

CHARACTERIZATION OF TRUST INTERESTS UPON DIVORCE

JIMMY L. VERNER, JR.
Verner & Brumley
A Professional Corporation
3131 TurtleCreek Blvd., Suite 1020
Dallas, Texas 75219
214.526.5234
214.526.0957.fax
jverner@vernerbrumley.com
www.vernerbrumley.com

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I. INTRODUCTION

One of the property interests a court sometimes encounters in a divorce case is the interest of one of the spouses in a trust. The spouse may have an interest in trust corpus, in trust income, or in both corpus and income. Upon divorce, whatever property interests exist must be characterized as separate or community property. If the interests are community property, they must be awarded to or divided between the parties as part of a just and right division of the parties' community estate.

A. Trust Corpus

A beneficiary's equitable interest in trust corpus is clearly his separate property when the corpus itself qualifies as separate property. In other words, if a third-party settlor created the trust for the beneficiary, or the beneficiary created the trust for himself from his separate property, then the corpus of the trust will be characterized as the beneficiary's separate property. This conclusion follows from a straightforward application of the Texas Constitution and the Family Code: The corpus of a trust is acquired by devise, if a testamentary trust; or by gift, if a third-party inter vivos trust. Obviously, the corpus of a trust that the beneficiary has created for himself from his own separate property must be the beneficiary's separate property.

The characterization of a beneficiary's equitable interest in trust corpus as separate property is so well settled that it rarely arises in the case law. For example, in *Commissioner v. Wilson*, 76 F.2d 766 (5th Cir. 1935), the Fifth Circuit bluntly stated that the beneficiaries' interests in trust corpus were "their separate property though acquired since marriage, because acquired by gift." *Id.* at 769. In *In re Long*, 542 S.W.2d 712 (Tex. Civ. App. - Texarkana 1976, no writ), the non-beneficiary spouse sought a ruling that income to a trust was community property. The non-beneficiary spouse did not even attempt to argue that the corpus of the trust should be considered community property. In *Taylor v. Taylor*, 680 S.W.2d 645, 650 (Tex. App. - Beaumont 1984, writ ref'd n.r.e.), the parties stipulated that the trust corpus should be considered separate property.

B. Trust Income

The contested issues in this area of the law center not on characterization of trust corpus but on how trust income should be characterized. The courts generally agree that a beneficiary's interest in undistributed trust income is his separate property if he has any interest in it at all. But there has been a division of opinion whether trust income, once distributed, should be considered the beneficiary's separate property or property of the community estate.

This Article focuses on how the courts have characterized trust income and the reasons the courts have given for their actions. This examination reveals that the courts have used one or more of three theoretical approaches to reach their decisions. This article labels these three approaches as (1) the power theory, (2) the equitable acquisition theory, and (3) the intent theory. The power theory centers on whether the beneficiary may command any trust distributions. If not, then trust income remains trust property, and the beneficiary's equitable interest in it is the beneficiary's separate property. The equitable acquisition theory applies the inception of title doctrine to determine the character of trust income. The intent theory, as its name makes evident, looks to the settlor's intent to decide questions of characterization.

The Article demonstrates that the courts have relied upon the power theory to characterize undistributed trust income as either trust property in which the beneficiary has no interest or as the beneficiary's separate property. The intent theory has been invoked to characterize distributed trust income as the beneficiary's separate property. In contrast, under the equitable acquisition theory, distributed trust income has been characterized as community property. It remains to be seen whether the courts will apply the equitable acquisition theory to characterize undistributed trust income as community property.

II. SOME PRELIMINARY CONCEPTS

Interwoven with these three theories are several other rules of law. These rules tend to recur in the case law. These rules include the definitions of separate and community property, debtor/creditor law as it relates to the various types of marital property, and the inception of title doctrine so important to characterization. Before proceeding to the theories underlying trust income characterization, these other rules of law must be reviewed.

A. Separate and Community Property

Characterization of property is critical upon divorce. The trial court is charged with making a just and right division of the parties' community property upon divorce. Tex. Fam. Code § 3.63(a). If property is characterized as the separate property of one of the spouses, then the court may not divide that property upon divorce. *E.g.*, *Cameron v. Cameron*, 641 S.W.2d 210 (Tex. 1982); *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977).

Characterization of property begins with the Texas Constitution. Article 16, Section 15 of the Constitution states, in material part, as follows:

All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; . . . if one spouse makes a gift of property to the other that gift is presumed to include all the income or property which might arise from that gift of property

Tex. Const. art. 16, § 15. The omitted parts of this section address antenuptial and postnuptial agreements which could be important to trust issues upon divorce but which are beyond the scope of this Article.

As per Section 15, the legislature has passed laws more clearly defining the rights of the spouses. Family Code § 5.01 sets forth the working definition of separate and community property:

- (a) A spouse's separate property consists of:
 - (1) the property owned or claimed by the spouse before marriage;
 - (2) the property acquired by the spouse during marriage by gift, devise, or descent; and
 - (3) the recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage.
- (b) Community property consists of the property, other than separate property, acquired by either spouse during marriage.

Tex. Fam. Code § 5.01.

Although Family Code § 5.01 describes separate and community property, the statute is subordinate to the Constitution. The legislature does not have the power to expand the definition of separate property beyond that set forth in the Constitution. The Constitution defines the limits of what can be separate property. *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925).

B. Characterization and Debtor/Creditor Law

Characterization of property upon divorce also is important to defining the rights of third parties. The Family Code contains several provisions identifying which classes of property can be subjected to execution for payment of spousal debts. Tex. Fam. Code §§ 4.02, 4.031, 5.61. Collectively, these statutes state that the separate property of a spouse is not subject to execution for the other spouse's premarital or postmarital torts, the other spouse's premarital contracts, or the other spouse's post-marital contracts except for necessities. The same rules apply to recovery against a spouse's sole management, or "special" community property, except that sole management or special community property is subject to liability for the other spouse's torts.

These rules of law are important upon divorce because if property can be characterized as separate property, then it will be immune to execution for satisfaction of obligations incurred by the other spouse except for necessities. These rules of law also are important because many of the cases discussing the characterization of trust income have arisen in the debtor/creditor context rather than in the divorce context.

C. Inception of Title

A final principle of marital property law is important to this Article. This principle is known as the inception of title doctrine. Under this doctrine, the characterization of a property interest is determined as of the time when the property is acquired. *E.g.*, *Colden v. Alexander*, 141 Tex. 134, 171 S.W.2d 328 (1943). Acquisition occurs, under this doctrine, when the acquiring spouse first obtains a right or claim to the property and not when title to the property finally becomes vested in that spouse. *E.g.*, *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984).

Under the inception of title doctrine, property which would otherwise be considered community property should be characterized as separate property instead. For example, a married couple may purchase a house which one of the spouses contracted to purchase prior to marriage. The house will be considered the separate property of the purchasing spouse because the inception of title relates back to the right to acquire the house. *E.g.*, *Wierzchula v. Wierzchula*, 623 S.W.2d 730 (Tex. Civ. App. - Houston [1st Dist.] 1981, no writ).

The courts have applied the inception of title doctrine to less concrete rights than the right to purchase. For example, in characterizing pension plans, the courts have ruled that portions of retirement benefits are community property even though the employee spouse's right to receive retirement benefits has neither vested nor matured. *E.g.*, *May v. May*, 716 S.W.2d 705 (Tex. App. - Corpus Christi 1986, no writ). The courts have rejected the argument that the right to receive retirement benefits is a "mere expectancy" and therefore is not property divisible upon divorce. *E.g.*, *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976).

III. CHARACTERIZATION OF TRUST INCOME

The courts have invoked one or more of three theories to characterize trust income. To recap, these theories are the power theory, the equitable acquisition theory, and the intent theory. Each theory, and the case law applying it, is examined below.

A. The Power Theory

Under the power theory, the spouse who would bring income from a trust into the community estate must demonstrate that the beneficiary spouse has some right to the distribution of income from the trust. The theory's premise is that the community estate cannot be entitled to receive more than either one of the spouses is entitled to receive. If a spouse has no power to require a trust to distribute income, then that income cannot possibly be a part of the community estate. The income remains trust property rather than separate or community property. Only upon receipt by the beneficiary can income from a trust be characterized.

1. Cases Applying the Power Theory

The first divorce case to apply the power theory was *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd). In *McClelland*, the husband was the beneficiary of a testamentary trust. But the husband had no power to obtain undistributed trust income. Because

the income arising from the estate was not available to [the husband], and could not be reached by him, the right of his wife would be no greater than his, and she would not be allowed to work out and enjoy a right in his estate that was denied him.

Id. at 358. The court thus concluded that the trust's income belonged to the trust rather than to the community estate.

Later divorce cases continued to recognize that trust income is trust property until distributed. In *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App. - Fort Worth 1967, writ dis'm'd), the wife tried to characterize undistributed income in the husband's testamentary spendthrift trust as community property. The Fort Worth Court of Appeals summarized *McClelland*:

It was held there, in a divorce case presenting the identical question, that undistributed trust income was not community property where the trustee had the right to withhold it from the trust beneficiary because of provision to such effect in the trust instrument.

Id. at 515. The court found *Buckler* to be indistinguishable from *McClelland*. *Buckler* held that the husband had no "entitlement to undistributed income which the trustees had not seen fit to deliver to him." *Id.* at 516. Therefore, the undistributed trust income could not be community property.

The San Antonio Court of Appeals followed the same reasoning in *Currie v. Currie*, 518 S.W.2d 386 (Tex. Civ. App. - San Antonio 1974, writ dismissed), when it ruled that undistributed trust income could not be community property divisible upon divorce. The husband had no claim to any trust assets until they were distributed to him. The community estate could not have rights greater than the husband, so there were no community rights at all.

Currie's holding foreshadowed *In re Long*, 542 S.W.2d 712 (Tex. Civ. App. - Texarkana 1976, no writ). In *Long*, the husband's parents made him the beneficiary of a trust which provided that the husband would receive one-half of the trust's corpus at age twenty-five and the other one-half at age thirty. After the husband turned twenty-five, he allowed the trustees to retain the one-half of the trust to which he had become entitled on his twenty-fifth birthday. The husband and wife were divorced about two months after the husband turned twenty-six. The question before the court was how to characterize the income which had accrued between the husband's twenty-fifth birthday and the date of divorce on the one-half of the trust corpus to which the husband had become entitled when he turned twenty-five.

Long concluded that trust income "which a married beneficiary does not receive, and to which he has no claim other than an expectancy interest in the corpus," is not community property. *Id.* at 718. But the husband did have a present possessory interest in one-half the trust corpus at age twenty-five. Therefore, the court concluded, income accruing on that one-half of the corpus from the husband's twenty-fifth birthday to the date of divorce should have been considered community property by the trial court. *Id.* The fact that the husband permitted this income to remain in trust was irrelevant.

The Texarkana Court of Appeals spoke again to this point in *In re Burns*, 573 S.W.2d 555 (Tex. Civ. App. - Texarkana 1978, writ dismissed), but reached a different result on the facts presented. In *Burns*, the husband had neither received the trust income nor had any right to compel distribution. The court noted that the trust, not the parties, acquired the trust's income. The court held:

Since neither spouse actually or constructively acquired the undistributed trust and estate income during the marriage, such income, though earned during the marriage, remained a part of the respective trust or estate and was not subject to division by the court. Such income was not community property.

Id. at 557-58.

A subsequent case addressing this issue is *Taylor v. Taylor*, 680 S.W.2d 645 (Tex. App. - Beaumont 1984, writ refused n.r.e.). In *Taylor*, the wife's parents created a trust for the benefit of the wife. The original trust corpus consisted of "an undivided interest in Schmidts, a ladies' ready-to-wear store in Nacogdoches, Texas." *Id.* at 648. The trust corpus consisted only of the business enterprise itself, not any assets such as real estate or inventory. Fortunately, the dress shop prospered. After the wife's marriage, the wife used earnings from the dress shop which were distributed to her from trust to purchase certain real estate. *Id.* Upon divorce, the court characterized the real estate as the wife's separate property because the wife had purchased it with separate property trust proceeds. *Id.* at 649.

The most recent case

2. Limitations of the Power Theory

The power theory does not dictate an answer to the question of how trust income, once distributed, should be characterized. The power theory's essence is that undistributed trust income cannot be characterized as community property because, in the absence of a mandatory distribution requirement in the trust or a right to compel distribution on the part of the beneficiary, the beneficiary has nothing more than an expectancy interest in trust income. Once the beneficiary has received trust income, the right or power of the beneficiary to receive or demand the income becomes unimportant. Thus, the power theory provides no guidance in determining whether distributed trust income should be considered separate or community property.

In re Long, 542 S.W.2d 712 (Tex. Civ. App. - Texarkana 1976, no writ), suggests by its silence on the issue that distributed trust income is separate property. *Long* held that income on a trust distribution which accrues after distribution did or should have taken place is community property. But the wife in *Long* did not take the position that the distribution itself - part of which consisted of income earned on the corpus while in trust - should have been characterized as community property. *Long* merely assumes, but does not hold, that income on corpus while in trust cannot be community property upon distribution.

Only one "power theory" case has taken a position on this point, but its position is ill-reasoned and obiter dicta in any event. In *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App. - Fort Worth 1967, writ dism'd), the court was faced with how to characterize undistributed income in a discretionary distribution trust. The beneficiary of the trust was the husband. The husband called the court's attention to *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd), in which the court of appeals held that undistributed income in a testamentary trust could not be considered part of the community estate when the beneficiary had no power to obtain it. *McClelland* also characterized the beneficiary's monthly distribution of \$150 as separate property because the testator intended the beneficiary to have it as a devise. The wife in *Buckler* sought to distinguish *McClelland*, claiming that a testator has no power to make a gift of future income because gifts can be made only of existing property. The *Buckler* wife also argued that *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925), had overruled *McClelland* by holding that the Texas Constitution's list of types of separate property could not be statutorily expanded to include the rents and revenues from a wife's separate realty. The court of appeals apparently agreed that making a testamentary gift of income from a trust amounted to an attempt to create a new class of separate property. The court ruled that *Arnold* had overruled *McClelland* to that extent even though the characterization of distributed trust income was not before the court.

3. Summary of the Power Theory

The cases discussed above establish that undistributed trust income is neither separate property nor community property but is trust property. Typically, the beneficiary has only an expectancy of receiving undistributed trust income, not an enforceable property right to obtain it. If, however, the trust beneficiary has a right to compel a distribution from trust but

fails to do so, the beneficiary will be deemed to have constructive possession of the undistributed income. Income on the part of the trust which should have been distributed will be considered community property from the date on which distribution could have been compelled. Because the power theory addresses only the right of the beneficiary to receive or to compel distribution of trust income, the power theory does not address how the income should be characterized once it has been distributed.

B. The Equitable Acquisition Theory

The equitable acquisition theory posits that the beneficiary of a trust has a separate property interest in the trust corpus. Because income from separate property is community property, trust income must be community property. This theory grants that the beneficiary's separate property interest in the trust corpus is merely an equitable interest but concludes that the equitable rather than legal nature of the property interest is immaterial to the conclusion that trust income is community property.

1. Fifth Circuit Cases

The equitable acquisition theory came about not in divorce or creditors' cases but in tax cases. At one time, the Internal Revenue Code did not contemplate the filing of joint tax returns. Each spouse had to file a separate tax return. Because Texas is a community property state, trust income had to be characterized when preparing tax returns. Characterization of trust income materially affected the amount of tax that the spouses would have to pay. If trust income were characterized as community property, then the income would be split between the two taxpayers, resulting in lower overall taxes paid. On the other hand, if trust income were considered separate property, then the income could not be split between the spouses. The spouse who received the trust income would be required to pay taxes on that income, resulting in higher overall taxes paid.

The United States Court of Appeals first articulated this theory in *Commissioner v. Wilson*, 76 F.2d 766 (5th Cir. 1935). In *Wilson*, the husbands were income beneficiaries of certain trusts. The trusts mandated annual distribution of income after expenses had been paid. The trusts also required that corpus be paid out within ten years. *McCrary v. Commissioner*, 69 F.2d 688 (5th Cir. 1934)(describes trust provisions in detail). The Fifth Circuit held that income should be considered community property when received because the beneficiaries held an equitable interest in the trust corpus. The court reasoned that the income had accrued on a separate property interest, albeit an equitable one. Nevertheless, income from separate property is community property under the Texas Constitution, so the court characterized the income as community property upon receipt. *Id.* at 769.

The Fifth Circuit went on to characterize the income from the trusts as though the trusts did not exist: The court held oil and gas delay rentals to be community property because received for the use of property; the court held royalties to be separate property because they represented a depletion of the realty itself. Accordingly, the delay rentals should be considered community property, but the royalties should be considered separate property. The court remanded for further proceedings.

The Fifth Circuit endorsed this theory by three decisions made within a few days of one another in 1945. In *Commissioner v. Porter*, 148 F.2d 566 (5th Cir. 1945), the issue before the Court was whether trust income should be considered separate or community property. The court quoted *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799 (1925), to the effect "that income from separate property falls when received into the community." *Id.* at 567. Based upon this rationale, and the lack of any contrary intent in the trust instrument, the court held income from the trust to be community property. *Accord, Commissioner v. Sims*, 148 F.2d 574 (5th Cir. 1945) (same facts; brief opinion refers to *Porter*.)

In *McFaddin v. Commissioner*, 148 F.2d 570 (5th Cir. 1945), the Fifth Circuit reiterated its ten-year-old ruling in *Wilson*. The court specifically confirmed that income from a trust should be characterized as though the trust did not exist:

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.

Id. at 573. *McFaddin* did remand the case for further consideration, however, because the court agreed with the taxpayers' contention that income from after-acquired trust corpus, as opposed to original corpus, should be considered community property.

2. Claims Court Case

With the advent of the joint income tax return, the issue whether income from a trust should be considered community or separate property became unimportant to income tax law. The courts ceased to address this issue. However, the issue still could exist with respect to what should be included within an estate for estate tax purposes. That issue was placed before the United States Claims Court in *Wilmington Trust Co. v. United States*, 4 Cl. Ct. 6 (1983), *aff'd mem.* 753 F.2d 1055 (Fed. 1985).

In *Wilmington*, the husband died. His executors did not include as part of his estate the income from certain trusts established by the husband and his parents in behalf of the wife. The United States took the position that the mandatory distributions of net income from the trusts to the wife were community property. Therefore, half those distributions should be included in the decedent's estate for tax purposes.

The Claims Court conducted an extensive review of both Texas and federal law on this subject. According to *Wilmington*, Texas decisions

make it plain that, under Texas law, income to a married person as the beneficiary of a trust established by someone else as a gift, either inter vivos or testamentary, is the separate property of the married beneficiary.

Id. at 11. *Wilmington* criticized the Fifth Circuit's decisions for failing to recognize the relative powers of the beneficiaries and the trustees. Of *Wilson* and *Porter*, *Wilmington* said that

the court in both cases seemingly overlooked the circumstance that the income involved in each case was "from" a trust corpus, and the trust corpus was not the "separate property" of the beneficiaries of the trust. The beneficiaries had no right to or control over the corpus of the trust. Those powers were vested in the trustee.

Id. at 14. The court further distinguished these cases by noting that the beneficiary

never "acquired" - and she will never acquire - the corpus of any of these trusts. The corpus of each trust is to be held and controlled by the trustee or trustees during [the beneficiary's] lifetime, and, upon [the beneficiary's] death, the corpus will pass to her issue. Accordingly, the corpus of each trust was not [the beneficiary's] separate property, and the trust income was not from [the beneficiary's] separate property.

What [the beneficiary] "acquired" - and what she used to purchase the stocks and establish the bank accounts that are involved in the litigation - was the income from the trust property. As the income resulted from gifts made to trustees for [the beneficiary's] benefit, the income necessarily constituted her separate property under section 15 of article XVI of the Texas Constitution.

Id. The court thus concluded that the assets purchased from trust income were not part of the estate of the beneficiary's husband.

3. Limitations of the Equitable Acquisition Theory

The equitable acquisition theory has been used only to characterize trust income, and then only upon distribution. The theory is grounded on the concept that when a beneficiary owns an equitable separate property interest in trust corpus, trust income must be community property under the Texas Constitution because it is income from separate property.

In *Wilson*, this theory made analytical sense because the beneficiaries received income for a period of years and were to receive the trust corpus within ten years from the date of the creation of the trust. Thus, the beneficiaries had an equitable interest in the trust corpus. In *Wilmington*, the Claims Court declined to follow *Wilson* because of contrary Texas case law but also because the trust in *Wilson* was an income-only trust: The beneficiary did not have a property interest in the trust corpus because, under the terms of the trust instrument, the beneficiary never could receive the trust corpus.

These cases contrast sharply with the three Fifth Circuit cases decided in 1945, *Porter*, *Sims*, and *McFaddin*. In these three cases, the Fifth Circuit was faced with income-only trusts. The beneficiaries had no interest in the trust corpus, a necessary condition for applying the equitable acquisition theory. But the Fifth Circuit applied the theory anyway, leading to illogical results.

Regardless of whether these courts have correctly applied the equitable acquisition theory, one wonders whether the theory makes any real sense. Under the equitable

acquisition theory, if correctly applied, trust income to a beneficiary who also holds a remainder interest in the trust corpus must be community property because the income is from the beneficiary's separate property. But how should the income be characterized if the beneficiary is an income-only beneficiary? Despite the holdings in *Porter*, *Sims*, and *McFaddin*, the equitable acquisition theory does not supply an answer to this question.

C. The Intent Theory

A number of courts have considered what the settlor intended when creating a trust to determine the character of trust income. These cases have involved testamentary trusts. In characterizing trust income, the courts relied upon the touchstone principle in the construction of wills, the testator's intent:

The rule of primary importance that governs courts in construing wills is to ascertain the purpose and intention of the testator, and this is to be gathered from all the terms of the will when considered as a whole.

McClelland v. McClelland, 37 S.W. 350, 358 (Tex. Civ. App. 1896, writ ref'd). This time-honored principle is as valid today as it was when *McClelland* was decided in 1896. See, e.g., *McGill v. Johnson*, 799 S.W.2d 673, 674 (Tex. 1990). Although usually recited as the doctrine of the testator's intent, the same rule of law applies to the construction of trusts. E.g., *Myrick v. Moody*, 802 S.W.2d 735 (Tex. App. - Houston [14th Dist.] 1990, writ denied).

1. Divorce Cases Applying the Intent Theory

In *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd), the court ascertained and followed the settlor's intent in characterizing undistributed trust income as trust property rather than as community property. The *McClelland* beneficiary's father had created a testamentary trust which consisted mainly of rental property generating income of about \$1,425 per month. The testator directed that expenses be paid from income, then the beneficiary to receive a stipend of \$150 per month. Any residuary income over and above the expenses and the stipend were to be deposited into a bank and used to purchase bank stock once a certain amount of money had been accumulated. The stock, in turn, became part of the trust's assets.

After quoting the well-established rule that the testator's intent must be honored, the court concluded that the testator had intended to give the beneficiary a life estate in trust. The testator had no intention of paying the residual income over to the beneficiary even though the trustees had the power to make such a distribution in their discretion. On these facts, the court concluded that the testator had no intent to make the trust income anything other than the property of the trust. Because the income was part of the trust, the income could not be community property but was trust property.

The Fort Worth Court of Civil Appeals endorsed this reasoning in *Buckler v. Buckler*, 424 S.W.2d 514, Tex. Civ. App. - Fort Worth 1967, writ dism'd). The *Buckler* court was faced with a trust instrument like the one in *McClelland*. *Buckler* recited the facts of

McClelland, then recognized the non-beneficiary spouse's argument against the application of the intent theory. The non-beneficiary spouse argued that only the trust corpus could be separate property because a testator may not make a gift of that which is not yet in existence. Therefore, the income from the trust corpus, according to the non-beneficiary spouse, could not be trust property but must be community property. Relying upon *McClelland*, and noting that writ had been refused in *McClelland*, the *Buckler* court invoked stare decisis to rule that the income on the trust corpus could not be considered community property. *Id.* at 516.

2. Creditors' Cases Applying the Intent Theory

The courts have implicitly followed the intent theory in creditors' cases. Early Texas cases addressing this issue came about when creditors of the non-beneficiary spouse attempted to execute on income from the beneficiary spouse's trust. The courts held trust income to be separate property in several different situations. One frequent fact pattern occurred when the non-debtor spouse was the beneficiary of a testamentary trust. *E.g.*, *Martin Brown Co. v. Perrill*, 77 Tex. 199, 13 S.W. 975 (1890); *Gamble v. Dabney*, 20 Tex. 69 (1857). These cases hold that the income from a trust is not subject to execution to satisfy a husband's debt because the income is not community property.

An early Texas Supreme Court case was *Hutchison v. Mitchell*, 39 Tex. 488 (1873). In *Hutchison*, the husband placed a plantation into trust for the benefit of his wife. The husband's creditors then attempted - unsuccessfully - to execute on the rents and profits from the plantation. Under the trust instrument, both the plantation and its income had been placed into trust. *Id.* at 493. Thus neither trust corpus nor trust income was subject to execution for satisfaction of the husband's debts. The Court recognized that, had there been no trust, the income from the trust corpus would have been community property and therefore subject to execution. *Id.* Nevertheless, the Court permitted the husband to place trust income outside the reach of his creditors.

Not only has income from both testamentary and inter vivos trusts been held separate, but the courts have permitted spouses to place their own separate property into trust to place what would have been community income beyond the reach of creditors. In *Shepflin v. Small*, 23 S.W. 432 (Tex. Civ. App. 1893, no writ), the wife owned real estate as her separate property. The wife had a tenant named Small. Shepflin, who obtained a judgment against the husband, instituted a garnishment proceeding to subject Small's rent payments to satisfaction of the community debt. The wife then conveyed her real estate, in trust, to a third party. The court agreed that after this conveyance, Small's rental payments were the wife's separate property. Shepflin could no longer look to Small's rental payments as a source for satisfaction of the husband's indebtedness. *Accord, Monday v. Vance*, 32 S.W. 559 (Tex. Civ. App. 1895, no writ).

In only one of the "creditor" cases did a court fail to follow this rule, although the court reached the same result. In *Mercantile National Bank v. Wilson*, 279 S.W.2d 650 (Tex. Civ. App. - Dallas 1955, writ ref'd n.r.e.), the deceased husband's creditor attempted to execute on the income from a trust the wife had settled on herself prior to marriage. Without citation to any authority, the court stated that income on the trust corpus was community property.

But the court went on to hold that the trust income could not be taken in satisfaction of the deceased husband's debt because the income was statutorily exempt from execution.

IV. A COMPARISON OF THE THEORIES

Of the three theories discussed, the intent theory should be reaffirmed and followed by the courts. This theory relies upon a time-honored principle of law - that the settlor's intent is paramount in the construction of trusts. Moreover, the theory requires a particular result whether one is characterizing distributed or undistributed trust income. As more fully described above, the power theory dictates a result only when income is undistributed, while the equitable acquisition theory dictates a result only when income has been distributed. Thus, both alternative theories are inadequate because they do not extend to all possible factual scenarios.

Moreover, the intent theory is consistent with the power theory. Could it not be said that the power theory is no more than the application of the settlor's intent that trust income remain trust property until it is distributed? Under the power theory, undistributed trust income cannot be a part of the community estate when the beneficiary lacks the power to require its distribution. By the very nature of the trust instrument, the settlor of a discretionary payment income trust intends his beneficiary to have no such power. Thus, the power theory can best be described not as an independent theory of trust income characterization but as a corollary to the intent theory.

Analytically, the intent theory and the equitable acquisition theory are incompatible. Under the intent theory, a settlor may grant a beneficiary both a contingent interest in trust corpus and an interest in income from the corpus as his separate property. In contrast, the equitable acquisition theory states that a beneficiary receives income from a trust as community property when the beneficiary also has a contingent interest in the trust corpus. The equitable acquisition theory thus flies directly in the face of the principle that one who has the power to grant the greater estate also has the power to grant the lesser estate. Under the equitable acquisition theory, a settlor is robbed of this power if the settlor decides to make the beneficiary a contingent remainderman to the trust corpus as well as an income beneficiary of the income from the corpus.

Some equitable acquisition cases do, however, allow for consideration of the settlor's intent. In two of the equitable acquisition cases, the courts declined to rule out the possibility that income distributed from a trust could be separate property. In *Commissioner v. Porter*, 148 F.2d 566 (5th Cir. 1945), the court left open the possibility that a settlor could create a trust that granted income as separate property. *Id.* at 568. No such intent existed in the trust before the court in *Porter*. The same was true in *Commissioner v. Sims*, 148 F.2d 574 (5th Cir. 1945), in which the court noted that

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.

Id. at 574. But if this view were adopted, trust income would be considered community property unless the settlor specifically granted the income as separate property. It is submitted that by its very nature, trust income is intended to be separate property.

By bowing to the settlor's intent, at least when it is expressed, these equitable acquisition cases may have recognized the relative merits of two conflicting rules of law. One such rule is that the owner of property ought to be able to dispose of his property however he wishes. This rule underlies the intent theory. The other rule of law supports the equitable acquisition theory. This rule of law states that any property acquired during marriage is community property unless acquired by gift, devise or descent. The equitable acquisition cases contemplate that, when expressed, the settlor's intent prevails over the inception of title doctrine which underlies the equitable acquisition theory.

This point could prove decisive if a court ever applies the equitable acquisition theory to undistributed trust income. A beneficiary cannot reach undistributed trust income if the beneficiary has no present right to possess it. Similarly, a participant in a pension plan has only an expectation of receiving retirement benefits until his right to the retirement benefits vests and matures. Yet the courts have not hesitated to characterize the participant's interest in retirement benefits as community property. Courts have divided such benefits between spouses on an if, as and when received basis. *E.g., Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983). No reason exists not to apply the same analysis to undistributed trust income.

V. CONCLUSION

The characterization of trust income, whether distributed or undistributed, should depend on the settlor's intent in creating the trust. Although the settlor might not expressly so state, a third-party settlor's intent invariably will be that trust income should be the beneficiary's separate property when received.

The power theory endorsed by so many courts is consistent with and actually follows from the intent theory. Under the power theory, undistributed trust income cannot become separate property or community property until the beneficiary receives it. Prior to distribution, trust income remains trust property, not separate property or community property - just as the settlor intended.

The equitable acquisition theory states that trust income, once received, is community property if the income accrued on trust corpus in which the beneficiary had an equitable interest. The theory is flawed because it considers irrelevant the fact that the trustee has legal title to the trust corpus. Nevertheless, the equitable acquisition theory is superficially appealing because it relies on the simple proposition that income received during marriage is community property. The equitable acquisition theory may yet be revived to characterize undistributed trust income as community property on an if, as and when received basis in light of cases holding that unvested and unmatured property rights are community property and as such are divisible on divorce.

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