castleberry* has been the subject matter of litigation and controversy for almost thirty years. Just when taxpayers believe they have again put the issue to rest, the Government resurrects it. Whenever lawyers first become aware of *Castleberry* and its progeny, they uniformly react with expressions of disbelief followed by various analyses

26. See text accompanying notes 151-94 *infra*.

27. TEX. FAM. CODE ANN. § 5.22 (Vernon 1975) provides as follows:

- (a) During marriage, each spouse has the sole management, control, and disposition of the community property that he or she would have owned if single, including but not limited to:
 - (1) personal earnings;
 - (2) revenue from separate property;
 - (3) recoveries for personal injuries; and
 - (4) the increase and mutations of, and the revenue from, all property subject to his or her sole management, control and disposition.
- (b) If community property subject to the sole management, control, and disposition of one spouse is mixed or combined with community property subject to the sole management, control, and disposition of the other spouse, then the mixed or combined community property is subject to the joint management, control, and disposition of the spouses, unless the spouses provide otherwise by power of attorney in writing or other agreement.
- (c) Except as provided in Subsection (a) of this section, the community property is subject to the joint management, control, and disposition of the husband and wife, unless the spouses provide otherwise by power of attorney in writing or other agreement.

28. Of course, if the Fifth Circuit accepts either the "right of termination" argument or the "inability to compel" argument, it need never address this question.

29. See text accompanying notes 401-14 *infra*.

30. See notes 394-400 *infra* and accompanying text.

suggesting the incorrectness of the decision and offers of citations to earlier cases that if brought to the attention of the Fifth Circuit will clearly cause it to reverse the Tax Court. For that reason it is appropriate to examine the relevant precedent and to note the manner in which it was analyzed by the Tax Court.

Estate of Hinds. The issue presented in *Castleberry* was initially considered in 1949 in *Commissioner v. Estate of Hinds*.³¹ In *Hinds*, the decedent, *H*,³² and his spouse, *W*, had transferred certain community property to an irrevocable trust with income from the trust to be paid to *W* for life and then to their children. The Tax Court found that under Texas law the income of the trust was the community property of the spouses as long as the community existed.³³ From this finding, the Tax Court concluded that, under the predecessor of section 2036, one-half of the value of the property that the decedent transferred to the trust—one-quarter of the whole—was includable in his gross estate because under Texas law he had retained the right to one-half of the income from the transferred property. In reaching the question of includability, the Tax Court specifically noted that it made no difference, because of the community property law in Texas, whether the decedent, *H*, affirmatively retained the income right or whether it arose under operation of law.³⁴

The Internal Revenue Service nonacquiesced³⁵ in the Tax Court's determination and appealed on the grounds that the Tax Court had erred in determining the amount to be included in the decedent's gross estate. The Service contended that the entire value of the one-half community property interest transferred rather than one-half of that value—one-quarter of the whole—was includable in the gross estate.

The taxpayer in *Estate of Hinds* did not appeal because of monetary

31. 11 T.C. 314 (1948), *aff'd on other grounds*, 180 F.2d 930 (5th Cir. 1950), *nonacq.* 1949-1 C.B. 5.

32. In the cases discussed in this Article the donor spouse was the male, and for convenience of reference, the letter "*H*" will often be employed to refer to the donor spouse. The principles discussed, however, will be equally applicable when the donor spouse is the female partner.

33. The Tax Court decision in *Hinds* is particularly easy to criticize. The court clearly set forth the basis of its decision. It reasoned that since the taxpayer owned one-half the value of the community income generated by the transferred property, he must have retained such right to income.

As we have already pointed out, the decedent did not specifically retain or reserve any income from his part of the community property which was transferred to the trust; yet, under the law of Texas, he was clearly the owner of one-half of the income from the property which he conveyed to the trust so long as he should live. This being the case, we think decedent "retained" the right to one-half of the income from the property which he conveyed to the trust within the meaning of the language used in Section 811(c) above quoted.

11 T.C. at 324; *see* text accompanying notes 154-64 *infra*. In later cases, the courts have taken pains to point out that I.R.C. § 2036 contemplates retention at the time of transfer and that possession at death is not equivalent to retention at the time of transfer. *See, e.g., Terribery v. United States*, 517 F.2d 286 (5th Cir. 1975), *discussed at* text accompanying note 90 *infra*; *In re Estate of Lumpkin*, 474 F.2d 1092 (5th Cir. 1973).

34. 11 T.C. at 324.

35. 1949-1 C.B. 5.

reasons, but, upon appeal by the Internal Revenue Service, the taxpayer urged that the Tax Court's decision be affirmed, not because it was right, but because it gave the Service more than it was entitled to, and therefore it should not complain.

The Court of Appeals for the Fifth Circuit agreed with the taxpayer and affirmed the Tax Court's decision without approving it and denied the petition for review stating:

We do this upon the authority of the settled law of Texas, that whether the income be regarded as separate property of the wife or as community income from the wife's separate property, the taxpayer retained neither "the possession or enjoyment of, or the right to the income from," the property so as to make applicable [section 2036(a)(1)], invoked by the commissioner and in part applied by the Tax Court.³⁶

Largely as a result of the language used by the Fifth Circuit in *Estate of Hinds*, the Internal Revenue Service was unsuccessful in sporadic efforts to include in the gross estate of a deceased transferor under section 2036(a)(1) or its predecessor any part of the value of property transferred by one spouse to the other during lifetime on the grounds of retained life estate by operation of law.³⁷

Nonetheless, in 1975, the Service issued Revenue Ruling 75-504,³⁸ wherein the Commissioner stated he would not follow the dictum of the Fifth Circuit Court of Appeals in *Hinds*. The Commissioner probably based this decision upon the Ninth Circuit's reversal of the Tax Court with respect to the amount includable in the decedent's gross estate in *Estate of Bomash v. Commissioner*.³⁹

Estate of Bomash. In *Estate of Bomash v. Commissioner*⁴⁰ the decedent's husband had set up a testamentary trust consisting entirely of community property. By the terms of *H*'s will, fifty percent of the trust income was payable to *W* for life with the other fifty percent of the income going to children and grandchildren. Approximately one-half of the trust corpus consisted of *W*'s share of the community property and the other half of the corpus consisted of *H*'s share of the community. *W*'s share was placed in the trust by means of an endorsement to *H*'s will in which she acquiesced in his disposition of all of the community property.

The Tax Court found that *W*'s election to take under *H*'s will, rather than her statutory share, constituted a "transfer" of property within the meaning of section 2036(a) and held that one-half of the value of her one-half community property—one-quarter of the whole property—was includable in her gross estate. On appeal, the Ninth Circuit reversed the Tax

36. *Commissioner v. Estate of Hinds*, 180 F.2d 930, 932 (5th Cir. 1950) (footnote omitted).

37. See notes 356-63 *infra* and accompanying text.

38. 1975-2 C.B. 363, *discussed at text* accompanying note 42 *infra*.

39. 432 F.2d 308 (9th Cir. 1970), *rev'g* 50 T.C. 667 (1968).

40. 432 F.2d at 308.

Court and held that fifty percent of the trust corpus was includable in *W*'s estate.

The Tax Court had followed the reasoning of the Tax Court in *Estate of Hinds* that *W*, by her transfer, had completely intermingled her property with the property passing under *H*'s will and, since she retained only fifty percent of the income interest in the whole trust, she retained only fifty percent of the income from the property she transferred to the trust, that is, one-half of her one-half community property interest. The Ninth Circuit disagreed and reasoned:

The retention of 50% income from the entire trust corpus (which includes Fannie Bomash's half contribution) is identical *in substance* to a retained 100% income life estate in her own one-half of the community property. The objective economic reality of this case is the fact that Mrs. Bomash did not alter her position by placing her community property share in trust. We are guided by the Supreme Court's caution in *United States v. Grace's Estate*, 395 U.S. 316 . . . (1968) that "the law searches out the reality and is not concerned with the form". Most importantly, we heed the *Grace* Court's clear rule that "the taxability of a trust corpus * * * does not hinge on a settlor's motives, but depends on the nature and operative effect of the trust transfer".⁴¹

Revenue Ruling 75-504. In Revenue Ruling 75-504⁴² *H* gave *W* \$15,000 in cash from his separate property, which *W* deposited in a savings account as her separate property. On *H*'s death, one-half of the cash plus one-half of the accrued interest on the account to date of death was held to be includable in *H*'s gross estate. The Internal Revenue Service reasoned that under section 2036 *H* had "retained," by operation of Texas community property law, an income interest for his life with respect to one-half of the property transferred. It based its conclusions on the principle of Texas law that income from separate property is community property. The ruling further reasoned that although such income may be placed under the donee spouse's exclusive control and may be exempted from liabilities created by the donor spouse, the ownership interest of the donor spouse in that income cannot be eliminated, even by statute, since such income is community property and cannot be separate property under the Texas Constitution. This latter phrase relies upon Texas precedents that hold that a husband and wife cannot by agreement alter the characterization of community property income and characterize it as separate property until it is earned.⁴³ Although the Texas Constitution permits partition of existing community property,⁴⁴ income to be realized in the future is considered after-acquired property and requires further partition after it is realized.⁴⁵

Revenue Ruling 75-504 is the authority upon which the Service litigated

41. *Id.* at 311 (footnote omitted; citation omitted; emphasis in original).

42. 1975-2 C.B. 363.

43. See note 10 *supra* and note 449 *infra*.

44. TEX. CONST. art. XVI, § 15; see TEX. FAM. CODE ANN. § 5.42 (Vernon 1975).

45. See note 451 *supra* and accompanying text.

Castleberry and its progeny, and a number of other cases currently working their way through the administrative process.

B. *Estate of Castleberry v. Commissioner*⁴⁶

The Tax Court's Opinion. Mr. Castleberry, *H*, transferred to his wife, *W*, his community one-half share of income producing municipal bonds, which became Mrs. Castleberry's separate property. Relying on the principle of Texas law that income from separate property is community property, the Government sought to include one-half the transferred property in *H*'s gross estate on the authority of section 2036.

The taxpayer made three arguments in support of its contention that the Tax Court decision in *Estate of Hinds*⁴⁷ is incorrect and that section 2036(a)(1) is inapplicable to transfers of a Texas community property interest by one spouse to the other, where the donor spouse continues to hold a community property right to the income by operation of state law. Those arguments were:

- (1) The decedent "retained" no interest in the income from the bonds within the meaning of section 2036(a)(1) since there was no agreement, prearrangement, or understanding, either express or implied, between the donor and donee providing for such retention;
- (2) Even if the decedent "retained" an interest, it was not retained "under" the transfer as required by section 2036(a)(1); and
- (3) Decedent did not retain "possession or enjoyment of, or the right to the income from, the [transferred] property," since under Texas law his wife had the sole management, control, and disposition of the transferred property⁴⁸ and was free to deal with the community income from the transferred property without the participation, interference, or consent of the decedent,⁴⁹ and since the community income was not subject to any debts contracted by decedent.⁵⁰

The Tax Court disagreed with the taxpayer and offered these reasons:

- (1) Relying upon the reason given by the Tax Court in *Estate of Hinds*, the court distinguished decisions cited by the taxpayer⁵¹ and emphasized that those decisions did not hold that a finding of an implicit or an explicit agreement was a precondition to the legal conclusion that a decedent had retained an interest in the transferred property under section 2036(a). The court reasoned that such an agreement was unnecessary as, by operation of state law, decedent held an income interest in the transferred property after the transfer. The court, therefore, held that section 2036(a) applies when the donor holds an income interest in transferred

46. 68 T.C. 682 (1977), *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978).

47. Note 31 *supra*.

48. TEX. FAM. CODE ANN. § 5.21 (1975); *see* discussion at notes 105-37 *infra* and accompanying text.

49. TEX. FAM. CODE ANN. § 5.22 (1975), *quoted at* note 27 *supra*.

50. TEX. FAM. CODE ANN. § 5.61 (1975); *see* text accompanying notes 105-37 *infra*.

51. *See* discussion at note 161 *infra* and accompanying text.

property by operation of state law as well as when he expressly or impliedly retains the interest under the transfer instrument.

- (2) The court concluded that the petitioner's second argument was substantively identical to the first argument and that the petitioner was placing "too constricted an interpretation" on section 2036(a), and that the statutory language "means only that the life interest must be retained in connection with or as an incident to the transfer."⁵²
- (3) In rejecting the petitioner's third argument, the Tax Court expressed its perception of applicable Texas community property law in these terms: *W*'s control and right to disposition of the transferred property was not absolute with respect to the community income therefrom; her right of disposition over the transferred property was considered to be held in trust for the benefit of the community, and her control and use of the community income was subject to *H*'s right to an accounting if such income were used to benefit *W*'s separate property. Moreover, while under Texas law community income from *W*'s separate property was not directly subject to the debts the decedent incurred before marriage, that community income would be subject to the payment of *H*'s debts upon dissolution of the community at his death or divorce. Furthermore, one-half of the community income would be includable in the decedent's gross income for federal income tax purposes if Mr. Castleberry and his wife filed separate income tax returns.

Based upon this analysis, the Tax Court concluded that while the decedent had no direct control over the management of the income, *W* did not have ownership of more than one-half. *W* "controlled" *H*'s one-half "only in a fiduciary capacity for his benefit."⁵³ The decedent's right to income, therefore, was not illusory, but an enforceable right sufficient to require inclusion of a portion of the transferred property in his gross estate under section 2036(a)(1).

Analysis of the Opinion. In rejecting the taxpayer's third argument, the Tax Court was confused about Texas law and that confusion may have caused its failure to address the critical issue. The court, for example, stated: "We . . . are of the opinion that decedent's wife's control over the transferred property and community income was not absolute and adverse to decedent's interest and was not equivalent to ownership of the community income."⁵⁴ This statement is only partially true. While the wife's control over the "community income was not absolute," she had total dominion and control over the transferred property, including the right to dissipate it on any frolic of her own without any accountability to her spouse.⁵⁵ Unfortunately, this misstatement by the Tax Court was not an

52. *Estate of Castleberry v. Commissioner*, 68 T.C. 682, 687 (1977) (quoting from *Estate of McNichol v. Commissioner*, 265 F.2d 667, 670 (3d Cir), cert. denied, 361 U.S. 829 (1959)).

53. 68 T.C. at 690.

54. *Id.* at 688.

55. See note 11 *supra*.

isolated example, but is representative of the court's expressed perception of Texas law and characterizes its opinion. For example, despite overwhelming and unanimous authority to the contrary, the court stated: "We note initially that her right of disposition over the transferred property was not an arbitrary one but one held in trust for the benefit of the community."⁵⁶

In the following portion of the opinion, the court was technically correct, but it is obvious from the context that the court incorrectly assumed that the donor spouse had enforceable rights in the transferred property and not merely a claim to income once it was produced.

Her control and use of the community income was subject to limitations. For example, decedent or his heir could have brought an action for an accounting, were the community income used to benefit decedent's wife's separate property In addition, her control over the community income could not be exercised in fraud of decedent's rights as by making a gift to a third person⁵⁷

In view of these factors, we conclude that decedent's right to the income was not illusory, but an enforceable right sufficient to require inclusion of a portion of the transferred property in his gross estate under section 2036(a)(1).⁵⁸

In defense of the Tax Court's analysis, it could be explained that notwithstanding the Tax Court's obvious confusion about Texas law as applied to the facts in *Castleberry*, Texas law clearly would characterize any income produced by the transferred property as community property.⁵⁹ Moreover, the fact that no income was produced from the transferred property is irrelevant in determining whether the decedent retained a life estate in transferred property for federal tax purposes.⁶⁰

Unfortunately, this analysis is deceptively simple, and ignores, as did the Tax Court, the fundamental issue in *Castleberry*. That issue is whether the connection between *Castleberry's* transfer to his wife and the fact that any income produced by that property would be community property was severed by the fact that his wife had the absolute and unfettered right to cut off or divest him of any and all future income or future enjoyment of the transferred property by simply divorcing him, moving to a separate property state, dying with a will in favor of the milkman, or dissipating it all on the ponies.⁶¹ The income that was produced before one or more of these

56. 68 T.C. at 688.

57. *Id.*

58. *Id.* at 690 (footnote omitted).

59. See note 7 *supra*.

60. Estate of McNichol v. Commissioner, 265 F.2d 667, 670-71 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959); Estate of Wyly v. Commissioner, 69 T.C. 227, 231-32 (1977), *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978), *discussed at text* accompanying note 80 *infra*; Estate of McKee v. Commissioner, 37 T.C.M. (CCH) Dec. 35,049, at 490 (1978), *discussed at text* accompanying note 95 *infra*.

61. Prior to the decision in *Castleberry*, three courts applying Texas law reached results different from those reached in *Castleberry* on essentially the facts presented in *Castleberry*. See note 31 *supra* and notes 356-65 *infra*. These cases did not expressly consider the issue

events occurred, of course, would be community property and properly included in Mr. Castleberry's gross estate since he had the right to dispose of his one-half of this community income in his will if not otherwise.

The Tax Court had before it *Estate of Allen D. Gutchess*,⁶² the case that would seem to control *Castleberry*. In *Gutchess* the decedent had transferred his residence to his spouse, but continued to occupy the premises until his death. The Tax Court found the decedent had not retained a life estate in the premises, apparently because it believed at that time that retention of an interest by operation of law was not within the contemplation of section 2036(a). However, the Tax Court in *Castleberry* chose to focus on the following paragraph from *Gutchess* as the basis for distinguishing the holding in that case:

Respondent also makes some argument that under Ohio law (Ohio Rev. Code sec. 3103.04) one spouse cannot be excluded from residence in the other's dwelling except by decree of court, and no such decree was obtained here. It is difficult to see how that would have any bearing here. If decedent had some residence rights granted by Ohio law that would not mean retention of use and enjoyment "under" a transfer as required by the statute that is here involved.⁶³

Not only did the *Castleberry* court reject this reasoning, but it distinguished *Gutchess* on the ground that Gutchess's wife could exclude him from the premises, but Castleberry's wife could not cut off his enjoyment of the income.

We do not think that *Estate of Gutchess* is applicable. In that case, the decedent lived in the residence only at the *sufferance of his wife*. He would not have been able lawfully to continue to reside in the residence if his wife withdrew her consent. She could, had she chosen to do so, have had him ejected by court order. In this case, however, decedent's right to the community income was not defeasible. *His right was not dependent upon the actions or inactions of his spouse*. The dictum regarding rights under Ohio law referred, in context, to the mere requirement that an action be brought and a court decree obtained in order to remove the husband. The "requirement" referred to a mere procedural difficulty in the enforcement of the transferee's right to exclude the transferor, not a substantive diminution of the right itself.⁶⁴

At this point it is obvious the Tax Court did not appreciate that under Texas law Castleberry's wife could more easily cut off his enjoyment of the transferred property than could Mrs. Gutchess exclude her husband from the premises. All Mrs. Castleberry would have to do would be to dissipate the transferred property, which she could do at her pleasure without any accountability to anyone. This does not necessarily mean *Castleberry* is wrong. What it does mean is that the Fifth Circuit should address the

framed in the text above and perhaps that may help explain the Tax Court's refusal in *Castleberry* to defer to these precedents.

62. 46 T.C. 554 (1966), *acq.* 1967-1 C.B. 2.

63. 68 T.C. at 687 (quoting *Estate of Allen D. Gutchess*, 46 T.C. 554, 557 (1966)).

64. 68 T.C. at 687 (emphasis added).

fundamental issue in *Castleberry* and recognize that the grounds chosen by the Tax Court to distinguish *Gutchess* were invalid.

By way of explanation, it is suggested that perhaps the court was confused because neither the Commissioner⁶⁵ nor the taxpayer⁶⁶ seemed to focus on the determinative issues in their briefs. The taxpayer seemed to combine into one argument two principles of Texas law that when taken together may have appeared to assert a position the Tax Court found untenable. The taxpayer argued that Mr. Castleberry did not have a retained life estate because Texas law gave Mrs. Castleberry the sole management, control, and disposition "over her separate property and the community income produced by her separate property."⁶⁷ The taxpayer should have

65. Either the Commissioner did not understand this to be the issue or chose to ignore it. His trial brief in *Castleberry* simply slipped over the question of retention of an interest in the transferred property, choosing instead to state the problem, variously, in these terms:

With the above analysis of Texas law in mind, it is apparent, that in the instant case the decedent, Winston C. Castleberry, retained by operation of Texas State law a right to one-half of any income generated by the bonds which subsequent to the gift belonged to the decedent's wife as her separate property.

Brief for Respondent at 11. At another point, the Commissioner said:

It is abundantly clear in the instant case that the decedent prior to the transfer was entitled to one-half of any income generated from the community property which he gave to his wife. It is also clear that under Texas community property law the decedent was equally entitled to one-half of any income generated by the property after its transfer. Accordingly, the decedent had both before and after the transfer the same right to any income generated by the gifts of community property to his wife.

Id. at 12.

The Commissioner's reply brief to the Tax Court contained a misapplication of the law to the facts, which the court adopted as part of its decision. In discussing the interest of the donor spouse in the transferred property, the Commissioner made the following statement which is correctly applied only to the income produced by the transferred property and not to the transferred property itself:

[R]espondent submits that although one spouse may have sole management, control and disposition rights over separate property and community property, those disposition rights are not as all encompassing as petitioner alleges. As stated in *E. Oakes, Speer's Marital Rights in Texas*, § 365 at 529 "The right of disposition is not an arbitrary one. It is one of trust, for the benefit of the community."

Reply Brief for Respondent at 8.

66. The taxpayer cited *Estate of Allen D. Gutchess*, 46 T.C. 554 (1966), *acq.* 1967-1 C.B. 2, in his brief, but it appears this reference was largely for purposes of arguing that a § 2036 retention had to be consensual, that is, the result of an understanding, express or implied. Brief for Petitioner at 7-9. In its reply brief the taxpayer did cite *Estate of Uhl v. Commissioner*, 241 F.2d 867 (7th Cir. 1957), *discussed at* text accompanying notes 368-69 *infra*, but in drawing this parallel to *Castleberry*, went off on the ground that Mrs. Castleberry had sole management of "the income from the transferred property" and therefore he "could not compel her to pay him any portion of the income from the transferred property." Reply Brief for Petitioner at 11. In fact, Mr. Castleberry had ownership of any income produced from the transferred property. What he did not have was the right to prevent his wife from dissipating the transferred property, thereby cutting off any future income he might enjoy.

67. The Commissioner's appeal brief made only the following reference to *Gutchess*: "a case which the Tax Court in this case (R. 44-45) distinguished." Brief for the Appellee-Cross-Appellant at 21, *Estate of Castleberry v. Commissioner*, *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978). *See also* Brief for Petitioner-Appellant at 14-18, *Estate of Castleberry v. Commissioner*, *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978).

made manifest the stark reality that since the transferred property was the wife's separate property, under Texas law she could manage that property so as to deprive her spouse of any income interest in the property, and forced the court to address this issue. The taxpayer should have then proceeded to concede that any income produced by the transferred property was community income and therefore one-half of that community income was included in the transferor's gross estate. By failing to concede the inclusion of the community income, it could have appeared to the Tax Court that the taxpayer was indirectly urging a new rule of law on the court, to wit, that section 5.22 of the Texas Family Code giving each spouse "the sole management, control and disposition of the community property that he or she would have owned if single"⁶⁸ constitutes grounds for excluding sole management community property from the estate of the nonmanager spouse.⁶⁹ While there may be merit in this position, it is contrary to established principles.⁷⁰

68. See text accompanying notes 105-37 *infra*.

69. While the taxpayer's brief does not expressly reach this conclusion, it advances the argument that the nonmanager spouse's interest in sole management community property is "of such a limited nature that it did not constitute a 'right to income' within the meaning" of § 2036(a). In order for a court to agree, it would seem it would have to reason that the nonmanager spouse's interest in sole management community property was so limited that it should not be in his gross estate for federal estate tax purposes. Alternatively, the court would have to conclude that the standards for including property in the gross estate as probate property under § 2033 were different from the meaning Congress intended in § 2036 when it used the words "right to income." This was in part the view of the district court in *Estate of Deobald v. United States*, 444 F. Supp. 374 (E.D. La. 1977), discussed at note 85 *infra*. In that case, the court said that "retention" within the meaning of § 2036 meant "intentional retention." Either of these analyses, of course, would still permit the inclusion of that portion of the community income from the transferred property earned prior to the death of the transferor in the transferor's gross estate, while the property producing that income is excluded. This result is not anomalous. The community income is included because it is subject to disposition by the transferor at his death whereas the transferred property is the donee spouse's to dissipate. See also text accompanying notes 138-50 *infra*.

The analysis undertaken by the taxpayer in *Castleberry* is somewhat confusing and detrimental to its case inasmuch as the nonmanager spouse clearly does have an enforceable right or claim to any income produced by the other spouse's separate property. Recognizing this point, a court can easily reason erroneously that if the nonmanager has a "right to income" he must have some enforceable claim or interest in the transferred property that he retained at the time of the transfer. The correct reasoning, of course, is that the nonmanager spouse only has a right to income once it is produced; he has no enforceable right to compel the production of income or to restrict the management of the underlying property in any way. See text accompanying notes 231-33 *infra*. In other words, he cannot prevent his spouse's dissipation of the transferred property. For that reason the real issue becomes one of ascertaining the significance of the donee spouse's right to dissipate freely the transferred property.

70. *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231, 239 (5th Cir. 1958), cert. denied, 359 U.S. 913 (1959). The other cases offered are all income tax cases, but they would clearly seem to support the proposition in the text. For example, in *Brodav v. United States*, 455 F.2d 1097 (5th Cir. 1972), the court was confronted with the question of whether, under Texas property law, a community property bank account of which the husband had sole management and control and that held dividend income from the husband's separate property, was subject to levy for a tax debt of the wife incurred prior to marriage. In answering this question in the affirmative, the court stated:

The question of whether and to what extent the wife has property and rights to property is determined under the applicable state law However, once it has been determined under state law that the taxpayer owns property or rights

The court, therefore, did not distinguish between the property transferred to Mrs. Castleberry, which was her separate property, and the income from that property, which was community. The court found ample precedent providing that sole management community property is not excluded from the estate of the nonmanager, and, since the taxpayer did not do more to distinguish the transferred separate property from the community income it generated, the point simply escaped the Tax Court.

C. *Estate of Wyly v. Commissioner*⁷¹

The Tax Court's Opinion. Three months after *Castleberry*, the Tax Court relied on it in deciding *Wyly* in favor of the Commissioner. *Wyly* is different from *Castleberry* in that both Mr. and Mrs. Wyly joined in transferring their community property interests in certain corporate stocks to an irrevocable trust for Mrs. Wyly's benefit, whereas in *Castleberry* the donor spouse transferred his community interest in bonds directly to his wife in fee simple. The *Wyly* trust specifically provided that all of the trust income was to be paid to or for the benefit of *W* for life, with the remainder to continue in trust for grandchildren. In addition, "[d]uring the wife's lifetime the trustees have the discretionary right to invade the trust corpus for her benefit, and the wife has the right to withdraw up to \$5,000 of trust corpus annually."⁷² In this latter respect *Wyly* and *Castleberry* are the same in that in both cases the donee spouse can terminate any income interest given the donor by state law by either dissipating the transferred property, as in *Castleberry*, or, as in *Wyly*, by exercising her right to withdraw annually \$5,000 from the trust corpus and then dissipating the withdrawn amount.

The taxpayer made three arguments against includability of one-half of the trust corpus:

- (1) The trust income distributions were not community property, but were the separate property of the wife as the decedent did not make a gift of the stocks to his wife, but rather made a gift of the income derived from the stocks.⁷³ Thus, since the income was

to property, federal law is controlling for the purpose of determining whether a lien will attach to such property or rights to property.

Id. at 1099. The court further found that since the income from separate property is community property, a wife had a present vested interest in the bank account equal and equivalent to that of her husband. *Id.* at 1100-01. *United States v. Mitchell*, 403 U.S. 190 (1971), held that under the community property laws of Louisiana, a spouse has a present vested interest in community property equal to that of the other spouse and, therefore, is personally liable for federal income taxes on the spouse's one-half share of the community income even though she may not have received her share of the community income. A similar case in the Fifth Circuit involving Texas community property law, which was decided prior to the Supreme Court's decision in *Mitchell*, and which held contrary to the decision in *Mitchell*, was *Ramos v. Commissioner*, 429 F.2d 487 (5th Cir. 1970). After the *Mitchell* decision, the Fifth Circuit specifically overruled *Ramos* in *Brodav v. United States*, 455 F.2d 1097 (5th Cir. 1972).

71. 69 T.C. 227 (1977), *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978).

72. *Id.* at 228.

73. For analysis, see text accompanying notes 195-327 *infra*.

the property given to the wife, the income was her separate property under Texas law.

- (2) The trust income, after distribution to *W*, became her separate property by reason of the action of the spouses, and therefore decedent did not hold a community share therein.
- (3) If the distributions of trust income were community property, decedent's right to the trust income was so limited⁷⁴ that it did not constitute a retained right to income within the meaning of section 2036.

In response to petitioner's arguments, the Tax Court concluded that petitioner's first two arguments were contrary to well settled Texas law and the third argument was subject to the court's prior holding in *Estate of Castleberry*. Citing *Irwin v. Gavitt*⁷⁵ and *Commissioner v. Wilson*,⁷⁶ the court stated that *H*'s gift of trust income created an equitable interest in the trust corpus and it was that equitable interest, and not the right to the trust income, that was the subject matter of decedent's gift. While the equitable interest in the trust corpus constitutes *W*'s separate property, under Texas law the income distributions from that corpus during the decedent's lifetime were the community property of decedent and his wife.⁷⁷

In response to petitioner's second argument, the court concluded that Texas community property law prevents spouses from contracting or otherwise agreeing prospectively to change the character of their property so as to convert what would otherwise be community property to separate property or vice versa.⁷⁸ If such change cannot be accomplished prospectively, the decedent is then in the position of having the right to income even if he gives the income to his spouse upon its realization. Although the trustees could invest the trust corpus in non-income-producing property and had the right to make discretionary distributions of principal to *W* for her maintenance and support⁷⁹ without benefiting the decedent, the court concluded that retention of the *right* to income is the factor that triggers inclusion of the transferred property in a decedent's gross estate. Whether the decedent actually receives such distributions or whether the investment is made in income-producing property is immaterial as long as a right to income exists.⁸⁰ The court further concluded that distribution of income to *W* would not only benefit *W*, but also would benefit the community estate.

Analysis of the Opinion. As in *Castleberry*, the issue unaddressed by the Tax Court in *Wyly* was what significance should be attached to the right of the donee spouse to dissipate the transferred property and thereby deprive

74. For analysis, see text accompanying notes 105-37 *infra*.

75. 268 U.S. 161 (1925), *discussed at* text accompanying notes 300-02 *infra*.

76. 76 F.2d 766 (5th Cir. 1935), *discussed at* text accompanying notes 279-81 *infra*.

77. For analysis, see text accompanying notes 195-327 *infra*.

78. For analysis, see notes 450-51 *supra* and accompanying text.

79. *But see* text accompanying notes 191-92 *infra*.

80. *See* note 60 *supra* and accompanying text. *See also* notes 98-150 *infra* and accompanying text.

the decedent of his alleged community interest in the income produced by the transferred property. In *Wyly*, the donee spouse had the right to withdraw \$5,000 per annum from the trust. The corpus, once withdrawn, would be separate property and the donee spouse could dispose of it as she saw fit.⁸¹ In addition, she could divorce the transferor or move from Texas, in which case the income produced by the transferred property would be her separate property. Moreover, the transferor had no right under Texas law to compel his wife to seek enforcement of the terms of the trust by, for example, insisting that the trustee make the trust property productive.⁸² Given these possibilities, it is arguable that both *Gutchess*⁸³ and *Uhl*⁸⁴ control *Wyly*, as well as *Castleberry*.

D. *Estate of Deobald v. United States*⁸⁵

In *Deobald*, a case decided after *Castleberry* and *Wyly*, the District Court for the Eastern District of Louisiana reached a result contrary to the Tax Court's holdings in *Castleberry*, apparently without knowing of its existence. Deobald transferred separate property stock to his wife, which became her separate property. Mrs. Deobald also could have designated the income from her separate property as separate property under Louisiana law, but at the time of Deobald's death she had not taken this step.⁸⁶ The court, however, held that the wife's failure to make the declaration was not controlling. In holding section 2036 inapplicable and excluding the transferred property from Deobald's estate, the court held that section 2036 only applies when the transferor *intended* to retain an interest for life and not when that interest was conferred by operation of law.

Thus the courts have taken the position that the transferor himself must initiate the action by which he maintains a right in the income after transferring the property, before there is a retention under Section 2036(a). Where he intends to make a complete and absolute gift of his property, though, unbeknownst to him, community property laws may reserve to him a right to income, the courts have consistently held that he retained no life interest.⁸⁷

The district court concluded that the subjective intent of the transferor at the time of the transfer, rather than on the completeness of the transfer, is the controlling factor.⁸⁸

81. See note 11 *supra* and accompanying text.

82. See text accompanying notes 231-33 *infra*.

83. Estate of Allen D. Gutchess, 46 T.C. 554 (1966), *acq.* 1967-1 C.B. 2, *discussed at* text accompanying notes 62-63 *supra*.

84. *In re Estate of Uhl*, 241 F.2d 867 (7th Cir. 1957), *aff'g* 25 T.C. 22 (1955), *discussed at* text accompanying notes 368-69 *infra*.

85. 444 F. Supp. 374 (E.D. La. 1977). The Government's appeal on *Deobald* was dismissed because the United States filed its notice of appeal out of turn. Brief for Appellee-Cross-Appellant at 18 n.7, Estate of Castleberry v. Commissioner, *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978).

86. 444 F. Supp. at 380.

87. *Id.* at 381-82.

88. The Government offers a rather ingenious argument in response to those who suggest that "retention" under § 2036 must be express or by implication.

Based on the combination of factors such as (1) the nature of the contingency right to income [with the continued possession of that right solely in the power of his spouse], and (2) an absence of any implied or explicit agreement at the time of the transfer to retain an interest, this Court concludes that Mr. Deobald did not retain an interest in the stock, in a manner as anticipated by Section 2036(a).⁸⁹

To emphasize the importance of the retention requirement, the *Deobald* court looked to the Fifth Circuit decision in *Terriberry v. United States*.⁹⁰ In that case the insured was trustee of a trust that owned policies on his life. While the insured's wife had the right to revoke the trust or remove the trustee, she never exercised the power and the proceeds of the insurance were included in the insured's gross estate. The *Deobald* court distinguished *Terriberry* on the ground that inclusion of life insurance in the insured's gross estate under section 2042 requires only that he possess incidents of ownership at death. Section 2036, on the other hand, requires that the transferor retain an interest in the transferred property at the time of the transfer. The court quoted from an earlier Fifth Circuit case to explain the distinction: "Thus, under Section 2036 and Section 2038 the decedent must have retained some control over property he initially transferred while under Section 2042 it is enough if at death the decedent merely possessed an incident of ownership, the means by which he came into possession being irrelevant." ⁹¹

Finally, in a dictum, the court indicated that the Government should not have prosecuted this tax case on such a hypertechnical basis. The court stated that if the Government's contentions were carried to their logical conclusion, spouses domiciled in Louisiana

in effect . . . could never make a bona fide transfer to each other where the grantor absolutely, unequivocally, and irrevocably parts with all of his title, possession, and enjoyment of income-bearing community or separate property. . . . As in the present case, even where the husband has done everything unilaterally possible to make a complete gift to his wife, the Internal Revenue Service, by its proposed taxing scheme, would still have the right to tax the transferred

Respondent submits that under community property laws, the petitioner's argument would require a transferor-spouse in Texas to perform a useless act. Under Texas community property law the earnings from separate property of a spouse are community property. See *Arnold v. Leonard*, 273 S.W. 799 (Tex. 1925). Since the transferor spouse retains by law a community property interest in the income from the separate property of his spouse, why should he be required as petitioner alleges to specifically state he is retaining an income interest in the property? In addition, as pointed out in respondent's original brief, Code § 2036 is equally applicable where the retained interest is created by state law rather than by the positive act of reservation or retention by the decedent. See *United States v. Gordon*, 406 F.2d 332 (5th Cir. 1969); *Estate of Robert Manning McKeon*, 25 T.C. 697 (1956), acq. 1958-2 C.B. 6.

Reply Brief for Respondent at 5-6, *Estate of Castleberry v. Commissioner*, 68 T.C. 682 (1977), appeal docketed, No. 78-1612 (5th Cir. Mar. 23, 1978).

89. 444 F. Supp. at 383.

90. 517 F.2d 286 (5th Cir. 1975).

91. 444 F. Supp. at 382 (inexactly quoting *Estate of Lumpkin v. Commissioner*, 474 F.2d 1092, 1097 (5th Cir. 1973)).

property as part of the husband's estate. This Court must find such taxing rationality anomalous, and rejects the government's position.⁹²

E. *Estate of McKee v. Commissioner*⁹³

The final case in this recent series is *McKee*, decided by the Tax Court on March 29, 1978, in which the court distinguished *Deobald* as it held to the views it announced in *Castleberry*.

In *McKee* the decedent had given his wife a life insurance policy and \$5,000 in cash from a community bank account as a combined wedding and birthday gift. The Government abandoned its effort to include the life insurance in the decedent's gross estate on section 2036 grounds, but prevailed in having the Tax Court include one-fourth of the \$5,000 cash gift as a transfer subject to a retained life estate.

The taxpayer argued that since cash does not automatically generate income, *W* would have to take affirmative steps to invest the cash in a manner to yield income that would then be community property. Since Texas law did not require *W* to invest the cash gift, the donor would have no right to income. The Tax Court rejected this argument, relying on *Castleberry* and *Wyly*, and erroneously stated that *W*'s power to invest in non-income-producing property and her right to dispose of the property were not absolute and were held in trust for the benefit of the community.⁹⁴

In explaining its holding, the court repeated, as in *Wyly*, that the mere right to income triggers inclusion. Whether the decedent actually received income or whether the gift is invested in income-producing property is immaterial. The court also noted that the 1932 amendment to the predecessor statute of section 2036 substituted the phrase "right to the income" for "income." The legislative history of the 1932 amendment stated that this change was "designed to reach a case where decedent had the right to the income, though he did not actually receive it."⁹⁵ The court then expanded the holding in *Castleberry* and *Wyly* as follows:

Finally, we do not believe *Estate of Castleberry* or *Estate of Wyly* may be distinguished on the basis of the types of property involved. *Estate of Castleberry*, *Estate of Wyly*, and this case involve bonds, stocks, and cash, respectively. Section 2036(a)(1) focuses on the right to income, not the character of the underlying property or the actual receipt of income. We would open the door to tax avoidance schemes if we held that a decedent could retain for his life the right to income from a transfer of cash, either by operation of law or by agreement, prearrangement or understanding, and nevertheless escape section 2036(a)(1). We would soon be faced with numerous transfers where property was converted to cash prior to transfer and then later rein-

92. 444 F. Supp. at 383.

93. 37 T.C.M. (CCH) Dec. 35,049 (1978).

94. See note 54 *supra* and accompanying text.

95. H.R. REP. NO. 708, 72d Cong., 1st Sess. 47 (1932), reprinted in 1939-1 C.B. (Part 2) 491.

vested in other income-producing property.⁹⁶

The *McKee* court distinguished *Estate of Deobald*,⁹⁷ stating that under Louisiana law the wife has the power to declare income from a gift of separate property as her separate property, and therefore her husband's community interest in the future income is defeasible. The court further noted that in *Castleberry* it relied on the "indefeasible" characteristic of income from the wife's separate property. A close reading of the *Deobald* opinion, however, indicates that the court placed almost no weight on the donee's right to declare the income from the transferred property her separate property. Moreover, as the donee in *Deobald* could have declared the income as her separate property, but did not, so too the donee in *McKee* could have given away the \$5,000 cash gift without the consent of the donor, but did not.

III. THE SOLE MANAGEMENT COMMUNITY PROPERTY ARGUMENT

Another issue in the *Castleberry* line of cases is whether the Texas concept of sole management community property so limits the transferor's community interest in the income from the transferred property that such interest is, in effect, no more than an expectancy⁹⁸ and, as such, not deemed to be the kind of interest to which section 2036 is addressed. On the one hand, there is the uncontroverted rule that since income from separate property is community,⁹⁹ one-half of that income is included in the gross estate of the first spouse to die.¹⁰⁰ On the other hand, there is the argument that while any income realized is community property, and therefore includable in the gross estate of each spouse at death to the extent of fifty percent, the standards for including property in a decedent's gross estate for federal estate tax purposes are not necessarily the appropriate standards for determining whether the decedent has retained, within the contemplation of section 2036, the possession or enjoyment of, or the

96. 37 T.C.M. (CCH) at 491. It has been suggested that the last sentence means that the Tax Court would include gifts, such as diamond rings, in the donor's gross estate to insure the integrity of the *Castleberry* principle since "Texas law gives a spouse a technical right to the income from all of the other spouse's separate property." Comment, *Section 2036 Inclusions in Community Property States: Complete Interspousal Gifts Could be Impossible*, 15 Hous. L. REV. 632, 672 (1978); see text accompanying notes 347-48 *infra*.

97. *Estate of Deobald v. United States*, 444 F. Supp. 374 (E.D. La. 1977).

98. See Brief for Petitioner-Appellant at 28-29, *Estate of Castleberry v. Commissioner*, appeal docketed, No. 78-1612 (5th Cir. Mar. 23, 1978). Mr. Castleberry's executor has urged that the nonmanager's interest in sole management community property is so limited or attenuated as to make his interest akin to that of an expectancy. *Id.* Apparently, the Commissioner believed the taxpayer was asserting that the interest of the nonmanager was a mere expectancy and not that the nonmanager's interest was so limited as to verge on being only a mere expectancy. While the taxpayer did not go on to make the distinction asserted in the text, the Commissioner dismissed the point on the ground that the United States Supreme Court in *Hopkins v. Bacon*, 282 U.S. 122, 125-27 (1930), specifically held that the interest of the nonmanaging spouse in Texas community property amounted to more than a mere expectancy. Brief for the Appellee-Cross-Appellant at 10.

99. See note 7 *supra*.

100. *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231, 239 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959).

right to income from, property that he transferred during his lifetime.¹⁰¹

A. *The Purpose of Section 2036*

The purpose of section 2036 has long been expressed in terms of including in a decedent's gross estate those transfers he made during his lifetime that were incomplete until his death.¹⁰² Whether a transfer is incomplete is not controlled by the decedent's intention, but by the effect of the transfer.¹⁰³ The issue to be determined is whether the effect of a particular transfer is to allow the transferor to have such possession or enjoyment of

101. For discussion, see text accompanying notes 135-50 *infra*. The dissent in *Castleberry* articulated this standard of inclusion. Judge Featherstone, joined by three other Tax Court judges, stated:

[P]roperty given to a wife by her husband becomes her separate property. The income from such property is community property, but, consistent with the language of art. 4614, *supra*, the wife has an exclusive right to its management, control, and disposition. Such income cannot be seized by her husband's creditors and, without her consent, cannot be conveyed by him to his creditors. The wife has the sole right to create contractual obligations with respect to such income. She has the right to exclusive possession of the property and the right to dispose of it. In her discretion, she can give it away or invest it in non-income-producing or income-producing property. She is free to deal with the community income from her separate property without the participation, consent, or interference of her husband.

These extensive attributes of ownership led the Court of Appeals in the *Hinds* case to conclude, correctly I believe, that under Texas law a husband who transfers property to his wife does not retain the right to the income therefrom within the meaning of section 2036.

68 T.C. at 695. This "something less than literal" application of the statute has found expression in estate tax cases involving life insurance and retained powers cases. I.R.C. § 2042 provides that life insurance proceeds will be included in an insured's gross estate if the proceeds are receivable by his estate or if he has any one of the incidents of ownership. In *Margrave v. Commissioner*, 71 T.C. No. 2 (Oct. 10, 1978) (No. 2210-76), *discussed at* notes 328-44 *infra* and accompanying text, the Tax Court in effect refused to apply literally the statutory standard to proceeds of life insurance payable to a revocable trust the insured had established simply because the owner of the policy could have changed the beneficiary. In *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970), and *Estate of Skiftor v. Commissioner*, 468 F.2d 699 (2d Cir. 1972), the respective courts have said that more is required than mere ownership of one or more of the incidents of ownership by the insured in order for the proceeds of the insurance to be included in his estate. As owner he must have the capacity to exercise the incidents to benefit himself.

Similarly, the courts have said that a retained power under I.R.C. §§ 2036(a)(2) and 2038 must be a substantial or significant power. The mere possession of the power alone is not enough to invoke the statute. Illustrative are *United States v. Byrum*, 408 U.S. 125 (1972), *discussed at* note 142 *infra* (retention of voting control insufficient power to warrant application of § 2036(a)(2) to shares transferred in trust), and *Old Colony Trust Co. v. United States*, 423 F.2d 601 (1st Cir. 1970) ("no aggregation of purely administrative powers" by a transferor as trustee will warrant including the transferred property in the transferor's gross estate under § 2036(a)(2)). There are also cases holding that when the transferor's retained power is subject to an ascertainable standard nothing is included in his gross estate under § 2036(a)(2). *See, e.g., Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967), *acq.* 1973-2 C.B. 3.

Thus, there are limits to the literal application of the estate tax statutes. The dissenters in *Castleberry* may have a point.

102. *United States v. O'Malley*, 383 U.S. 627, 630-31 (1966); *Commissioner v. Estate of Church*, 335 U.S. 632, 646 (1949).

103. *See Estate of Spiegel v. Commissioner*, 335 U.S. 701, 705 (1949), *discussed at* text accompanying notes 352-55 *infra* ("[T]he taxability of a trust corpus . . . does not hinge on a settlor's motives, but depends on the nature and operative effect of the trust transfer.").

transferred property or the right to income therefrom that failure to include the property in the decedent's estate would defeat the purpose of the federal estate tax, which is to tax at death that property in which the decedent has the economic equivalent of ownership at the time of his death.¹⁰⁴

B. *The Nature of Sole Management Community Property*

Texas classifies property owned by married persons as either separate or community. Separate property is defined in the state constitution,¹⁰⁵ and "[e]ach spouse has the sole management, control, and disposition of his or her separate property."¹⁰⁶ All other property owned by married persons is deemed community.¹⁰⁷ Texas, however, classifies community property according to source for purposes of each spouse's management rights over particular kinds of property. Thus, "[d]uring marriage, each spouse has the sole management, control, and disposition of the community property that he or she would have owned if single, including but not limited to . . . revenue from separate property."¹⁰⁸ All other community property is subject to "the joint management, control, and disposition of the husband and wife, unless the spouses provide otherwise by power of attorney in writing or other agreement."¹⁰⁹

As a practical matter, the rights and responsibilities of the manager of sole management community property are almost unlimited. Simpkins says: "It seems clear . . . that when one spouse has the sole management and control over certain community property, that control is absolute and binding on the other spouse for all purposes, including disposition, in the absence of fraud."¹¹⁰ What constitutes "fraud"? Again, Simpkins offers the following: "As a practical matter, the variety of ways or combinations through which a spouse could be defrauded is probably infinite . . ."¹¹¹

104. The reciprocal trust doctrine, for example, "was formulated in response to attempts to draft instruments which seemingly avoid the literal terms of § 811(c)(1)(B) [the predecessor of I.R.C. § 2036(a)(1)], while still leaving the decedent the lifetime enjoyment of his property." *United States v. Estate of Grace*, 395 U.S. 316, 320 (1969), *discussed at* text accompanying notes 154-57 *infra*.

105. TEX. CONST. art. XVI, § 15.

106. TEX. FAM. CODE ANN. § 5.21 (Vernon 1975). *See generally* Hudspeth, *The Matrimonial Property Act of 1967 - Six Areas of Change*, 31 TEX. B.J. 477 (1968); Huie, *Divided Management of Community Property in Texas*, 5 TEX. TECH L. REV. 623 (1974); McKnight, *Recodification of Matrimonial Property Law*, 29 TEX. B.J. 1000 (1966).

107. TEX. FAM. CODE ANN. § 5.01(b) (Vernon 1975).

108. *Id.* § 5.22(a)(2).

109. *Id.* § 5.22(c).

110. 3 L. SIMPKINS, *supra* note 7, § 21:23, at 394.

111. *Id.* § 21:1, at 366; *see* 1 E. OAKES, SPEER'S MARITAL RIGHTS IN TEXAS § 365, at 529 (4th ed. 1961).

To illustrate the point, Mr. Castleberry's executor chose an unfortunate example. Emphasizing the donee's right to dissipate her sole management community property, the taxpayer noted that the donee could have spent the bond income on her own living expenses. The Commissioner responded that such an expenditure would cause the transferred property to be included in the donor's gross estate inasmuch as such expenditure would discharge the donor's legal obligation of support. Brief for the Appellee-Cross-Appellant at 13-14, *Estate of Castleberry v. Commissioner*, *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978); *see* *Richards v. Commissioner*, 375 F.2d 997, 999-1000 (10th Cir. 1967); *Helvering v. Mercan-*

Fraud on the community may be "actual" or "constructive." "Actual" fraud requires a fraudulent intention, that is, an intent to deprive the other spouse of her community interest.¹¹² Constructive fraud, on the other hand, does not require intent.¹¹³ In a recent case, for example, constructive fraud was equated with unfairness.¹¹⁴

Nonetheless, the cases are legion in holding that acts complained of as fraudulent were not fraudulent.¹¹⁵ In fact, prior to the development of the constructive fraud doctrine, many complaints of fraud failed because the complainant failed to discharge his or her burden of proof.¹¹⁶

The 1975 court of civil appeals decision in *Horlock v. Horlock*¹¹⁷ is illustrative. In an action for divorce, Dorothy Horlock claimed her husband, Ray Horlock, defrauded the community by making gifts to his three daughters from a prior marriage. The gifts were made from community property and totaled \$131,517. Roy Horlock did not tell his wife that he was making the gifts, and he admitted that she would have "strenuously protested had she known of the gifts."¹¹⁸ Moreover, Roy filed federal gift tax returns reflecting the gifts and managed to have Dorothy's name forged in the returns without her knowledge and consent. The court held

tile-Commerce Bank & Trust Co., 111 F.2d 224, 226 (8th Cir.) *cert denied*, 310 U.S. 654 (1940); TEX. FAM. CODE ANN. § 4.02 (Vernon 1975) (establishing a duty to support). Treas. Reg. § 20.2036-1(b)(2) (1958) provides:

The "use, possession, right to the income, or other enjoyment of the transferred property" is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit. The term "legal obligation" includes a legal obligation to support a dependent during the decedent's lifetime.

112. *Marshall v. Land*, 413 S.W.2d 820 (Tex. Civ. App.—Dallas 1967), *aff'd*, 426 S.W.2d 841 (Tex. 1968) (revocable trust established by spouse with community property without knowledge of other spouse); 3 L. SIMPKINS, *supra* note 7, § 21:10, at 372.

113. *Marshall v. Land*, 413 S.W.2d 820, 824 (Tex. Civ. App.—Dallas 1967), *aff'd*, 426 S.W.2d 841 (Tex. 1968).

114. *Murphy v. Metropolitan Life Ins. Co.*, 498 S.W.2d 278 (Tex. Civ. App.—Houston [14th Dist.] 1973, writ *ref'd n.r.e.*) (purchase of life insurance for benefit of unrelated person is constructive fraud absent special circumstances); *accord*, *Carnes v. Meador*, 533 S.W.2d 365, 370 (Tex. Civ. App.—Dallas 1975, writ *ref'd n.r.e.*).

115. 3 L. SIMPKINS, *supra* note 7, §§ 21:2-:27; Johanson, *Revocable Trusts and Community Property: The Substantive Problems*, 47 TEXAS L. REV. 537, 564-73 (1969). Nonetheless, it is clear that a defrauded spouse has a remedy in the form of a right to reimbursement. *United States v. Rempel*, 326 U.S. 367, 370 (1945); *Hopkins v. Bacon*, 282 U.S. 122, 126 (1930); 3 L. SIMPKINS, *supra* note 7, § 22:38. Such right of reimbursement, however, arises only upon dissolution of the community. 3 L. SIMPKINS, *supra* note 7, § 22:38, at 501; *see* *Gonzales v. Gonzales*, 117 Tex. 183, 300 S.W. 20 (1927); *Lindsay v. Clayman*, 151 Tex. 593, 254 S.W.2d 777 (1952).

116. 3 L. SIMPKINS, *supra* note 7, § 21:23, at 394-95. Illustrative cases include: *Locke v. Locke*, 143 S.W.2d 637 (Tex. Civ. App.—Beaumont 1940, no writ) (failure of proof of fraud when spouses separated and one spouse consumed community property in excess of his living expenses); *Irwin v. Irwin*, 110 S.W. 1011 (Tex. Civ. App.—1908, no writ) (no fraud where husband abandoned wife and consumed all his earnings during period of abandonment).

117. 533 S.W.2d 52 (Tex. Civ. App.—Houston [14th Dist.] 1975, writ *dism'd*).

118. *Id.* at 54.

that Roy's transfers did not constitute either actual or constructive fraud on the community.

The court said actual fraud "involves dishonesty of purpose or intent to deceive" and that the complainant "has the burden of showing that the gifts were made with the primary purpose of depriving her from having the use and enjoyment of the assets comprising the gifts."¹¹⁹ The court held that Dorothy did not sustain her burden of showing actual fraud inasmuch as there was ample evidence to support the trial court's finding that Roy's "intention in making the gifts was to benefit both the community estate and the parties' individual estates upon the death of each or both of them."¹²⁰ The court stated that "[t]he single fact that the appellee intentionally prevented the appellant from finding out about the gifts which he made to his daughters does not constitute actual fraud."¹²¹ The court also stated that "important in considering the rights of disposition" possessed by Roy Horlock was the fact that the subject matter of the gift was Roy's sole management community property. It commented that "[i]t is not necessary that one spouse approve or agree with the dispositions made by the other spouse of that other spouse's special community property."¹²²

Having found no actual fraud, the court considered whether constructive fraud had occurred and noted that the test was unfairness and that Roy Horlock had the burden of proving fairness. Applying the unfairness test requires consideration of three factors. Those three factors are "[t]he size of the gift in relation to the total size of the community estate, the adequacy of the estate remaining to support the wife in spite of the gift, and the relationship of the donor to the donee."¹²³ The court found that the gift constituted only 13.1517% of Roy Horlock's \$ 1 million estate, was made to his daughters who were minors at the death of their mother, and took nothing from his wife's estate.

In the most recent case involving managerial control over sole management community property, *Valdez v. Ramirez*,¹²⁴ decided on July 26, 1978, the Texas Supreme Court did not ever mention fraud as a limitation on the right of the spouse having the management right. It was clear, however, from the court's statements that it found no intent to deceive or unfairness in the managing spouse's disposition of her sole management community property. The case, nonetheless, is important because it reflects the limited rights of the nonmanager spouse in sole management community property.

Mrs. Valdez, who survived her husband, had elected to have her government pension paid to her and her husband under a joint and survivor payment option. Mrs. Valdez had been receiving benefits under the plan for two years at the time of her husband's death. Mr. Valdez's children by a former marriage claimed their father's community interest in the govern-

119. *Id.* at 55.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. 574 S.W.2d 748 (Tex. 1978).

ment pension under the applicable intestate statute, section 45 of the Texas Probate Code.¹²⁵ The Texas Supreme Court refused the children's claim on the ground that the employee spouse's selection of the pay out option was a valid exercise of her right to manage her sole management community property. Implicit in the court's opinion was its finding that the settlement option selected by Mrs. Valdez was fair inasmuch as the option selected would have given Mr. Valdez an annuity for life had he been the survivor. Also important to the court was the underlying purpose of retirement benefit plans, namely, "to provide financial support and security to aged employees"¹²⁶ rather than, as in this case, the adult children of a deceased nonemployee spouse. The court, however, did note that the intestate statute would have applied if Mrs. Valdez had not elected a payment option.

Perhaps the court, having found no such fraud, inadvertently omitted any suggestion that it might have reached a different result upon a showing of fraud.¹²⁷ Alternatively, perhaps Mr. Valdez's children did not assert fraud. A final possibility is that the court might have been saying that even with a showing that the employee spouse's election of the payment option was a fraud on the community, it would not have reached a different result. If the latter, *Valdez v. Ramirez* would represent new law, and the question would be whether the holding is limited to the employee benefits area.

Prior to *Valdez* it would have seemed that the nonmanager spouse would have the right to make a disposition at death of his one-half of his spouse's sole management community property. Has that right now been abrogated, or does *Valdez* merely confirm present law and stand for the proposition that the managing spouse is free to make a lifetime disposition of her sole management community property and that such a disposition can be overturned by the other spouse upon a showing of fraud? One cannot but believe that this latter proposition is the one for which *Valdez* should be cited, but it would have been easier to make out such a case had the Texas Supreme Court at least mentioned the absence of any fraud on

125. TEX. PROB. CODE ANN. § 45 (Vernon 1956).

126. 574 S.W.2d at 750.

127. On December 13, 1978, after this Article was prepared, the Texas Supreme Court denied respondent's motion for rehearing and filed an opinion that noted the absence of any suggestion of fraud on the part of Mrs. Valdez in electing the joint and survivor annuity option. 574 S.W.2d 748, 751 (Tex. 1978). In its opinion, the court placed great emphasis on its determination that a joint survivorship annuity was "clearly authorized by federal law to serve a federal purpose." *Id.* at 140 (citing *Free v. Bland*, 369 U.S. 663 (1962)). The court said that, in such a case, state law would be preempted "in the absence of its use to perpetuate a fraud by one spouse on the other." 574 S.W.2d at 752.

It would seem that rather than announce this perception of federal preemption in the pension and profit sharing area, the court would have been better advised simply to base its decision on the absence of fraud. The federal government would have no greater interest in the beneficiary designations made by one of its employees than would a private employer. In other words, no federal purpose is being accomplished by creating a special class of pension beneficiary designations. This argument will surely be made in other cases where spouses dispute the beneficiary designations made by one of them. The "absence of fraud" finding would have been a better precedent.

the community. As it stands, *Valdez* arguably is authority for the proposition that the beneficiaries of the estate of the nonmanager spouse can never frustrate the managing spouse's disposition of sole management community property even if fraud is alleged.¹²⁸ If that is true, *Valdez* is, as previously stated, important new law.

These questions aside, it is clear that the nonmanager spouse has strictly limited rights in sole management community property. The sum total of those rights is as follows:

- (1) If the manager spouse has not made a lifetime disposition of her sole management community property, the nonmanager, at his death, can either dispose of fifty percent of his spouse's sole management community property by will,¹²⁹ or this fifty percent will pass by the intestacy statutes of Texas.¹³⁰
- (2) Creditors of the nonmanager spouse may not proceed against his spouse's sole management community property, except in the following two situations:¹³¹
 - (a) During the lifetime of the nonmanager, claims arising out of his tortious conduct may be satisfied out of the other spouse's sole management community property.¹³² The courts, however, are authorized to consider the facts surrounding the tort and determine the order in which separate and community property will be subject to execution and sale to satisfy the claim.¹³³
 - (b) In addition, creditors furnishing necessities to the nonmanager spouse may proceed against his spouse's sole management community property.¹³⁴

Even if the fraud on the spouse doctrine applies after *Valdez*, the *Valdez*

128. See *Kirkland v. Kirkland*, 359 S.W.2d 651 (Tex. Civ. App.—Fort Worth 1962, writ ref'd n.r.e.); *Buehler v. Buehler*, 323 S.W.2d 67 (Tex. Civ. App.—Texarkana 1959, writ ref'd n.r.e.). In *Buehler* the decedent died intestate, survived by his second wife, whom he designated as beneficiary, and by a son of his first wife. The son asserted that the designation was testamentary and void since it had not been executed with the required formalities of a will. The court rejected the son's contention and recognized the designation as a valid third-party beneficiary contract.

In the later case of *Kirkland* the decedent was a school teacher and member of the Texas Teachers Retirement System. The decedent had designated his sister as beneficiary of the death benefits, overlooking his wife of twenty years and his son. Following *Buehler*, the *Kirkland* court rejected the widow's contention that the designation was void since the card had not been executed with the formalities of a will. The widow also argued that she was defrauded of her community property interest since she failed to join in the designation. While the court seemed to assume that the wife would have had rights had she been defrauded, it held that since all the considerable separate and community property of the decedent went to his wife and son, except for the death benefits, there had been no fraud upon the wife. The point of the case is that a designation without the knowledge of the nonemployee spouse may be valid when that spouse is otherwise provided for.

129. TEX. PROB. CODE ANN. § 58 (Vernon 1956).

130. *Id.* § 45.

131. See Huie, *Divided Management of Community Property in Texas*, 5 TEX. TECH L. REV. 623 (1974); see generally Comment, *Section 5.22 of the Texas Family Code: Control and Management of the Marital Estate*, 27 SW. L.J. 837 (1973).

132. TEX. FAM. CODE ANN. §§ 5.61(b)(2), (d) (Vernon 1975).

133. *Id.* § 5.62.

134. See *id.* § 4.02.

result suggests some interesting federal estate and gift tax questions. Inasmuch as Congress has not expressly included sole management community property in the estate of the nonmanager spouse, could it be argued that sole management community property is included in the nonmanager spouse's gross estate only if he has the right to dispose of it at death? Moreover, could it be argued that the managing spouse's control over her sole management community property is so pervasive that her lifetime transfers of that property will not result in the nonmanager spouse having made a taxable gift?

With respect to employee benefits, Congress has expressly recognized the limited nature of the interest of the nonmanager in sole management community property. Section 2039(d) provides that if the nonemployee spouse dies first, his community interest in his spouse's employee benefit plan shall be excluded from his estate for federal estate tax purposes. A corresponding provision, section 2517(c), provides that for federal gift tax purposes, a lifetime transfer of her spouse's employee benefits shall not be treated as a taxable gift by the nonemployee spouse.

Thus, the limited nature of the nonmanager's rights in sole management community property is a strong argument for the proposition that the donor spouse did not have the use, possession, or enjoyment within the meaning of section 2036 of the sole management community income produced by the property he transferred to his spouse as her separate property. The taxpayer, however, must face the proposition, which the courts have pronounced in the clearest of terms, that community property is owned by the two spouses equally and the management rights of a spouse over his sole management community property do not amount to complete ownership of that property.¹³⁵

Interestingly, in *Wyly*, other than noting the spouses' equal ownership of sole management community property, all the Commissioner could say about the donor spouse's rights in the sole management community income produced was to note what the managing spouse could not do, namely:

[S]he could not have made excessive or capricious gifts of decedent's share of the community property income . . . or have used it to improve her own separate property The principles of accounting apply between the various estates of spouses in Texas . . . and where appropriate, courts can order an accounting with respect to community income from separate property while the marital community con-

135. See, e.g., *United States v. Mitchell*, 403 U.S. 190, 203-05 (1971), *discussed at* note 70 *supra*; *Hopkins v. Bacon*, 282 U.S. 122 (1930); *Poe v. Seaborn*, 282 U.S. 101 (1930); *Bowling v. United States*, 510 F.2d 112, 113 (5th Cir. 1975); *Lange v. Phinney*, 507 F.2d 1000, 1005 (5th Cir. 1975); *Brodway v. United States*, 455 F.2d 1097, 1099 (5th Cir. 1972); *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959); *Norris v. Vaughan*, 152 Tex. 491, 500, 260 S.W.2d 676, 682 (1953); *King v. Bruce*, 145 Tex. 647, 654, 201 S.W.2d 803, 807 (1947); *Carnes v. Meador*, 533 S.W.2d 365, 371 (Tex. Civ. App.—Dallas 1975, writ ref'd n.r.e.). See generally W. DE FUNIAK & M. VAUGHN, *PRINCIPLES OF COMMUNITY PROPERTY* § 105 (2d ed. 1971); Comment, *supra* note 131, at 838.

tinues.¹³⁶

From this the Commissioner concluded that the “[d]ecedent’s right to the community income, if any, to be generated by the trust was thus both ‘ascertainable’ and ‘legally enforceable’ and therefore sufficient to activate Section 2036(a)(1).”¹³⁷

C. Conclusion

If it could be said that the nonmanager spouse has the right to dispose of his one-half of his spouse’s sole management community property at death,¹³⁸ it would seem that this right is sufficient to bring that property within the section 2036 concept of possession or enjoyment or right to income. What greater right could a taxpayer have than the right to dispose of property at the time of death. Such right, for example, is the basis of section 2041, relating to powers of appointment, the one attribution section within the federal estate tax.

The issue is complicated, however, because, first, the nonmanager spouse may be divested of his right of disposition by actions of the manager spouse, and secondly, there is disagreement as to the tests to be applied in determining whether a decedent’s interest in transferred property is that contemplated by Congress when it enacted section 2036. The *Castleberry* court provided that the test is whether the transferor’s interest is illusory.¹³⁹ The taxpayer in *Wyly*, however, claims the test is whether the decedent’s interest is substantial and not insignificant.¹⁴⁰ In the case where the decedent’s interest is in sole management community property, the taxpayer argues that the nonmanager spouse’s control over the income is not substantial and is really insignificant. The Commissioner, on the other hand, argues that “[a]ll that is required is that a decedent retain a ‘property right’ in the income, . . . or that he retains [*sic*] a right to have the income applied to his ‘pecuniary benefit,’ Treasury Regulations Section 20.2036.1(b)(2), or that he retains [*sic*] an ‘economic benefit’ from the property transferred.”¹⁴¹ The Commissioner further asserts that the sub-

136. Brief for the Appellee at 20, *Estate of Wyly v. Commissioner*, *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978) (citations omitted); *see* *Dakan v. Dakan*, 125 Tex. 305, 317-18, 83 S.W.2d 620, 627 (1935); *Harris v. Royal*, 446 S.W.2d 351, 352 (Tex. Civ. App.—Waco 1969, writ ref’d n.r.e.).

137. Brief for the Appellee at 20, *Estate of Wyly v. Commissioner*, *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978).

138. *See* notes 129-30 *supra* and accompanying text. *But see* *United States v. Stewart*, 270 F.2d 894 (9th Cir. 1959), *cert. denied*, 361 U.S. 960 (1960); *Caswell v. United States*, 205 F. Supp. 576 (N.D. Cal. 1962).

139. *Estate of Castleberry v. Commissioner*, 68 T.C. 682, 690 (1977), *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978).

140. Brief for Appellant at 12-13, *Estate of Wyly v. Commissioner*, *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978).

141. Brief for Appellee at 25, *Estate of Wyly v. Commissioner*, *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978); *see* *Commissioner v. Estate of Church*, 335 U.S. 632 (1949); *First National Bank v. United States*, 342 F.2d 415, 416-17 (5th Cir. 1965); *Greene v. United States*, 237 F.2d 848, 852 (7th Cir. 1956). In *Estate of Church* the United States Supreme Court held that the decedent had retained an interest within the meaning of I.R.C. § 2036 so long as his interest was a property right in the income. 335 U.S. at 644-45.

stantial control test urged upon the court by the taxpayer is not applicable to section 2036(a)(1), when the inquiry is that of use, possession, enjoyment, or right to income. The Commissioner maintains that the substantial control test is properly applied only as to section 2036(a)(2), when the inquiry is that of the decedent's retained right to designate who shall enjoy the income from the transferred property during the decedent's lifetime.

The Commissioner appears to be in error in his statement of the applicable law. The United States Supreme Court in *United States v. Byrum*¹⁴² used a "substantial present economic benefits" test¹⁴³ in applying section 2036(a)(1), and held for Byrum, the taxpayer. Byrum had established an irrevocable trust for the benefit of his children with shares of stock in three closely held corporations. The trustee was an independent banking institution, but Byrum expressly retained the right to vote the shares of stock in the trust and to disapprove any sale of those shares. The Supreme Court found "that Byrum's retention of voting control was not the retention of the enjoyment of the transferred property within the meaning of the statute."¹⁴⁴ The Court noted:

The Government points to the retention of two "benefits." The first of these, the power to liquidate or merge, is not a *present* benefit; rather, it is a speculative and contingent benefit which may or may not be realized. Nor is the probability of continued employment and compensation the substantial "enjoyment of . . . [the transferred] property" within the meaning of the statute.¹⁴⁵

At this juncture, the reader will undoubtedly point to the anti-*Byrum* rule adopted by Congress in 1976 and modified by the Revenue Act of 1978.¹⁴⁶ The modification created new section 2036(b) to deal with the

142. 408 U.S. 125 (1972).

143. *Id.* at 149; *accord*, Estate of Gilman v. Commissioner, 547 F.2d 32, 35 (2d Cir. 1976); Yeazel v. Coyle, 68-1 U.S. Tax Cas. ¶ 12,524 (N.D. Ill. 1968).

144. 408 U.S. at 150.

145. *Id.* at 149-50. The substantial present economic benefit test apparently was first articulated in Commissioner v. Estate of Holmes, 326 U.S. 480, 486 (1946). That case involved a deceased transferor who, as trustee, had the power to accelerate the enjoyment by the trust beneficiaries of the property he had placed into the trust during his lifetime. The Court held that the decedent's power caused the trust property to be included in his gross estate (as it would be under present law, namely I.R.C. § 2038). In reaching its decision, the Court articulated the notion that the words "enjoy" and "enjoyment" in the estate and gift statutes "connote substantial present economic benefit." 326 U.S. at 486. Although the Court in *Byrum* would appear to be the first court to find that a retained interest was insubstantial under this test, *Byrum* was not the first case to extend the *Holmes* substantial benefit test to § 2036(a)(1). In Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959), the court used this test in applying § 2036(a)(1) and held that the decedent had retained a life estate in property that he transferred during life. *McNichol* is the leading case supporting the proposition that a life estate need not be expressly retained in order to apply § 2036(a)(1).

Justice White (joined by two others) dissented in *Byrum*. He correctly pointed out that "nowhere in the statute . . . do the words 'substantial' and 'present'—or suggestions to that effect—appear." 408 U.S. at 154 n.3. Furthermore, he correctly noted that *Holmes* was not "a case in which the Court intended or attempted to narrow the meaning of § 2036(a)(1)." *Id.* Nonetheless, both the majority in *Byrum* and the court in *McNichol* seem clear as to the applicable standard. Logic supports their conclusion.

146. Revenue Act of 1978, Pub. L. No. 95-600, § 702(i)(1), 92 Stat. 2931.

Byrum case and redesignated subsection (b) as subsection (c). New section 2036(b) now provides:

(b) VOTING RIGHTS.—

(1) IN GENERAL.—For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

(2) CONTROLLED CORPORATION.—For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

(3) COORDINATION WITH SECTION 2035.—For purposes of applying section 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.¹⁴⁷

As a result of the congressional response to *Byrum*, does the Supreme Court's decision have any vitality? The answer would seem to be an obvious yes. All that Congress did was change the result in *Byrum* in a very specific way. It did not reject the "substantial present economic benefits" test used in *Byrum*. If Congress had wanted to eliminate the substantiality requirement from the Supreme Court's test, it would have modified section 2036(a)(1) in a much different fashion. Nonetheless, while it is true that Congress did not change the substantial benefit test, there do not appear to be any cases except *Byrum* in which a court has excluded transferred property from a transferor's gross estate on the ground that the decedent's use, possession, or enjoyment of, or right to income from, the transferred property was not substantial or was insignificant.

All of the other cases that involve inquiries as to the substantiality or significance of the degree of control retained by the decedent involved assertions by the Commissioner that the decedent retained a section 2036(a)(2) right to designate who would enjoy the income from the transferred property during his lifetime.¹⁴⁸ Moreover, there are two cases holding that a decedent's contingent right to income required the inclusion of the transferred property in the transferor's gross estate.¹⁴⁹

147. *Id.*

148. See *United States v. Byrum*, 408 U.S. 125 (1972); *United States v. O'Malley*, 383 U.S. 627 (1966); *Lober v. United States*, 346 U.S. 335 (1953).

149. *Marks v. Higgins*, 213 F.2d 884 (2d Cir. 1954); *Commissioner v. Nathan's Estate*, 159 F.2d 546 (7th Cir. 1947), *cert. denied*, 334 U.S. 843 (1948). See also *Treas. Reg. § 20.2036-1(b)(i), (ii)* (1958). Other cases have found that retention of any economic benefit will cause inclusion of the transferred property in the donor's gross estate. See *First National Bank v. United States*, 342 F.2d 415 (5th Cir. 1965); *Greene v. United States*, 237 F.2d 848, 852 (7th Cir. 1956); *Helvering v. Mercantile Commerce Bank & Trust Co.*, 111 F.2d 224, 226 (8th Cir.), *cert. denied*, 310 U.S. 654 (1940) (upholding *Treas. Reg. 80, art. 18* (1937), the predecessor of *Treas. Reg. § 20.2036-1(b)(2)* (1958), which provides that an interest is retained if the income is to be applied toward the "pecuniary benefit" of the donor).

Applying the substantial benefits test of *Byrum* to Mr. Castleberry's transfer to his spouse could easily lead to the conclusion that the interest given Mr. Castleberry by Texas law in the income from the transferred property was not the kind of interest contemplated by section 2036 inasmuch as Mr. Castleberry's interest in the income produced is protected only by the doctrine of fraud on the spouse. *Valdez* and *Horlock*, thus, would seem to be important precedents to the estates of *Castleberry*, *Wyly*, and *McKee* in support of their arguments.

Valdez could mean that the donor spouse has an interest at his death in the income produced by the transferred property only if the donee spouse does not take it away from him, and whether she relieves him of his interest fraudulently or while acting in the best interest of the community is irrelevant. At the very least, *Valdez* means that a nonfraudulent disposition by the donee spouse of the income produced by the transferred property will cut off any interest of the donor spouse in that income. Thus, *Valdez* would seem to say that the donor spouse's rights under Texas law to any income produced by the trust, if it is sole management community property as alleged, are not worth much, if anything. Certainly, it could be argued that such rights do not constitute a section 2036(a)(1) interest.¹⁵⁰

Thus, the taxpayers in *Castleberry*, *McKee*, and *Wyly* might prevail on the ground that their interest in the community income generated by the transferred property is so insubstantial that it is beyond the reach of section 2036(a)(1). If not, they may argue that they "retained" no interest in the transferred property even though they had a section 2036(a)(1) interest in that property at the time of their respective deaths.

IV. THE "RETENTION BY OPERATION OF LAW" ISSUE

A taxpayer may have an interest in property that he has transferred, but that property will not necessarily be included in his estate unless he "retained" that interest within the meaning of section 2036(a)(1).

A. *The Three "Old" Retention Tests: In General*

Three different tests for determining whether there has been a "retention" of an interest within the meaning of section 2036(a) can be discerned in the cases making that determination. To facilitate discussion the three tests are labeled the express retention test, the facts and circumstances test, and the economic effects test.

The express retention test is self-defining. The test inquires as to whether the transferor has any legally enforceable right to the use or enjoyment of the transferred property, or a right to the income from the

150. Taxpayers with this issue should consider avoiding the Tax Court and litigating in the district court where it would seem a jury trial could be available on the factual issue whether an income interest provided by Texas law in transferred property constitutes a substantial present economic benefit under the *Byrum* test for § 2036(a)(1). See *Kokes v. United States*, 68-1 U.S. Tax Cas. ¶ 12,530 (D. Neb. 1968).

transferred property.¹⁵¹

The facts and circumstances test, on the other hand, does not depend upon finding that the transferor has legally enforceable rights to an interest in the transferred property, but more nearly on whether the transferor, in fact, has for life the use, possession, enjoyment of or right to income from the transferred property.¹⁵² In such cases, the courts have expressed a willingness to imply an understanding or agreement between the parties to allow the transferor to enjoy the property.¹⁵³

The economic effects test is hard to isolate, partly because it is still in the formulation stage. The question is under what circumstances, *if any*, will the courts imply a *retention* of a life estate from the mere fact that the decedent had the economic benefits at his death from property that he had at one time transferred. The economic effects test is rooted in *United States v. Estate of Grace*,¹⁵⁴ decided by the United States Supreme Court in 1969. In that case the spouses had established reciprocal trusts for each other. Because of the coordination that obviously took place in the establishment of the respective trusts, Joseph Grace was deemed the transferor of the trust established by his wife for his benefit and she was deemed to be the transferor of the trust he had established for her benefit. This attribution of transferor-like status to each spouse resulted in the Court's including in Joseph Grace's gross estate the value of the trust in which he had a life estate even though that trust had been established by his spouse. The Court said that, although there had been no express retention of a life estate nor any intent manifested in an agreement to maintain a right in the transferred property, "the settlor in a very real and objective sense did retain an economic interest while purporting to give away his property."¹⁵⁵ The Court held that a life estate has been retained when "the arrangement . . . leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."¹⁵⁶ Finally, the Court stated that "[i]t is no answer that the transferred properties were different in character. For purposes of the estate tax, we think that economic value is the only workable criterion."¹⁵⁷

Perhaps the Supreme Court did not intend in *Estate of Grace* to articulate a new broad standard for application of section 2036, and intended the case to be limited to its facts. For whatever reasons, the courts have been slow to develop *Estate of Grace*. While the language of the Court's opin-

151. See, e.g., *Commissioner v. Estate of Church*, 335 U.S. 632 (1949) (holding that the predecessor of § 2036(a)(1) applied to a retained right to income from property transferred in trust).

152. See, e.g., *Tubbs v. United States*, 472 F.2d 166 (5th Cir.), cert. denied, 411 U.S. 983 (1973); *Estate of McNichol v. Commissioner*, 265 F.2d 667 (3d Cir.), cert. denied, 361 U.S. 829 (1959).

153. See *Tubbs v. United States*, 472 F.2d 166, 166 (5th Cir.), cert. denied, 411 U.S. 983 (1973); *Estate of McNichol v. Commissioner*, 265 F.2d 667, 670-71 (3d Cir.), cert. denied, 361 U.S. 829 (1959).

154. 395 U.S. 316 (1969).

155. *Id.* at 323-24.

156. *Id.* at 324.

157. *Id.* at 325.

ion was cited as authority in *Bomash*,¹⁵⁸ only one estate tax case has extended the holding to a different set of facts. In *Bischoff v. Commissioner*¹⁵⁹ a grandfather established four trusts for his grandchildren and made the grandmother the trustee. The grandmother established four identical trusts for the same grandchildren and made the grandfather the trustee. The trustee of each trust would have section 2036 or section 2038 powers if the settlor of the trust was deemed the trustee under the reciprocal trust doctrine. The taxpayers claimed that the reciprocal trust doctrine is not applicable when, as there, neither settlor at his death possesses any economic interest in the property transferred to the trusts. The Tax Court held that the *Estate of Grace* did not restrict the application of the reciprocal trust doctrine to crossed economic interests such as the life estates Mr. and Mrs. Grace enjoyed. "We simply are not convinced that the Supreme Court intended to close a perceived loophole under section 2036(a)(1) and, at the same time, permit one to flourish under sections 2036(a)(2) and 2038(a)(1)."¹⁶⁰

In *Castleberry* the Tax Court seems to have held that a finding of a retention of an interest in transferred property is unnecessary so long as the transferor has an economic interest in the transferred property at his death.

We find the reasoning no less valid today and are of the opinion that petitioner has misconstrued the thrust of our decisions wherein we did or did not find an agreement, prearrangement, or understanding that decedent has retained a life interest in the transferred property. Those decisions did not hold that a finding of an implicit or explicit agreement was a precondition to the legal conclusion that a decedent had retained an interest in the transferred property under section 2036(a)(1). Petitioner is correct in noting that in each of those cases the decedent would have had no interest in the transferred property absent an agreement. However, in the instant case such an agreement was unnecessary. *By operation of State law decedent held an interest in the transferred property after the transfer. We therefore concluded that section 2036(a)(1) applies where the donor holds an income interest in transferred property by operation of State law as well as where he expressly or impliedly retains the interest under the transfer instrument.*¹⁶¹

158. *Estate of Bomash v. United States*, 432 F.2d 308, 311 & n.11 (9th Cir. 1970), *rev'g* 50 T.C. 667 (1968), *discussed at* text accompanying notes 39-41 *supra*.

159. *See Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977).

160. *Id.* at 47.

161. *Estate of Castleberry v. Commissioner*, 68 T.C. 682, 686 (1977), *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978) (footnote omitted; emphasis added), *discussed at* notes 46-70 *supra* and accompanying text. The Commissioner states: "Before the transfer of the bonds, decedent had a one-half community property ownership interest [*sic*] in the income from the bonds. After the transfer, he had exactly the same interest. Thus, there was a retention in substance and Section 2036(a)(1) applies." Brief for the Appellee-Cross-Appellant at 16-17, *Estate of Castleberry v. Commissioner*, No. 78-1612 (5th Cir. Mar. 28, 1978). While decedent had a one-half community interest in any income produced by the transferred property both before and after, there was no guarantee that after the transfer the donee spouse would not dissipate, die, divorce, or depart, and thereby frustrate the produc-

The Fifth Circuit must decide whether to accept this new application of *Estate of Grace* as a basis for deciding retained life estate cases.

The effect of the Tax Court's position is to emasculate the retention requirement of section 2036(a) and render it much more like section 2038 than its literal language would seem to permit. Section 2038 applies to transfers where enjoyment was subject to the transferor's power at his death "to alter, amend, revoke or terminate"¹⁶² even if that power was not retained by the decedent at the time of the transfer. It is often said that section 2036(a)(2) and section 2038 reach the same kind of interests. In that sense, section 2036(a)(2) is considered the lifetime branch of section 2038. A Treasury Regulation under section 2036, however, emphasizes the distinction between the kinds of interests each section is designed to reach. That regulation provides that "[t]he phrase 'right . . . to designate' . . . does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life. (See however, section 2038 for the inclusion of property in the gross estate on account of such a power.)"¹⁶³

The Tax Court's emasculation of the retention requirement expressly provided for in section 2036 is far-reaching not only because it contravenes an express statutory provision, but also because the Second Circuit has read a retention requirement into section 2038. In 1972 the Second Circuit claimed that section 2038 had been applied only in cases in which the transferor retained the taxable power at the time of the transfer.¹⁶⁴ It, therefore, refused to apply section 2038 to a case in which there was no express retention.

Actually, the economic effects test of *Estate of Grace* bears some similarity to the facts and circumstances test. They are distinguishable, however, in the sense that under the economic effects test, the courts would not have to find any facts and circumstances from which to imply an agreement or understanding that the transferor will have the enjoyment of the transferred property. Moreover, the economic effects test would seem to require, out of faithfulness to *Estate of Grace*, a showing that the transferor has a substantial or significant interest in the transferred property at death.¹⁶⁵ Under the facts and circumstances and express retention tests,

tion of any income. Before the transfer, the donor could prevent that result. See text accompanying notes 173-74 *infra*.

Accord, *Estate of Hinds v. Commissioner*, 11 T.C. 314 (1948), *aff'd on other grounds*, 180 F.2d 390 (5th Cir. 1950), *discussed at* note 33 *supra*.

In the portion of the *Castleberry* opinion devoted to determining the amount included in Mr. Castleberry's gross estate, the Tax Court seemed to see *Estate of Grace* as being limited to the reciprocal trust context. See note 385 *infra* and accompanying text. This suggests that the Tax Court may not have appreciated the implication that can be drawn from its analysis.

162. Treas. Reg. § 20.2038-1(a) (1958).

163. *Id.* § 20.2036-1(b)(3).

164. See *Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972), *nonacq.*, 1978-1 C.B. 3. *But cf.* Rev. Rul. 70-348, 1970-2 C.B. 193 (donor to custodianship under Uniform Gifts to Minors Act who becomes successor custodian has I.R.C. § 2038 power to terminate even though not retained at time of transfer).

165. See text accompanying note 156 *supra*.

having found a retention, the only question seems to be whether the decedent has any interest, however insignificant, in the transferred property at his death.

B. *The Express Retention Test: As Applied to Castleberry and McKee*

Both Messrs. Castleberry and McKee did all they could to divest themselves of the transferred property. Neither decedent retained, by any standard, any interest in the transferred property—the tree—subsequent to the transfer.¹⁶⁶ What each did have was the legally enforceable right¹⁶⁷ to one-half of any income produced by the transferred property—the fruit—by virtue of the Texas community property principle that income from separate property is community.¹⁶⁸ The issue then is whether the connection between the transfer and the fact that any income produced by the transferred property is community is broken by the fact that the donee spouse has the unfettered right to dissipate the transferred property and thereby deprive the decedent of any income or other enjoyment of the transferred property.¹⁶⁹ Such potential for a severance of the nexus between the transfer and the interest would appear to negate retention, express or otherwise. Furthermore, there is a weaker argument that asks how the decedent could have retained the use, possession, or enjoyment of, or right to the income from, the transferred property when he had no right to compel the donee spouse to manage the transferred property in any way for his benefit or to constrain her in her management of that property.¹⁷⁰

C. *The Facts and Circumstances Test: As Applied to Castleberry and McKee*

The issue is whether from the facts and circumstances that existed at the time of the transfer, the courts could imply an agreement or understanding that the decedent would in fact retain for his life the use, possession, or enjoyment of, or right to income from, the transferred property.¹⁷¹ In *Castleberry and McKee* there is simply nothing in the record that would suggest any agreement or understanding between the respective transferors and transferees that the transferors would enjoy either the transferred property or the income therefrom. While the statute is not concerned with actual enjoyment, but the right to such enjoyment, the absence of such enjoyment would be taken as some evidence that there was no agreement or understanding between the respective transferors and transferees.¹⁷²

166. The Commissioner concedes that under his interpretation of Texas law, it is "impossible for one spouse to give to another the complete right to income from property." Brief for the Appellee-Cross-Appellant at 17, *Estate of Castleberry v. Commissioner*, No. 78-1612 (5th Cir. Mar. 23, 1978) (footnote omitted).

167. *But cf.* notes 106-38 *supra* and accompanying text.

168. *See* note 7 *supra*.

169. *See* notes 59-66 *supra* and accompanying text.

170. *See* *Estate of Uhl v. United States*, 241 F.2d 867 (7th Cir. 1957), *aff'g* 25 T.C. 22 (1955). For further discussion, see text accompanying notes 231-33 *infra*.

171. *See* note 152 and accompanying text.

172. There is nothing in the *Castleberry* or *McKee* records to indicate that the transferors

D. *The Economic Effects Test: As Applied to Castleberry and McKee*

As noted earlier, the United States Supreme Court's decision in *United States v. Estate of Grace*¹⁷³ is the source of the economic effects test. Since the Supreme Court found retained life estates in *Estate of Grace* from the mere fact that coordination between the spouses took place in the establishment of the trusts, perhaps it is now fair to say that the retention requirement of section 2036(a) is to be broadly interpreted so as to carry out the legislative policy of tracing not only incomplete transfers, but also schemes that have tax avoidance purposes even though they are not within the literal language of the statute. The test of *Estate of Grace* appears to be an inquiry as to whether the transferor is in substantially or approximately the same position before and after the transfer. Thus, were Messrs. Castleberry and McKee in approximately the same economic position after their respective transfers to their spouses that they would have been in had the transfers not been made? The answer is a resounding no! Before the transfer, Mr. Castleberry, for example, enjoyed the right to manage at least jointly, if not solely, the community property transferred. After the transfer, the transferred property was the wife's separate property, subject to her unfettered right of disposition. Only the income produced by the transferred property was community property, and as to that, management was now committed exclusively to her, subject only to the limitation that she not so manage the income produced as to work a fraud on the community.¹⁷⁴

Moreover, the transfers by Mr. Grace and Mrs. Bomash are distinguishable from the transfers by Messrs. Castleberry and McKee. Both Mr. Grace and Mrs. Bomash were in the same economic position after the transfer that they would have been had the respective transfers been made to trusts that they each had established for their respective benefits.

E. *The Retention by Operation of Law Test*

The district court in *Deobald* stated that under section 2036 the subjective intent of the donor is to be emphasized and that there has been no retention under section 2036(a) unless "the grantor had the intent manifested in an agreement at the time of transfer, to maintain a contingency interest or right in the transferred property."¹⁷⁵ Nonetheless, there would

ever enjoyed the transferred property. In *Wyly* the trust included only non-income-producing property. Brief for Appellant at 16, *Estate of Wyly v. Commissioner*, No.78-1306 (5th Cir. Feb. 28, 1978).

173. 395 U.S. 316 (1969).

174. See notes 105-34 *supra* and accompanying text.

175. 444 F. Supp. 374, 382 (E.D. La. 1977). For discussion of this case, see text accompanying notes 85-92 *supra*. The United States Supreme Court has clearly and unequivocally expressed a contrary view in *Estate of Spiegel v. Commissioner*, 335 U.S. 701, 705-06 (1949) (emphasis added), discussed at text accompanying notes 352-55 *infra*:

In *Commissioner v. Church*, 335 U.S. 632, 701, . . . we have discussed the *Hallock* holding in relation to the scope of the "possession or enjoyment" provision of § 811 (c) and need not elaborate what we said there. *What we said demonstrates that the taxability of a trust corpus under this provision of § 811 (c)*

seem to be no reason why an interest in transferred property cannot be retained by operation of law. The courts have had no difficulty including in a decedent's gross estate interests in property that resulted from the operation of state law.¹⁷⁶ Furthermore, despite the district court's view in *Deobald*, lack of volition on the part of the decedent has not kept so-called involuntary transfers out of the gross estate of incompetents when such transfers are made by court order during the period of incompetency but within three years of death.¹⁷⁷

Nevertheless, even the Treasury has not heretofore contemplated retention by operation of law to be within the ambit of section 2036. Its regulations under section 2036 speak of the decedent who has "retained or reserved" an interest in the transferred property, but make no mention of retention by operation of law.¹⁷⁸ On the other hand, its regulations under section 2037 state that that section includes "an interest arising either by the express terms of the instrument of transfer or *by operation of law*."¹⁷⁹

Also difficult to reconcile is *Helvering v. Helmholtz*,¹⁸⁰ in which the Supreme Court said that the retention of an interest in transferred property by operation of law is not grounds for including the transferred property in

does not hinge on a settlor's motives, but depends on the nature and operative effect of the trust transfer. In the *Church* case we stated that a trust transaction cannot be held to alienate all of a settlor's "possession or enjoyment" under § 811 (c) unless it effects "a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter. In other words such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies." We add to that statement, if it can be conceived of as an addition, that it *is immaterial whether such a present or future interest, absolute or contingent, remains in the grantor because he deliberately reserves it or because, without considering the consequences, he conveys away less than all of his property ownership and attributes, present or prospective.* In either event the settlor has not parted with all of his presently existing or future contingent interests in the property transferred. He has therefore not made that "complete" kind of trust transfer that § 811 (c) commands as a prerequisite to a showing that he has certainly and irrevocably parted with his "possession or enjoyment." Any requirement less than that which we have outlined, such as a post-death attempt to probe the settlor's thoughts in regard to the transfer, would partially impair the effectiveness of the "possession or enjoyment" provision as an instrument to frustrate estate tax evasions.

In the later case of *United States v. Estate of Grace*, 395 U.S. 316, 323 (1969), the Supreme Court noted that *Spiegel* established that taxability "does not hinge on a settlor's motives, but depends on the nature and operative effect of the trust transfer."

176. See *Estate of Spiegel v. Commissioner*, 335 U.S. 701 (1949), discussed at text accompanying notes 352-55 *infra*; *Thomas v. Graham*, 158 F.2d 561 (5th Cir. 1946).

177. *City Bank Farmers Trust Co. v. McGowan*, 323 U.S. 594 (1944).

178. *Treas. Reg. § 20.2036-1(a)* (1958).

179. *Id.* § 20.2037-1(c)(2) (emphasis added); see *Estate of Spiegel v. Commissioner*, 335 U.S. 701 (1949), discussed at text accompanying notes 352-55 *infra*.

180. 296 U.S. 93 (1935). Illustrative cases on the issue of revocation by the settlor of an otherwise irrevocable trust include *Woodruff v. Trust Co.*, 233 Ga. 135, 210 S.E.2d 321 (1974) (inherent right of settlor sole beneficiary to terminate irrevocable trust); *Underhill v. United States Trust Co.*, 227 Ky. 444, 13 S.W.2d 502 (1929) (with consent of beneficiaries).

the transferee's gross estate. In *Helmholz* the Court held that an irrevocable trust that was subject to the transferor's expressed power of revocation, but only with the consent of all beneficiaries, was not includable in the transferor's gross estate. It explained that her reserved right of revocation with consent of all the trust beneficiaries was no different from the right that state law gives her to revoke with the consent of the beneficiaries of the trust.

Despite these precedents, there does not appear to be any convincing argument against recognizing retention by operation of law so long as the question is whether the decedent has an interest at death in property that he transferred during life. The effect is the same whether he expressly retained the interest or whether it was given to him by operation of law. The only qualification that perhaps should be attached to the new test of retention by operation of law is to require that the decedent actually benefit or intend to benefit from the retention. In other words, when the taxpayer knows that local law will give him an interest in the transferred property, perhaps the property should be included in his estate.¹⁸¹ It is a much different case when the decedent had neither the knowledge nor the benefit from the transferred property. Of course, even in such cases, at the transferor's death, his will disposes of that portion of the income produced by the transferred property that is now the donee spouse's separate property.¹⁸² Yet perhaps, and most probably, it is enough to include only the income produced in the transferor's estate without asserting the retention issue as a basis for recapturing the means of production.

F. *Conclusion: As to Castleberry and McKee*

Thus, while retention by operation of law is not a troublesome issue, that is not the question in *Castleberry*. The unanswered question is whether the connection between the donor spouse's transfer of property and his right to any income produced from the transferred property is broken by either the donee spouse's unfettered right to dissipate the transferred property or the donor spouse's inability to compel the production of income or otherwise control the enjoyment of the transferred property.

Notwithstanding *Estate of Grace*, the retention issue cannot be resolved by simply pointing out that before and after the transfer Messrs. Castleberry and McKee had the right to any income produced by the transferred property. It is one thing to have control of the means of production before the transfer, and quite another to be totally at the mercy of the transferee's management of the means of production for one's enjoyment of the transferred property after the transfer. Barring any agreement or understanding between the transferor and the transferee as to how the means of production would be managed, the transferor should not be deemed to have retained a life estate in the transferred property.

181. This would make the retention by operation of law test analogous to the facts and circumstances test. See text accompanying note 152 *supra*.

182. See notes 129-30 *supra* and accompanying text.

G. *The Economic Effects Test: As Applied to Wyly*

As applied to the *Wyly* transfer, the *Estate of Grace* economic effects test might be a basis on which to rest inclusion of Mr. Wyly's transfer in his gross estate inasmuch as Mr. Wyly is in substantially the same economic position after the transfer as he would have been had the transfer been made to a trust established expressly for his benefit. This assumes, of course, that trust income is community property.¹⁸³ If that is the case, the only difference between a trust Mr. Wyly established for his own benefit and the one established for his wife's benefit is that it appears that Mrs. Wyly had the sole management of the income generated by the transferred community property.¹⁸⁴ Had the transfer been made to a trust established expressly for Mr. Wyly's benefit, he would have had the sole management of the trust income once it was distributed.¹⁸⁵ Only a jury could decide whether Mr. Wyly was in approximately the same economic position in both cases.¹⁸⁶

H. *The Express Retention, Facts and Circumstances, and Operation of Law Tests: As Applied to Wyly*

In order for the express retention, facts and circumstances, and operation of law tests of includability to apply, it is not necessary that Mr. Wyly be in substantially the same economic position both before and after the transfer. These tests require either a *de jure* or a *de facto* retention. The economic position test, in contrast, does not require a finding of a retention so long as the economic position of the transferor would be substantially the same after the transfer as it would have been if the transfer had been made to a trust established expressly for the benefit of the transferor.¹⁸⁷

Under the other tests, the finding of a *de jure* or a *de facto* retention means the courts will find a retained life estate even in cases in which the interest retained is of significantly less value than the transferor's interest in the property before the transfer. Nonetheless, applying the facts and circumstances test, it cannot be said that Mr. Wyly had a retained life estate. There is absolutely nothing in the record to suggest that the transfer in trust was conceived of as a device to allow Mr. Wyly to continue to enjoy the transferred property yet keep it out of his estate. Moreover, there is nothing to indicate that was the effect of the transfer. There were no income distributions during the continuance of the trust,¹⁸⁸ and Mr. Wyly never contemplated having any interest in the property transferred in trust. Clearly, from the facts and circumstances, it could not be implied that Mr. Wyly retained a life estate in the transferred property.

183. See notes 195-344 *infra* and accompanying text.

184. See note 27 *supra*.

185. *Id.*

186. See note 150 *supra*.

187. See text accompanying notes 126-32 *supra*.

188. See Brief for Appellant at 16, *Estate of Wyly v. Commissioner*, No. 78-1306 (5th Cir. Feb. 10, 1978).

Obviously Mr. Wyly did not expressly retain a life estate in the property transferred in trust. The state law of Texas, however, arguably gave him an interest in the income distributed from the trust to Mrs. Wyly.¹⁸⁹ There would seem to be a retention here inasmuch as the terms of the irrevocable trust were fixed at the time of the transfer. Mr. Wyly knew that Mrs. Wyly would get all the income since the trust mandated such distributions. Because trust income is arguably community, the effect of the transfer was to give Mr. Wyly a right to income for life. His knowledge of these legal consequences would seem to be relevant only under the facts and circumstances test.

The only basis for avoiding this conclusion is to note that:

- (1) Only Mrs. Wyly could compel the trustees to honor the terms of the trust. Mr. Wyly had no enforceable rights against the trustees.¹⁹⁰
- (2) Mrs. Wyly had the right to withdraw \$5,000 from the trust annually.¹⁹¹ In addition, Mrs. Wyly could have divorced Mr. Wyly or moved to another state and thereby divested him of any interest in the trust. It is unclear whether Mrs. Wyly's ability to terminate Mr. Wyly's interest by exercise of these rights is sufficient to break the connection between Mr. Wyly's transfer and the fact that he had for a period, which in fact did not end before his death, an interest in any trust income that was distributed.
- (3) This proposition assumes, of course, that trust income is community property. Perhaps it can be said that Mr. Wyly clearly earmarked¹⁹² the trust income as his wife's separate property inasmuch as the Wyly trustees could pay the income from the trust directly to the wife, to any legal guardian appointed for her, or directly to a third party for the wife's maintenance and sup-

189. See note 7 *supra*. But see text accompanying notes 195-344 *infra*.

190. See notes 231-33 *infra* and accompanying text.

191. See Record, Exhibit 2-B, Section III(c), Estate of Wyly v. Commissioner, *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978). The Commissioner acknowledges right of withdrawal raises the "possibility that [the] decedent's income interest in the withdrawn corpus might be extinguished," but concludes that the possibility is immaterial to the operation of § 2036(a) because there has been no showing that it was, in fact, extinguished. Brief for the Appellee at 30, Estate of Wyly v. Commissioner, *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978). The critical issue is not so much whether the decedent had an interest in any income produced which in fact did not end before his death. See I.R.C. § 2036(a)(1). He obviously did. The question is whether he could have retained an interest by operation of law within the meaning of § 2036 in the income produced by transferred property when the transferee could terminate or cut off such income interest by death, departure, divorce, or dissipation. The Commissioner would appear to be saying that these events are mere possibilities that in fact never occurred. What if one or more of them did occur? Suppose, for example, that Mrs. Wyly withdrew the trust corpus over the year in \$5,000 installments as she had a right to do. If the \$5,000 were safely secured in a savings account that produced income that was community property, would the Commissioner take the position that Mrs. Wyly had found a safe harbor and the connection between transfer and Mr. Wyly's right to any income produced from the savings account had been broken? If so, would it have behooved Mrs. Wyly and others similarly situated to make those annual withdrawals to defeat the principle of the *Wyly* case? Would it have behooved Mrs. Castleberry to convert the municipal bonds to cash and reinvest the proceeds to break the chain. Or would the Commissioner insist upon tracing? See text accompanying notes 347-48 *infra*.

192. See notes 309-15 *infra* and accompanying text.

port.¹⁹³ Payment of the trust income to her legal guardian would not impair its community character if it was community property, but such authorization would suggest that the income was earmarked as separate property.

I. *Conclusion: As to Wyly*

Thus, it is unclear whether Mr. Wyly retained an interest in the transferred property. Both the taxpayer and the Commissioner will find support for their respective positions under both the *Estate of Grace* economic effects test and the retention by operation of law test. The Fifth Circuit will be forced to balance the competing interests. Perhaps one factor in its decision should be whether there are tax avoidance implications in any decision for the taxpayer. Alternatively, perhaps the standard in retention by operation of law cases should be whether, from the facts and circumstances, the transferor had the actual use, possession, or enjoyment of the transferred property or whether he actually received the income to which he had the right under state law. In other words, perhaps the standard should be that taxpayers not have unwittingly visited upon them tax consequences that they never contemplated in cases where the purpose of the statute is to frustrate tax avoidance schemes. Finally, there should be some means by which Texas taxpayers could avoid having property from which they have done all that is possible to divest themselves included in their estates. Whether taxpayers like Mr. Wyly should have such protection is another question inasmuch as Mr. Wyly could have inserted a stipulation in the trust agreement that no benefits under the trust would accrue for his benefit.¹⁹⁴ But, then, what lawyer would even have believed in 1971, when the *Wyly* trust was established, that the Commissioner would take the position he has taken in *Wyly* and succeed!

V. WHETHER TRUST INCOME IS COMMUNITY PROPERTY

The Tax Court in *Wyly* believed that income from a trust is community property.¹⁹⁵ Accordingly, the court reasoned that the decedent spouse retained a life estate in the community property he transferred to a trustee for the benefit of his spouse for life because one-half of the income from the trust would be his community property.

Whether trust income is separate or community has been the subject of debate in Texas for years. There are four notions that play a role in this determination:

- (1) In 1925, the Texas Supreme Court announced in *Arnold v. Leonard*¹⁹⁶ that neither the legislature nor the parties can expand the constitutional definition of separate property. Since the

193. Brief of Appellant at 16-17, *Estate of Wyly v. Commissioner*, No. 78-1306 (5th Cir. Feb. 10, 1978).

194. See notes 309-15 *infra* and accompanying text.

195. *Estate of Wyly v. Commissioner*, 69 T.C. 227 (1977), *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978).

196. 114 Tex. 535, 273 S.W. 799 (1925), *discussed at note 7 supra*.

constitution states that separate property is that received by gift, bequest, or inheritance,¹⁹⁷ the court reasoned that all other property must be community property. Accordingly, income from separate property must be community property.

- (2) Except in the employee benefits cases, only one Texas court claims to have held that trust income is community property and the facts in that case make the alleged holding questionable.¹⁹⁸
- (3) Several pre-1925 Texas Supreme Court opinions hold that the income from a trust is separate property.¹⁹⁹
- (4) The Fifth Circuit has announced that Texas permits income from separate property to remain separate when the donor clearly indicated that the income was to be separate, but in all the other cases income from a trust is community property.²⁰⁰

It is submitted that careful analysis will dispel the myth that the Texas courts have declared trust income to be community property. That is not to say, however, that trust income is necessarily separate. Rather, classification of trust income as separate or community depends upon the circumstances that gave rise to the transfer in trust. There is no policy reason for adopting a blanket rule that trust income is necessarily separate or that it is necessarily community. In fact, the integrity of the community property system requires that in some instances trust income be considered community.

A. Analysis

The most important determination that must be made is whether policy reasons exist for rendering the civil law concept of community property inapplicable to trusts, that is, for treating trust income as separate property. On balance, there seems to be no reason not to extend community property principles to property held in trust in appropriate circumstances. Moreover, in some instances the integrity of the community property system will require such an extension. For example, in the case of employee benefits held in trust, both spouses must receive equal portions of those benefits in the event of divorce or death to prevent emasculation of the principle of community property inasmuch as these benefits are clearly the fruits of one or both spouses' labor. There is equally no reason why property transferred in trust by gift, devise, bequest, or inheritance for the benefit of one spouse cannot be classified as his or her separate property, notwithstanding *Arnold v. Leonard*.

Arguably, administrative problems²⁰¹ present themselves when the veil of the trust is pierced in the guise of classifying trust property as separate or community, particularly if the trust must bear the burden of the *Arnold*

197. TEX. CONST. art. XVI, § 15.

198. *In re Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.—Texarkana 1976, no writ), discussed in text accompanying notes 259-62 *infra*.

199. See cases cited in note 219 *infra* and text accompanying notes 238-40 *infra*.

200. See text accompanying notes 285-87 *infra*.

201. See Branscomb & Miller, *Community Property and the Law of Trusts*, 20 Sw. L.J. 699, 718 (1966).

v. Leonard principle that income from separate property is community. The response, however, is that classification as separate or community is no more difficult with personal trusts than with employee benefit trusts. Moreover, any competent trustee will segregate trust income and principal in his books of account.²⁰²

Furthermore, in the case of most trusts, classification never becomes an issue. Practically speaking, classification is only important in the event of divorce or death. In the event of divorce, interests in trust are matters of negotiation for property settlement purposes, and if agreement cannot be reached, equitable division is committed to the courts. Upon the death of a spouse, the decedent has the right to dispose of his or her half of any community property held in trust,²⁰³ and the decedent's executor would seem to be under a duty to identify and collect the decedent's portion of any community property held in trust, whether it be a personal trust or an employee benefit trust.²⁰⁴

Civil law characterization of trust income as community or separate property introduces no additional complexity into federal income tax determinations. For federal income tax purposes, trusts are taxed on the income they retain²⁰⁵ and beneficiaries are taxed on the income distributed to them.²⁰⁶ Furthermore, every distribution from a trust will be deemed to carry out the income of the trust to be taxed to the recipient²⁰⁷ to the extent of the trust's distributable net income,²⁰⁸ except when the distribution is in satisfaction of a specific bequest.²⁰⁹ Classification of trust income as community property would simply mean that if the spouses filed separate income tax returns, each could report fifty percent of the income on his separate return.²¹⁰

Similarly, no real problems are presented in the case of discretionary pay trusts²¹¹ or trusts in which the trustee's discretion to pay is limited by a standard.²¹² Such cases, however, invite the development of different rules because it is difficult to justify treating trust income as community property that merely awaits the trustee's exercise of discretion to distribute the income. When the trust is not mandatory pay, that is, when there is no right

202. G.G. BOGERT & G.T. BOGERT, *HANDBOOK OF THE LAW OF TRUSTS* § 111 (5th ed. 1973); A. SCOTT, *ABRIDGEMENT OF THE LAW OF TRUSTS* § 172 (1960).

203. See note 273 *infra*.

204. See Johnson & Jones, *How Community Property Laws Affect Employee Benefit Plans*, 3 *COMMUNITY PROP. J.* 3 (1976).

205. I.R.C. §§ 641, 661(a).

206. *Id.* § 662(a).

207. *Id.*

208. *Id.* § 643(a).

209. *Id.* § 663(a)(1).

210. See *id.* § 1(d).

211. "Discretionary pay" trusts, as used in this Article, refer to those trusts in which all distributions are committed to the sole discretion of the trustee or person other than the beneficiary.

212. "Discretionary pay trusts subject to a standard," as used in this Article, refer to those trusts in which the trustee's discretion in making distributions is subject to an ascertainable standard such as maintenance, care, and support. Such a standard has been identified in *Treas. Reg. § 20.2041-1(c)(2)* (1958).

to income on the part of the beneficiary, it is reasonable to conclude that the settlor of the trust intended that the beneficiary spouse have the benefit of the trust property as needed, earmarking any remaining balance for the remainderman. Whether known to him or not, such a settlor is thinking of the trust as a power of appointment. He sees himself setting in motion a transfer of property and committing to his trustee the obligation to complete the gift by either exercising his discretion in favor of the income beneficiary or by withholding his exercise of discretion, thereby completing the gift in favor of the remainderman. Essentially, the trustee is charged with filling a gap in the settlor's instrument of gift.²¹³ In such a case, whether the property actually distributed is income or principal is irrele-

213. See Bolich, *The Power of Appointment: Tool of Estate Planning and Drafting*, 1964 DUKE L.J. 32, 33.

In Counts, *Trust Income—Separate or Community Property?*, 30 TEX. B.J. 851, 914 (1967), it was said:

As to the truly discretionary trust, by the very terms of the instrument itself, the beneficiary has no indefeasible interest or claim to the item until it is distributed, certainly no such interest as would require it to be regarded as "acquired" by the beneficiary, in the sense of the constitutional provision and thus, hardly can it be said that the community would have some kind of interest when the beneficiary of the trust has acquired no interest, and at best has some nature of expectancy, or some contractual remedy depending upon the particular trust involved (e.g. perhaps founded on abuse of discretion by the trustee). Moreover, after distribution, and receipt by the trust beneficiary even if it is a distribution of current income it is acquired by way of gift or devise by the beneficiary. In the first place, it was the income item itself which the trustor gave. In the second place, the trustee in exercising his discretionary authority to make the distribution qualifies as a donor for the purpose of a decision that the beneficiary receives the item as a gift within the meaning of the constitutional provision. Thirdly, it is quite realistic to treat the trustee as completing the gift from the trustor which remained incomplete until the distribution was made. If the distribution is of an item which was originally income to the trustee but by virtue of the terms of the trust had been added to the principal of the trust by the trustee, then the further contention may be made that the distribution to the beneficiary of the item is legally the same as a distribution of that which came into trustees hands initially as principal.

Mr. Counts also objects to treating trust income distributed from a discretionary pay trust subject to a standard as community property:

[I]t is in direct violation of the terms of the trust and thus of the terms of the original transfer made by the person who presumably had the fee simple title in the property and the right to transfer it by such means and subject to such conditions and restrictions as he chose so long as his desires were not illegal or contrary to public policy.

Id. at 915.

Others have made an analogy to a corporation in support of the proposition that *undistributed* trust income in a discretionary pay trust cannot be community property:

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. 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. 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.

Branscomb & Miller, *supra* note 201, at 719 (footnotes omitted); see notes 254-55 *infra* and accompanying text.

vant to the settlor. He simply wants such distributions as in the judgment of the trustee are necessary.

Accordingly, it is appropriate for a court to conclude that since the beneficiary spouse has no interest in the corpus of a discretionary pay trust, the settlor has made a gift of the property distributed whether it be income or principal. Having received this distribution by way of gift, the property distributed is the beneficiary spouse's separate property.²¹⁴ This is the only sensible conclusion because the beneficiary spouse has no right to compel distribution from the trust absent a showing that the trustee has acted in an arbitrary and capricious fashion.²¹⁵ In other words, she would have no legally enforceable claim against the trust for any distributions whatsoever. In such a case it could not be said that the settlor gave the beneficiary the trust corpus as her separate property and therefore any income is community. The settlor's gift to the beneficiary is that which the trustee determines to distribute to her. That distribution is the gift and it is separate property.

It goes almost without saying that a property owner can give away less than a fee simple;²¹⁶ a life estate, for example, can be the subject matter of a gift.²¹⁷ Moreover, the Fifth Circuit in applying Texas law has suggested that when the settlor of a trust clearly earmarks a mandatory pay income interest in a trust as separate property, such income when distributed shall remain separate property.²¹⁸ The rule of *Arnold v. Leonard* is not frus-

214. See TEX. CONST. art. XVI, § 15; TEX. FAM. CODE ANN. § 5.01(a) (Vernon 1975).

215. G.G. BOGERT & G.T. BOGERT, *supra* note 202, § 89; A. SCOTT, *supra* note 202, § 128.3; see, e.g., *In re Ferrall's Estate*, 41 Cal. 2d 166, 258 P.2d 1009 (1953).

216. Judge Ocie Speer has stated:

It must be conceded that if an estate were conveyed by any other than the husband to a trustee, in trust that the issues, rents, increase, profits, and the like be by such trustee delivered to the wife, in her separate right, the gift, bequest, or devise, as the case might be, would be specifically of such issues, rents, increase, or profits, and would hence be within the letter and spirit of the statute making them the separate property of the wife. For surely one entitled to convey the greater, may convey the lesser, estate. In such a case it is not the fee nor the corpus of the property granted, but only its use, rents, profits, and increase.

1 E. Oakes, *supra* note 111, § 420, at 622 (footnotes omitted).

217. G.G. BOGERT & G.T. BOGERT, *supra* note 202, § 25, at 70-71; A. SCOTT, *supra* note 202, § 77; see, e.g., *Martin Brown Co. v. Perrill*, 77 Tex. 199, 13 S.W. 975 (1890), *discussed at* text accompanying notes 240-42 *infra*; *Sullivan v. Skinner*, 66 S.W. 680 (Tex. Civ. App. 1902, writ ref'd), *discussed at* text accompanying notes 245-47 *infra*.

218. See text accompanying notes 285-93 *infra*.

A number of reasons have been offered to support the proposition that a settlor need *not* expressly earmark trust income as separate in order to have the income treated as the separate property of the trust beneficiary.

In the first place, there certainly does not seem to present itself any valid reason why the stated intention of the trustor should be frustrated on the grounds of public policy, or illegality, and the trust property having been transferred upon the express trust condition that the sole beneficiary of the trust should be the beneficiary designated by the trustor, not his or her spouse, or a "Community estate" such conditions should control. Indeed, the trustor never parted with the property except subject to this condition. The rights of the beneficiary's spouse are certainly in no manner violated. If analysis is to be required in relation to the constitutional provision, it can be said (1) that it was the

trated by such a result because the gift is the income interest rather than the underlying property that gives rise to the income.

Since a donor can earmark a mandatory pay interest in a trust as the beneficiary's separate property, can it not be said that any gift of a mandatory pay interest in a trust is separate property whether or not the donor so declared? In most cases in which one beneficiary is given the income for life with remainder to a third party, it is clear that the donor did not intend to make a gift of an interest in the trust corpus to the life tenant. Rather, the gift to the life tenant is only the income interest, and the remainderman has the interest in the trust corpus. Whether or not the donor earmarks his gift to the life tenant as separate property, it seems clear that the gift is of the income interest, and the income interest, therefore, must be separate property inasmuch as property acquired by gift is separate property.

Furthermore, on several occasions prior to its 1925 decision in *Arnold v. Leonard*, the Texas Supreme Court stated that common law equity principles, and not civil law principles, apply in resolving questions arising out of the trust relationship, and, for that reason, if for no other, trust income is separate property whether it is produced by a mandatory pay trust or a discretionary pay trust, and without regard to whether it is earmarked as separate property.²¹⁹ While the Texas Supreme Court has never modified

income itself which was given by the trustor, (2) that there is no completed gift until the distribution is made by the trustee and (3) there is no completed gift except subject to the prescribed preexisting condition which the trustee attached to the distribution.

Counts, *supra* note 213, at 915. Mr. Counts offered these additional remarks:

To ascribe to the receipt the legal status of community property is plainly to make the spouse of the beneficiary a co-beneficiary of the trust contrary to the express desires of the trustor and to recognize in the beneficiary's spouse any rights of the beneficiary in respect of the trustee's funds is to violate the trust and contractual stipulations which the trustor made applicable to the funds.

Id. Finally, Mr. Counts recalled the United States Supreme Court's remarks about spendthrift trusts, offered in *Nichols v. Eaton*, 91 U.S. 716, 725 (1875):

To compel them (the trustees) to pay any of this income to a son after bankruptcy, or to his assignee, is to make a will for the testatrix which she never made; and to do it by a decree of a court is to substitute the discretion of the chancellor for the discretion of the trustees . . . [A] court of equity will not interfere to control (trustees) in the exercise of a discretion vested in them by the instrument under which they act. . . . And certainly they would not do so in violation of the wishes of the testator.

. . . [T]he doctrine, that the owner of property, in the free exercise of his will in disposing of it, cannot so dispose of it, but that the object of his bounty, who parts with nothing in return, must hold it subject to the debts due his creditors, though that may soon deprive him of all the benefits sought to be conferred by the testator's affection or generosity, is one which we are not prepared to announce as the doctrine of this court.

Counts, *supra* note 213, at 916.

219. See *McLeod v. Board*, 30 Tex. 238 (1867); *Magee v. White*, 23 Tex. 180 (1859); *Gamble v. Dabney*, 20 Tex. 69 (1857); *Shelby v. Burtis*, 18 Tex. 644 (1857); *Cartwright v. Hollis*, 5 Tex. 152 (1849); TEX. REV. CIV. STAT. ANN. art. 7425b—45 (Vernon 1960); Newman, *Income Distributions from Trusts: Separate or Community Property?*, 29 TEX. B.J. 449 (1966); notes 238-40 *infra* and accompanying text.

Could not Mrs. Wyly also argue that trust income is not community property because it was not acquired, using the words of the Texas Supreme Court, as "income from their prop-

or questioned its holdings in these early cases, *Arnold v. Leonard* is cited as inferential authority for the proposition that trust income is community inasmuch as the Texas Supreme Court held that income from separate property is community.²²⁰ It is submitted that *Arnold v. Leonard* does not support any such conclusion and that, accordingly, the old Texas precedents correctly state that trust income is separate property in Texas. All that *Arnold v. Leonard* held was that the legislature cannot expand the definition of separate property.²²¹ Later cases have also held that spouses may not alter or expand the definition of separate property.²²² These decisions are not incompatible with the earlier Texas Supreme Court cases that hold trust income to be separate property. The basis for those early decisions was (1) that the principles of community property do not apply to trusts inasmuch as trusts are a creature of the common law, and (2) the income interest in the trust is the subject matter of the gift to the income beneficiary, and if it is a gift, it is her separate property even though the settlor did not expressly so state.

It could even be argued that it is inappropriate to extend the principle of *Arnold v. Leonard* to the trust context inasmuch as it mixes common law precepts with civil law precepts. The civil law does not even contemplate the institution commonly known as a trust,²²³ and the community property system is a civil law concept. Pursuing this argument to its logical conclusion, thus, could lead to the conclusion that property held in trust is neither separate nor community inasmuch as the community property system is inapplicable to trusts. That position is untenable inasmuch as the integrity of the community property system demands a case by case determination, with the court integrating the different systems. Perhaps it can be said that where the transaction is donative in nature, that is, where the acquisition is by lucrative title, the trust income will be separate, but where the transaction is commercial, that is, where the acquisition is by onerous title, the trust income will be community.²²⁴ Such a classification scheme would

erty," *Graham v. Franco*, 488 S.W.2d 390, 392 (Tex. 1972), *discussed at note 7 supra*, inasmuch as the trust principle *cannot* be considered the property of the life income beneficiaries? See notes 216-18 *supra* and notes 259-67 *infra* and accompanying text.

220. See *Davis, Income Arising from Trusts during Marriage Is Community Property*, 29 TEX. B.J. 901 (1966), *discussed at note 226 infra*.

221. See note 7 *supra*.

222. *Id.*

223. 1 A. SCOTT, THE LAW OF TRUSTS §§ 1.8-9 (3d ed. 1967); Note, *Common Law Trusts in Civil Law Courts*, 67 HARV. L. REV. 1030 (1954).

224. William Q. de Funiak in his treatise excellently summarizes the definition of onerous and lucrative title and explains the distinction between the same according to the dictates of Spanish civil law:

That property acquired by husband and wife during the marriage through their labor or industry or other valuable consideration is said to be acquired by onerous title. Other valuable consideration might consist of payment of money, rendition of services, performance of conditions, payment of charges to which the property was subject, and the like. With the exception that property acquired through valuable consideration which is wholly the separate property of one spouse naturally retains the character of separate property, property acquired by onerous title is always community property . . .

Property acquired by lucrative title is that acquired through gift, succession,

accommodate both the employee benefits situation in which the trust property was produced by the labor of one or both spouses and, also, the situations in which the gifts have been made in trust as a means of fractionalizing interests in the transferred property.

If the civil law recognized the trust in the English law sense, apparently, trust income would be separate property and not community. This would be consistent with the treatment of the legal life estate. Surely the legal life estate is the gift, and accordingly, any income produced must be separate property because it is the subject matter of the gift.²²⁵

A line of federal tax cases suggests that the income interest in a trust cannot be the subject matter of the gift. That is, the gift is of the interest in the underlying property, and, therefore, income from the trust is community property.²²⁶ These cases are premised on *Irwin v. Gavit*,²²⁷ which held

inheritance or the like. It has its basis in pure donation on the part of the donor

W. DE FUNIAK & M. VAUGHAN, PRINCIPLES OF COMMUNITY PROPERTY § 62, at 127-28 (2d ed. 1971) (footnotes omitted).

225. Professor de Funiak apparently believes that trust income should be classified as separate property even in jurisdictions in which income from separate property is community. After discussing Judge Hutcheson's decision in *Commissioner v. Porter*, 148 F.2d 567 (5th Cir. 1945), *discussed at* text accompanying notes 282-85 *infra*, he comments:

The only actual gift involved is a gift of trust income itself to a married person. Since this is given to a named married person it would seem to be given to such married person as separate property. Any so-called equitable interest in the trust has no value to the beneficiary since by the very nature of the trust as a spendthrift trust, it could not be sold or otherwise disposed of. All that is given, to repeat, is certain income and it would appear to be plainly the separate property of the recipient.

W. DE FUNIAK & M. VAUGHN, *supra* note 224, § 71.2, at 165 (footnote omitted). His conclusion is significant inasmuch as he demonstrates that the Texas principle that income from separate property is community is historically correct. The Spanish law, which was based on the Visigothic laws and customs, insisted that the fruits and profits of separate property were community. *Id.* § 71. Thus, de Funiak apparently believes trust income is different from income produced from separate property. *But see* *Commissioner v. Terry*, 69 F.2d 969 (5th Cir. 1934), *discussed at* text accompanying notes 276-78 *infra*.

226. *See* notes 275-93 *infra* and accompanying text.

Professor Davis agrees with the federal courts on the issue: "Analysis of the controlling principles laid down by Texas and Federal cases indicates . . . that the Texas law is that income arising from such trusts and distributed to the married beneficiary is community property. The principles also indicate that undistributed income from such trusts is also community property." Davis, *supra* note 220, at 901. However, he cites no cases for this conclusion except those already discussed in this paper, which he analyzes as follows:

Applying the principles laid down in *Arnold v. Leonard*, it is seen that the *method of acquiring* income arising from the corpus of trust property during marriage is different than by "gift, devise or descent." Such income is acquired by earnings of the trust corpus, *Lesage v. Gately*, 287 S.W.2d 193 (Tex. Civ. App. 1956 error dismissed). Therefore such income does not, by definition, fall within the class of separate property, as fixed by the Constitution. There can be no title to income nor any acquisition of income until the income comes into existence. If income comes into existence during marriage its property status as community property is thus fixed.

Id. at 902. The analysis is deficient, however, in that Professor Davis fails to consider whether there can be a gift of an income interest in a trust.

Professor Davis' argument appears to be as follows: if income accrues in a trust whether it be discretionary pay or mandatory pay—for the benefit of a married person, the income must be community because it is not acquired by gift, devise, or bequest, which is the only

that a gift of an income interest in trust does not qualify for the exclusion

constitutionally permissible basis on which to acquire separate property. See TEX. CONST. art. XVI, § 15; *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925); *Branscomb & Miller*, *supra* note 201, at 723. Thus, if the accrued income is distributed to a designated income beneficiary, it comes out as community property if the distributee was married at the time the income was earned, whether or not the distributee was married at the time of distribution. Cf. *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976) (military pension), *discussed at text* accompanying notes 269-72 *infra*. If the income is accumulated, added to principal, and subsequently distributed to a remainderman, the income comes out as community property if the remainderman was married at the time the income was earned by the trust even if the remainderman was not married at the time of distribution. Shades of the accumulation throwback rules! See I.R.C. §§ 665-667.

Other commentators have stated:

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. 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.

Branscomb & Miller, *supra* note 201, at 715 (footnote omitted). Referring to *McFaddin v. Commissioner*, 148 F.2d 570 (5th Cir. 1945), *discussed at text* accompanying note 288 *infra*, Messrs. *Branscomb and Miller* emphasized the difficulties encountered in a system such as that proposed by Professor Davis:

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.

Branscomb & Miller, *supra* note 201, at 716.

Further support for Professor Davis's position is offered by analogizing the trust to a corporation where the shares of stock represent a bundle of rights.

[T]he 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. 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 property where the stock itself is separate.

Id. at 718 (footnotes omitted).

Nonetheless, there is ample—if old—precedent to suggest that the Texas courts have resolved this issue in favor of recognizing gifts of an income interest to be the separate property of the trust beneficiary, see notes 310-15 *infra* and accompanying text, even though the federal courts applying Texas law may arguably have reached a different result. See notes 275-93 *infra* and accompanying text. With the *Wily* case casting a shadow over interspousal transfers in trust by Texas taxpayers, the Texas courts will undoubtedly be asked to look at this issue again. Resolution of the controversy will depend upon a balancing of interests. What policy considerations argue against allowing a taxpayer to make gifts of an income interest in a trust to his spouse as her separate property? While Texas strictly adheres to the notion that the Constitution allows spouses to change the character of their community property only by partition after the property is in being, *but see* note 451 *infra*, it would seem difficult to support an argument that a gift of an income interest is tantamount to a prospective alteration of the community character of one's property. On the one hand, you have the gift of the income interest, and on the other, a clear judicial determination that a transfer in trust cannot anticipatorily alter the community character of property. Apples and apples or apples and oranges?

227. 268 U.S. 161 (1925).

from income treatment accorded gifts under the predecessor of section 102. *Irwin* is in accord with the basic federal tax notion that income remains income until it is taxed as income to someone. Justice Holmes explained the Court's decision thusly: "Apart from technicalities we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it. The fund is appropriated to the production of the same result whichever form the gift takes."²²⁸ Several courts have relied upon Justice Holmes's language in holding that the recipient of trust income has an interest in the trust corpus,²²⁹ although *Irwin* stands only for the proposition that income from a gift in trust is taxable to the recipient.²³⁰

One remaining question is whether the nonbeneficiary spouse has a legally enforceable claim to his portion of the alleged community income as against the trustee of a mandatory pay trust if that trustee refuses to make the distribution. Upon the death of the nonbeneficiary spouse, his executor would appear to have such a claim,²³¹ and upon divorce a court undoubtedly has jurisdiction to compel the trustee to make distributions in accordance with court orders.²³² Nevertheless, the question is whether the nonbeneficiary can enforce the terms of the trust. In other words, is the effect of Texas community property law that allegedly declares income from separate property to be community such that each mandatory pay trust in Texas has an invited, albeit unwelcome, beneficiary looking to the trustee for an accounting? Or could it be said that because the trust income will be sole management community property,²³³ enforcement of the trust is committed to the beneficiary spouse who has management responsibility? If that were the case, query whether the remedy would be against the beneficiary spouse for breach of duty to the community for not securing enforcement of the terms of the trust.

For the reasons just given the Tax Court may have wrongly assumed in *Wyly* that trust income is community property. If so, all the other issues in *Wyly* are moot.

B. *The Precedents*

Notwithstanding the foregoing analysis, whether trust income is separate or community property remains, after more than a century, an unsettled question, largely because of the Fifth Circuit opinions and a lack of careful delineation of what was said in *Arnold v. Leonard*. This portion of

228. *Id.* at 167-68.

229. *Commissioner v. Sims*, 148 F.2d 574 (5th Cir. 1945), *discussed at text* accompanying notes 286-87 *infra*; *Commissioner v. Snowden*, 148 F.2d 569 (5th Cir. 1945), *discussed at note 282 infra*; *Commissioner v. Porter*, 148 F.2d 566 (5th Cir. 1945), *discussed at text* accompanying notes 282-83 *infra*; *Commissioner v. Wilson*, 76 F.2d 766 (5th Cir. 1935), *discussed at text* accompanying notes 279-81 *infra*; *Commissioner v. Terry*, 69 F.2d 969 (5th Cir. 1934), *discussed at text* accompanying notes 276-78 *infra*.

230. *See* notes 294-305 *infra* and accompanying text.

231. *See* *Johnson & Jones*, *supra* note 204.

232. G. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 861, at 11-13 (2d ed. 1962).

233. *See* note 11 *supra*.

the Article demonstrates that the Texas Supreme Court has resolved that question, despite assertions to the contrary.²³⁴ Because of the uncertainty that has prevailed now for more than fifty years, it is also necessary to examine all of the Texas cases that have considered this question to demonstrate that the original holdings of the supreme court have not been changed.

The following propositions are relevant to donative transfers in trust.

- (1) Trust income is separate property if it is earmarked as separate.²³⁵
- (2) Trust income is separate property even if it is *not* earmarked as separate, because:
 - (a) the common law rules apply to trusts and not civil law or community property rules;²³⁶ or
 - (b) the gift is of the income interest in the trust and, therefore, the income interest is separate property.²³⁷

Creditor Claims. In an 1873 decision on the issue, *Hutchison v. Mitchell*,²³⁸ the Texas Supreme Court held that the husband may by deed declare an express trust in favor of his wife, giving her the exclusive use and enjoyment of all the rents and profits of the trust estate, provided there is no fraud in the transaction. In such a case, the court held that the rents and profits would be the separate property of the wife and not subject to the debts incurred by the husband after the creation of the trust.

Had Mrs. Mitchell held this property in her own name and right, there can be no doubt but that its accumulations would have belonged to the community estate of herself and her husband, and might have been subject to the execution levied upon it. . . .

. . . [W]e think the rules of the common law, and no other law, apply to the estate of Mrs. Mitchell, under the trust deed to Douglass. The deed appears to have been made at a time when the husband was free from debt, and in such circumstances as utterly to repel the idea of

234. Brief for the Appellee at 13-18, *Estate of Wyly v. Commissioner*, No. 78-1306 (5th Cir. Feb. 10, 1979).

235. *Hutchison v. Mitchell*, 39 Tex. 488 (1873), discussed at note 238 *infra*.

236. *Id.*; *Magee v. White*, 23 Tex. 180, 191 (1859) (dictum).

237. *Martin Brown Co. v. Perrill*, 77 Tex. 199, 13 S.W. 975 (1890), discussed at text accompanying notes 240-42 *infra*; *Gamble v. Dabney*, 20 Tex. 69 (1857). In *Gamble* a father established a trust "to provide for, support, and maintain" his married daughter. A creditor obtained a judgment against her and her husband and sought to levy against the trust property. The court barred the levy "[b]ecause the deed expressly stipulates that her interest is to be enjoyed by her, and shall not be liable to pay the debts of the husband." *Id.* at 77. Describing the interest of the wife, the court said:

It gives Mrs. Dabney a usufructuary interest, jointly with her children, during her life, separate and apart from the power of her husband; and at her death it vests the remainder of the property in her children then living. From the nature of the gift her interest is varying and indeterminate, according to the exigencies of her own condition and that of her children.

Id. at 77.

238. 39 Tex. 488 (Tex. 1873) ("Her separate property was not the land, but its produce." *Id.* at 490-91.)

fraud in the establishment of the trust.²³⁹

In a later case, *Martin Brown Co. v. Perrill*,²⁴⁰ the wife's grandfather's will directed that her share "be secured to her for life, with power to give it to her children, if any."²⁴¹ The decedent's executor transferred the property to the wife's husband, who agreed to hold the fund as her trustee. The husband's creditors claimed that the trust income was community. The Texas Supreme Court held that the income from this essentially mandatory pay trust was the wife's separate property. The court explained its decision in these terms:

The court concur in the opinion that appellants' contention cannot be maintained, and we agree substantially in the result, that the judgment is in this particular correct. As to the grounds of that conclusion, we are not in accord. One opinion is that it is the income, and not the *corpus*, of the fund that was bequeathed to the plaintiff by her grandfather, and that, therefore, the interest on the money comes literally within the definition of "separate property," as given in the statute; that is to say, that the income of the fund is acquired directly "by devise." Rev. St. art. 2851. The other opinion is that when the husband borrows the money of the wife, and agrees to pay her interest, the effect of the contract is to make the interest her separate property.²⁴²

A similar finding was reached in *Shepflin v. Small*,²⁴³ in which a debtor and his wife conveyed the wife's separate property to a trustee, with the provision that the rents collected by the trustee were to be used for the support of the wife and children. The court refused to allow a creditor of the husband to garnish the rent, holding that the creation of the trust had the effect of withdrawing the rents from the community estate. Relying on *Shepflin*, the court in *Monday v. Vance*²⁴⁴ held that a married woman has the right to convey her property, in trust, to herself and her children, so as to withdraw the rents from the community estate, and the conveyance will not be fraudulent as to her husband's creditors.

In *Sullivan v. Skinner*²⁴⁵ creditors of the husband garnished tenant rental payments due the wife. The wife's father had bequeathed the rental property to her for life, but not in the trust, with the remainder to her children in fee simple. The terms of the will were "[f]or the term of her natural life, with full power to receive for her sole and separate use, and no other, the rents and profits of the same, and on her death the same to

239. *Id.* at 493-94 (emphasis added).

240. 77 Tex. 199, 13 S.W. 975 (1890).

241. *Id.* at 202-03, 13 S.W. at 976.

242. *Id.* at 204, 13 S.W. at 977.

243. 23 S.W. 432 (Tex. Civ. App. 1893, no writ). The language of the discretionary pay trust was as follows: "In trust to collect the rents and appropriate the same to the support and maintenance of the wife and to the education and maintenance of their children." *Id.* at 432.

244. 32 S.W. 559 (Tex. Civ. App. 1895, no writ). The language of the discretionary pay trust was as follows: "The rents and profits, if any, to be applied to the support of Mrs. Rice, and to the support and education of her children." *Id.* at 559.

245. 66 S.W. 680 (Tex. Civ. App. 1902, writ ref'd).

belong to any child or children of the said [wife]."²⁴⁶ The court held that the rental payments were the subject matter of the father's gift to his daughter and, therefore, those rental payments when produced constituted her separate property. The court stated:

In other words, the rents and profits issuing from the property during her life was all she could get out of it, unless she should sell her life estate therein. These "rents and profits" she was empowered by the will "to receive for her sole and separate use and no other." This use excluded the right of her husband to any interest in the rents and profits, and made them her separate property.²⁴⁷

In *Mercantile National Bank v. Wilson*,²⁴⁸ one of the more recent state court decisions, the Dallas court of civil appeals stated, in what appears to be a dictum, that undistributed trust income is community property from the date of the wife-beneficiary's marriage to her husband. Nevertheless, the court concluded that such trust income was special community property²⁴⁹ and therefore not reachable for satisfaction of a community debt incurred by the husband. Thus, the creditor would have lost whether the court determined the income to be the separate property or the special community property of the wife. Unfortunately, the orderly development of the law in this area has been distorted because of the dictum in *Mercantile*. *Mercantile* is cited as holding that trust income is community property,²⁵⁰ even though the court's dictum apparently played no role in its decision.

*Property Rights on Divorce. McClelland v. McClelland*²⁵¹ apparently was the first Texas case to address the issue of property rights in a trust on divorce of the beneficiary and spouse. *McClelland* involved a suit for divorce and a determination of property rights. The wife alleged that her husband was the sole heir to a large estate held in trust and that the income accrued therefrom during marriage amounted to \$120,000 at the commencement of the suit. She contended that the income was community property, notwithstanding the fact that the property had been devised by the husband's father in trust for the husband. The trustee had, under the terms of the will, the discretion to accumulate all of the income from the trust property with the exception of a small support payment. The court of civil appeals held that the wife was not entitled to any income

246. *Id.* at 681.

247. *Id.*

248. 279 S.W.2d 650 (Tex. Civ. App.—Dallas 1955, writ ref'd n.r.e.). The application for writ of error was refused on the ground of "no reversible error." Thus it is at least possible to infer that the supreme court regarded the lower court's comment on undistributed income as a dictum in view of the fact that whether the undistributed income was viewed as special community, separate, or rather property of the trust itself, the same result would have been reached.

249. *Id.* at 654. Special community property is another way of describing sole management community property. In this case, the so-called special community property was income derived from the spouse's separate property.

250. L. SIMPKINS, *supra* note 7, § 15:42; Branscomb & Miller, *supra* note 174, at 713.

251. 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd).

actually distributed by the trustee to the husband "because these amounts were his separate property, devised to him by the will, in which the wife had no community interest."²⁵² Further, the court held that since the husband could not demand distribution of the accumulated income, the wife could not assert a claim that the husband did not have. The court stated:

It is not the purpose and object of the statutes that create the community interest of husband and wife in property to prevent a testator from making a disposition of his property to either upon conditions and trusts which limit the right of the beneficiary, or restrict his interest to a limited extent, and define what its character shall be. This is the right of the testator. The law did not impose upon him the duty of devising and bequeathing his property to his son, and when he elected to do so he had the authority to determine what interest in his estate the son should enjoy; and, having defined this interest, the wife, by force of the community statutes, could not exceed and extend it.²⁵³

In the relatively recent case of *Buckler v. Buckler*²⁵⁴ the provisions of a spendthrift trust created for the benefit of a husband were found to so restrict his rights and interests as to exclude his entitlement to income that the trustees had not seen fit to distribute to him. The Fort Worth court of civil appeals held that the undistributed income did not constitute community property for purposes of the distribution of the property on divorce. The court relied on *McClelland v. McClelland*²⁵⁵ in making its determination, and rejected the wife's argument that *McClelland* had been indirectly overruled by the Texas Supreme Court in *Arnold v. Leonard*.²⁵⁶ The issue before the court was the nature of income arising from the corpus of a discretionary pay trust in a divorce action, and the court stated that the *McClelland* holding on that issue was unaffected by *Arnold v. Leonard*.²⁵⁷

252. *Id.* at 359.

253. *Id.* at 358.

254. 424 S.W.2d 514 (Tex. Civ. App.—Fort Worth 1968, writ dismissed w.o.j.). The Texas Supreme Court lacked jurisdiction of the property dispute because it was merely ancillary to the divorce action, and there was no conflict among courts of appeals on this point. See TEX. REV. CIV. STAT. ANN. art. 1728(2) (Vernon 1962).

255. 37 S.W. 350 (Tex. Civ. App. 1896, writ refused), discussed at text accompanying notes 251-53 *supra*.

256. 114 Tex. 535, 273 S.W. 799 (1925), discussed at note 7 *supra*.

257. The court stated:

Arnold v. Leonard held that property acquired during marriage other than as the result of gift, devise or descent necessarily could not be part of the separate estate, in view of the Texas Constitution, and hence would have the character of community property. The decision does overrule a portion of the holding in *McClelland*, but it does not overrule the holding which is material to the question before us. As to such the Supreme Court, which disposed of the application for writ of error in *McClelland* by the notation "writ refused", has not had occasion to reconsider the decision therein made. It is not the province of a Court of Civil Appeals to anticipate that the Supreme Court would, if afforded the opportunity, reverse itself as applied to a prior holding it has made. We are bound by the prior holdings of that court, specific or construable.

424 S.W.2d at 516 (emphasis added). While the reference in the opinion is unclear, apparently the portion of the *McClelland* decision that the court considered overruled is the *McClelland* court's holding that distributed trust income is separate property.

*Currie v. Currie*²⁵⁸ clearly holds that undistributed trust income is not community property in a case where trust income was to be added to corpus and all distributions were made according to the trustee's "uncontrolled discretion."

Unfortunately, in the most recent divorce case involving trust income, *In re Marriage of Long*,²⁵⁹ the Texarkana court of civil appeals added to the confusion by its opinion explaining its decision. The trust in dispute provided that the income of the trust was to be either distributed or accumulated at the discretion of the trustee until the beneficiary, *H*, reached twenty-five, at which time fifty percent of the trust corpus was to be distributed to him. When *H* reached thirty, the balance of the trust was to be distributed to him. *H* and his wife, *W*, separated before *H* reached twenty-five, but the divorce proceeding was not commenced until a later time. When *H* reached twenty-five, he "decided to leave his half interest in the trust though he was entitled to withdraw approximately \$85,000."²⁶⁰ The court held that the income accumulated by the trustee prior to the time *H* reached twenty-five was *H*'s separate property and the income accumulated in the portion of the trust not distributable until *H* reached thirty was his separate property. Only the income earned after *H* reached twenty-five by that portion of the trust that became distributable at age twenty-five was community property and therefore subject to distribution in the divorce proceeding.

The opinion is unclear as to whether *H*'s decision to allow the distributable one-half of the trust to continue in trust was in fact a reconveyance in trust subject to the terms of the existing trust or merely a decision to postpone acceptance of the distribution. In the latter event, one-half of the trust would have remained immediately available to *H* and the trustee would have been acting as a mere agent. In such case the income generated by the portion of the trust held by the trustee as *H*'s agent would be community property in accordance with the principle of *Arnold v. Leonard*.

Unfortunately, the explanation given by the court for its decision was misleading if it considered the trustee to be merely *H*'s agent as to one-half of the trust. The court said:

Unlike the situation in *Currie*, supra, the beneficiary in the case before us was entitled to a present possessory interest in one-half of

The court also commented further on the effect of the writ refusal by the Texas Supreme Court, stating:

In 1896 the notation "writ refused" by the Supreme Court meant that said court approved the result reached by the Court of Civil Appeals of Texas but did not necessarily approve the opinion; or it might not even mean approval of the result reached where error was not preserved and presented to the Supreme Court. It is, however, inconceivable that the matter here under consideration was not made a point of error before the Supreme Court in that case.

Id. at 515.

258. 518 S.W.2d 386 (Tex. Civ. App.—San Antonio 1974, writ dismissed).

259. 542 S.W.2d 712 (Tex. Civ. App.—Texarkana 1976, no writ).

260. *Id.* at 718.

the trust corpus and the income from that one-half. In the *Mercantile Bank* case, supra, undistributed income was in the hands of the trustees but the beneficiary had a present possessory interest in the funds. As in the *Mercantile Bank* case, we conclude that the income on the trust corpus should have been labeled community property.²⁶¹

On the other hand, the court's opinion would be both significant and internally inconsistent if *H* had irrevocably reconveyed the distributed portion of the trust to the trustee and it had become a part of the corpus to hold until *H* reached thirty. Except for the distributed portion of the trust, the court had said that the corpus and accumulated income was separate property, citing *Currie v. Currie*.²⁶² If it now said that the portion *H* conveyed irrevocably to the trust on the same terms of the property already in trust was to be classified differently, it would mean either that the identity of the trust settlor was relevant to classification, or that *H*'s reconveyance in trust was akin to a fraudulent transfer.

It is unfortunate that the court's narrow holding was explained by such broad statements. It made necessary this analysis and speculation inasmuch as it has become fashionable to cite *Marriage of Long* for the broad proposition that trust income is community. The court held no such thing.

In *In re Marriage of Burns*,²⁶³ decided by the Texarkana court of civil appeals on September 19, 1978, the court had before it all of the issues discussed in this subpart. Bill and Barbara Burns were divorcing, and Barbara claimed that undistributed trust income held for Bill's benefit was community property. Bill Burns was the beneficiary of six trusts, three of which had been established by his parents and grandparents. Bill had established the other three trusts. Five of the trusts came into existence prior to the marriage. Bill established the sixth trust after the marriage with separate property. The three trusts established by Bill's ancestors were spendthrift trusts. Five of the six trusts were discretionary pay trusts in which "the trustee or trustees could either withhold or distribute the income and/or corpus at their sole discretion."²⁶⁴ The remaining trust required that its income be accumulated until May 28, 1982, when the entire corpus and accumulated income was to be distributed to Bill.

The court held that the undistributed trust income in each of the trusts was separate property. While correct in result, the explanation offered by the court may be questionable. The court relied on section 5.01(b) of the Texas Family Code, which provides that "[c]ommunity property consists of the property, other than separate property, acquired by either spouse during marriage."²⁶⁵ The court concluded that Bill had not "acquired" the trust income during marriage as required by the statute inasmuch as it had not been distributed and he did not "have a present or past right to require

261. *Id.*

262. 518 S.W.2d 386 (Tex. Civ. App.—San Antonio 1974, writ dismissed), discussed at note 258 *supra*.

263. 573 S.W.2d 555 (Tex. Civ. App.—Texarkana 1978, writ filed).

264. *Id.* at 557.

265. TEX. FAM. CODE ANN. § 5.01(b) (Vernon 1975).

its distribution so as to compel a finding that there was a constructive acquisition."²⁶⁶ The court, thus, seemed to ignore the question whether the trust income was the subject matter of the gift and, therefore, separate property. As the opinion stands, the court would appear to be saying that had the income been distributed it would have constituted community property.

The opinion is internally inconsistent in one significant respect. The court did not seem to appreciate that the trust scheduled to terminate in 1982 was a mandatory pay trust. It called for the accumulation of income, but it also required a distribution of all of the accumulated income in 1982. While Bill Burns did not have a right to reduce the accumulated income to possession during marriage, his right to such income was certainly "acquired" during the marriage.

While the opinion is not clear as to whether this 1982 trust is the one established by Bill Burns after marriage from his separate property, one could draw that inference. If that were the case, could the court have been saying essentially that a spouse can convert what would otherwise be community income into separate income by laundering the income producing property through a trust? Alternatively, even assuming that the court would hold distributed income to be community, could the court be saying that a spouse could prevent community income from coming into being by sheltering that income in a trust? That is doubtful. Accordingly, the 1982 mandatory pay trust should have been controlled by the dicta in *Marriage of Long* and it should have been eligible for division by the court in the divorce proceeding. Yet when it comes to whether a spouse can make a gift to his spouse of the income interest in a trust, the question is much different, and so too should be the results.

Employee Benefits Cases. Issues related to the classification of income as separate or community property have arisen in the employee benefit area, but the development and resolution of these issues have in no way been premised on the Texas rule that income from separate property is community property. The employee benefit cases are mentioned here only because upon casual inspection they could be interpreted as precedent for classifying undistributed trust income as community property since Texas clearly classifies trustee employee benefits as community property. The obvious basis for such classification is that such trusts are established in consideration of the performance of services by one spouse, and therefore the contributions to the trust, as well as the income generated by those contributions during the continuance of the trust, must be community property. To hold otherwise would effectively emasculate the community property system.

The leading case of *Herring v. Blakeley*²⁶⁷ is indeed appropriately styled,

266. 573 S.W.2d at 557.

267. 385 S.W.2d 843 (Tex. 1965).

The basis of *Herring* is the proposition that the community character of property cannot be altered by placing it in trust, cf. *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961)

for a red herring was introduced that has successfully diverted the attention of at least one writer²⁶⁸ on the issue of trust income classification. The husband, while employed, participated in a profit-sharing trust together with rights under a retirement annuity agreement. Both the employer's and the husband's contributions were made during marriage. The benefits under both plans were payable only upon the husband's death or termination of employment. The plans contained spendthrift provisions and clauses forbidding the husband to assign or otherwise dispose of his interests in the trusts, although he could name parties other than his wife as the beneficiary of the plans. Under both plans the interests were vested. The marriage ended in divorce, and subsequently the former husband died. The trustee argued that the plan benefits were not community property because of the spendthrift and nonassignment provisions of the plans. The court, however, held the interest in the plans to be community property, reasoning that the vested interest in the plan was "property" at the time of divorce even though neither spouse could compel distribution of either fund at the time of divorce. Thus, the former wife was entitled to one-half of the interest in the profit-sharing trust and the annuity plan determined as of the date of the divorce.

The later case of *Cearley v. Cearley*²⁶⁹ held that retirement benefits that

(stock purchased with community funds), discussed in note 451 *infra*; *Brown v. Lee*, 371 S.W.2d 694 (Tex. 1963) (life insurance policy purchased with community funds), unless such conveyance is for the benefit of the community and not a fraud on the community. See note 131 *supra* and accompanying text. Since the contributions to the employee benefits plan trust are community, they have been placed in trust for the benefit of the employee. Moreover, income from community property must be community.

On the other hand, property placed in a trust as a result of gift, devise, or bequest is not community, and for that reason, there is no reason to ignore the trust entity as is necessary when the property placed in trust is community, the integrity of which must be secured as a matter of policy.

Thus, is property placed in trust by gift separate? It is submitted that that is irrelevant and that this line of investigation is inappropriate. The real question is what is the subject matter of the gift. In most cases, it is the amounts distributed by the trustee to the trust beneficiary. See text accompanying note 213 *supra*.

Speculation as to whether the trust income is separate or community is fruitless. For example, if you conclude it is community, that would mean by definition that both spouses have a legally enforceable claim to it whether or not it is distributed. That would be nonsense in cases where all distributions are discretionary with the trustee. Moreover, in cases of mandatory pay trusts, you could hold that trust income is community and that each spouse has a legally enprovable claim to the income when produced even if not yet distributed. But why should that be the result? What policy reason precludes analyzing the transaction in terms of the donor's having made a gift of an income interest, and gifts are separate property?

Furthermore, it is inappropriate to reason as has been suggested, see *Davis, supra* note 220, at 975, that a gift in trust is based on an agreement between the trustee and the donor to alter the character of property and that such agreements are invalid. Trusts by definition are not governed by contract principles. They are donative transactions requiring delivery, donative intent, and acceptance. The use of the word "agreement" in connection with the word "trust" is a misnomer. In this context, agreement means acceptance by the trustee of the property transferred in trust subject to the terms and conditions outlined in the acceptance document commonly referred to as the agreement.

268. *Davis, supra* note 220, at 976.

269. 544 S.W.2d 661 (Tex. 1976); *accord, Taggart v. Taggart*, 552 S.W.2d 422 (Tex. 1977).

were not yet vested also constituted community property and, therefore, were divisible upon divorce. In *Cearley*, the husband had served nineteen years in the Air Force, eighteen of those years married, and on divorce lacked one year before his retirement benefit interest was "vested." The husband argued that the benefits were not acquired or vested during marriage and thus were not community property. The court of civil appeals agreed with him, stating an all events test to the extent that "[t]he conditions must be such as would entitle the claimant [husband] to institute an action, if necessary, for a money judgment."²⁷⁰ The Texas Supreme Court, however, reversed the court of civil appeals, stating:

The portion that he earned during the months of coverture became contingent earnings of the community which may or may not bloom into full maturity at some future date. We hold that such rights, prior to accrual and maturity, constitute a contingent interest in property and a community asset subject to consideration along with other property in the division of the estate of the parties under Section 3.63 of the Family Code.²⁷¹

Although the *Cearley* court quoted *Herring* to support its position,²⁷² *Herring* stands only for the proposition that the plan rights must be "vested." The Texas Supreme Court, however, recognized that the husband's employee benefits might never vest, and, therefore, it stated that the trial court could provide for the nonemployee spouse by giving her an interest in the benefits "if, as, and when the benefits are received by the retiring spouse."²⁷³ In other words, the court said that actual recognition of the

270. *Cearley v. Cearley*, 536 S.W.2d 96, 98 (Tex. Civ. App.—Austin 1976).

271. 544 S.W.2d at 665-66.

272. The portion of the *Herring* opinion that was quoted was the statement that "[c]ommunity rights may exist in interests that cannot be reduced to possession, such as remainder or reversion rights." *Id.* at 665 (quoting *Herring v. Blakeley*, 385 S.W.2d 843, 847 (Tex. 1965)).

273. 554 S.W. 2d at 666; see *Cruse v. Cruse*, 572 S.W.2d 68 (Tex. Civ. App.—Houston [14th Dist.] 1978, no writ). If the employee spouse is the first to die, the problems of determining the community nature and valuation of vested retirement benefits are not as complex, since the benefits are currently payable. However, if the nonemployee spouse is the first to die, her personal representative should have a claim against the plan for the nonemployee decedent's community interest, and the same problems of determining community character, valuation, and settlement arise in this context as in divorce situations. *But see Valdez v. Ramirez*, 574 S.W.2d 748 (Tex. 1978), discussed at notes 124-34 *supra* and accompanying text. "If the personal representative fails to pursue the claim, he may be liable to the decedent's heir for loss of the claim." See Hughes, *Community-Property Aspects of Profit-Sharing and Pension Plans in Texas—Recent Developments and Proposed Guidelines for the Future*, 44 TEXAS L. REV. 860, 877-78 (1966); Johnson & Jones, *supra* note 204, at 7.

Furthermore, does *Cearley* make a nonvested plan interest a community asset for death purposes, and thus an asset in the gross estate of the nonemployee spouse? How would such a nonvested interest be valued for estate tax purposes? Section 2039(d) of the Internal Revenue Code presents some relief, but not as to the part of the plan benefits applicable to employee contributions. Could it be argued that § 2039 requires inclusion of such plan benefits in the gross estate of the nonemployee spouse, subject to a later refund should the benefits fail; or, alternatively, that estate tax on this amount must be paid at a later date when the benefits are finalized. This is a perplexing problem, and one not easily escapable since *Cearley* states that the nonvested interest is definitely a property interest.

Of course, it may be argued that *Cearley* applies only to the divorce situation inasmuch as

community interest of the nonemployee spouse can be postponed until the benefits are distributed.

Furthermore, the Texas courts have recognized that the employee benefits cases are of limited precedential effect. Recently, in *Vibroch v. Vibrock*²⁷⁴ the court of civil appeals held that if renewal commissions on insurance policies are unearned and unaccrued at the time of divorce, an award in favor of the wife for the property right of the husband that had not yet come into existence at the time of the divorce decree is impermissible, since as of that time one might never come into existence. The court expressly refused to apply the rationale of *Cearley* to the facts before it, even though the wife urged it to do so.

The Fifth Circuit Income Tax Cases. The Fifth Circuit has consistently held that distributed trust income is community property under Texas law. Each case arose as the result of a taxpayer claim that the trust income was community, and therefore he should be permitted to split his income with his spouse for federal income tax purposes. This question has been moot since the 1948 changes in the Internal Revenue Code allowing spouses who file joint federal income tax returns to split their separate income.²⁷⁵

In *Commissioner v. Terry*,²⁷⁶ the first in a series of cases on this issue handed down by the Fifth Circuit, the court held that the income generated by a legal life estate was community income. The court explained that the testator's gift was the life estate as separate property, and, therefore, the income from the separate property was community property. The court cited *Irwin v. Gavitt*²⁷⁷ and quoted this portion of Justice Holmes' opinion: "Apart from technicalities we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it."²⁷⁸

*Commissioner v. Wilson*²⁷⁹ involved a trust that required annual distribution of all trust income. In holding the distributed income to be community property, the Fifth Circuit rejected the Commissioner's argument that the property lost its character as separate or community as the result of the interposition of the trust. Citing *Irwin v. Gavitt*, the court stated:

It is argued that the result should be otherwise because the husbands do not get the revenue directly from the property but through the hands of the trustee and subject to the expenditures which he is authorized to make. But the trustee is bound to act always for the

the Texas courts seem to have developed a different standard when the nonemployee spouse dies first. See notes 124-28 *supra* and accompanying text.

274. 549 S.W.2d 775 (Tex. Civ. App.—Fort Worth 1977), *writ ref'd n.r.e. per curiam*, 561 S.W.2d 776 (Tex. 1977).

275. Prior to 1948, taxpayers were not permitted to file joint income tax returns. Since then, joint returns and income splitting are permitted between spouses even though one spouse has no income of his or her own. See I.R.C. § 6013.

276. 69 F.2d 969 (5th Cir. 1934).

277. 268 U.S. 161 (1925), *discussed at text* accompanying notes 294-308 *infra*.

278. 69 F.2d at 969.

279. 76 F.2d 766 (5th Cir. 1935).

benefit of the beneficiaries and to divide the net results among them. All net income and corpus ultimately go to them. The beneficiaries receive the income as income. The corpus is theirs in equity, the legal title being conveyed to the trustee expressly for their benefit. In *Irwin v. Gavitt*, . . . where the trust instrument did not expressly give the corpus to the beneficiary but only the income, it was held that the payments were taxable income from a corpus impliedly given. Income accruing from the separate equitable estates of the husbands during the marriage though collected and paid over by a trustee belongs to their respective communities.²⁸⁰

Thus, the Fifth Circuit totally disregarded the trust entity on the basis of the alleged holding in *Irwin v. Gavitt* that the gift was of the trust corpus and not of the right to income. Turning to oil royalty income, however, the court felt compelled to follow state law and accordingly held that "so much of the trust income of respondents as can be shown to be derived from royalties is their separate property."²⁸¹

*Commissioner v. Porter*²⁸² involved income distributed to two married women from a New York trust created by their father. All distributions from the trust were made at the discretion of the trustee. The Commissioner argued that the trusts were created for the "separate use and benefit" of the two women, and therefore the income was their separate property. In holding the distributed property community, the Fifth Circuit stated:

Taxpayer, invoking the rule settled in *Arnold v. Leonard*, . . . that income from separate property falls when received into the community, the rule settled in *Commissioner of Internal Revenue v. Terry* . . . and *Commissioner of Internal Revenue v. Wilson* . . . that the fact that the income is from property given in trust instead of direct to the taxpayers does not alter the general rule, and the rule that "a gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund", *Irwin v. Gavitt* . . . insists that the Tax Court was right, the commissioner was wrong.

The commissioner, arguing that a spendthrift trust, a trust for the collection and distribution of income, is the same in legal effect as one in which it is provided that the income "is to be received to their sole and separate use and no other", stoutly insists, on the authority of *McClelland v. McClelland*, . . . that the income in question here was separate property.

. . . .
 . . . Here what is in question is not undistributed income in the hands of the trustees as in *McClelland's* case, but income distributed to the daughters, no longer fettered but their own, and our only concern is to determine in what character it became their own. Did it come to them, as the commissioner contends, within the constitutional

280. *Id.* at 769 (citations omitted).

281. *Id.* at 770.

282. 148 F.2d 566 (5th Cir. 1945). The next case in the sequence, *Commissioner v. Snowden*, 148 F.2d 569 (5th Cir. 1945), dealt with precisely the same issue except the beneficiary was a male.

definition of separate property, by gift, devise or descent, for their separate use and benefit, and, therefore, as their separate property? Or did it, as taxpayers contend and the Tax Court has found, come to them as ordinary income from trust property of which they are beneficiaries, and, therefore, as community? We think it entirely plain that when they received the income it fell into the community.²⁸³

*McClelland v. McClelland*²⁸⁴ involved both distributed and undistributed income and the court of civil appeals held that both kinds of income were separate. The Fifth Circuit, however, apparently believed that *McClelland* involved only undistributed income and distinguished *McClelland* on this basis.

Significantly, the Fifth Circuit stated that the donor could make a valid gift of an income interest as the separate property of a spouse, but to make such a gift, the trust instrument must, "in the most precise and definite way, and by the use of language of unmistakable intent, make that desire and intention clear."²⁸⁵ The court, however, further stated that there was no such language in the trust instrument in question.

In *Commissioner v. Sims*²⁸⁶ Judge Hutcheson held that whether the trust was a spendthrift trust was not material under *Porter*, but again commented on how a gift of separate income is made: "Here, as there, the trust instrument contains no clause or provision manifesting an intent to make the income from the trust property other than the Texas law makes it, community property."²⁸⁷

*McFaddin v. Commissioner*²⁸⁸ standing alone would have little impact on the question of the role of trust language on the characterization of property. It reflects the Fifth Circuit's insistence upon disregarding the trust entity in order to find that trust income is community for income tax purposes. While finding that property originally placed in trust by the settlors became the beneficiaries' separate property, it noted that the trust income consisted of both oil royalties, which are separate property under Texas law, and other income that if received directly by the beneficiaries would be community property under Texas law. It then concluded that the community property portion of the trust income was commingled with the separate property income to such an extent that the two were unidentifiable, and thus, the income from the whole became community. The trustees had used the separate property income of the trust to purchase other property for the trust. The Fifth Circuit rejected the Tax Court conclusion that such after-acquired property was separate property and that, therefore, the income from that property was separate.

The theory of the Tax Court that none of the commingled property with which the after-acquired property was purchased was commu-

283. 148 F.2d at 567-69 (citations omitted; footnotes omitted; emphasis added).

284. 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd), *discussed at* text accompanying notes 251-53 *supra*.

285. 148 F.2d at 568.

286. 148 F.2d 574 (5th Cir. 1945).

287. *Id.*

288. 148 F.2d 570 (5th Cir. 1945).

nity property because, under the terms of the trust instrument, gross income was treated as corpus, the rights of the beneficiaries did not attach to gross income but only to the distributable net income, and the gross income used by the trustees was, therefore, not community property, will not at all do. *The 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 brought them, were community property.²⁸⁹

The Fifth Circuit opinions in *Porter, Sims*, and *McFaddin* were all written by Judge Hutcheson. While Judge Hutcheson found for the taxpayer in each case that the income was community property, he noted in both *Porter* and *Sims* that the donor could have earmarked the income produced from the separate property as separate. The judge consistently adhered to this position through his final decision on the subject in *Commissioner v. Estate of Hinds*,²⁹⁰ in which he stated:

It seems to me . . . we should meet the issue head on and also hold that the Texas law, in instances where it is made clearly to appear, permits that to be done which General Hinds clearly undertook to do in the trust instrument here, viz., to make the income from the property conveyed to the trustee the separate property of the wife.²⁹¹

Judge Waller concurred in the majority's opinion in *Hinds*, but felt the majority had not "fully met the issue in this case as its importance seems to deserve."²⁹² In his opinion the judge made the following statement:

It seems undisputed that even though the corpus of the community property conveyed by the husband and wife to the trust estate is no longer community property, nevertheless the income of the wife received from the trust estate would, during the existence of the community [*sic*], have been community income unless there was a clear, definite, and distinct intention expressed in the trust indenture to make such income her separate, rather than community, property. I think that the trust indenture did make it quite clear not only that "neither the possession or enjoyment of, or the right to the income from" the trust estate was retained by the husband but that the income from the property of the trust estate was clearly and expressly made the separate property of the wife, for which she and she alone should be taxable.

289. *Id.* at 573 (emphasis added; footnotes omitted).

290. 180 F.2d 930 (5th Cir. 1950), *discussed at* text accompanying notes 31-39 *supra*.

291. 180 F.2d at 934.

292. *Id.* at 932.

I believe that the *income*—not the corpus—would have been community property had the trust agreement not clearly provided to the contrary.²⁹³

In summary, each of the Fifth Circuit's decisions were premised on the notion expressed in *Irwin v. Gavitt* that the gift was of an equitable interest in the trust corpus and not of the income, and, therefore, the income was subject to income tax and would not qualify for the exclusion from gross income applied to gifts. The Fifth Circuit essentially reasoned that since the trust distribution was income for federal tax purposes, it must be income for state law purposes. Furthermore, if it is income for state law purposes, it will be community property since income from separate property is community.

The decisive question is whether the corpus of the trust is the subject matter of the gift and, therefore, the separate property, or is the income the subject matter of the gift. The Fifth Circuit answers by saying that *Irwin v. Gavitt* tells us that the trust corpus is the subject matter of the gift. In concluding, however, the Fifth Circuit carved out an exception where the donor expressly declares the income produced to be separate property in deference to those Texas cases holding that the income is the subject matter of the gift.²⁹⁴

Regrettably, this premise relied upon by the Fifth Circuit was not crucial to the court's decision in *Irwin v. Gavitt* and, thus, is of limited precedential value. Moreover, it should not have been seized upon by the Fifth Circuit in these property law cases because income for tax accounting purposes is not necessarily income for trust accounting or state law purposes.²⁹⁵ Gain realized from the sale of trust property, for example, is gross income for federal income tax purposes,²⁹⁶ but is credited to trust corpus for trust accounting purposes unless the governing instrument otherwise provides.²⁹⁷ Another example involves distribution in kind from an estate. Suppose that the decedent's entire will consists of this one sentence: "All to my wife." Assume further that shortly after the decedent's death his automobile is transferred to his wife. That is obviously a distribution in fulfillment of the bequest in the will. In other words, it is a distribution of principal for state law purposes. Nevertheless, for federal income tax purposes, the distribution of the automobile constitutes a distribution of taxable income to the surviving spouse to the extent of the estate's distributable net income.²⁹⁸

There are many other examples, but these few should suffice to illustrate that the Supreme Court in *Irwin v. Gavitt*²⁹⁹ need not have suggested that the gift was of an equitable interest in the corpus of the trust, and not of

293. *Id.*

294. See text accompanying notes 238-52 *supra*.

295. See Browning, *Problems of Fiduciary Accounting*, 36 N.Y.U. L. REV. 931 (1961).

296. I.R.C. § 641(b).

297. See TEX. REV. CIV. STAT. ANN. art. 7425b-27(B) (Vernon 1960); G.G. BOGERT & G.T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 822 (2d ed. 1962).

298. I.R.C. § 662.

299. 268 U.S. 161 (1925).

the income, in order to explain its decision. Justice Holmes, writing for the Court, could have simply said that income is income until it is taxed to someone. He could have explained that to hold otherwise would result in emasculation of the federal income tax inasmuch as such a ruling would cause every taxpayer to seek the shelter of a trust for his income.

Actually Justice Holmes' opinion is closer to the mark than one would be led to believe by the various lower courts' tendencies to quote portions of the opinion out of context. Justice Holmes said, for example:

If these payments properly may be called income by the common understanding of that word and the statute has failed to hit them it has missed so much of the general purpose that it expresses at the start. Congress intended to use its power to the full extent.³⁰⁰

The opinion continues:

The language quoted [from the statute] leaves no doubt in our minds that if a fund were given to trustees for *A* for life with remainder over, the income received by the trustees and paid over to *A* would be income of *A* under the statute. It seems to us hardly less clear that even if there were a specific provision that *A* should have no interest in the corpus, the payments would be income none the less, within the meaning of the statute and the Constitution, and by popular speech. In the first case it is true that the bequest might be said to be of the corpus for life, in the second it might be said to be of the income. But we think that the provision of the act that exempts bequests assumes the gift of a corpus and contrasts it with the income arising from it, but was not intended to exempt income property so-called simply because of a severance between it and the principal fund.³⁰¹

Moreover, it was more of an afterthought that caused Justice Holmes to use the words that became the basis of the Fifth Circuit decisions on these property law issues.

The Courts below went on the ground that the gift to the plaintiff was a bequest and carried no interest in the corpus of the fund. We do not regard those considerations as conclusive, as we have said, but if it were material a gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund. Apart from technicalities we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it. The fund is appropriated to the production of the same result whichever form the gift takes.³⁰²

Finally, even Justice Holmes recognized that the gift was of the income and not the corpus: "This is a gift from the income of a very large fund, as income."³⁰³ Thus, he did not find it necessary to rule that if it is a gift it could not be income and vice versa. Today there is little question but that the income tax and the gift tax are not mutually exclusive.³⁰⁴ For example,

300. *Id.* at 166.

301. *Id.* at 167 (emphasis added).

302. *Id.* at 167-68 (emphasis added).

303. *Id.* at 168.

304. C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 678-81 (2d ed. 1962).

a gift of an income interest does not mean that the transfer is not subject to both the gift tax and the income tax. The income tax is a tax on the realization of income. The gift tax is an excise tax on the transfer of property, and the property transferred could easily be a right to income that will be taxed as income when the income is realized.³⁰⁵

Finally, the precedential effect of these Fifth Circuit cases is limited because in applying federal tax law federal courts follow state property law determinations.³⁰⁶ In ascertaining applicable state property law, federal courts are only bound by the determinations of the highest court of the state.³⁰⁷ If the highest court of the state has not addressed the issue, the federal court is free to make its own independent determination of what state property law would be in a particular case. The Texas Supreme Court, however, has indicated in cases decided before *Arnold v. Leonard* that trust income is separate property.³⁰⁸ The Fifth Circuit expressly recognized those cases as apparently consistent with *Arnold v. Leonard*, but held that the rulings were limited to situations in which the donor expressly earmarked the income interest as the spouse's separate property.³⁰⁹ Examination of the opinions in question reveals that in *Hutchison v. Mitchell*,³¹⁰ *Martin Brown Co. v. Perrill*,³¹¹ *Shepflin v. Small*,³¹² *Monday v. Vance*,³¹³ *McClelland v. McClelland*,³¹⁴ and *Sullivan v. Skinner*³¹⁵ the donor had not so earmarked the income interest, yet the Texas courts held that the income was the donee's separate property. Note, too, that *Martin Brown Co.* and *Sullivan* involved legal life estates and not trusts. Thus, these cases in effect involved mandatory pay trusts, yet the respective courts held that the income was separate property. Furthermore, the Texas Supreme Court reached the same result in *Hutchison*, which involved an express trust.

Beyond this, efforts to distinguish the Fifth Circuit decisions from the Texas state court decisions will probably not be productive. For example, the presence or absence of a spendthrift provision in a particular case does

305. See I.R.C. § 102(b)(2).

306. See *Morgan v. Commissioner*, 309 U.S. 78 (1940).

307. See *Commissioner v. Estate of Bosch*, 387 U.S. 456, 463 (1967); *Estate of Salter v. Commissioner*, 545 F.2d 494, 497 (5th Cir. 1977); *Cox v. United States*, 421 F.2d 576, 580 (5th Cir. 1970); C. LOWNDES & R. KRAMER, *supra* note 304, §§ 4.15-28.

308. See *Martin Brown Co. v. Perrill*, 77 Tex. 199, 13 S.W. 975 (1890), *discussed at* text accompanying notes 240-42 *supra*; *Hutchison v. Mitchell*, 39 Tex. 488 (1873), *discussed at* notes 238-39 *supra* and accompanying text.

309. See text accompanying note 285 *supra*.

310. 39 Tex. 488 (1873), *discussed at* notes 238-39 *supra* and accompanying text.

311. 77 Tex. 199, 13 S.W. 975 (1890), *discussed at* notes 240-42 *supra* and accompanying text.

312. 23 S.W. 432 (Tex. Civ. App. 1893, no writ), *discussed at* note 243 *supra* and accompanying text.

313. 32 S.W. 559 (Tex. Civ. App. 1895, no writ), *discussed at* note 244 *supra* and accompanying text.

314. 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd), *discussed at* notes 251-68 & 284-85 *supra* and accompanying text.

315. *Sullivan v. Skinner*, 66 S.W. 680 (Tex. Civ. App. 1902, writ ref'd), *discussed at* text accompanying notes 245-47 *supra*.

not appear to be significant. *McClelland* certainly contained a valid spendthrift clause that prevented the beneficiary from reaching prospective trust distributions until the funds were actually distributed to him. In *Mercantile National Bank*,³¹⁶ however, the spendthrift clause appears to have been invalid, since the settlor was the sole beneficiary. Although the court in *Buckler*³¹⁷ refers to the trust as a spendthrift trust, it seems clear from the opinion that it was merely a discretionary pay trust entitling the beneficiary only to such income as the trustee, in his discretion, decided to give him. In *Sims*³¹⁸ Judge Hutcheson made it clear that spendthrift clauses were of no moment in reaching the tax decisions.

Any attempt to characterize trust income as separate or community property on the sole basis of whether it has been distributed meets with little success as well. The early cases of *Hutchison*, *Shepflin*, *Monday*, and *Sullivan*, all of which were creditor claims cases decided prior to *Arnold v. Leonard*, held distributed trust income to be the separate property of the trust beneficiary. The tax cases of *Porter*³¹⁹ and *Snowden*³²⁰ reach precisely the opposite result.

Undistributed income was characterized as separate property in *McClelland* and *Buckler*, both of which involved divorce actions. Yet the fact that the trust income cannot be reduced to possession by the trust beneficiary is not determinative. *Benedict v. Benedict*³²¹ indicates that there may be community property rights in such property that must be recognized on divorce. Moreover, *Herring*³²² and *Cearley*,³²³ both divorce actions, if construed broadly, suggest that it makes no difference whether the property is reduced to possession by the married beneficiary. If it is community, then it is community for all purposes. Finally, *Mercantile Bank*, a creditor case, states in a dictum that trust income is community property from the date of the marriage of the trust beneficiary.

Finally, it is interesting to note that in none of the Fifth Circuit tax decisions discussed in this subpart was the settlor of the trust the spouse of the trust beneficiary. Score another one for Mr. Wyly's claim to have earmarked the income interest from the trust as Mrs. Wyly's separate property.

316. *Mercantile Nat'l Bank v. Wilson*, 279 S.W.2d 651 (Tex. Civ. App.—Dallas 1955, writ ref'd n.r.e.), discussed at notes 248-50 *supra* and accompanying text.

317. *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App.—Fort Worth 1967, writ dismissed), discussed at notes 254-57 *supra* and accompanying text.

318. *Commissioner v. Sims*, 148 F.2d 754 (5th Cir. 1945), discussed at text accompanying notes 286-87 *supra*.

319. *Commissioner v. Porter*, 148 F.2d 566 (5th Cir. 1945), discussed at text accompanying notes 282-83 *supra*.

320. *Commissioner v. Snowden*, 148 F.2d 569 (5th Cir. 1945), discussed at note 282 *supra*.

321. 542 S.W.2d 682 (Tex. Civ. App.—Fort Worth 1976, no writ).

322. *Herring v. Blakeley*, 385 S.W.2d 843 (Tex. 1965), discussed at notes 267-68 *supra* and accompanying text.

323. *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976), discussed at text accompanying notes 269-73 *supra*.

Conclusion. Any attempt to categorize the cases must be on the basis of whether the action involves creditor's claims, divorce, or tax consequences with some attempt made to effect any clearly expressed intent of the settlor. Efforts to characterize along the lines of distributed or undistributed income or spendthrift trust provisions show little promise. Until the Texas Supreme Court speaks, *Arnold v. Leonard* continues to stand squarely across the threshold of any meaningful analysis. Nevertheless, *Buckler*, in rejecting *Arnold v. Leonard* as not encompassing the issue of trust income, displays cogent reasoning that should be given respect by the Texas Supreme Court when the issue comes before it.

What lesson is there in the meantime for those who wish to determine whether Mr. Wyl's gift was of the trust corpus or the income produced by the trust corpus? Could it not be argued that undistributed trust income in a discretionary pay trust is merely community property awaiting distribution, and therefore transfers to such a trust by one spouse for the benefit of the other spouse constitute transfers subject to a retained life estate by operation of law? To paraphrase a famous quotation, you could make that argument—but it would be wrong! It would be wrong because a discretionary pay trust arising by gift, bequest, or devise—as contrasted with one established as a means of compensation for services rendered—is more like a power of appointment awaiting the donee or trustee's exercise of discretion to complete the gift. In *Tobin v. Commissioner*³²⁴ the Fifth Circuit ruled that undistributed trust income in a discretionary pay trust was separate property. It explained:

The express purpose of each of these trusts was to provide for the financial protection of loved ones against misfortune and their own improvidence. It becomes manifest that if undistributed income held in an irrevocable trust, as here, solely for the protection of certain beneficiaries against financial want, is community property and held subject to community debts, that such holding would clearly defeat the express purpose for which the trusts were originally created.³²⁵

The Commissioner had attempted to couple the grantor trust rules³²⁶ and the reciprocal trust doctrine as then articulated in *Lehman v. Commissioner*³²⁷ to cause undistributed trust income to be taxed to the husband and wife as their community income rather than to the trust, which the Commissioner apparently perceived to be a tax shelter without substance. Both husband and wife had each used their respective portions of their community estate to establish trusts for the benefit of the other spouse. All distributions from the respective trusts were committed to the discretion of an advisory committee of three individuals.

In addition, there seems to be agreement that a donor may expressly earmark the income produced by a gift in trust as the donee's separate

324. 183 F.2d 919 (5th Cir.), *cert. denied*, 340 U.S. 904 (1950).

325. 183 F.2d at 921.

326. The grantor trust rules were codified by the Internal Revenue Code of 1954 and today appear as I.R.C. §§ 671-678.

327. 109 F.2d 99, 100 (2d Cir.), *cert. denied*, 310 U.S. 637 (1940).

property. There is also some indication that even the Fifth Circuit will infer such an intention in appropriate circumstances. Thus, there is no reason why the income produced from a mandatory pay trust such as in *Wyly* could not be earmarked expressly or inferentially as the separate property of the donee spouse. The pattern of conduct in *Wyly* and the language of the trust agreement would support a determination that the donor spouse had manifested an intention to make the income produced by the trust Mrs. Wyly's separate property.

VI. ADDITIONAL BASES FOR CRITICIZING CASTLEBERRY AND MCKEE

The Tax Court has focused on the concept of "retention" of a life estate and held that the life estate can be either expressly or impliedly retained. *Castleberry*, *Wyly*, and *McKee* added "by operation of law" to the means by which a life estate can be retained.

A. *Margrave v. Commissioner*

On October 10, 1978, the Tax Court announced its decision in *Margrave v. Commissioner*.³²⁸ In *Margrave* the decedent's spouse had all of the incidents of ownership in a policy of insurance on the decedent's life, including the right to change the beneficiary. The proceeds were paid to an inter vivos trust established by the decedent that became irrevocable at his death. The surviving spouse could have changed the beneficiary at any time, but chose not to do so. Since the proceeds were paid to the decedent's trust, the Commissioner asserted that the proceeds should be included in the decedent's gross estate. The Tax Court found for the taxpayer on the ground that the decedent's spouse had the right to change the beneficiary and thereby deprive the decedent of any ability to direct the disposition of the proceeds.

Prior to decedent's death, the designation of the trustee as beneficiary created only an expectancy that it would continue to remain such until the policy became payable. . . . Thus, decedent's interest in the trust as regards the policy proceeds was merely a power over an expectancy subject to the absolute whim of the policy owner, Mrs. Margrave, and was, by the terms of the trust itself, extinguished at the moment of his death. . . . This simply does not constitute an incident of ownership.³²⁹

Throughout its opinion the court emphasized that the critical fact in its decision was Mrs. Margrave's power to change the beneficiary.

By the terms of the policy, the trustee had only the right to receive the proceeds and this right was subject to Mrs. Margrave's power, as the owner of the policy, to change the designation of the trustee as beneficiary. The trustee, therefore, did not have an enforceable right to the proceeds, as it might have had if the beneficiary designation had been irrevocable—a right which could have been treated as

328. TAX. CT. REP. (CCH) Dec. 35,456.

329. *Id.* at 3505-06 (footnote omitted).

“property” subject to the decedent’s power of appointment. Clearly, during his lifetime, decedent did not have the ability to “enlarge or shift the beneficial interest” (see section 20.2041(b)-(1), Estate Tax Regs.) in “any property.” He could not confer any benefit upon anyone, including himself or his creditors. As a consequence, prior to his death, decedent had no more than a power over an expectancy.³³⁰

Again, the court stated:

The fact is, however, that the right to the proceeds did not become vested in the trustee until death had actually occurred. Until that moment, Mrs. Margrave could have changed the beneficiary designation and destroyed decedent’s control of the proceeds via the trust and, therefore, the capacity of the trustee to receive the proceeds.³³¹

There were seven dissenting judges in *Margrave*. The dissenting opinion of Judge Fay commented on the surviving spouse’s right to change the beneficiary of the policy and thereby deprive her husband of any ability to direct the flow of the policy proceeds. Unfortunately, all that Judge Fay said was that this right of the surviving spouse was “simply of no relevance” and of “no significance” since Mrs. Margrave never exercised her power.³³²

In a separate dissent, Judge Chabot could find no distinction between the case where the proceeds are payable to an insured’s executor, and therefore included in the insured’s estate by virtue of the literal language of section 2042, and the facts in *Margrave* where the proceeds are payable to the insured’s revocable trust, which is essentially a testamentary device.³³³ Admittedly, the distinction seems to be without substance unless the majority’s opinion is interpreted as an exception to section 2042; that is, the holding may imply that even if the proceeds were payable to the insured’s executor, the fact that the surviving spouse had the power to change the beneficiary immediately before the insured’s death, although she did not, means that the proceeds would not have been included in the insured’s gross estate. Alternatively, the majority opinion may stand for the proposition that since the scheme for payment of the policy proceeds is not within the literal reach of the statute, the proper emphasis is on the substance of the transaction. The question then becomes whether this was a tax avoidance scheme or an attempt by the surviving spouse to use the insured’s revocable trust as a vehicle for completing her own dispositive scheme.

It is more than likely that the surviving spouse simply used the insured’s revocable trust as an economical means of completing her legitimate estate planning objectives. She probably did not want the proceeds of the insurance to be included in her estate if her husband died first. To avoid that result she could have established an irrevocable trust and directed the proceeds to that trust for her benefit, thus keeping the proceeds out of her

330. *Id.* at 3507.

331. *Id.*

332. *Id.* at 3510-12.

333. *Id.* at 3514-18.

estate if all distributions to her from the trust were absolutely discretionary with the trustee.³³⁴ Instead of her creating her own trust, however, she directed the insurance proceeds to her husband's revocable trust, which undoubtedly contained a by-pass trust³³⁵ that set forth terms similar to those that she would have included in any irrevocable trust she would have created to receive these proceeds. Thus, the scheme involved only legitimate tax avoidance. Consequently, why should the taxpayer be penalized by an extension of the statute on the grounds of substance over form when, in fact, the substance of the transaction was decidedly not illegitimate tax avoidance. In other words, let us give expression to substance over form, that is, the substance of the transaction, which involves inquiry into intention, rather than the form of the transaction, which might call for literal application of the statute.

Margrave may have been incorrectly decided because section 2042 is clear in calling for the inclusion in the insured's gross estate of policy proceeds payable to his executor. Nonetheless, the case is important because the court recognized either (1) that the surviving spouse's right to change the beneficiary was significant, or (2) that the court will look at the tax avoidance implication of transactions before extending a statute to reach transactions not within the literal language of the statute. If the former, the taxpayers in *Castleberry* and progeny now have a case in which the court has recognized the significance for federal estate tax purposes of the right of a third person to totally deprive the decedent of an interest in property. Even Judge Quealy's dissent seemed to indirectly accept the validity of this proposition. Stating that he was "not persuaded by the argument that the decedent merely had an 'expectancy' or that the right of the decedent to direct the proceeds of the policy could be revoked or terminated by his wife, the owner of the policy,"³³⁶ the judge then said: "The real question is whether, at the time of his death, the decedent was possessed of the power to direct the proceeds of the policy. It is clear that he was."³³⁷ Why? Because Judge Quealy was convinced that Mr. and Mrs. Margrave colluded³³⁸ in devising this scheme.

Furthermore, there is nothing in this record from which it could be inferred that the decedent's wife would, contrary to decedent's intentions, deprive the decedent of his right to designate to whom would be paid the proceeds of the insurance. In order for her to obtain a policy of insurance on decedent's life, it was necessary for the decedent to

334. See *Pyle v. Commissioner*, 313 F.2d 328 (3d Cir. 1963); *Goodnow v. United States*, 302 F.2d 516 (Ct. Cl. 1962); *Estate of Uhl v. Commissioner*, 241 F.2d 867 (7th Cir. 1957), *rev'g* 25 T.C. 22 (1955).

335. See text accompanying notes 428-37 *infra*.

336. TAX. CT. REP. (CCH) Dec. 35,456, at 3514.

337. *Id.*

338. Judge Goffe, in his concurring opinion, reproduced some of the testimony developed at the trial to demonstrate that there was no prearrangement or collusion between the spouses to allow the proceeds of the insurance to be disposed of under the insured's trust. Judge Goffe concluded: "In view of Mr. Schwartz' testimony it is not difficult to understand why respondent never requested a finding of fact in his brief that decedent and Mrs. Margrave had a prearranged plan for disposition of the insurance proceeds." *Id.* at 3510.

consent to and to join in the application for such insurance. *The decedent filled out the application form.* Logic would lead to the inference that decedent had a voice in the disposition of the proceeds. This was not a plan that could be evolved without the mutual agreement and consent of both the owner of the policy and the insured.

It is clear from the record that the designation of the trust as beneficiary resulted from a prearranged plan which gave decedent the opportunity to direct the proceeds.³³⁹

Does this mean that in the absence of the collusion he perceived to have existed Judge Quealy might have been with the majority?

In *Castleberry* there was no prearrangement or agreement that the donee spouse would manage the transferred property for the benefit of the donor. State law requires her to manage any income produced by the transferred property for the benefit of the community, but how she manages the transferred property—the means of production—is committed to her absolute and complete discretion.³⁴⁰ As commented earlier, she could dissipate it all during a day at the races. Mrs. Margrave could have done the same thing had she wanted to do so.

Looking at other precedents, the contingent retained life estate cases³⁴¹ are different, as are the reversion cases.³⁴² In both situations, the interests were to become possessory in the transferor upon the timely expiration of prior estates. Possession and enjoyment depended upon the natural processes of chance selection in the order of deaths. *Margrave* and *Castleberry* and progeny are different; in neither case is chance selection a factor. The donor spouse in *Castleberry* and progeny takes an interest only so long as a third party, the donee spouse, does not exercise her right to die, depart, divorce, or dissipate the transferred property.³⁴³

Accordingly, the principle of *Margrave* is support for the taxpayers in *Castleberry*, *Wyly*, and *McKee* even if the principle of *Margrave* was incorrectly applied to the facts in that case. Admittedly Mr. Castleberry had more than an expectancy; he had an ownership interest in any income produced by the transferred property.³⁴⁴ In fact, however, no income was produced, and more importantly, his wife could have deprived him at any time of receiving any income, other than that already produced, by death, divorce, departure, or dissipation of the transferred property.

339. *Id.* at 3514 (footnote omitted).

340. See notes 105-37 *supra* and accompanying text.

341. See note 149 *supra*.

342. See note 176 *supra* and note 352 *infra* and accompanying text.

343. This right to cut off interests of third persons has significance for questions in other tax contexts. For example, in *Crummey v. United States*, 397 F.2d 82 (9th Cir. 1968), a minor child's unexercised right to demand immediate distribution of property transferred to an accumulation trust for his benefit qualified the transfer for the \$3,000 per donee per annum gift tax exclusion. Furthermore, such unexercised rights to demand distribution are sufficient to warrant including in the gross estate of the person having those unexercised demand rights the portion of the property subject to the rights. See I.R.C. § 2041(b)(2); Treas. Reg. § 20.2041-3(d)(3) (1958); Rev. Rul. 75-415, 1975-2 C.B. 374; Rev. Rul. 73-405, 1973-2 C.B. 321.

344. See text accompanying notes 91-123 *supra*.

B. Bizarre Implications

A literal reading of section 2036 suggests that it is impossible for a taxpayer who has transferred property and retained a life estate in that property to later avoid having the property included in his gross estate by divesting himself of the life estate, by gift or release. While there are no cases on this point, *United States v. Allen*³⁴⁵ raised the issue in a contemplation-of-death context. *W* had transferred "Blackacre," but retained a life estate. Within three years of her death, she sold the life estate for its actuarially determined value to one of the remaindermen, a son. The court included Blackacre in her gross estate, but gave her credit for the consideration she received when she sold the life estate to the remainderman. The court's majority based the inclusion of Blackacre in *W*'s gross estate on a contemplation-of-death theory. The concurring opinion, on the other hand, stated that Blackacre would have been in *W*'s gross estate pursuant to section 2036 even if she had transferred it beyond the three-year period because she had retained a right to income for life at the time of transfer.

The result suggested by the concurring opinion would be bizarre, but literally this is happening in Texas with interspousal transfers. The transferor can never exclude the property from his estate if he transfers it to his wife.³⁴⁶ Incredible you say! Consider that the Tax Court clearly seemed to contemplate tracing transferred property in cases in which the donee spouse converted the transferred property and reinvested the proceeds.³⁴⁷ To hold otherwise would, as the court suggests, allow taxpayers to frustrate the principle of *Castleberry* by converting the transferred property into cash and then reinvesting the proceeds. Extending the Tax Court's logic, does that mean that in cases in which tracing is impossible the last dollar held by the donee spouse would be presumed to bear the taint of the transfer? Certainly that would be the case where the transferor has retained a legally enforceable life estate, say, for example, in a transfer in trust for the benefit of the transferor. The same principle should apply to *Castleberry*-like transfers if the logic of *Castleberry* is correct, even though the donor spouse has no ability to restrict the donee spouse in her enjoyment of the transferred property. His only right is to any income produced *after* it is produced. Whether that right should be enough to bring it within section 2036(a), inasmuch as the transferor has no enforceable right to control the tree that produces the fruit,³⁴⁸ is for the Fifth Circuit.

345. 293 F.2d 916 (10th Cir.), *cert. denied*, 368 U.S. 944 (1961).

346. Such a conclusion would not be unprecedented. See *Howard v. United States*, 125 F.2d 986, 989-90 (5th Cir. 1942) (Louisiana law).

347. See note 96 *supra* and accompanying text. The spectre of tracing seemed so remote before *McKee* that it never even occurred to the first commentator on *Castleberry* who opined that "the husband has a retained life estate in one-half of all the gifts that he has given to his wife and that are still possessed by her at his death." Note, *Gift Tax Liability Resulting From Marriage in Texas*, 55 TEXAS L. REV. 1427, 1427 (1977) (emphasis added); see note 191 *supra*.

348. See text accompanying notes 151-94 *supra*.

C. Policy Considerations

Congress has long been reluctant to include property in a decedent's gross estate after he has parted with dominion and control over the property. For example, in 1954, when Congress abolished the premium payment test for determining the estate tax consequences of life insurance, the committee report commented on the unfairness of taxing proceeds of life insurance to the premium payer long after he lost control of the policy, or in cases in which he never had dominion and control of the policy, but merely paid premiums. The report stated: "No other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property" ³⁴⁹

D. Hypertechnical Basis

Courts have also been reluctant to include property in the decedent's gross estate on hypertechnical grounds. For example, in *Morton v. United States*³⁵⁰ the proceeds of life insurance were excluded from the insured's gross estate even though he had the technical power to change the beneficiary. The court held that it was "legally impossible" for the decedent to exercise any of the powers purportedly given to him in the policy in any way that would cause economic benefit to accrue to him notwithstanding the "policy facts" giving him the legal right to change the beneficiary.³⁵¹

E. Estate of Spiegel v. Commissioner³⁵²

The *Deobald* opinion states that "[a]s the foundation for its argument, the government refers the Court to *Spiegel's Estate v. Commissioner*."³⁵³ Spiegel transferred certain stocks to a trust that provided that "the trust income was to be divided among his three children; if they did not survive him, to any of their surviving children. On his death . . . the corpus was to be distributed in the same manner."³⁵⁴ No provision was made as to disposition of the trust corpus if Spiegel survived all of the indicated beneficiaries. The Supreme Court included in Spiegel's gross estate the value of his contingent right to receive the corpus should he survive the indicated beneficiaries.

Estate of Spiegel is correct because Spiegel had an interest in the trust at his death. But if *Spiegel* is the basis for the Commissioner's position in *Castleberry*, the holding should also be extended to transfers of separate property to a spouse in those separate property jurisdictions that have in-

349. S. REP. NO. 1622, 83d Cong., 2d Sess. 124, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4757.

350. 457 F.2d 750 (4th Cir. 1972).

351. Arguably the case is in conflict with *Commissioner v. Estate of Noel*, 380 U.S. 678 (1965), which accepted the policy facts principle as applied to flight insurance and rejected the actual ability theory.

352. 335 U.S. 701 (1949).

353. *Estate of Deobald v. United States*, 444 F. Supp. 374, 380 (E.D. La. 1977), discussed at note 85 *supra*.

354. 335 U.S. at 703.

testacy statutes providing that each spouse is an intestate taker of the other spouse's estate. The Government probably would resist such an extension by explaining that in such a case, the donee spouse—the prospective decedent—could dispose of the property by gift during life or by will at death. However, the same could be said of *Castleberry*, yet *Castleberry's* gift was included in his gross estate.³⁵⁵

F. *Pearson v. Campbell*³⁵⁶

In addition to *Deobald*,³⁵⁷ *Pearson v. Campbell* seems plainly contrary in result to *Castleberry*, yet the Commissioner in his reply brief in the Tax Court dismisses the precedential effect of *Pearson* by stating that “[t]he opinion does not set forth the reason or any authority in support of the court’s finding.”³⁵⁸ Nonetheless, *Pearson* seems directly on point. The

355. See text accompanying notes 54-70 *supra*.

Spouses domiciled in Ohio, for example, face many of the same limitations as Texas spouses on separate property, including that received by gift from the other spouse. The donor spouse has a forced heirship right to any property subject to disposition by the donee spouse's will and his right is superior to any disposition of that property made in her will. See OHIO REV. CODE ANN. § 2107.39 (Page 1976). This means he can claim his intestate share of her probate property notwithstanding a contrary disposition in the donee spouse's will. In addition, the donor spouse has a claim to a \$5,000 allowance for support that is superior to any disposition of that property by the donee's will. See *id.* § 2117.20. Moreover, the donee spouse cannot make a lifetime conveyance of any of her real property—whether such property was acquired from the decedent or not—without the donor spouse's consent. *Id.* § 2103.02. If such property is disposed of without his consent, after her death, he can claim dower interest in the transferred property equal to one-third its value for life. *Id.*

These interests are contingent in the sense that the claimant must survive his spouse in order to assert their rights. Admittedly, that is different from the right of the Texas donor spouse to any income produced by the transferred property. His interest is contingent only on there being income and the donee spouse neither dissipating the property, moving to a separate property jurisdiction, or divorcing him. If she divorced him, he can claim one-half the income produced from the transferred property prior to divorce but will have no further claim to any income subsequently produced by the transferred property. In a separate property jurisdiction, the divorced spouse may have a claim to alimony which is not available to him in Texas.

Are all these similarities and differences worth further analysis? Of greater importance is whether federal tax consequences should be dependent upon such subtle distinctions. One hopes not. It would almost seem probable that Congress contemplated including transferred property in the transferor's gross estate only where he intended to retain benefits from the transferred property for his life and not simply where he unknowingly, unwittingly, and involuntarily acquired various interests in that property which he attempted to dispose of completely. Of course, in applying federal law, courts are concerned not only with what Congress intended but also what it did in fact. Thus, the question, did Congress provide in § 2036(a)(1) that all transfers between spouses in Texas will be included in the transferor's gross estate at his subsequent death? See text accompanying note 370 *supra*.

356. 10 Am. Fed. Tax. R.2d ¶ 145,932, 62-2 U.S. Tax. Cas. ¶ 12,120 (N.D. Tex. Nov. 7, 1962). The Commissioner dismisses the precedential effect of *Pearson*, Estate of Robert W. Wier, 17 T.C. 409 (1951), *discussed at* text accompanying note 361 *infra*, and *Frankel v. United States*, No. 75-H-1806 (S.D. Tex. Apr. 7, 1977), *discussed at* text accompanying note 366 *infra*, as “simply make-weights.” Brief for Appellee-Cross-Appellant at 15, Estate of *Castleberry v. Commissioner*, No. 78-1612 (5th Cir. Mar. 23, 1978).

357. Estate of *Deobald v. United States*, 444 F. Supp. 374 (E.D. La. 1977), *discussed at* note 85 *supra*.

358. Reply Brief for Respondent at 13, Estate of *Castleberry v. Commissioner*, 68 T.C. 682 (1977), *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978).

facts of *Pearson*, using the Commissioner's own words, are as follows:

In that case the decedent-husband had purchased various stocks over various years and registered the stock in his wife's name. The stock certificates were kept in her possession and the findings of fact state that the husband never exercised any control over the disposition. It was further found that the decedent intended to make a gift of the stocks to his wife, and in each instance there was a delivery of the certificates. In setting forth its conclusions of law, the court found that the interest of the decedent in these corporate stocks was not sufficient to make it a part of his taxable estate within the meaning of Code § 2036.³⁵⁹

The Tax Court in *Castleberry* adopted this very same language to explain away *Pearson*.³⁶⁰

G. *Estate of Robert W. Wier*³⁶¹

Perhaps the case most strongly supportive of the taxpayer in *Castleberry* is *Estate of Robert W. Wier*, in which the decedent made various gifts to his wife including his community interest in their homestead. The Internal Revenue Service attempted to include one-half the value of the homestead in the decedent's gross estate because Texas law gave the decedent his homestead interest. The Tax Court found for the taxpayer, relying on *Hinds*,³⁶² because the decedent's interest in the homestead was subordinate to the wife's power to control and manage her separate property.³⁶³

Interestingly, the Commissioner chose to distinguish *Wier* from *Gutchess*.³⁶⁴ The Service acquiesced in *Gutchess* in 1967 and again confirmed its position in 1970.³⁶⁵

H. *Frankel v. United States*³⁶⁶

In *Frankel* the District Court for the Southern District of Texas granted summary judgment in favor of the taxpayer. Mr. Frankel had made transfers to his wife of cash and bonds. The taxpayer argued in his brief that, on the authority of *Hinds*, *Pearson*, and *Estate of Wier*, the donor spouse's community property interest in the income after the transfer was not the kind of interest that was intended to come within the scope of section

359. *Id.*

360. 68 T.C. at 690.

361. 17 T.C. 409 (1951), *acq.* 1952-1 C.B. 4, *acq. withdrawn and nonacq.* 1966-2 C.B. 8.

362. Note 31 *supra*.

363. The Tax Court's opinion noted that the Commissioner conceded in his brief that "none of the cash and securities transferred by the decedent to his wife are includable in the decedent's gross estate by reason of a retention of an interest in the income from such property." 17 T.C. at 421.

364. *Estate of Hinds v. Commissioner*, 11 T.C. 314 (1948), *aff'd on other grounds*, 180 F.2d 930 (5th Cir. 1950), *nonacq.* 1949-1 C.B. 5.

365. Rev. Rul. 70-155, 1970-1 C.B. 189.

366. No. 75-H-1806 (S.D. Tex. Apr. 7, 1977) (order granting summary judgment), *appeal docketed*, No. 98-2585 (5th Cir. July 26, 1978).

2036.³⁶⁷I. *Estate of Uhl v. Commissioner*³⁶⁸

Estate of Uhl v. Commissioner provides further support for the taxpayer in *Castleberry*. In *Uhl* the decedent had established a trust that provided that the trustee was to distribute \$100 to him each month and such other amounts of the trust income as the trustee determined in the exercise of his sole discretion. The court held that only that portion of the trust necessary to produce \$100 of income per month was included in the decedent's gross estate. The remaining portion of the trust was excluded because the decedent "reserved no right to compel the trustee to pay him any sums other than the \$100.00 a month."³⁶⁹

Similarly, it can be said that the *Castleberry* taxpayer has not reserved a right, express, implied, or by operation of law, to compel the donee to invest or dispose of the transferred property in any particular way whatsoever.

J. *Legislative History of Section 2036*

There does not appear to be anything in the legislative history of section 2036 that would indicate a congressional intent to include interspousal gifts in the estate of the donor spouse solely on the grounds that he retained an estate for life in the transferred property because of the local law principle that income from separate property is community property.³⁷⁰

K. *Section 2034*

The law is replete with analogous situations where Congress or the courts have recognized the contingent nature of interests in property. So as not to make the list longer, the final example is section 2034. In that section Congress specifically says that a surviving spouse's dower interest is not an interest in property such as would cause its exclusion from the decedent's gross estate. Why? Because the spouse's interest is inchoate until the death of her spouse. So too, a Texas spouse's right to community income is inchoate until such time as that income is produced.

367. Brief for Plaintiffs in Support of Their Motion for Partial Summary Judgment at 4-10.

368. 241 F.2d 867 (7th Cir. 1957), *rev'g* 25 T.C. 22 (1955); *see* *Commissioner v. Irving Trust Co.*, 147 F.2d 946 (2d Cir. 1945); *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941) (dictum); *Estate of Pardee*, 49 T.C. 140, 149 (1967), *acq.* 1973-2 C.B. 1; Rev. Rul. 76-273, 1976-2 C.B. 268.

369. 241 F.2d at 869 (emphasis added).

370. *See* 74 CONG. REC. 7078-79, 7198-99 (1931); S. REP. NO. 665, 72d Cong., 1st Sess. 49 (1932), *reprinted in* 1939-1 C.B. (Part 2) 532; H.R. REP. NO. 708, 72d Cong., 1st Sess. 46 (1932), *reprinted in* 1939-1 C.B. (Part 2) 490-91. *See also* *Commissioner v. Estate of Church*, 335 U.S. 632 (1949); *Commissioner v. Estate of Arent*, 297 F.2d 894 (2d Cir. 1962). Of course, the clear intent of Congress was to tax at death any transfer where an interest was retained by the transferor at death. *See* notes 102-04 *supra* and accompanying text.

L. *Congressional Review*

Taxpayers have relied on *Hinds* and the decisions that have followed it for thirty years. The present seems like an awkward time to produce a different result. Major tax revision was accomplished in 1954, 1969, and 1976, thereby giving Congress numerous opportunities to change the result in *Hinds* if it were so minded. For instance, Congress acted in 1976³⁷¹ to change the rule declared in 1972 by the United States Supreme Court in *United States v. Byrum*³⁷² when it last considered section 2036. Interestingly, the Supreme Court in *Byrum* explained its decision in part by reference to taxpayer reliance:

The modification of this principle now sought by the Government could have a seriously adverse impact Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.³⁷³

M. *Conclusion*

Clearly there seems absolutely no basis for the decision in *Castleberry* except the Government's interest in exploring the outer perimeters of section 2036. It is a test case that succeeded without any real foundation in the statutes, legislative history, regulations, or prior cases.

N. *Epilogue*

The Government's reliance on section 2036(a)(1) was wrong on all fronts. If it was serious about including all interspousal transfers into the donor's gross estate, it should have pitched its case on section 2038, which provides:

In General. The value of the gross estate shall include the value of all property—

(1) Transfers after June 22, 1936.—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such

371. See I.R.C. § 2036(a) (last sentence); JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 588-89 (1976).

372. 408 U.S. 125 (1972).

373. *Id.* at 134-35.

power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.³⁷⁴

Under section 2038 there is no concept of retention or reservation of a life estate as there is under section 2036. The only issue under section 2038 is whether the transferor has an interest at death in the property that he transferred during his lifetime. Thus, in cases like *Castleberry*, *Wyly*, and *McKee*, where the donee continued to hold the transferred property at the death of the donor, it may arguably make some sense to include a portion of the transferred property in the donor's gross estate on the grounds that at his death the income from the transferred property was community property.

It is appropriate to note, however, that despite the literal language of section 2038, it appears that no court has ever included in a transferor's gross estate, pursuant to section 2038, property that he transferred during life unless the transferor retained dominion and control over the transferred property at the time of the transfer. The Second Circuit claims in *Estate of Skifter v. Commissioner*³⁷⁵ to have performed an exhaustive analysis of the cases in search of such precedent and could find none.

From this it can be suggested that there is no judicial precedent for including any portion of an interspousal transfer in the donor's gross estate solely for the reason that income from separate property is community property. The donor must have some right to compel the production of income or other enjoyment of the property.³⁷⁶ Moreover, he must have some reasonable expectation that he cannot legally be deprived of such enjoyment at the whim and caprice of the donee in order for the transferred property to be pulled back into his estate.³⁷⁷

VII. AMOUNT RECAPTURED

From *Castleberry*, *Wyly*, and *McKee* these rules can be stated:

- (1) If community property is the subject matter of the transfer, only twenty-five percent of the community property transferred will be included in the donor's gross estate; and³⁷⁸
- (2) If community property is transferred to a mandatory pay trust, fifty percent of the property transferred will be included in the donor's gross estate.³⁷⁹

Revenue Ruling 75-504 provided that when the subject matter of the interspousal transfer is separate property, one-half of the value of the trans-

374. I.R.C. § 2038.

375. 468 F.2d 699, 704 (2d Cir. 1972), *nonacq.* 1978-1 C.B. 3.

376. See note 368 *supra* and accompanying text.

377. See text accompanying notes 62-70 *supra*.

378. Estate of *Castleberry v. Commissioner*, 68 T.C. 682 (1977), *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978), *nonacq.* 1979-1 I.R.B. 7; Estate of *McKee v. Commissioner*, 37 T.C.M. (CCH) Dec. 35,049 (1978).

379. See Estate of *Wyly v. Commissioner*, 69 T.C. 227 (1977), *appeal docketed*, No. 78-1306 (5th Cir. Feb. 10, 1978).

ferred property is included in the transferor's gross estate.³⁸⁰

A. *Castleberry and McKee*

The Commissioner believes that fifty percent of the community property subject to an interspousal transfer should be included in the transferor's gross estate on the ground that after the transfer, the donor is in substantially the same position as he was before the transfer since income from separate property is community property.³⁸¹

This substance over form argument prevailed in *Bomash*,³⁸² but the Tax Court in *Castleberry* rejected it on three grounds:

- (1) The court claimed that the Commissioner ignored Treasury Regulation section 20.2036-1(a), which provides: "If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding proportion of the amount described in the preceding sentence."³⁸³
- (2) Next, the court said:
Decedent *retained* a right to only one-half of the income from his interest in the bonds he transferred to his wife. In addition he was entitled to one-half of the income from his wife's interest in the bonds by virtue of Texas community property law. Respondent ignores these facts when he suggests that decedent in effect retained 100 percent of the income from the interest he transferred in the bonds.³⁸⁴
- (3) Finally, the court said:

In addition, *United States v. Estate of Grace* . . . relied upon by the Ninth Circuit in *Estate of Bomash* would be inapplicable to the present case as only decedent made a transfer of property. Unlike *Estate of Bomash*, in this case no reciprocal transfers were made by decedent and his wife which would give rise to invocation of the reciprocal trust doctrine as enunciated in *Estate of Grace*. We therefore conclude decedent retained only one-half of the income from the property he transferred to his wife and only one-half of the value of the property he transferred (or one-quarter of the total value of the bonds) is includable in his gross estate under section 2036(a)(1).³⁸⁵

The Tax Court would seem to have misapplied *Estate of Grace*.³⁸⁶ The essence of *Estate of Grace* as expressed by the Supreme Court itself is that

380. 1975-2 C.B. 363, *discussed at text* accompanying notes 42-45 *supra*.

381. *Estate of Castleberry v. Commissioner*, 68 T.C. 682, 690 (1977), *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978), *nonacq.* 1979-1 I.R.B. 7.

382. *See notes 39-41 supra* and accompanying text.

383. *Estate of Castleberry v. Commissioner*, 68 T.C. 682, 692 (1977), *appeal docketed*, No. 78-1612 (5th Cir. Mar. 23, 1978), *nonacq.* 1979-1 I.R.B. 7 (quoting Treas. Reg. § 20.2036-1(a) (1958)).

384. 68 T.C. at 692.

385. *Id.* at 693 (citation omitted).

386. *United States v. Estate of Grace*, 395 U.S. 316 (1969), *discussed at text* accompanying notes 154-57 *supra*.

“the law searches out the reality and is not concerned with the form.”³⁸⁷ Accordingly, the fact that the decedent, Mr. Grace, was not the transferor of the property in which he was deemed to have retained a life estate was not at all significant to the Supreme Court. Similarly, unless form is to be exalted over substance, it should not matter that Mrs. Castleberry did not transfer her one-half of the community. Before the transfer Mr. Castleberry had a right to one-half the income from the transferred property and after the transfer he had the same right.³⁸⁸

That raises the question that if she did not transfer it, how was it transmuted into separate property. Further, if it was not transmuted, it must still be community. Fortunately, Texas law is clear that the transfer by one spouse of his half of the community to his spouse as her separate property transmutes the spouse's community interest in the transferred property into her separate property.³⁸⁹ But for this authority, it could have been argued that *H*'s transfer of his half of the community did not transmute *W*'s one-half of the community into her separate property. If that had been the case, the Tax Court should have included in Mr. Castleberry's gross estate one-half of *W*'s one-half of the community under section 2033 and one-half of his one-half of the community under section 2036 and the authority of Revenue Ruling 75-504.³⁹⁰

Extending this analysis, to reach the results the Tax Court reached in both *Castleberry* and *McKee*, the court would have had to have found that *H* and *W* first partitioned their community property into their respective separate property. In such a case *H* would include in his gross estate only one-quarter of the separate property he transferred to *W*, his former one-half of the community. It is doubtful that a partition occurred in either *Castleberry* or *McKee* inasmuch as Texas law requires a partition of community property to be formalized.³⁹¹

B. *Wyly*

In *Wyly* community property was transferred to a mandatory pay trust

387. 395 U.S. at 321.

388. This analysis assumes that it has already been decided that Mr. Castleberry retained a life estate in the transferred property and the only issue is how much is included in his estate. On the question whether he has retained such an interest, see text accompanying notes 151-94 *supra*.

389. *H* may transfer his interest in the community property to *W*, and the character of the title will be changed thereby to that of *W*'s separate property. The cases hold that the entire property, including *W*'s community interest, becomes the separate property of *W* upon such a transfer. Although such cases are subject to the construction that the interest not transferred remains community property, the courts have given effect to the parties' intention that the transfer makes the entire property the separate property of the transferee. See *Kellett v. Trice*, 95 Tex. 160, 66 S.W. 51 (1902); *Kahn v. Kahn*, 94 Tex. 114, 58 S.W. 825 (1900); *Lewis v. Simon*, 72 Tex. 470, 10 S.W. 554 (1889); *Story v. Marshall*, 24 Tex. 306 (1859) (land purchased with community funds; *H*'s conveyance of his interest to *W* changed the character from community to the separate property of *W*); *Forman v. Glasgow*, 219 S.W.2d 845 (Tex. Civ. App.—Waco 1949, no writ); Annot., 37 A.L.R. 282 (1925) (conveyance of community property by one spouse to the other).

390. See notes 42-45 and accompanying text.

391. TEX. FAM. CODE ANN. § 5.42(a) (Vernon 1975).

for the benefit of *W* for life. The Tax Court included fifty percent of the value of the transferred property in *H*'s gross estate on the ground that *H* retained a right, by operation of law, to the income from one-half the transferred property because in Texas trust income is community property.

In reaching this result the Tax Court had to distinguish *Wyly* from *Castleberry*, in which it included only twenty-five percent of the transferred community property in the decedent's gross estate. To do this the court relied on *United States v. Estate of Grace*³⁹² and the reciprocal trust doctrine. Noting that both Mr. and Mrs. *Wyly* transferred their respective community interests to the irrevocable trust, unlike *Castleberry* wherein only Mr. *Castleberry* made a transfer, the Tax Court stated:

In this case, by contrast, the wife did make a transfer into the trust of her community share. At the same time that the husband gave her a one-half life interest in the income from his share of the community, she gave him under Texas law a one-half interest in the income from her share. We cannot validly distinguish this case from *United States v. Estate of Grace* In that case it was held that, regardless of the presence of tax-avoidance purposes or bargained-for consideration, reciprocal transfers by spouses who created crossed life estates in each other would be treated as transfers with retained life estates. The only significant difference between *Estate of Grace* and the present case is that in *Estate of Grace* the reciprocal life estates were expressly created, while here they were created by operation of Texas law. In view of the pragmatic rationale of *Estate of Grace*, this distinction appears immaterial. We hold, therefore, that the decedent's gross estate included his full community one-half of the property transferred in trust for the benefit of his wife.³⁹³

VIII. TAX CONSEQUENCES OF CASTLEBERRY, WYLY, AND MCKEE

So far this Article has been devoted to analyzing the bases for the opinions in *Castleberry* and its progeny. What, however, are the effective tax consequences of transfers already made? Clearly the transfers in *Castleberry*, *Wyly*, and *McKee* were subject to federal gift tax when the transfers were initially made. The transfers were then "complete"³⁹⁴ in that the transferor no longer had any dominion and control over the transferred property. The federal gift tax and the federal estate tax, however, are not mutually exclusive.³⁹⁵ The same transfer, therefore, can be subject to both taxes, which is the case in *Castleberry* and its progeny if the Tax Court opinions are upheld. The harshness of this result is ameliorated, however, by the fact that each transferor's estate will receive credit against its ulti-

392. 395 U.S. 316 (1969), discussed at notes 154-57 *supra*.

393. *Estate of Wyly v. Commissioner*, 69 T.C. 227, 233 (1977), appeal docketed, No. 78-1306 (5th Cir. Feb. 10, 1978).

394. See *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941); *Rheinstrom v. Commissioner*, 105 F.2d 642 (8th Cir. 1939); *Estate of Ben F. Hazelton, Jr.*, 9 T.C.M. (P-H) ¶ 40,425 (1940); *Treas. Reg. § 25.2511-2* (1972); *Rev. Rul. 76-273*, 1976-2 C.B. 269. But see *Commissioner v. Vanderweele*, 254 F.2d 895 (6th Cir. 1958); *Rev. Rul. 62-13*, 1962-1 C.B. 181.

395. C. LOWNDES, R. KRAMER & J. MCCORD, *FEDERAL ESTATE AND GIFT TAXES* § 31.1, at 769 (3d ed. 1974).

mate estate tax liability for the gift tax paid at the time of the transfer.³⁹⁶

The real injury to the taxpayer results because the *Castleberry* pull back of interspousal transfers will frustrate time-honored legitimate tax planning techniques. If the transferor dies first, his estate will include a portion of the transferred property. At the subsequent death of the donee spouse, her estate will include 100 percent of the transferred property unless she has consumed or otherwise disposed of the property before her death.³⁹⁷ Thus, in cases in which the spouses are committed to equalizing their respective estates and saving the so-called second tax,³⁹⁸ the portion of the property pulled back into the transferor's estate nonetheless will be subject to estate tax twice, once in his estate and once in hers. There is nothing wrong with taxation of the same property in both spouses' estates when they have the appropriate ownership interests. It is unfortunate, however, that such double taxation is brought about by the frustration of time-honored legitimate tax planning.

The transferor's one consolation is that the dollars paid in gift tax at the time of the transfer are out of the transferor's gross estate for purposes of computing his federal estate tax liability.³⁹⁹ Of course, he does not have

396. See I.R.C. §§ 2001(b)(2), 2012.

If *Castleberry* and *Wily* are sustained on appeal, will donor spouses be deemed to have made a gift for federal gift tax purposes of only a remainder interest to the donee spouse? Appealing as the suggestion may be, the Commissioner might assert that the value of the donor spouse's interest in the income produced by the transferred property is unascertainable and therefore incapable of valuation inasmuch as the donee spouse could cut off the donor's interest in the income produced by the transferred property by dissipation, divorce, death, or departure from Texas. Cf. Private Letter Ruling No. 7838042 (release of a putative donor's rights held not to create a taxable gift under I.R.C. § 2501(a)(1) because the rights were too speculative in nature to be valued).

397. See I.R.C. § 2033.

398. See text accompanying notes 422-24 *infra*.

399. However, if the transferor dies within three years of the transfer, both transferred property and the gift tax paid will be included in his gross estate. See I.R.C. § 2035.

Would the Commissioner be barred from claiming that the donor spouse retained an interest under I.R.C. § 2036 in the transferred property if the Commissioner accepted the donor spouse's gift tax return reflecting a transfer of the entire interest in the transferred property to the donee spouse and not merely the transfer of a remainder interest? Attention should be given to *Richard V. Madden*, 52 T.C. 845 (1969), *aff'd per curiam*, 440 F.2d 784 (7th Cir. 1971), in which it was held that for purposes of the basis rules of I.R.C. § 1014, the decedent's executor has the burden of proving that jointly held property was *required to be included* in the estate of the deceased joint tenant. In this case, the surviving spouse argued that the jointly held property had acquired as its basis for income tax purposes that value at which it was included in the estate of the deceased joint tenant. Noting that the estate tax rules for jointly held property have been on the books since 1916, the court said:

However, we cannot believe that Congress contemplated that the term "required" should be construed so as to give survivors an option to decrease income tax by increasing estate tax, or to shift to the respondent, in income tax controversies, the burden of proving that less property was required to be included in gross estate than was actually included. There is no indication that Congress contemplated that it was conferring upon a surviving joint tenant the privilege of paying more estate tax than was necessary so as to reduce his income tax liability on the subsequent sale of the property. It seems more likely that when the term "required" was used, it was assumed that the executor or other interested person would attempt to secure the maximum exclusion of the jointly owned property from the estate; only to the extent that the executor was unable to show that the property was not excludable was it required to

those dollars available for his use in the meantime.

Last, but most importantly, note that if the property transferred is the donor's separate property, the one-half of the property pulled back into his estate qualifies for the marital deduction and, therefore, the pull back will in most cases wash out.⁴⁰⁰ Thus, if the interspousal transfer is made from

be included in gross estate. Such an interpretation of "required" is consistent with the practice that existed in 1954 and has the effect of imposing the burden upon the person who has the information most readily available.

52 T.C. at 849.

In considering *Madden* it may be appropriate to note that the government voluntarily refunded the estate tax paid by the decedent's executor that was attributable to the inclusion of the joint property in her estate. The court seemed to find this significant. It said: "We are not concerned with a situation in which there has been a final determination of the amount includable in gross estate; the estate tax return involved herein was not accepted by the respondent." *Id.*

Obviously, the standards for inclusion under I.R.C. §§ 1014 and 2040 respectively are different. Perhaps, for that reason, it is inappropriate to even suggest that *Madden* may have any application in this context.

400. See I.R.C. § 2056. The estate tax marital deduction is limited to the lesser of:

- (a) the property actually passing to the surviving spouse; and
- (b) the greater of:
 - (i) \$250,000; or
 - (ii) one-half of the decedent's adjusted gross estate.

It seems that this "wash out" will always occur in the following cases:

- (a) where the decedent's separate property estate is valued at less than \$500,000 and he gives his spouse up to, but not beyond, \$250,000; and
- (b) where the decedent's separate property estate is valued at more than \$500,000 and he gives his spouse not more than 50% of his separate property.

The wash out will also occur in some cases where the decedent gives his spouse more than 50% of his adjusted gross estate, but identification of those cases will depend upon case-by-case analysis for the wash out will not occur in all such cases.

More importantly, to secure the wash out and avoid either overqualifying or underqualifying the marital gift, the donor spouse should use a formula marital deduction clause in his will. See notes 432-37 *infra* and accompanying text.

May it be suggested that with the advent of adjusted taxable gifts, I.R.C. § 2001(b), there will be some cases in which the Commissioner will have little revenue incentive to assert the *Castleberry* principle to pull back interspousal transfers of community property. Gifts made after Dec. 31, 1976, will be *taken into consideration* as adjusted taxable gifts in computing the donor's federal estate tax liability. If *Castleberry* applies, post-'76 gifts *will be included* in the donor's gross estate for federal estate tax purposes. The only difference in treatment is that if the gift is taken into consideration as an adjusted taxable gift, (1) it will be assigned its fair market value on the date of the gift, and (2) the \$3,000 per donee per annum exclusion, *id.* § 2503(b), will not be taken into consideration as an adjusted taxable gift. On the other hand, if § 2036(a) applies to the transfer, the transferred property will be included in the donor's gross estate at its fair market value at the date of his death, *id.* § 2031(a), or on the alternate valuation date, *id.* § 2032(a), and any claim at the time of the gift to the \$3,000 exclusion will be ignored and the entire value of the transferred property—at the estate tax valuation date—will be included in the donor's gross estate. If the transferred property has experienced substantial appreciation, the tax revenue produced by recapture on retained life estate grounds under § 2036(a) would be greater than if the transferred property is recaptured as an adjusted taxable gift under § 2001(b). However, if the transferred property has depreciated since the date of the gift it would be to the Commissioner's advantage to avoid recapture on § 2036(a) grounds inasmuch as recapture as an adjusted taxable gift will produce more tax. It is also doubtful that the Commissioner would attempt recapture under § 2036(a) for the sole purpose of disallowing the \$3,000 exclusion. Given these considerations, perhaps the Commissioner's pull back power under *Castleberry* will be infrequently exercised.

Furthermore, where the donee spouse dies first, divorces the donor, or moves to a separate

separate property, whether *Castleberry* and its progeny are upheld on appeal is totally irrelevant for purposes of the bottom line. For such cases, *Castleberry* and its progeny hold only academic interest.

IX. AVOIDING CASTLEBERRY, WYLY, AND MCKEE

Under such circumstances, how can interspousal transfers be structured so as to avoid *Castleberry*-like consequences? Unfortunately, the answer is not very appealing. Unless *Castleberry* and its progeny are reversed by the Fifth Circuit, interspousal transfers will have to be made to a trustee under an irrevocable trust for the benefit of the donee spouse. Moreover, to assure avoidance of the *Wyly* principle, distributions from the trust must be committed to the discretion of the trustee. Probably, the trustee's exercise of discretion could be subjected to a standard without running afoul of *Wyly*.⁴⁰¹

For estate tax purposes, transfers to an irrevocable trust will not be included in the transferor's gross estate unless made within three years of

property jurisdiction, the transferred property will not be included in the donor's gross estate under § 2036(a). However, where the donee spouse merely dissipates the transferred property or exchanges it for cash or other property, *Estate of McKee v. Commissioner*, 37 T.C.M. (CCH) Dec. 35,049 (1978), would be authority to include the transferred property in the donor's gross estate. See note 96 *supra*.

401. See notes 211-13 *supra* and accompanying text. Note, however, that when distributions are subject to a standard, the trustee's discretion is clearly more limited than it would be if distributions were solely discretionary with the trustee. Accordingly, the beneficiary will have a legally enforceable claim against a trustee whose discretion is subject to a standard. Does that mean that the trust is more like a mandatory pay trust than a discretionary pay trust? And if it is more like a mandatory pay trust, is it important to earmark all distributed trust income as the separate property of the trust beneficiary? See notes 310-15 *supra* and accompanying text.

Suppose the settlor transfers property to an irrevocable trust that provides that the trustee will distribute income and principal as needed for his spouse's maintenance, care, and support. In such a case apparently nothing will be included in the settlor's gross estate unless collusion can be shown between the trustee and the settlor. See *Commissioner v. Estate of Douglass*, 143 F.2d 961 (3d Cir. 1944); *Estate of Green v. Commissioner*, 64 T.C. 1049 (1975), *acq.* 1976-2 C.B. 2; *Estate of Mitchell v. Commissioner*, 55 T.C. 576 (1970), *acq.* 1971-2 C.B. 3.

Estate of Mitchell held that an irrevocable trust created by decedent was not included in his gross estate even though the trustee, the decedent's son, had discretion to pay income and principal for the decedent's wife's support. The court said the trustee was not controlled by the decedent and under Connecticut law neither the decedent nor his wife could compel distribution since the trust was not set up to discharge the decedent's obligation to support his wife.

In the earlier case, *Estate of Douglass*, the court held that property transferred by a decedent during his lifetime to trustees, not including decedent, with discretion to apply income to maintenance, education, and support of his minor child was not includable in the decedent's gross estate even though the income was to be used to discharge his legal obligation of support. Treas. Reg. § 20.2036-1(b)(2) (1960) would seem to command a different result. See *Estate of Chrysler*, 44 T.C. 55, 60-62 (1965), *rev'd with respect to other issues*, 361 F.2d 508 (2d Cir. 1966).

But *Estate of Green* held that the entire date of death value of a trust was includable in the decedent's gross estate under § 2036 when the irrevocable trust had been created by the decedent for her children. The trustee had discretion to pay the decedent a maximum of \$25,000 yearly for her "health, welfare, and happiness," but the trustee orally agreed to distribute \$6,000 per quarter to decedent even though that exceeded the income generated by the trust.

death.⁴⁰² Such transfers, however, will be subject to the federal gift tax,⁴⁰³ and the \$3,000 per donee per annum exclusion⁴⁰⁴ will not be available to offset the gift because the transfer in trust will be deemed a gift of a future interest.⁴⁰⁵ The trust income will be taxed to the trust except to the extent of amounts distributed to the beneficiary.⁴⁰⁶ In that case, the amounts distributed will be deductible by the trust⁴⁰⁷ to the extent of the trust's distributable net income,⁴⁰⁸ and, to the same extent, the distributions will constitute taxable income to the beneficiary.⁴⁰⁹

To the extent that the trust accumulates income it will be subject to the throwback rules.⁴¹⁰ Of course, the accumulation distributions have some appeal in that distributions in kind will receive a step-up in basis to the extent such distributions do not exceed distributable net income and undistributed net income.⁴¹¹

The accumulation throwback rules can be avoided by a mandatory pay trust, but at the cost of the loss of the opportunity to distribute appreciated property and thereby step up the basis of that property.⁴¹² In addition, the donor spouse would have to declare expressly that the trust income is separate property to avoid the application of the *Wylly* principle.⁴¹³

Finally, is it possible to avoid *Castleberry* by having the donor spouse declare at the time of the interspousal transfer that the income produced from the transferred property shall be separate and not community property? Dean McKnight has pointed out that "[t]he Supreme Court of Texas has . . . stated on three occasions that the settlor of a trust or the donor of other *inter vivos* gifts may provide that the future income from the property shall be the separate property of the donee."⁴¹⁴ While Dean McKnight is correct in his statement of Texas law, it would seem that in light of *Arnold v. Leonard* the proposition may only be valid when the transfer is in trust. When the transfer is in fee simple to the donee, the gift is of the underlying property and it seems clear that in such a case the gift is of the tree and not the fruit.

402. See I.R.C. § 2035.

403. See Treas. Reg. § 25.2511-1 (1972).

404. I.R.C. § 2503; see Treas. Reg. § 25.2511-2(b) (1973); *Higgins v. Commissioner*, 129 F.2d 237, 242 (1st Cir.), cert. denied, 317 U.S. 658 (1942); *Dwight W. Ellis, Jr.*, 51 T.C. 182 (1968), aff'd per curiam, 437 F.2d 442 (9th Cir. 1971); *Joseph Goldstein*, 37 T.C. 897 (1962).

405. See Treas. Reg. § 25.2503-3(a) (1954).

406. I.R.C. §§ 641, 661(a).

407. *Id.* § 661(a).

408. *Id.* § 643(a).

409. *Id.* § 662(a).

410. *Id.* §§ 665-667.

411. See *Ferguson & Campfield, Post '76 Income Tax Planning for Trusts*, in 2 NOTRE DAME EST. PLAN. INST. 789, 829-51 (R. Campfield ed. 1978).

412. *Id.*

413. See text accompanying notes 310-15 *supra*.

414. McKnight, *Family Law, Annual Survey of Texas Law*, 30 Sw. L.J. 68, 79 (1976); see McKnight, *Family Law: Husband and Wife, Annual Survey of Texas Law*, 31 Sw. L.J. 105, 113-15 (1977).

X. STRATEGY FOR INTERSPOUSAL TRANSFERS

When all of the spouses' property is community, the only incentive for interspousal lifetime gifts is possible avoidance of creditors and to gamble that the donee spouse will outlive the donor spouse.⁴¹⁵ In the latter case, however, taxes at the donee spouse's death are likely to be greater than if the property were taxed one-half at donor spouse's death and the other half in donee spouse's estate. On the other hand, when some part or all of the spouse's property is separate, there is some incentive to equalize the respective estates of *H* and *W*⁴¹⁶ to avoid the risk that the spouse with the lesser estate will die first, resulting in the loss of the marital deduction and estate splitting at death.

A. Creditor Avoidance

While separate property of one spouse is not subject to the separate debts of the other spouse, separate property is subject to liability for community debts and the owner's separate debts.⁴¹⁷ Moreover, there is a presumption that all debts incurred after marriage are community debts. Accordingly, a spouse's separate property often cannot be insulated from the claims of creditors as most debts will be community debts.⁴¹⁸

Furthermore, although a judge "may determine, as he deems just and equitable," the order in which particular separate and community property will be subject to execution where both kinds of property are subject to liability,⁴¹⁹ no authority directs the court first to satisfy community debts from community property in marshalling the assets. In many Texas courts, however, this may be the equitable practice and separate property would be insulated to the extent that sufficient community assets were available to satisfy community debts. In any event, a spouse's separate property would not be subject to the separate debts of the other spouse.⁴²⁰ Clear and very strong evidence of separate debt status, however, is necessary to overcome the presumption of community debt.⁴²¹

415. With the integration of the federal estate and gift tax taking into consideration post-'76 gifts in determining federal estate tax liability, interspousal gifts seem even less attractive. The only tax incentive for gifts to a spouse after 1976 is to take advantage of the \$3,000 per donee per annum exclusion, I.R.C. § 2503(b), and to avoid having any appreciation experienced by the transferred property subsequent to the date of the transfer included in the transferor's gross estate. Compare I.R.C. § 2001(b) with *id.* § 2031(a). See note 399 *supra* and text accompanying note 446 *infra*.

416. See text accompanying note 446 *infra*.

417. See *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975); *Gleich v. Bongio*, 128 Tex. 606, 99 S.W.2d 881 (1937).

418. 527 S.W.2d at 171.

419. See TEX. FAM. CODE ANN. § 5.62 (Vernon 1975).

420. *Cockerham v. Cockerham*, 527 S.W.2d 162, 171 (Tex. 1975); *Pope Photo Records, Inc. v. Malone*, 539 S.W.2d 224, 227 (Tex. Civ. App.—Amarillo 1976, no writ); *Texas Commerce Bank Nat'l Ass'n v. Tripp*, 516 S.W.2d 256, 259 (Tex. Civ. App.—Fort Worth 1974, no writ); TEX. FAM. CODE ANN. § 5.61(a) (Vernon 1975).

421. *Cockerham v. Cockerham*, 527 S.W.2d 162, 171 (Tex. 1975); *Broussard v. Tian*, 156 Tex. 371, 373, 295 S.W.2d 405, 406 (1956).

B. Possible Estate and Gift Tax Consequences

Section 2010 provides a phased-in credit of up to \$47,000 for decedents dying in 1981 or thereafter against federal estate and gift tax liability. The exemption equivalent to the credit is \$175,625. Accordingly, tax planning is unnecessary for estates of less than \$175,625 after 1981 except to take advantage of the orphan's deduction provided in section 2057.

C. Saving the Second Tax

The key to tax planning for the married taxpayer is to cause each spouse to be taxed on only one-half of the property held by the family unit. If *H* and *W* have \$600,000 of community property and *H* gives his half of the community to *W*, *H*'s federal estate tax liability will be \$40,800,⁴²² but at *W*'s subsequent death, her estate tax liability will be \$145,800,⁴²³ assuming she does not remarry. This can be displayed as follows:

	<u><i>H</i>'s Death</u>	<u><i>W</i>'s Subsequent Death</u>
Gross Estate	<u>\$300,000</u>	<u>\$600,000</u>
Tax	87,800	192,800
Less: Unified Credit	<u>(47,000)</u>	<u>(47,000)</u>
Amount Due	<u>\$ 40,800</u>	<u>\$145,800</u>

On the other hand, if *H*'s will provided that his one-half of the community property should be placed in trust for *W* for life with remainder to her then living lineal descendants per stirpes, *H*'s estate tax would still be \$40,800, but the tax liability at *W*'s subsequent death would be reduced to \$40,800 since only one-half of the community property will be taxed to her.⁴²⁴ The computations are as follows:

<u><i>H</i>'s Death</u>		<u><i>W</i>'s Subsequent Death</u>	
Gross Estate	<u>\$300,000</u>	Gross Estate	<u>\$300,000</u>
Tax	87,800	Tax	87,800
Unified Credit	<u>(47,000)</u>	Unified Credit	<u>(47,000)</u>
Amount Due	<u>\$ 40,800</u>	Amount Due	<u>\$ 40,800</u>

If property is the separate property of one of the spouses, the key to optimum estate taxation is to equalize the spouses' estates, perhaps by lifetime gifts, particularly if they can be made tax free.⁴²⁵ If the separate property is divided equally between the spouses, each spouse can then direct his fifty percent of the property to a by-pass trust for the benefit of his spouse for life and the tax consequences will be the same as those indicated in the preceding example as to community property.

422. I.R.C. § 2001(c).

423. For reasons of convenience, the author will (a) assume zero administration expenses in all examples, (b) ignore all state inheritance taxes, (c) ignore any possible credit for prior transfers, I.R.C. § 2013, and (d) assume that a rich uncle paid the federal estate tax on the death of the first spouse to avoid depleting the estate of the surviving spouse.

424. I.R.C. § 2033.

425. See text accompanying notes 438-41 *infra*.

In cases in which the client is not inclined to equalize his property with his spouse by a program of lifetime gifts, the marital deduction becomes the key to his tax planning. Each decedent survived by a spouse is entitled to the marital deduction⁴²⁶ in computing his taxable estate. The deduction is equal to the lesser of:

- (1) the greater of \$250,000 and one-half of *H*'s adjusted gross estate; and
- (2) the value of the property actually passing from *H* to *W*.

Thus, in estates of less than \$500,000 the maximum marital deduction is always \$250,000. In estates of more than \$500,000 the maximum marital deduction is equal to one-half the decedent's adjusted gross estate.

Until the Tax Reform Act of 1976, the marital deduction was only available as to separate property. Now the estate tax marital deduction, but not the gift tax marital deduction, is applicable to community property in a very limited sense as described below. Assume an estate consisting of \$300,000 of separate property and \$300,000 of community property. Assume further that the decedent's debts, administration expenses, and losses (sections 2053 and 2054) total \$45,000.

Separate Property	\$300,000
1/2 Community	<u>150,000</u>
Gross Estate	450,000
Less: Debts, etc.	<u>(45,000)</u>
Marital Deduction	<u>(135,000)</u>
Taxable Estate	<u>\$270,000</u>

The marital deduction reflected in this hypothetical is the maximum marital deduction available on these facts. Section 2056(c)(1) provides that the maximum marital deduction is the greater of (1) \$250,000, reduced by the gift tax marital deduction adjustment provided in section 2056(c)(1)(B), and further reduced by the community property adjustment provided in section 2056(c)(1)(C); and (2) fifty percent of the decedent's adjusted gross estate, reduced by the gift tax marital deduction adjustment provided in section 2056(c)(1)(B). The computations, which assume no lifetime gifts were made,⁴²⁷ can be displayed as follows:

(1) Computation of Adjusted Gross Estate

Gross Estate	\$450,000
Less: Comm. Prop. [§ 2056(c)(2)(B)(1)(ii), (iii)]	(150,000)
Portion of Debts, etc. Allocable to Separate Prop. [§ 2056(c)(2)(B)(iv)]:	
$\frac{\$300,000}{450,000} \times 45,000$	(30,000)
Adjusted Gross Estate	<u>\$270,000</u>
Fifty percent of Adjusted Gross Estate	<u>\$135,000</u>

426. I.R.C. § 2056(c).

427. For further explanation and an illustration of the gift tax marital deduction adjustment, see text accompanying note 441 *infra*.

(2) Community Property Adjustment to
\$250,000 Minimum Marital Deduction

Minimum Marital Deduction			\$250,000
1/2 Community Property		\$150,000	
Less: Debts, etc.:	\$45,000		
$\frac{\$300,000}{450,000} \times \$45,000 =$	<u>(30,000)</u>	<u>(15,000)</u>	<u>135,000</u>
Community Property Marital Deduction			<u>\$115,000</u>

Obviously, a marital deduction predicated on one-half the decedent's adjusted gross estate of \$270,000 will be greater than the \$250,000 marital deduction after it is adjusted as indicated above for the community property in the decedent's estate.

Assume *H* has \$600,000 of separate property, no community property, and *W* has no separate property. *H*'s will provides "all to *W*." Assuming that *W* does not remarry, the tax consequences are:

	<u><i>H</i>'s Death</u>	<u><i>W</i>'s Subsequent Death</u>
Gross Estate	\$600,000	\$600,000
Less: Marital Deduction	<u>(300,000)</u>	<u>—0—</u>
Taxable Estate	<u>\$300,000</u>	<u>\$600,000</u>
Tax	\$ 87,800	\$192,800
Unified Credit	<u>(47,000)</u>	<u>(47,000)</u>
Amount Due	<u>\$ 40,800</u>	<u>\$145,800</u>

While the marital deduction reduces the tax at *H*'s death, it does nothing to reduce the tax at *W*'s subsequent death. Accordingly, marital deduction planning is generally expressed in these terms: the spouse with the larger estate should provide in his will for his surviving spouse to receive the maximum marital deduction allowed his estate for federal estate tax purposes with the balance going into a so-called "by-pass trust" for the spouse. Generally, the by-pass trust will provide that the surviving spouse is to receive all the income for life from the trust with the remainder to the decedent's then living lineal descendants per stirpes.⁴²⁸

Assume that *H* has \$600,000 of separate property, no community property, and that *W* has no separate property. With the will described above, the tax consequences are:

	<u><i>H</i> Dies First</u>	<u><i>W</i>'s Subsequent Death</u>
Gross Estate	\$600,000	\$300,000
Less: Marital Deduction	<u>\$300,000</u>	<u>—0—</u>
Taxable Estate	<u>\$300,000</u>	<u>\$300,000</u>
Tax	\$ 87,800	\$ 87,800
Less: Unified Credit	<u>(47,000)</u>	<u>(47,000)</u>
Amount Due	<u>\$ 40,800</u>	<u>\$ 40,800</u>

428. In this case no part of the by-pass trust property will be included in the gross estate

Marital deduction planning with a by-pass trust feature, however, is ineffective if the spouse with the lesser estate dies first. To illustrate:

<u>W Dies First</u>		<u>H's Subsequent Death</u>	
Gross Estate	—0—	Gross Estate	\$600,000
		Less: Marital Deduction	<u>—0—</u>
		Taxable Estate	<u>\$600,000</u>
		Tax	\$192,800
		Less: Unified Credit	<u>(47,000)</u>
		Amount Due	<u>\$145,800</u>

Because the order of spouses' deaths cannot be predicted, at a minimum it is incumbent upon the taxpayer with separate property who is relying on the marital deduction, and his dying first, to provide in his will a presumption that he will be deemed to be survived by his spouse if there is any uncertainty about the order of death.⁴²⁹ Otherwise the Texas Uniform Simultaneous Death Act⁴³⁰ will deem his spouse to have predeceased him and the marital deduction will be lost.

Where the decedent's estate includes both separate property and community property, the taxpayer's will should provide that *W* take an amount equal to the maximum marital deduction and the balance of the decedent's separate property and his one-half of the community should be directed to a by-pass trust for the benefit of *W* for life with remainder to his then living lineal descendants per stirpes.

Importantly, a taxpayer can avoid the necessity of characterizing property as separate property or community property for federal estate tax purposes by using a formula marital deduction clause.⁴³¹ Such clauses are either:

- (1) a pecuniary formula that usually begins: "I give to my spouse *an amount* equal to the maximum marital deduction"; or
- (2) a fractional formula that usually begins: "I give to my spouse *that fraction* of my estate that is equal to the maximum marital deduction."

of the surviving spouse. The federal estate tax only applies to transfers, I.R.C. § 2001, and, in this case, the surviving spouse is not a transferor of the trust property. I.R.C. § 2041 causes some nontransferors to be treated as transferors, but a properly drafted by-pass trust would not give the surviving spouse any § 2041 powers.

429. See Treas. Reg. § 20.2056(e)-2(e) (1958).

430. TEX. PROB. CODE ANN. § 47 (Vernon 1956 & Supp. 1978-79).

431. See Johanson, *Community Property: The Migrant Client*, 252 TAX MNGM'T (BNA) A-20 to -21 (1971).

The Internal Revenue Service lacks interest in classifying property as separate or community whenever the formula clause is used since only one-half the property will be in *H*'s estate whether his property is characterized as separate or community. Choosing between the clauses is a complicated process. In the most general of terms, these points are noteworthy:⁴³²

- (1) For purposes of preparing the federal estate tax return, it makes no difference whether you use a fractional formula or a pecuniary formula.
- (2) The issues relative to the respective clauses usually arise at the time for distribution of the estate.
 - (a) Use of a pecuniary formula means that the surviving spouse is entitled to a dollar amount. If the estate does not have adequate amounts of cash in hand, it means the property must be sold or distributed in kind to *W*. If appreciated property is sold, the estate will be forced to recognize the gain on the property as taxable income (eligible for capital gain treatment).⁴³³ If the property is distributed in kind, it means that not only must the property be valued at the time of distribution⁴³⁴ (a second valuation), but also any appreciation in the property will be recognized as taxable income (capital gain) by the estate.⁴³⁵
 - (b) Use of the fractional formula clause means that the surviving spouse is entitled to a fraction of every asset in the estate (or the fund against which the fraction is applied).⁴³⁶ This is allegedly a disadvantage, but perhaps it can be overcome by providing for a non pro rata distribution.⁴³⁷ Fractionalization can also be avoided by defining the fund against which the fraction is applied so as to exclude the property that should not be fractionalized.

D. *Relationship of Lifetime and Death-time Marital Deduction*

The tax consequences of interspousal transfers of separate property have been complicated by the changes introduced by the 1976 Tax Reform Act, and the Revenue Act of 1978 provided only modest clarification. The most important factor is the critical interrelationship among the \$3,000 per donee per annum exclusion, the gift tax marital deduction, and the estate tax marital deduction.

Prior to the Tax Reform Act of 1976, the gift tax marital deduction was equal to fifty percent of the value of the property transferred to the spouse.

432. See generally Berall, *Marital Deduction Planning*, in 2 NOTRE DAME EST. PLAN. INST. 183 (R. Campfield ed. 1978).

433. See I.R.C. § 1040(a).

434. See Edwards, *Marital Deduction Formulae—A Planner's Guide*, 1967 DUKE L.J. 254, 260.

435. See I.R.C. § 1040(a).

436. See Edwards, *supra* note 434, at 264.

437. See Rev. Rul. 69-486, 1969-2 C.B. 159; Campfield, *Carry-Over Basis: Enormous Implications*, 41 TEX. B.J. 689 (1978).

After the 1976 changes, the gift tax marital deduction is unlimited as to the first \$100,000 of transfers to the spouse, zero as to the second \$100,000, and fifty percent of the value of the property transferred as to gifts in excess of \$200,000.

The taxpayer contemplating a transfer to his spouse, perhaps to equalize estates, faces this further question: is the \$3,000 per donee per annum exclusion subtracted before the marital deduction is taken? It did not matter under prior law unless the amount of the gift was less than \$6,000, in which case the Internal Revenue Service maintained that the exclusion was subtracted first. Treasury Regulation section 25.2524-1, example 2 provides:

The only gifts made by a donor to his spouse during calendar year 1969 were a gift of \$2,400 in May and a gift of \$3,000 in August. The first \$3,000 of such gifts is excluded under the provisions of section 2503(b) in determining the "total amount of gifts" made during the calendar year. The marital deduction for 1969 of \$2,700 (one-half of \$2,400 plus one-half of \$3,000) otherwise allowable is limited by section 2524 to \$2,400. The amount of taxable gifts is zero (\$5,400-\$3,000 (annual exclusion) - \$2,400 (marital deduction)).

Under the new law, the gift tax minimum marital deduction is affected by whether the exclusion is subtracted before or after the marital deduction is taken. Thus, the question is whether a gift of \$100,000 to a spouse provides a marital deduction of \$100,000 or only \$97,000. The answer is that the \$3,000 exclusion is subtracted first, and the marital deduction is only \$97,000. How do we know this? For two reasons. First, because Treasury Regulation section 25.2524-1, example 2 tells us so! Secondly, because section 2524 limits the gift tax marital deduction to "the amount of gifts against which such deductions are applied."

Could the Treasury have been wrong in the position it took in Treasury Regulation section 25.2524-1, example 2? It is not likely since the Treasury adhered to the position with full knowledge of the hardship imposed on some taxpayers in the years following 1971 by the advent of the quarterly gift tax filing requirement.⁴³⁸ The hardship is illustrated as follows. Assume *H* gives *W* \$4,000 in the first quarter of 1975. His gift tax computation would look like this:

Transfer to <i>W</i>	\$4,000
Less: Exclusion	<u>3,000</u>
	\$1,000
Less: Marital Deduction as Limited by § 2524	<u>(1,000)</u>
Taxable Gift	<u>\$ -0-</u>

In the second quarter of 1975 assume *H* gives \$5,000 to *W*. His gift tax computation would look like this:

Transfer to <i>W</i>	\$5,000
Less: Exclusion	-0-

438. *Id.* § 6019(a).

Marital Deduction	(2,500)
Taxable Gift	<u>\$2,500</u>
Prior to 1971 and the introduction of the quarterly filing requirements for gift tax returns, <i>H</i> 's taxable gift for 1975 would be as follows assuming he made no other gifts during 1975:	
Transfer to <i>W</i>	
1st Quarter	\$4,000
2nd Quarter	5,000
Less: Exclusion	<u>(3,000)</u>
	\$6,000
Less: Marital Deduction	<u>(4,500)</u>
Taxable Gift	<u>\$1,500</u>

Thus, there was a difference of \$1,000 in the amount of gifts *H* was deemed to have made in 1975 simply because of the quarterly filing requirement as it integrated with the substantive provisions of the statute.

The Tax Reform Act seems to have changed the above result by indirection by providing that quarterly returns are not required until the total gifts for the current quarter and all prior quarters exceed \$25,000.⁴³⁹ In all other cases, the return will be due on the 15th day of the second month after the close of the calendar quarter.⁴⁴⁰ In the case discussed above, then, no gift tax returns would be due until February 15th of the year following the one in which the gifts were made. Moreover, *H* will be deemed to have made only \$1,500 in taxable gifts in 1974 as is reflected in the last example appearing above, rather than \$2,500. How did the change beneficial to the taxpayer come about? It is the direct result of the change in the filing requirements. Thus, a substantive change was brought about by a procedural change.

In addition, those contemplating interspousal transfers must also recognize that a lifetime transfer to one's spouse of less than \$200,000 against which the gift tax marital deduction is claimed will reduce the decedent's estate tax marital deduction.⁴⁴¹ There is, however, no reduction in the estate tax marital deduction if the taxpayer makes gifts of more than \$200,000 to his spouse. This rule can be expressed in these terms: The estate tax marital deduction shall be reduced by an amount equal to the difference between fifty percent of the total lifetime gifts and the gift tax marital deduction claimed. Applying this rule, for example, to the \$250,000 estate tax minimum marital deduction will result in a maximum reduction of \$48,500, to a minimum of \$201,500, following a single marital gift of \$103,000. This conclusion is demonstrated in the following table. Note the dependence of the conclusions in the table on the limiting effect

439. *Id.* § 6075(b)(2).

440. *Id.* § 6075(b)(1).

441. *Id.* § 2056(c)(1)(B). The reduction in the decedent's estate tax marital deduction will occur only if the gift to his spouse was required to be reported for federal gift tax purposes and the gift was not made within three years of the donor's death. See Revenue Act of 1978, Pub. L. No. 95-600, § 702(g)(1), (2), 92 Stat. 2931.

SCHEDULE A
ILLUSTRATION OF MAXIMUM REDUCTION IN ESTATE TAX MINIMUM MARITAL DEDUCTION BY LIFETIME GIFTS

	\$101,000 transfer to W	\$100,000 transfer to W	\$102,000 transfer to W	\$103,000 transfer to W	\$104,000 transfer to W	\$190,000 transfer to W
Assume: \$101,000 Transfer to Wife						
Estate Tax Minimum Marital Deduction	\$250,000	\$250,000	\$250,000	\$250,000	\$250,000	\$250,000
Lifetime Transfer	101,000	100,000	102,000	103,000	104,000	190,000
Less: Exclusion	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
Gift Tax Marital Deduction	(98,000)	(97,000)	(99,000)	(100,000)	(100,000)	(100,000)
Taxable Gift	—	—	—	—	1,000	87,000
Gift Tax Marital Deduction claimed	98,000	97,000	99,000	100,000	100,000	100,000
Less: 50% of value of gift	(50,500)	(50,000)	(51,000)	(51,500)	(52,000)	(95,000)
Reduction in Estate Tax Marital Deduction	47,500	47,000	48,000	48,500	48,000	5,000
Adjusted Estate Tax Minimum Marital Deduction	\$202,500	\$203,000	\$202,000	\$201,500	\$202,000	\$245,000

of old section 2524 on the new marital deduction as was more fully described earlier.

E. *Planning Considerations*

For effective estate planning two conclusions may be made:

- (1) Bromide I: The new \$250,000 minimum marital deduction probably should never be utilized. As can be seen from Schedule B appearing at the end of this subpart, there are no tax advantages to its utilization, and serious tax disadvantages arise at the death of the second spouse. At best, it should be utilized only to the extent of taking advantage of the exemption equivalent to the unified credit available to the surviving spouse. Thus, in the case in which *H* has a \$300,000 estate and *W*'s estate is zero, *H* should utilize the \$250,000 alternate maximum estate tax marital deduction by giving *W* \$175,625.
- (2) Bromide II: Effective utilization of the new unified credit is essential to responsible estate planning. It is imperative that taxpayers avoid underutilization of the exemption equivalent (\$175,625) to the Unified Credit (\$47,000).

The Tax Reform Act of 1976 introduced an extraordinary degree of complexity into the planning for the smaller estate (those under \$500,000) under the guise of taxpayer benefit. Those who take advantage of the alleged benefit at the death of the first spouse—namely, the \$250,000 minimum marital deduction—will often pay a heavy price at the death of the second spouse. Schedule B at the end of this subpart compares the cost of dying under the different assumptions discussed in the balance of this subpart.

There are two kinds of estate planning clients. Some want property management as well as tax planning for the property passing to their loved ones. Others want only tax planning and would prefer to avoid the use of trusts. Clients falling into the latter group need only a nonmarital or by-pass trust and it is almost dishonest in such cases to routinely direct the marital share into a life estate, power of appointment trust.⁴⁴² The client who also wants property management to accompany his tax planning, on the other hand, should have the benefit of both a by-pass trust and a marital trust, probably of the life estate, power of appointment variety.

In addition, when the client's estate is relatively modest, but large enough to warrant tax planning, the formula for allocation of his assets between the marital and nonmarital share should be determined by whether the client wants tax planning only or tax planning coupled with professional management of the property passing to his loved ones. For example, if the client has an estate of \$250,000 of separate property, \$175,625 should be directed to the nonmarital or by-pass trust if the client wants both property management and tax planning. If he wants tax planning only, however, only \$75,000 should be directed to the nonmarital or by-pass trust with the balance, \$175,000, directed to the surviving spouse in fee simple to be taxed to her at her death to the extent not consumed or

442. See I.R.C. § 2056(b)(5).

SCHEDULE B

COMPARISON OF WILLS WITH NO TAX PLANNING WITH THOSE WITH SOLELY TAX PLANNING AND THOSE WITH BOTH TAX PLANNING AND PROPERTY MANAGEMENT FEATURE

Assumption: *H* has estates in the indicated amounts. *H* predeceases *W*. *H* has made no lifetime taxable transfers.

	Tax Consequences at <i>H</i> 's Death				
	No Tax Planning	Solely Tax Planning	No Tax Planning	Solely Tax Planning	Tax Planning & Prop. Mgmt.
Adjusted Gross Estate	\$200,000	\$200,000	\$250,000	\$250,000	\$250,000
Less: Marital Deduction	(200,000)	(175,000)	(250,000)	(175,000)	(75,000)
Taxable Estate	<u>\$ —</u>	<u>\$ 25,000</u>	<u>\$ —</u>	<u>\$ 75,000</u>	<u>\$ 175,000</u>
Tentative Tax	\$ 47,000	\$ 4,900	\$ 16,900	\$ 16,900	\$ 47,000
Unified Credit	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)
Tax Liability	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Tax Consequences at <i>W</i> 's Subsequent Death					
Taxable Estate	\$200,000	\$175,000	\$250,000	\$175,000	\$ 75,000
Tentative Tax	\$ 54,800	\$ 46,800	\$ 70,800	\$ 46,800	\$ 16,900
Unified Credit	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)
Tax Liability	<u>\$ 7,800</u>	<u>\$ —</u>	<u>\$ 23,800</u>	<u>\$ —</u>	<u>\$ —</u>

Tax Consequences at H's Death

	No Tax Planning	Tax Planning & Prop. Mgmt.	Solely Tax Planning	No Tax Planning	Tax Planning & Prop. Mgmt.	Solely Tax Planning	No Tax Planning	Solely Tax Planning	Both Solely Tax Planning & Tax Planning Plus Prop. Mgmt.
Adjusted Gross Estate	\$ 300,000	\$ 300,000	\$ 300,000	\$ 400,000	\$ 400,000	\$ 400,000	\$ 400,000	\$ 400,000	\$ 500,000
Less: Marital Deduction	(250,000)	(125,000)	(175,000)	(250,000)	(225,000)	(225,000)	(250,000)	(225,000)	(250,000)
Taxable Estate	\$ 50,000	\$ 175,000	\$ 125,000	\$ 150,000	\$ 175,000	\$ 175,000	\$ 150,000	\$ 175,000	\$ 250,000
Tentative Tax	\$ 10,600	\$ 46,800	\$ 31,300	\$ 38,800	\$ 47,000	\$ 47,000	\$ 47,000	\$ 47,000	\$ 70,800
Unified Credit	(47,000)	(47,000)	(47,000)	47,000	(47,000)	(47,000)	47,000	(47,000)	(47,000)
Tax Liability	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 23,800

Tax Consequences at H's Subsequent Death

Taxable Estate	\$ 300,000	\$ 125,000	\$ 175,000	\$ 400,000	\$ 225,000	\$ 225,000	\$ 500,000	\$ 250,000
Tentative Tax	\$ 87,800	\$ 31,300	\$ 46,800	\$ 121,800	\$ 62,800	\$ 62,800	\$ 155,800	\$ 70,800
Unified Credit	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)
Tax Liability	\$ 40,800	\$ —	\$ —	\$ 74,800	\$ 15,800	\$ 15,800	\$ 108,800	\$ 23,800

disposed of in the meantime.⁴⁴³

Drafting such dispositive instruments is not easy. Yet, clients who do not want the bulk of their property tied up in trust should not be thrust into that kind of arrangement when it is unnecessary.

F. *Contrast the Old with the New: Some Examples*

Under pre-1977 law, the maximum tax free transfer to a spouse was \$186,000, determined as follows:

Lifetime Transfer		\$ 66,000
Less: Exclusion	\$ 3,000	
Marital Deduction	33,000	
Exemption ⁴⁴⁴	<u>30,000</u>	(66,000)
Taxable Gifts		<u><u>—0—</u></u>
Deathtime Transfers		\$120,000
Less: Exemption ⁴⁴⁵	60,000	
Marital Deduction	<u>60,000</u>	<u>(120,000)</u>
Taxable Estate		<u><u>—0—</u></u>

After 1980, a taxpayer willing to make a lifetime transfer of \$354,250 of separate property to his spouse can transfer an additional \$250,000 of separate property to her tax free at death, for a total of \$604,250 tax free transfers to his spouse. The computation is as follows:

Lifetime Transfer	\$354,250
Less: Exclusion	(3,000)
Marital Deduction	<u>(175,625)</u>
Taxable Gift	<u>\$175,625</u>
Tax	\$ 47,000
Unified Credit	<u>(47,000)</u>
Tax	<u>—0—</u>
Death-time Transfer	\$250,000
Less: Marital Deduction	<u>(250,000)</u>
Taxable Estate	<u>—0—</u>
Adjusted Taxable Gifts	<u>\$175,625</u>
	<u>\$175,625</u>
Tentative Tax	\$ 47,000
Less: Unified Credit	<u>(47,000)</u>
Tax Liability	<u><u>—0—</u></u>

G. *Special Incentive to Make Lifetime Gifts to One's Spouse: Trap or Windfall?*

After 1980, the combination of the unlimited \$250,000 estate tax marital deduction and the \$47,000 unified credit (\$175,625 exemption equivalent)

443. This assumes that the surviving spouse has no property of her own.

444. I.R.C. § 2521 (repealed for gifts made after Dec. 31, 1976 by Tax Reform Act of 1976, P.L. 94-455, § 2001(b)(3), 90 Stat. 1849).

445. I.R.C. § 2052 (repealed for estates of decedents dying after Dec. 31, 1976, by Tax Reform Act of 1976, P.L. 94-455, § 2001(a)(4), 90 Stat. 1848).

will allow a taxpayer to transfer \$425,652 of separate property tax free to his spouse at death. Again, as was discussed under Planning Considerations above, and demonstrated in Schedule B, which appeared at the end of that subpart, a taxpayer would never want to do this because of the onerous tax liability that would result at *W*'s subsequent death.

However, a taxpayer who is willing to make a lifetime gift of \$103,000 to his spouse can actually increase the amount of separate property passing to his spouse tax free to \$480,125 and, at the same time postpone payment of all transfer taxes (estate and gift) until his wife's subsequent death! This argues well for making lifetime transfers to the surviving spouse. In the meantime, of course, there is the old adage: A tax postponed is a tax saved! This example assumes, of course, that *H* uses a by-pass or nonmarital trust to shelter a portion of his property from the second tax at *W*'s subsequent death.

<u>At <i>H</i>'s Death</u>	
Lifetime Transfer	\$103,000
Less: Exemption	(3,000)
Marital Deduction	<u>(100,000)</u>
Taxable Gifts	<u>—0—</u>
Death-time Transfer	\$377,125
Less: Marital Deduction	<u>(201,500)</u>
Taxable Estate	\$175,625
Adjusted Taxable Gifts	<u>—0—</u>
Total	<u>\$175,625</u>
Tentative Tax	\$ 47,000
Less: Unified Credit	<u>(47,000)</u>
Tax Liability	<u>—0—</u>

Caveat. Note in this example that the maximum unlimited estate tax marital deduction has been reduced to \$201,500 because the taxpayer used the \$100,000 unlimited gift tax marital deduction.⁴⁴⁶

<u>At <i>W</i>'s Subsequent Death</u>	
<i>W</i> 's Taxable Estate:	
<i>H</i> 's Lifetime Gift	\$103,000
<i>H</i> 's Death-time Gift	201,500
	<u>\$304,500</u>
Adjusted Taxable Gifts	<u>—0—</u>
Taxable Estate	<u>\$304,500</u>
Tentative Tax	\$ 89,330
Less: Unified Credit	<u>(47,000)</u>
Tax Liability	<u>\$ 42,330</u>
<u>Total Transfer Taxes</u>	
At <i>H</i> 's Death	—0—
At <i>W</i> 's Death	\$ 42,330
Total	<u>\$ 42,330</u>

446. I.R.C. § 2056(c)(1)(B).

The taxpayer could gradually restore the full estate tax marital deduction by making gifts of \$3,001 to his spouse annually without gift tax cost. Or, in lieu of making a lifetime gift of \$103,000 to his spouse, he could make annual gifts of \$6,000 to his spouse without gift tax cost, without reducing the maximum estate tax marital deduction, and without creating any adjusted taxable gifts.

If *H* declines to make lifetime transfers and holds his property until death-time, the computation can be displayed as follows:

<u>At <i>H</i>'s Death</u>		
<i>H</i> 's Gross Estate		\$480,125
Less: Marital Deduction		250,000
		<u>230,125</u>
Adjusted Taxable Gifts		<u>—0—</u>
		<u>\$230,125</u>
Tentative Tax		\$ 64,440
Less: Unified Credit		(47,000)
Tax Liability		<u>\$ 17,440</u>
<u>At <i>W</i>'s Subsequent Death</u>		
<i>W</i> 's Taxable Estate		\$250,000
Adjusted Taxable Gifts		<u>—0—</u>
		<u>\$250,000</u>
Tentative Tax		70,800
Less: Unified Credit		(47,000)
Tax Liability		<u>\$ 23,800</u>
<u>Total Transfer Tax</u>		
At <i>H</i> 's Death		\$ 17,440
At <i>W</i> 's Death		23,800
Total		<u>\$ 41,240</u>

As the illustration shows, it does not cost much more to make lifetime transfers than it does for the testator to hold his property until death. The

real incentive for the lifetime transfer is demonstrated by the final display showing the consequences of the spouse with the lesser estate dying first when compared to the tax consequences when the estates are equalized or the spouse with the larger estate dies first.

<u>W's Death</u>	—0—	<u>H's Subsequent Death</u>	
Gross estate		Gross Estate	<u>\$480,125</u>
		Tentative Tax	149,042
		Unified Credit	<u>(47,000)</u>
		Amount Due	<u>\$102,042</u>

Finally, the new three-year recapture rule of section 2035, which replaces the old contemplation of death rule, should not discourage a taxpayer from making a lifetime transfer of separate property to his spouse. Such a turn of events would simply cause inclusion of the lifetime transfer in the decedent's gross estate as if no transfer had been made.

XI. PRENUPTIAL AND POSTNUPTIAL AGREEMENTS

With the increasing frequency of second marriages, prenuptial agreements will become more common as prospective spouses attempt to preserve their respective property for the benefit of their offspring from prior unions. In addition, career minded prospective spouses might choose this device as a means of maintaining the integrity of their respective property interests. Furthermore, if Texas would allow self-executing agreements to partition community property, a person who transfers property to his spouse could stipulate that any income produced by the transferred property is the separate property of the transferee spouse and thus prevent the inclusion of a portion of the transferred property in the donor spouse's gross estate under the rationale of *Castleberry* and its progeny.

A. *Validity of Prenuptial Agreements in Other Jurisdictions*

Prenuptial agreements are apparently valid in all separate property jurisdictions and all community property jurisdictions other than Texas. Courts have commented that such agreements enjoy a favored place in the law and are to be encouraged as settling marital rights.⁴⁴⁷ Nonetheless,

447. See 2 A. LINDEY, SEPARATION AGREEMENTS AND ANTE-NUPTIAL CONTRACTS § 90, at 90-25 & 90-30 (rev. ed. 1978, May 1978 Supp.). Similarly, antenuptial and postnuptial agreements were enforceable under the Spanish system of community property. See W. DE FUNIAK & M. VAUGHN, *supra* note 224, § 135. It has been pointed out that Texas statutes, prior to the first Texas Constitution, declared that the community property "laws

there are literally hundreds of cases throughout the United States invalidating prenuptial agreements. These are often older cases, many of which involve surviving spouses who, because of education or experience, appear to have been taken advantage of by their spouse.

Such agreements, however, are sustained by the courts provided:

- (1) the old cases can be distinguished; and
- (2) the court can be convinced that:
 - (a) a disproportionate distribution of the decedent's property in favor of his spouse is not inherently evil (some courts recite that such agreements are favored by the law but then proceed to invalidate the agreement on grounds of inadequate provision for the surviving spouse);
 - (b) in fact, contemplation of such disproportionate distribution is the primary reason for such an agreement; and,
 - (c) the critical issue is whether the agreement is fairly made and whether both parties understood its terms.

To best insure that a prenuptial agreement will be upheld, each party should be represented by separate and independent counsel, and full disclosure of the net worth and incomes of each party should be made.⁴⁴⁸

B. *Validity of Prenuptial Agreements in Texas*

Williams v. Williams. In *Williams v. Williams*,⁴⁴⁹ a husband and wife executed a prenuptial agreement in which the wife agreed to relinquish all of her rights in the separate property of the husband, which included the homestead, the household furnishings, and the family car. The husband in turn agreed to relinquish all of his rights in the wife's separate property. The parties further agreed that "[a]ll income from the separate estate of each party, including dividends, interest, rents and salaries . . . shall remain the separate property of each party."⁴⁵⁰ The husband died four months later and the wife decided to exercise her homestead rights. The trial court held the agreement to be valid. The court of civil appeals reversed and held for the wife on the grounds that since the homestead right did not arise until the death of one of the spouses, the contract purporting to waive the wife's homestead rights was unenforceable because it attempted to waive a right not then in existence.

The Texas Supreme Court reversed the court of civil appeals and upheld

should operate only in lieu of voluntary premarital contracts." Note, *Antenuptial Agreements: Perspectives on the Texas Constitution and the Community Property System*, 56 TEXAS L. REV. 861, 863 (1978). The Texas Constitution did not alter this statute—it was not changed until 1967—but the failure to provide expressly in the constitution for prenuptial and postnuptial agreements that prospectively classify marital property allowed the courts to find such agreements incompatible with the constitution. See text accompanying notes 449-51 *infra*.

448. See, e.g., *In re Borton's Estate*, 393 P.2d 808 (Wyo. 1964).

449. 569 S.W.2d 867 (Tex. 1978) (citing *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961); *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925); *Gorman v. Gause*, 56 S.W.2d 855 (Tex. Comm'n App. 1933, judgment adopted); TEX. CONST. art. XVI, § 15; TEX. FAM. CODE ANN. § 5.01 (Vernon 1975)).

450. 569 S.W.2d at 869.

the agreement to the extent it barred Mrs. Williams from claiming her statutory rights as surviving spouse to the decedent's residence, automobile, and household furnishings, all of which were his separate property. However, the court went on to say that the agreement was void:

to the extent that income or other property acquired during marriage should be the separate property of the party who earned or whose property produced such income or acquisition. Such provisions were no more than a mere agreement between the parties to establish the character of the property prior to its acquisition during marriage in violation of both the Texas Constitution and the Family Code.⁴⁵¹

451. *Id.* at 870 (citations omitted).

Apparently, spouses may enter into prenuptial agreements whereby one spouse agrees to convey his portion of any community property produced during the marriage to the other spouse as her separate property and such contracts are enforceable in Texas. The court in *Gorman v. Gause*, 56 S.W.2d 855 (Tex. Comm'n App. 1933, judgment adopted), expressed this dictum by way of illustrating the function of art. 4612 of the Texas Revised Statutes of 1925, which was the basis of the dispute in *Gorman*. The parties had entered into a marriage agreement that provided that property acquired during marriage that would otherwise be community property will be separate. The heirs of the first spouse to die asserted the validity of the agreement and asked what utility art. 4612 had if not to sanction agreements such as their decedent entered into. Article 4612 provided, in pertinent part:

Parties intending to marry may enter into such stipulations as they may desire, provided they be not contrary to good morals or to some rule of law; and in no case shall they enter into an agreement, or make any renunciation, the object of which would be to alter the legal orders of descent, either with respect to themselves, in what concerns the inheritance of their children or posterity, which either may have by any other person, or in respect to their common children

56 S.W.2d at 857-58. The court held the agreement invalid on the ground of the *Arnold v. Leonard* rule of implied exclusion. See note 7 *supra*.

It is difficult to perceive the distinction made by the *Gorman* court between contracts in which the spouses anticipatorily agree that which would otherwise be community shall be separate, and those contracts in which the spouses have a legally binding obligation to convey community property, "when acquired," to the other spouse as her separate property. Nonetheless, the court said:

When property has been acquired and its status once fixed as separate or community property as defined by the laws of this state, the husband and wife are at liberty to make such disposition thereof as they please, or as they may have obligated themselves to do in an antenuptial agreement, provided only that the terms of such an agreement do not exceed the limitations specified in the statute authorizing the same.

56 S.W.2d at 858.

While the *Gorman* court based its decision on the prohibition in art. 4612 of "stipulations . . . contrary to good morals or to some rule of law," it is clear the court had to rest its ultimate conclusion on the constitutional definition of separate property in TEX. CONST. art. XVI, § 15, as the rule of law that barred the agreement. Thus, the substitution of TEX. FAM. CODE ANN. § 5.21 (Vernon 1975) for art. 4612 is not relevant to the foregoing analysis.

In the later case of *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961), the Texas Supreme Court continued to insist upon the same strict interpretation of the definition of separate property in TEX. CONST. art. XVI, § 15 as it articulated in *Arnold v. Leonard*, with the result being apparent frustration of the spouse's intent and an exaltation of form over substance. In *Hilley* the court held that in order for spouses to create a joint tenancy with right of survivorship relationship in community property, they must first partition the property as provided in the predecessor of TEX. PROB. CODE ANN. § 46 (Vernon Supp. 1978-79), and each spouse must then join in a conveyance to themselves as joint tenants with right of survivorship. The court said a joint tenancy with right of survivorship could not be created by the parties who simply register community property in their joint names with rights of survivorship and ignore the intermediate partition step.

This latter point was only in issue because Mrs. Williams claims that this portion of the agreement was void—a point with which the court agreed—and if one point of the agreement was void, the entire agreement was void. The court held that the agreement was severable and that the agreement's waiver of homestead rights was not affected by the fact that another portion of the agreement was void.

Arguably, the Texas Supreme Court's declaration voiding agreements to keep separate that property that would otherwise be community was reached without a full consideration of the issue and, therefore, in another case a different decision could be reached on this point. While such a change of positions is unlikely, the current view of the court appears to lack a policy basis. Of course, the easy retort is that the policy basis for the court's decision is article XVI, section 15 of the Texas Constitution, defining separate property, and the rule of implied exclusion of *Arnold v. Leonard*. It, nonetheless, seems rather anomalous to allow postnuptial agreements partitioning existing community property as the constitution has permitted since 1948, yet void agreements in which parties agree to classify property that would otherwise be community when it comes into being as separate property. Not anomalous, it is said, but required by the constitution! Perhaps the draftsmen of the constitutional change simply overlooked agreements to keep separate that which would otherwise be community. Amending the constitution is no easy task—nor should it be—and that may explain the failure to make further amendment. The legislature in section 5.41 of the Texas Family Code seems to have done all that it could in providing that persons "intending to marry" may "enter into a marital property agreement as they may desire." Of course, it remains unclear whether section 5.41 extends to postnuptial agreements. From the face of the statute, it would appear that the legislature did not contemplate postnuptial agreements in drafting section 5.41.

The outcome of the issue as to the validity of agreements to keep separate that property that would otherwise be community when it comes into existence is important to Texas domiciliaries, for as things presently stand, transfers from one Texas spouse to the other will be recaptured on the

One possible justification for the court's view in *Hilley* is that Texas is committed to the community property system as a matter of public policy, and to allow spouses to terminate ownership interests given them by law in community property by simply registering community property as joint tenants with right of survivorship may not be in the best interests of the spouses. Requiring partition first may serve to induce a reflective state of mind and discourage overreaching.

Finally, by way of comparison, apparently all of the other community property jurisdictions allow prenuptial and postnuptial contracts that purport to change the nature of marital property acquisitions. Even the Spanish community property law allowed such contracts. Vaughn, *The Policy of Community Property and Interspousal Transactions*, 19 BAYLOR L. REV. 20, 67-68 (1967). Thus, the Texas view is strange inasmuch as Texas has adopted the historically correct view that income from separate property is community. See note 7 *supra*.

It has been demonstrated that the Texas courts went to great lengths to protect the female spouse from overreaching and fraud by her male counterpart. See Note, *supra* note 447, at 866-67. There was also concern about protecting creditors. *Id.* at 867-68.

authority of *Castleberry* and included in the gross estate of the donor spouse even where the transfer was accomplished many years before the death of the donor. Given the importance of this issue to Texans, it is pertinent to ask what policy considerations support the present view of the Texas Supreme Court. Only one comes to mind. Apparently, the supreme court believes that spouses' decisions to partition or not partition existing community property will be more intelligently made with less fraud and overreaching than would occur when such agreements are made prospectively. While there is merit to this consideration, spouses would be similarly protected by the standards of "full disclosure" and "agreements understandably made" by which prenuptial agreements are currently judged for validity.

The Texas Supreme Court had a similar policy judgment to make in *Williams* as to the validity of the portion of the prenuptial agreement that barred the surviving spouse's claim to the homestead and exempt property. The court noted that the rights in question are "provided by law for the protection of the family and to secure a home for the surviving spouse" and, for that reason, the public policy of the state, perhaps, should not permit them to "be waived by a premarital agreement."⁴⁵² The court stated that section 5.41 of the Texas Family Code, authorizing premarital agreements,

should be construed as broadly as possible in order to allow the parties as much flexibility to contract with respect to property or other rights incident to the marriage, provided the constitutional and statutory definitions of separate and community property or the requirements of public policy are not violated.⁴⁵³

The court, therefore, upheld the agreement, concluding that "[t]he weight of authority and the better rule . . . allows the premarital waiver of these rights."⁴⁵⁴ In so doing, the court rejected Mrs. Williams' argument that "the policy of the law favoring the security of the widow by preventing an improvident relinquishment of the homestead, or other similar rights, is paramount to the policy of the law favoring flexibility in premarital agreements."⁴⁵⁵ The court articulated the factors that should be considered in determining the validity of prenuptial agreements that stipulate that property otherwise community shall be separate. Those considerations are whether the parties are mature individuals, whether there is any suggestion of fraud, overreaching, or a lack of understanding, whether there is full disclosure of the property interests, whether both parties have substantial separate property, whether there are interests of minor children to protect, and whether either party is adversely affected by the agreement.⁴⁵⁶

Interestingly, the constitutional prohibition against partitioning the homestead contained in article XVI, section 52 of the Texas Constitution is

452. 569 S.W.2d at 869.

453. *Id.* at 870.

454. *Id.*

455. *Id.*

456. *Id.*

much stronger and more direct than the rule articulated in *Arnold v. Leonard* that spouses may not classify property as separate prior to acquisition.⁴⁵⁷ While the former is an express constitutional prohibition,⁴⁵⁸ the latter is merely a rule considered by the court to be a necessary derivative of the constitutional definition of separate property set forth in article XVI, section 15 of the Texas Constitution. Yet the court in *Williams* has allowed the homestead to be partitioned in a prenuptial agreement, while refusing to permit the partition of property to be acquired in the future in a prenuptial agreement.

Possibly, as the dissent suggested, the reason that a spouse's waiver of homestead rights had not been litigated prior to *Williams* is because of the clarity of the constitutional provision, which specifically states that the homestead shall not be partitioned.⁴⁵⁹ The majority, however, determined that although section 52 grants a "surviving" spouse the right to occupy the homestead, it cannot be construed as "a constitutional prohibition to a waiver of that right by prospective spouses."⁴⁶⁰

With federal tax decisions like *Castleberry* and *McKee* hanging overhead, the rule of implied exclusion⁴⁶¹ as applied to prenuptial agreements will continue to haunt Texas taxpayers. Fortunately, it appears that the income produced by transfers in trust can be earmarked as separate property to avoid *Wyly*.⁴⁶²

Other Texas Cases. *Huff v. Huff*⁴⁶³ presents the classic case. In September 1967, two days before their marriage, Jessie and Louis Huff, then domiciled in Louisiana, entered into a prenuptial agreement declaring that the property they acquired during marriage that otherwise would be community would remain the separate property of the person producing the property. They moved to Dallas in June 1968, where they resided until divorced. Incident to their divorce Jessie sought to have the contract declared invalid, although the contract was valid under Louisiana law. In 1977, prior to the *Williams* decision by the supreme court, the Waco court of civil appeals upheld the *Huff* agreement as not in violation of Texas

457. *Id.* at 874 (Chadick, J., dissenting). TEX. CONST. art. XVI, § 52 provides that a homestead

shall not be partitioned among the heirs of the deceased during the lifetime of the surviving husband or wife, or so long as the survivor may elect 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.

458. *But see* *McLeod v. Board*, 30 Tex. 239 (1869). The supreme court held that a prenuptial agreement barred a surviving spouse's claim to intestate property. "That the husband may be excluded, by an express stipulation, from all interest or participation in the distribution on the death of the wife of property settled by marriage contract to her sole and separate use is not a matter of dispute." *Id.* at 244.

459. 569 S.W.2d at 874.

460. *Id.* at 870.

461. *See* note 7 *supra*.

462. *See* notes 309-15 *supra* and accompanying text.

463. 554 S.W.2d 841 (Tex. Civ. App.—Waco 1977, writ *dism'd*).

Constitution article XVI, section 15, and stated it was sanctioned by Texas Family Code section 5.41.

Huff v. Huff would seem to declare that Texas allows prenuptial agreements which anticipatorily partition or allow property that otherwise would be community to remain the separate property of the person producing the property. If *Huff* is good law, taxpayers could avoid *Castleberry* and *McKee* results by agreeing with their donee spouses at the time of the transfer that income from the transferred property will be the separate property of the donee spouse.

Since *Williams*, the value of *Huff* as precedent is in doubt. Moreover, while *Huff* states that the Louisiana premarital agreement to change future community income to separate property income does not violate the Texas Constitution article XVI, section 15, or Texas Family Code section 5.41, which sanctions premarital agreements "as they may desire," the court's actual judgment was merely to affirm the trial court's judgment which "gave effect to this agreement in its division of the property" within its wide discretion to make division of the property.

Arguably, *Huff* does not hold that the agreement was valid in Louisiana and, therefore, was valid in Texas; nor, arguably, does it question prior precedents that hold such agreements to be invalid. It could be said that the decision of the trial court merely adopted the agreement for the purpose of dividing the property existing at time of divorce.

The remaining Texas cases on this point support the decision in *Williams*. For example, in *Amarillo National Bank v. Liston*⁴⁶⁴ and *Chandler v. Alamo Manufacturing Co.*⁴⁶⁵ the respective courts declared that both prenuptial and postnuptial agreements that attempted to change the character of community property income to separate property were void. In *Chandler* a gift of rentals before they accrued was void, and in *Liston* a gift of interest and earnings before they accrued was void.

C. Postnuptial Agreements

Annual partition agreements with respect to community income generated by the transferred property would be effective to take that income out of the decedent's estate. They, however, would not abrogate the existence of the decedent's right to the income from the transferred property, and it is the right to income that determines includability of the transferred property in the decedent's gross estate under *Castleberry* and its progeny.

The Texas precedents are difficult to categorize, although there is clear authority invalidating postnuptial agreements that purport to anticipatorily partition income that would otherwise be community property when it comes into being. In *Armstrong v. Turbeville*,⁴⁶⁶ for example, the court

464. 464 S.W.2d 395, 407 (Tex. Civ. App.—Amarillo 1970, writ ref'd n.r.e.).

465. 140 S.W.2d 918, 920 (Tex. Civ. App.—Austin 1940, no writ). See also *Frame v. Frame*, 120 Tex. 61, 36 S.W.2d 152 (1931); *Brokaw v. Collett*, 1 S.W.2d 1090 (Tex. Comm'n App. 1928, judgment adopted).

466. 216 S.W. 1101 (Tex. Civ. App.—El Paso 1919, writ dismissed); accord, *Strickland v.*

held that *H* and *W* cannot by mere postnuptial agreement change the character of property to be thereafter acquired so as to convert community property into separate property. The court, however, noted that this does not prevent a spouse from making a gift to his spouse of his interest in community property "then in esse," when it can be done without injury to the rights of others. Thus, the community property status of rents collected was not affected by *H* and *W*'s agreement to treat rents as separate property. Only when the agreement was observed and actually carried out by delivery of the rents to the possession of *W*, would the collected rents become the separate property of *W* by gift, unless such would be in fraud of creditor's rights.

*George v. Reynolds*⁴⁶⁷ presents the classic case of a postnuptial separation agreement. Upon *H*'s death, *W* challenged the validity of the agreement, which the two had entered into thirty-one years earlier, and won. Although the court recognized that postnuptial agreements between *H* and *W* who are separating will be upheld when fair and equitable, it refused to imply that *H* and *W* have the power to change the status of property thereafter acquired from community to separate by mere agreement made in advance.

D. *The Will Contract Precedents*

The Texas Supreme Court has indulged the development of a curious precedent in the will contract cases of *Graser v. Graser*,⁴⁶⁸ decided in 1948, and *Weidner v. Crowther*,⁴⁶⁹ decided in 1957. Article 4610 of the Texas Revised Civil Statutes, since repealed,⁴⁷⁰ prohibited prenuptial agreements that "alter the legal orders of descent." This led the court in *Graser* to invalidate a prenuptial agreement that called for each spouse to make a will in favor of the other spouse. Later, in *Weidner*, the court upheld a contract calling for reciprocal wills where one spouse had kept his bargain by dying with a will that complied with the terms of the contract. Even though the surviving spouse refused the benefits provided her by the decedent's will, the court said she was bound to leave a will that was in compliance with the contract. The court explained that while article 4610 applied by its terms only to prenuptial agreements, the courts as a matter of policy

Wester, 131 Tex. 23, 112 S.W.2d 1047 (1938); *Cauble v. Beaver-Electra Ref. Co.*, 115 Tex. 1, 274 S.W. 120 (1925). *Davis v. Davis*, 108 S.W.2d 681 (Tex. Civ. App.—Fort Worth 1937, no writ), indicated that in order for personal earnings of *W*, earned monthly, to be changed from community property to separate property, it would be necessary for *H*, each month, as the income was earned, to make a gift of the same to *W*. See *Speckels v. Kneip*, 170 S.W.2d 255 (Tex. Civ. App.—El Paso 1942, writ ref'd). *Contra*, *Corrigan v. Goss*, 160 S.W. 652 (Tex. Civ. App.—El Paso 1913, writ ref'd).

467. 53 S.W.2d 490 (Tex. Civ. App.—Eastland 1932, writ dism'd); cf. *Jernigan v. Scott*, 518 S.W.2d 278 (Tex. Civ. App.—San Antonio 1974, writ ref'd n.r.e.). In *Jernigan* the court applied "laches-type" reasoning, and held *W* was precluded from attacking an agreement's validity because of a 30-year delay and acquiescence. *Jernigan* implied the agreement would have been invalid but for the fact that *W* was barred from arguing this issue.

468. 147 Tex. 404, 215 S.W.2d 867 (1948).

469. 157 Tex. 240, 301 S.W.2d 621 (1957).

470. 1969 Tex. Gen. Laws ch. 888, § 6, at 2733.

had extended it to postnuptial agreements as well; nonetheless, article 4610 could not apply to contractual wills because article 8281 of the Texas Revised Civil Statutes, authorizing the making of wills, is "[o]f equal dignity with Article 4610."⁴⁷¹

Thus, the Texas Supreme Court is in the anomalous position of saying that it will validate contracts that the legislature has declared illegal, but it will not validate contracts that the constitution allegedly declares illegal. That is, the supreme court refuses to validate prenuptial or postnuptial contracts that purport to declare that property that would otherwise be community shall be separate on the grounds that article XVI, section 15 of the Texas Constitution prohibits such contracts. Yet, in *Gorman v. Gause*⁴⁷² the court stated in a dictum that spouses may enter into premarital agreements whereby one spouse agrees to convey his portion of any community property produced during marriage to the other spouse as her separate property.

Perhaps one unarticulated basis for reconciling *Williams, Weidner*, and the *Gorman* dictum is that the court wishes to avoid protracted litigation by limiting the possible ways that spouses can accomplish partition of their community property by requiring strict compliance with the legislation implementing the 1948 constitutional grant of authority to spouses to partition their community property.⁴⁷³ For example, in the famous case of *Spinks v. Rice*⁴⁷⁴ the Virginia Supreme Court held that the legislature did not contemplate that people could pass property at the time of death by contract. While contracts to make or not make a will are generally enforced,⁴⁷⁵ the contract is not the dispositive instrument anymore than is the contract to sell real estate. Contracts to sell real estate contemplate delivery of a deed, and the making of the deed will be required if the contract is deemed enforceable. So, too, could the Texas Supreme Court be saying that death-time transfers of property are accomplished by will, lifetime transfers of property are accomplished by deed, and partitions of community property are accomplished in the manner specified by the legislature. None of the foregoing can be accomplished by self-executing agreements. This literalism, the supreme court perhaps believes, should lighten the judicial burden in that it avoids litigation over various informal arrangements where proof is at a minimum. Otherwise, there is no justification for enforcing contracts to make wills, deeds, and partitions and declining enforcement of self-executing agreements to accomplish the task of passing property interests.

Perhaps it is worth noting that the supreme court in *Weidner* said that mutual wills will be enforced when the terms of the will are not inequita-

471. 157 Tex. 240, 247, 301 S.W.2d 621, 625 (1957).

472. 56 S.W.2d 855 (Tex. Comm'n App. 1933, judgment adopted), discussed at note 451 *supra*.

473. TEX. CONST. art. XVI, § 15.

474. 187 Va. 730, 47 S.E.2d 424 (1948), noted in 34 VA. L. REV. 741 (1948).

475. Comment, *The Contractual Will: Invitation to Litigation and Excess Taxation*, 48 TEXAS L. REV. 909 (1970).

ble. "We are not called upon in this case to decide whether one could obtain the aid of a court of equity to enforce an inequitable disposition of property by a mutual will."⁴⁷⁶ Apparently, then, there are good will contracts and bad will contracts. Is this to suggest that the Texas Supreme Court may not, after all, recognize contracts in which spouses bind themselves to later accomplish a property transfer, the effect of which is to prospectively determine the status of their property? In other words, the result in *Weidner* may have been reached on equity principles and not because the court recognized the validity of the contract.⁴⁷⁷

However, if the dictum in *Gorman* is correct, it would seem possible to avoid the application of *Castleberry* by having the donor spouse and donee spouse contract at the time of the transfer for the donor spouse to convey to his spouse his interest in any community income produced by the transferred property. In such a case, the only interest he has retained is the consideration he received from the donee in return for his promise. Query what consideration could be used, keeping in mind the requirement of Treasury Regulation section 25.2512-8 that transfers must be for adequate and full consideration in money or money's worth.⁴⁷⁸ Could she agree to make a similar promise with respect to community income produced by property not involved in the transfer? How would you value her promise?

E. Conclusion

In light of the constitutional grant of authority to spouses to partition community property once it comes into being, one can only speculate about what policy considerations would warrant a court to invalidate a marital agreement in which the parties anticipatorily partition their community property by declaring that neither spouse shall have any interest in that property that would be the other spouse's sole management community property if the marital agreement were not in force. Perhaps the courts perceive that a more informed decision to partition or not partition can be made by the spouses after the property is in existence and its value can be ascertained.

Nonetheless, it seems that the justices of the Texas Supreme Court must be curious about the justification for the rule of implied exclusion in *Arnold v. Leonard*. The court held in *Williams* that a spouse can waive a specific prohibition in the Texas Constitution; it has been said in *Gorman v. Gause* that a prenuptial contract to transfer community property to the other spouse is valid; yet in *Williams*, on the authority of *Gorman*, and in

476. 157 Tex. 240, 246, 301 S.W.2d 621, 625 (1957).

477. It has been suggested that as the result of the repeal of art. 4610, *Weidner* should be read as allowing prospective spouses "to execute an enforceable postnuptial agreement directing distribution of their property even though the agreement is not embodied in a will." Note, *supra* note 447, at 877-78. It was even suggested that such contracts should be given in the event of divorce. *Id.* at 880. The difficulty with that proposition is that antenuptial agreements are sometimes declared inoperative in the case of divorce of the parties even if the agreement expressly contemplates divorce. See Berall, *Estate Planning for the Second Spouse*, in 1 NOTRE DAME EST. PLAN. INST. 343, 359 (R. Campfield ed. 1977).

478. Treas. Reg. § 25.2512-8 (1958).

Arnold v. Leonard it held that the constitution prohibits any expansion of the definition of separate property even though the constitution says no such thing. Thus the court must find itself in the anomalous position of saying a spouse can waive an express constitutional prohibition—the homestead right—but cannot alter a judicially implied constitutional prohibition.

The time has come to re-examine the validity of *Arnold v. Leonard*. There may in fact be some policy reason for sustaining that decision, but so long as contracts to partition or transfer later are sustained, such policy justification for the rule of *Arnold v. Leonard* is difficult to identify. In the meantime, however, Texas spouses who wish to make interspousal transfers will be frustrated by *Castleberry* until the Fifth Circuit reverses the Tax Court or Texas changes its law and allows self-executing agreements to partition community property. Fortunately, it appears that the income produced by property transferred in trust can be earmarked as separate property to avoid *Wyly*.

XII. DISCLAIMERS

Even if spouses may not anticipatorily agree between themselves that property that is ordinarily community shall be separate, is it possible for one spouse to disclaim or refuse to accept any community interest he obtains by operation of law? While federal taxing legislation expressly contemplates disclaimer,⁴⁷⁹ federal tax law follows state property law determinations, and state law would seem to bar an effective disclaimer.⁴⁸⁰

XIII. CONCLUSION

The Tax Court decisions in *Castleberry* and its progeny have raised a number of important issues relative to the orderly administration of the tax laws. An initial question is whether a transferor can be deemed to have retained an interest in transferred property for purposes of section 2036(a)

479. I.R.C. § 2518.

480. See *Williams v. Williams*, 569 S.W.2d 867 (Tex. 1978), discussed at notes 448-57 *supra* and accompanying text. Except where the legislature has acted to change the common law, renunciation, disclaimer, or refusal to accept property acquired by operation of law, such as inherited property, is not permitted. See, e.g., *Coomes v. Finegan*, 233 Iowa 448, 7 N.W.2d 729 (1943). See generally *Howe, Renunciation by the Heir, Devisee or Legatee*, 42 KY. L.J. 605 (1954); Newman, *Substantive and Tax Aspects of Disclaimers and Renunciations*, 7 INST. EST. PLAN. §§ 73.500-.504.1 (1973); Newman & Kalter, *The Need for Disclaimer Legislation—An Analysis of the Background and Current Law*, 28 TAX LAW. 571 (1975); Newman & Kalter, *Disclaimers of Future Interests: Continuing Problems and Suggested Solutions*, 49 NOTRE DAME LAW. 827 (1974). TEX. PROB. CODE ANN. § 37A (Vernon Supp. 1978-79) expressly permits disclaimer of property to be received “under any will of or by inheritance from a decedent.” While community property comes into being by operation of law, it is not acquired by will or inheritance. Accordingly, it is doubtful whether disclaimer of a community interest would be permitted even though partition of community property is permitted, TEX. CONST. art. XVI, § 15, after the community property comes into being. Disclaimers, not being expressly sanctioned by the legislature would be barred by the common law rule. In addition, the policy of Texas is to prohibit anticipatory alterations in the character of property that would be community when it came into being. See notes 449-51 *supra* and accompanying text.

when his only interest in the transferred property is that given him by operation of state property law. In 1977 the Louisiana district court in *Estate of Deobald v. United States* held that for purposes of invoking section 2036(a)(1), the retained interest must be retained by prearrangement, be it express or implied. Similarly, in 1966, the Tax Court in *Estate of Allen D. Gutchess* held that retention by operation of law is not retention *under* the transfer as required by section 2036(a)(1). While the Commissioner acquiesced in *Gutchess* in 1967, his nonacquiescence in *Estate of Robert W. Weir* in 1966 suggested that he saw a difference between the case where a taxpayer in a separate property jurisdiction conveyed his residence to his spouse and continued to occupy it until his death and the case where a Texas taxpayer does the very same thing. The Commissioner appears not to have explained the difference. In *Castleberry*, for example, the Tax Court distinguished its prior decision in *Gutchess* on the grounds that Mrs. Gutchess could freely exclude Mr. Gutchess from the premises he transferred to her while Mrs. Castleberry could not defeat Mr. Castleberry's right under Texas law to one-half the income produced by the property he transferred to her. The Tax Court failed to appreciate that while Mrs. Castleberry could not deprive her husband of his community one-half interest in the income produced by the transferred property, she could deprive him of any future income by dissipating the transferred property, by divorcing him, by departing to another jurisdiction, or by dying with a will in favor of someone other than Mr. Castleberry. It appears from the opinion in *Gutchess* that Mrs. Gutchess would have to do even more. She could exclude Mr. Gutchess from the premises he transferred to her only by obtaining a court order. Like Mrs. Castleberry, Mrs. Gutchess could not recover the enjoyment her husband experienced by having remained upon her premises after the transfer.

While not meaning to belabor the comparison of *Castleberry* and *Gutchess*, it is important to note that the Tax Court chose not to directly confront the obvious inconsistency between its holding in *Gutchess* that retention by operation of law was not contemplated by section 2036(a) and its holding in *Castleberry*. In choosing to distinguish the cases on the grounds noted above, the Tax Court instead suggested a fundamental weakness in its conclusion. The question is how could Mr. Castleberry have retained an interest in the transferred property if his spouse could deprive him of that interest by death, departure, dissipation, or divorce. In such an event all he would have would be the income produced by the transferred property prior to occurrence of the terminating event. Retention by definition would seem to contemplate more. It would seem to contemplate a legally enforceable right, or at the very minimum, some prearrangement with the donee whereby the donee agreed to cause, or, in fact, caused, the transferred property to produce income or other benefit for the donor.

It is unfortunate, too, that the Tax Court in *Castleberry* confused the transferred property, which was the donee's separate property, with the

income produced by that property. It was the income produced that was community property and not subject to the donee spouse's death, dissipation, divorce, or departure. Had the Tax Court been able to keep this distinction in mind, it would, perhaps, have reached a different result.

Thus, retention by operation of law is the first issue in *Castleberry*. There would seem to be no reason why section 2036(a) would not reach an interest retained by operation of law. But the important question is whether an interest could be retained at all if the underlying property in which the interest is allegedly retained is subject to the donee's unfettered dominion and control.

A further question raised by *Castleberry* is what kind of interest is reached by section 2036(a). Does section 2036(a) reach any interest in transferred property or must the interest represent a substantial present economic benefit as suggested by the United States Supreme Court in *United States v. Byrum*. Without considering the standard set down by the Supreme Court, the court in *Castleberry* said that section 2036(a) reached any interest which was not illusory. The illusory standard and the substantial present economic benefit standard are radically different. For example, the community income produced by the property Mr. Castleberry transferred to his wife as her separate property is subject to his spouse's sole management. The only restriction on her management of this community income produced by her separate property is that she cannot dispose of it in such a way as to constitute a fraud on the community. The Texas cases are such that there is little that the managing spouse cannot do. The cases are few that find the managing spouse has defrauded the community by her conduct. Accordingly, if the standard is one of illusoriness, then, Mr. Castleberry may have the kind of interest that section 2036(a) would reach. But if the Supreme Court's standard of substantial present economic benefit is to prevail, then it is doubtful that his interest has the requisite quality. Thus, despite the fact that Mr. Castleberry's community one-half of the income produced by the transferred property will be included in his estate for federal estate tax purposes and will be subject to disposition by him in his will, the transferred property will not be included in his estate.

The *Wyly* case raises an issue beyond those raised in *Castleberry*. That issue is whether trust income is community or separate property in Texas. Careful examination of the cases that have considered this question leads inexorably to the conclusion that trust income is separate property. At the very least, there seems to be some unanimity that a settlor of a trust can earmark the trust income as separate property.

Assuming, however, that a court concludes that trust income is community, *Wyly* should be reversed for the same reasons *Castleberry* should be reversed. Mrs. Wyly's claim is not as strong as Mrs. Castleberry's, but Mrs. Wyly had the right to withdraw \$5,000 of trust corpus annually. This draw down power is a general power of appointment, and for purposes of federal estate and gift taxation, a general power is tantamount to owner-

ship. Thus, Mrs. Wyly and Mrs. Castleberry are in relatively the same position. Both of them can defeat their respective spouse's right to any income produced by the transferred property by merely divorcing their respective spouses, leaving Texas, by dissipating the transferred property, or by dying prior to their respective spouses.

For the taxpayer contemplating a transfer to his spouse, in most instances there will be little incentive to do so. But if that incentive exists in a particular case, the donor can avoid the application of *Castleberry* and *Wyly* by making the transfer in trust and earmarking the income as his spouse's separate property. The same result can probably be obtained if all trust distributions are discretionary with the trustee.

This suggestion indicates the harshness of the rules of *Castleberry* and *Wyly*. Is it possible that Congress contemplated penalizing Texas taxpayers who make gifts to their spouses? Highly unlikely. That is not to say, however, that section 2036(a) should not apply when one Texas spouse transfers property to his spouse with the intention of enjoying one-half the community income produced by that property as a result of a prearrangement or agreement with his spouse. This latter situation is different from both *Castleberry* and *Wyly*.

The harshness of the results in *Castleberry* and *Wyly* are exacerbated because there is little Texas taxpayers can do short of divorce to insulate interspousal transfers from the reach of the rules announced in these cases. For example, while Texas taxpayers can make such transfers in trust, they cannot enter into self-executing prenuptial agreements that provide that income produced by each spouse's separate property shall constitute that spouse's separate property. While there seems no good reason for such a rule, the Texas Supreme Court in 1978 reaffirmed its belief that the Texas Constitution bars such agreements.

If *Castleberry* and *Wyly* are sustained on appeal, Texas must consider changing its constitution⁴⁸¹ or seeking congressional relief. In the meantime, if *Castleberry* and *Wyly* are sustained:

- (1) One-half of all transfers of separate property made in fee simple to a spouse during the donor spouse's lifetime will be included in the donor's estate.
- (2) One-fourth of all transfers of community property made in fee simple to a spouse during the donor spouse's lifetime will be included in the donor's gross estate.

481. See, e.g., Tex. H.J.R. 54 (1979).