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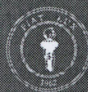

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AICPA/AAML NATIONAL CONFERENCE ON DIVORCE
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I. Introduction

Albeit perhaps a condemnation of our society and its view of relationships in general, current statistics indicate that in the United States 40-50 % of first marriages end in divorce and 60-67% of second and subsequent marriages end in divorce. *See* http://www.divorcerate.org; *see also* U.S. Census Bureau, Marriage and Divorces. However, often it seems to those of us who practice family law that many estate planning and business attorneys advise their clients and/or draft documents as if the clients will never face the prospect of divorce. Problematic situations have arisen so frequently in cases on which we have worked that our mantra has become "There are things worse than paying the IRS." When one has to tell a client that his or her separate property has been irrevocably and irretrievably transferred to the other spouse, the spouse who has just left the client for the personal trainer, or when one has to tell a client that he or she has no access to funds to pay bills due to the terms of a trust on which they are a Trustee, it does not really matter to that client how much tax a business or estate planning lawyer ever intended to save them.

In this paper we will briefly discuss the types of estate planning and business planning documents we most often encounter and the views of Courts toward these documents in various states in the divorce process. We will also discuss certain specific dilemmas inadvertently created for family law clients by well-meaning lawyers working in the corporate, transaction, taxation and estate planning fields.

II. Vehicles for Estate Planning, Business Planning and Creditor Protection

A. Family Limited Partnerships

Family limited partnerships ("FLPs") are widely used to solve a variety of estate planning problems. Examples include the following:

i. Extra jurisdictional avoidance of probate.

A FLP can be an effective means of avoiding probate in a jurisdiction other than the jurisdiction of domicile of a decedent. Since personal property (like an interest in a FLP) is generally subject to the probate laws of the jurisdiction of the decedent's domicile, while real property interests are generally subject to the probate laws of the jurisdiction where the property is located (notwithstanding the jurisdiction of domicile of the decedent), a FLP can be used as a probate avoidance technique in a jurisdiction where real property is located.

> EXAMPLE #1: A resides and is domiciled in State Z. The bulk of A's estate is personal property and real property located in State Z. However, A owns vacation real property, but no other property, in State X. A wishes to avoid probate in two jurisdictions (Z and X) upon her death. A transfers the vacation property to a FLP in exchange for interests in the FLP. As personal property, the interests in the FLP are deemed to reside with A in State Z and are therefore subject to the probate processes of State Z. Upon the death of A, it will not be necessary for A's personal representative to open an ancillary probate in State X because A owns no real property interests there.

ii. Advantages of shared ownership and management of assets.

A FLP can provide a means by which members of a family can jointly own and manage property to the advantage of all participants. By aggregating property within a FLP, the members of a family can achieve efficiencies of scale with respect to management, investment, accounting, legal, office and other costs. As older family members experience reduced interest in or ability to manage jointly owned assets, a

structure exists for appointing younger, abler family members as managers. A FLP may qualify for investments requiring large minimum outlays (for example, hedge fund accounts or private placement investments for which minimum accepted investment amounts are significant) that individual family members might not be able to afford absent a pooling of resources.

iii. Asset protection.

Ownership of assets through FLPs offers asset protection advantages as compared to outright ownership of underlying FLP property. Creditors of individual FLP owners generally cannot attach or foreclose upon assets of the FLP, but rather are limited to taking a "charging order" against the FLP interest of a defaulting owner. Acquisition of a charging order against an interest in a FLP does not confer upon the acquiror voting or management rights in the FLP. For these and other reasons, obtaining a charging order against a FLP interest is generally an unattractive alternative to a creditor.

iv. Valuation discounts for transfer tax purposes.

Although FLPs should not be implemented solely for tax avoidance reasons, properly structured FLPs established for legitimate business, asset protection and succession planning reasons can result in attractive suppression of value of underlying assets for transfer tax purposes.

> EXAMPLE #2: A owns real property worth $10,000,000. For legitimate business, asset protection and succession planning purposes, A forms a FLP with her son, B. Upon formation, A transfers the real property in exchange for a 49.5% limited partner interest in the FLP. B transfers cash of $10,000,000 for a 49.5% limited partner interest in the FLP, and also contributes a commensurate amount (i.e., $202,020) of cash for a 1% general partner interest. The FLP property is managed by B (as general partner) in accordance with the terms of the partnership agreement during the remainder of A's life.

> Upon A's death, the real property contributed by A is worth \$20,000,000 and the aggregate assets of the partnership are worth \$32,500,000. An appraisal of A's partnership interest is ordered in connection with administration of A's estate. Since A's limited partner interest is an unregistered security that carries with it no voting or management rights in the FLP, the appraiser properly applies valuation discounts for lack of marketability and lack of control aggregating 40% of the value of an undiscounted 49.5% interest in the underlying FLP assets. As a result, the appraiser concludes that A's interest in the partnership is worth \$9,652,500 for transfer tax purposes. Had A owned the real property outright upon her death, her estate would have included the full value of the real property interest, i.e., \$20,000,000, in her estate for federal estate tax purposes. In this example, therefore, one result of implementation of the FLP is to reduce A's taxable estate for federal transfer tax purposes by over \$10,000,000.

B. Irrevocable Trusts

Irrevocable trusts serve numerous functions in estate planning.

i. Asset protection.

In most common law jurisdictions, an irrevocable spendthrift trust can be used to transfer the benefit of property to a third party beneficiary without risk of attachment or seizure of the property by the creditors (including a spouse) of the trust beneficiary.

> <u>EXAMPLE #3</u>: A establishes an irrevocable spendthrift trust for his son, B. B suffers business setbacks and faces insolvency. B's wife, C, files for divorce. The assets of the trust generally will not be subject to claims of B's creditors, and generally will not be subject to property claims of C in divorce.

ii. Control.

A properly drafted irrevocable trust can allow the trust settlor to retain control of property while excluding the property from the settlor's estate for transfer tax purposes.

> <u>EXAMPLE #4</u>: A establishes an irrevocable trust for his daughter, C. A names himself as trustee for C. The trustee is empowered to distribute funds from the trust to or for the benefit of C for her health, education, maintenance and support. A dies while

> still serving as trustee of the trust. The assets of the trust will not be included in A's estate for federal estate tax purposes.

iii. Insurance.

Perhaps the most popular use of an irrevocable trust is to hold insurance on the life of the trust settlor. If properly structured, significant wealth transfer can be achieved.

> EXAMPLE #5: A establishes an irrevocable life insurance trust for his two young children, B and C. A's spouse, D, is named as trustee. A makes regular gifts of $10,000 per year to the trust from A's separate marital estate that are used to fund an annual premium on a $10,000,000 life insurance policy on A's life. A dies in the fifth year of the trust. The entire $10,000,000 of life insurance proceeds are paid to the trustee and excluded from A's estate for transfer tax purposes. The policy proceeds remain in trust, subject to administration by D, as trustee, for the benefit of the children, until the trust is split into two trusts (one for each child) when the youngest child attains age 30. Thereafter, each child becomes his/her own trustee of the funds in his/her trust.

iv. GRATs and GRUTs.

Grantor retained annuity trusts ("GRATs") and grantor retained unitrusts ("GRUTs") are popular forms of irrevocable trusts. Under these arrangements, a trust settlor transfers assets (often an interest in a family limited partnership) to a trust and retains a current income interest. The settlor typically designates younger family members as beneficiaries of the remainder interest in the trust. In this context, the divided beneficial ownership of the trust (i.e., the existence of different beneficiaries for the current interest in the trust versus the remainder interest in the trust) is referred to as "split interests" in the trust.

In order to qualify for desired transfer tax valuation rules relative to transfers of split interests in a trust, a settlor's retained current interest must take the form of either an annuity interest (i.e., a fixed payment made at least annually) or a unitrust interest (i.e., a

payment made at least annually that is based upon a fixed percentage of the periodically determined fair market value of the trust property); use of the former results in a GRAT, the latter a GRUT. In practice, planners more frequently use GRATs.

For transfer tax purposes, only the value of the non retained remainder interest in a GRAT or GRUT is considered to constitute a gift upon formation of the trust. The IRS requires valuation of such remainder interests according to special valuation tables that vary with prevailing interest rates. Often, the tax planning associated with a GRAT is to "zero out" the GRAT by providing for the settlor to retain a sufficiently large current interest to cause the gifted remainder interest to be of minimal value for transfer tax purposes. In order for the transfer tax planning to be effective, however, for either a GRAT or a GRUT, the settlor must survive the term of the current interest.

v. Qualified Personal Residence Trusts.

Another form of irrevocable trust popular for estate planning purposes is the qualified personal residence trust ("QPRT"). The transfer tax benefits of the QPRT are also based upon establishing and transferring a split interest in a trust. Under the QPRT, a trust settlor transfers a personal residence to a trust and retains a right to reside in the residence for a certain term. Again, the remainder interest is typically given to younger family members. The IRS split interest valuation tables are applied in order to value the transferred remainder interest. Upon completion of the fixed term of the trust, the remainder interest vests and the entire (fee simple) interest in the residence (formerly held by the trust) passes to the younger generation remainder beneficiaries of the trust without further transfer tax effect. Again, in order for the desired transfer tax planning to be effective, the settlor must survive the fixed term of the retained interest.

vi. Charitable Lead and Remainder Trusts.

Other popular forms of irrevocable trusts for estate planning purposes include split interest trusts known as "charitable lead" trusts and "charitable remainder" trusts. In each case, a settlor creates an irrevocable trust with split interests, but in this case, one of the split interests is designated for charity. Thus, the charitable lead trust is a trust providing for current distributions to a charity with a remainder distribution to noncharitable beneficiaries (typically younger members of the settlor's family). Alternately, the charitable remainder trust provides for current distributions to the settlor or other noncharitable beneficiaries (for example, younger members of the settlor's family) with a remainder distribution to charity. In each case, special valuation rules are used to value any noncharitable gifts.

C. Revocable Trusts

Revocable trusts principally serve two important functions in estate planning.

i. Probate avoidance.

In states that do not provide for independent (non court supervised) probate administration, significant expense can often be avoided by "opting out" of the probate system. By transferring all assets into a trust prior to death, and by including in the terms of the trust the trust settlor's directions as to disposition of the trust assets upon the trust settlor's death, the trust settlor can avoid the probate process entirely, as generally the trustee will oversee disposition of the assets and fulfillment of the terms of the trust upon the trust settlor's death without interference by or need for approval from a probate court.

Revocable trusts can be useful even for persons residing in states that offer independent administration of probate estates if real property (such as a vacation

property) is owned in another jurisdiction that does not offer non court supervised estate administration. Thus a revocable trust holding title to a vacation home can serve to avoid probate in the jurisdiction where the property is located.

ii. Uninterrupted asset management in the event of incapacity.

A trust settlor can also effect disability planning by transferring all assets to a revocable trust. By naming a successor trustee who would step in and oversee administration of trust assets for the benefit of the trust settlor upon the incapacity of the trust settlor, the trust settlor establishes a means of assuring uninterrupted management of assets and payment of expenses in the event of incapacity.

D. Survivorship Agreements

A financial account established by two or more persons as "joint tenants with right of survivorship" ("JTWROS") principally serves to avoid probate of assets held in or subject to the account upon death of a joint tenant. Under a typical JTWROS arrangement, upon the death of one joint tenant, ownership of assets held in or subject to the JTWROS account pass to the surviving joint tenant(s) by operation of contract law rather than subject to any probate process. As a result, it is not necessary to use the probate system to establish ownership of the assets in connection with death of the deceased joint tenant.

In addition, most community property states recognize "community property with right of survivorship" agreements, which combine the benefits of survivorship with the community property designation. Like JTWROS arrangements, upon the death of one spouse, ownership of assets subject to the "community property with right of

survivorship" agreement pass to the surviving spouse by operation of contract law and bypass the need for probate.

E. Transmutation Agreements and Partition or Exchange Agreements

Transmutation agreements and partition or exchange agreements principally serve to protect community assets from creditors. Partition or exchange agreements can be an effective means of creating a community-free or marital-free estate, thereby generally eliminating characterization issues, limiting rights of creditors, and granting the spouses unfettered control over their separate estates. Transmutation agreements can likewise be used to create a community-free or marital-free estate, but can also be used to augment the community estate by converting a spouse's separate property into community property.

Additionally, in connection with the formation of a FLP, some estate planners may advise spouses to enter into partition or exchange agreements. Although this may make funding the FLP easier for the estate planner, spouses should be aware that they may be relinquishing community property rights. Thus, spouses should always be advised to seek independent counsel before entering into a partition or exchange agreement.

Partition and exchange agreements are also used by spouses who wish to clarify their respective ownership and management rights in their estate during marriage, as well as to clearly define the character of their properties upon dissolution of marriage (whether the marriage ends in divorce or death).

III. Presumptions Relating to the Character of Separate, Marital and Community Property

A general presumption exists that property acquired during the marriage is marital or community property subject to division at divorce. *See, e.g., In re Marriage of Short*, 890 P.2d 12 (Wash. 1995); *Hemsley v. Hemsley*, 639 So.2d 909 (Miss.1994); *Petties v. Petties*, 129 S.W.3d 901 (Mo.App. W.D. 2004); *In re Marriage of Haines*, 39 Cal.Rptr.2d 673 (Cal.App. 4 Dist. 1995).

Some states also recognize a separate property presumption, which can arise from "significant recitals" in deeds or contracts. Under Texas law, for example, presumptions as to the separate character of property arise from "significant recitals" contained in a deed or contract when the conveying instrument from one spouse recites that separate property consideration was paid or that the property was taken as the other grantee/spouse's separate property. *See Henry S. Miller Co. v. Evans*, 452 S.W.2d 426, 431 (Tex. 1970). Generally, courts view these recitals as irrebuttable presumptive evidence of an intent to make a gift of separate property. *See, e.g., Letcher v. Letcher*, 421 S.W.2d 162 (Tex.Civ.App.- San Antonio 1967) (husband conveyed the community property ranch to his wife as her separate property; years later at divorce, the court refused to allow the husband to contend that no transfer was intended); *Raymond v. Raymond*, 190 S.W.3d 77, 81 (Tex.App.-Hous. (1 Dist.) 2005) ("When there has been a conveyance of property by one spouse to another and a delivery of the deed, the presumption exists that it was the intention of the grantor spouse to make the property the separate property of the grantee spouse and in the absence of fraud, accident, or mistake, such conveyance cannot be disturbed.").

Once a separate property presumption arises, or separate property is proven through tracing principles, most community property states recognize constitutional or statutory protection of separate property. Every community property state, except Wisconsin and Washington, restricts or prohibits the divestiture of a spouse's separate property on divorce. *See* Wis. Stat. § 767.61; Wash. Rev. Code § 26.09.080; Edwin Holmes, When May a Court Divide & Transfer Divorcing Spouses' Separate Property? Lang v. Lang, 161 Wis. 2d 210, 467 N.W.2d 772 (1991), 28 Idaho L. Rev. 1078, 1080-81 (1991).

The states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, and Texas statutorily and/or constitutionally prohibit the divestiture of separate property. *See* Ariz. Rev. Stat. § 25-318(A); Cal. Civ. Code § 4800(a); Idaho Code § 32-903; La. Civ. Code art. 2341; Nev. Rev. Stat. § 125.150(4); *Stojanovich v. Stojanovich*, 476 P.2d 950 (Nev. 1970); N.M. Stat. § 40-4-7; Tex. Fam. Code § 3.63(a); *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977).

Set forth below is a discussion of how use of the above-described vehicles for estate and business planning can invoke the community and separate property presumptions, diminish values and/or the extent of the marital estate available for division, and/or limit access to resources, and how these vehicles can therefore create significant problems for divorcing spouses.

IV. Law Applicable to Division of FLPs at Divorce

A. Property Transferred to the FLP is Not Divisible

Under the Uniform Partnership Act, adopted by every state except Louisiana, "[p]roperty acquired by a partnership is property of the partnership and not of the partners

individually." *See* Unif. Partnership Act 1997 § 203. Courts have interpreted this to mean that partnership property cannot be characterized as marital or community or separate property, and is not divisible at divorce. *See, e.g., Marshall v. Marshall*, 735 S.W.2d 587, 594 (Tex. App.—Dallas 1987) (partnership property not part of the community estate); *Angle v. Angle*, 506 So.2d 16, 17 (Fla.App. 2 Dist. 1987) (partnership property not part of the marital estate). Thus, when a spouse conveys property to the partnership, that property does not retain the character of either separate or marital or community, but rather becomes the property of the partnership. *See, e.g., Roach v. Roach*, 672 S.W.2d 524 (Tex.App.-Amarillo 1984) (husband's separate real property conveyed to the partnership became partnership property and could not be characterized as either community or separate); *see also Kenworthy v. Hadden*, 151 Cal.Rptr. 169, 172 (Cal.App. 3 Dist. 1978); *Dotson v. Grice*, 647 P.2d 409, 412 (N.M. 1982); *Nationwide Resources Corp. v. Massabni*, 658 P.2d 210, 215 (Ariz.App. Div. 2 1982); *Noble v. Noble*, 706 N.W.2d 166, 172-74 (Wis.App. 2005).

> EXAMPLE #6: A inherited $12 million from her parents before her marriage to B. During marriage, A and B formed a FLP, with A and B each owning 49.5% of the FLP as limited partners, and with an LLC (of which A and B each own 50% of the membership interests) being the general partner. Upon formation, A transferred her $12 million separate property inheritance to the FLP. A and B also transferred a nominal amount of community property to the FLP. Five years later, A and B divorce.
>
> A's $12 million initial investment in the FLP, which otherwise would have been A's separate property, could be presumed to have been gifted 49.5% to B in the FLP formation. By becoming an equal owner of the general partner, A has potentially relinquished management rights to separate property (which otherwise would have been exclusively hers to manage).

There are some state variations to the general rule against the division of partnership property. For example, some courts have held that although the transfer of property into a partnership divests a spouse of the right to the specific piece of property, the spouse acquires a corresponding interest in the partnership in exchange – i.e., the interest in the specific asset is merely traded for an interest in the partnership. *See, e.g., Kenworthy*, 151 Cal.Rptr. at 172 (community property transferred to partnership traded for community interest in partnership); *Dotson*, 647 P.2d at 412 (community interest in specific asset traded for community interest in partnership).

The same is true for separate property, which if contributed into the FLP would correspondingly translate into a separate property ownership interest of the contributing spouse in the partnership to the extent the partnership was capitalized with that spouse's separate property. *See, e.g., D & KW Family, L.P. v. Rampart Capital Corp.*, 2002 WL 1585920 (Tex.App.-Hous. (1 Dist.) 2002). Then in the above example, if A is able to overcome the presumption of a gift and trace her separate property assets into the FLP, she may be able to preserve her separate estate's interest in the FLP. However, if as is the case in some estate plans, the separate property was partitioned prior to its contribution, with a portion partitioned to B, then part of A's separate property will have irrevocably become B's separate property, and A unwittingly will have divested herself of property which would have otherwise been absolutely protected from award to B on divorce in most jurisdictions. Further, in some states, the income from separate property is community property, unless the separate property is created by a gift from one spouse to the other, in which case the income from the gifted property is the separate property of the recipient spouse. *See, e.g.,* Tex. Fam.Code § 3.102(a)(2); *Lucy v. Lucy*, 162 S.W.3d

770 (Tex.App.-El Paso Apr 12, 2005); *Fierro v. Fierro*, 2007 WL 1241338 (Tenn.Ct.App. 2007). Therefore, for example, in Texas, while distributions from A's interest in the FLP would be community property, distributions from B's interest in the FLP would be B's separate property -- hardly an equitable, and of course a totally unintended, result all the way around.

In addition, at least one state court has held that the rule against division of partnership property does not apply where a husband and wife are the only partners in a partnership. *See Hogan v. Hogan*, 352 S.W.2d 184 (Ark. 1961) ("The Uniform Partnership Act does not prevent a chancellor, in a divorce proceeding, from dividing the partnership property between a man and wife who are the partners, when there are no other partners or creditors involved.").

B. Divisible FLP Assets

i. FLP interests

A partner's interest in a partnership, that is, the "right to receive his [or her] share of the partnership profits and surplus," is divisible at divorce and can be characterized as separate or marital or community property. *Harris v. Harris*, 756 S.W.2d 798, 802 (Tex. App.-Houston [14th Dist.], 1988); *see also Lane v. Lane*, 202 S.W.3d 577 (Ky. 2006); *Nationwide Resources Corp.*, 658 P.2d at 215; *Schiller v. Schiller*, 625 So.2d 856, 859 (Fla.App. 5 Dist. 1993); *McClennen v. McClennen*, 464 P.2d 982 (Ariz.App. Div. 1 1970); *Peddycord v. Peddycord*, 479 N.E.2d 615 (Ind. Ct. App. 3d Dist. 1985); *Kluck v. Kluck*, 561 N.W.2d 263 (N.D. 1997); *Elmaleh v. Elmaleh*, 584 N.Y.S.2d 857 (N.Y.A.D. 2 Dept. 1992); *Humphrey v. Humphrey*, 157 P.3d 451 (Wyo. 2007).

Although the states are in accord on the general rule that a partnership interest is subject to division and/or allocation on divorce, courts have disagreed on the proper method of valuing such interests. *See, e.g., Hertz v. Hertz*, 99 N.M. 320, 657 P.2d 1169 (1983) (partnership agreements are dispositive of value); *Drake v. Drake*, 809 S.W.2d 710 (Ky. Ct. App. 1991) (partnership agreement is only one factor in determining value); *In re Marriage of Fonstein*, 131 Cal.Rptr. 873 (Cal. 1976) (contractual withdrawal rights used to value partnership interest); *McCabe v. McCabe*, 575 A.2d 87 (Pa. 1990) (accounts receivable not includable in valuation of partnership); *In re Marriage of Huff*, 834 P.2d 244 (Colo. 1992) (trial court may consider various valuation methods, including partnership/corporate buy-sell agreements and capitalization of excess earnings); *In re Marriage of Hall*, 692 P.2d 175 (Wash. 1984) (goodwill includable in partnership interest for purposes of division); *Travis v. Travis*, 795 P.2d 96 (Okla. 1990) (goodwill not divisible upon divorce).

ii. FLP distributed income

Distributions of partnership profits and surplus during the marriage are treated as income and are presumptively community or marital property. *See Gibson v. Gibson*, 190 S.W.3d 821 (Tex.App.-Fort Worth 2006) (profits and surplus from partnership are subject to division in a divorce proceeding); *Maloney v. Maloney*, 826 N.E.2d 864 (Ohio App. 2 Dist. 2005) (partnership dividends subject to division); *Macdonald v. Macdonald*, 532 A.2d 1046 (Me. 1987) (profits from partnership in which husband was partner were income to husband, and thus properties acquired with those earnings were part of marital estate in divorce suit); *In re Marriage of Geraci*, 51 Cal.Rptr.3d 234 (Cal.App. 2 Dist. 2006) (partnership profits are community property); *Selby v. Selby*, 149 S.W.3d 472

(Mo.App. W.D. 2004) (any farm property bought with husband's partnership profits after the parties' marriage was marital property to the extent of husband's interest in the partnership).

These distributions are presumptively community or marital property regardless of the character of the property transferred into the partnership. *See Lifshutz v. Lifshutz*, 199 S.W.3d 9 (Tex.App.-San Antonio 2006) (where spouse contributed his separate property to a partnership, the property did not retain its separate character and distributions from the partnership were considered community property); *Harris*, 756 S.W.2d at 802 (distributions of a partner's share of profits and surplus are community property even if the partner's partnership interest is separate property); *but see Legrand-Brock v. Brock*, 2007 WL 4762535 (Tex.App.-Beaumont 2008) (where a spouse owns separate-property stock in a dissolving corporation and receives distributions of liquidated assets, the distributions remain the spouse's separate property).

> <u>EXAMPLE #7</u>: A owns overriding royalty interests in several oil and gas properties, which he owned before his marriage to B. After marriage, A forms a FLP with B. Upon formation, A transfers all of his royalty interests to the FLP in exchange for a 49.5% limited partner interest in the FLP. Each month, the royalty interests generate approximately $20,000 which is distributed by the partnership on receipt.
>
> The partnership distributions, which would have otherwise been A's separate property royalties, may be considered to be converted into community income on distribution by the partnership.

C. Problems with Division of FLP Interests

i. Valuation problems

As discussed above, one reason that FLPs are attractive to estate planners is because FLP interests are generally discounted significantly for valuation purposes due to

lack of marketability (arising, for example, from restrictions on transferability), lack of control and other reasons. The discounted value of FLP interests can reduce gift and estate tax liability on transfers of such interests, and thus FLPs can be a cost-effective way to transfer wealth between family members. However, these discounts can be problematic when dividing assets on divorce because the assets in the FLP may be significantly undervalued. For example, the fair market value of a piece of real estate worth $1 million outside the FLP might only be valued at a fraction of that amount once transferred into the FLP.

ii. How do you divide FLP interests?

How do you make an equitable, or a just and right, division of FLP interests? There are essentially only two options: (1) each spouse retains an interest in the partnership, or (2) one spouse retains the entire interest and agrees to "buy out" the other spouse's share of the interest. *See* Bernard E. Jones, The Family Limited Partnership – Marital Property and Ethical Considerations, State Bar of Texas, Building Blocks of Wills, Trusts and Estate Planning (2001); J. Lindsey Short Jr., Estate Planning vs. Family Law, 26th Annual Advanced Family Law Course (2000).

If the former approach is taken, there may be significant disadvantages for the non-partner or non-managing spouse. In most circumstances one spouse will control the general partner in the FLP. A minority limited partner spouse is not entitled to participate or interfere in partnership management, nor is he or she usually in a position to remove the general partner from a management role. As a result, the benefit of the non-partner spouse's interest is diminished and unmarketable due to lack of control. Moreover, the

non-partner spouse is only entitled to receive distributions if and when made by the partnership, and has no authority over the timing or amount of distributions.

If the latter approach is taken, how should the spouse giving up his or her interest be compensated? What is the value of his or her interest in the FLP? As discussed above, assigning a value to a FLP interest can be difficult due to the general rule of discounting the fair market value of FLP assets.

iii. FLPs in which children own interest

Where the children of one or both spouses own limited partnership interests in the FLP, the division of FLP interests at divorce becomes even more complicated. Almost any type of asset may be transferred into a FLP. While the FLP frequently contains a profitable business or valuable piece of real estate, it may also contain ordinary household items, such as furniture or jewelry. Where children own an interest in the FLP at the time of their parents' divorce, the children may own a percentage of items in the FLP such as household furniture or jewelry, making it virtually impossible to achieve a division of the estate without dissolving the FLP and distributing everything out, sometimes with significant tax consequences.

> EXAMPLE #8: A owns a successful medical practice. For purposes of malpractice protection, A and B form a FLP, and they transfer every asset they own except A's medical practice into the FLP. The FLP assets consist of all stock accounts as well as their furniture, artwork and jewelry. A and B each acquire a 45% interest in the FLP and their son acquires a 9% interest in the FLP, with the general partner having a 1% interest. Seven years later, A and B divorce.
>
> At divorce, it is nearly impossible to divide A and B's marital estate without "buying out" their son's interest, because their son's FLP interest has become a portion of every asset which originally comprised their estate.

V. Law Applicable to Irrevocable Trusts

A spouse's interest in an irrevocable trust generally is not subject to division at divorce. A beneficiary's interest in undistributed income of an irrevocable trust is typically a purely anticipatory right, and the beneficiary usually has no power to compel distribution. The undistributed income of an irrevocable trust is not actually earned during the marriage, and therefore is not divisible by the divorce court. *See Matter of Marriage of Burns*, 573 S.W.2d 555, 557 (Tex.Civ.App.-- Texarkana 1978) (when trust beneficiary cannot compel payment, undistributed trust income is not property "acquired" within the meaning of the Family Code); *Wilmington Trust Co. v. U.S.*, 4 Cl.Ct. 6 (Cl.Ct. 1983) (where a married beneficiary of a trust does not have any right to take over the corpus of the trust itself, income from the trust is a gift to the beneficiary which constitutes separate property); *In re Chamberlin*, 918 A.2d 1 (N.H. 2007) (corpus of irrevocable charitable trust established by spouses during the marriage was not marital property, for purposes of equitable division in divorce action because spouses, as settlors, could not invade the trust corpus).

VI. Law Applicable to Revocable Trusts

Several states have enacted legislation which provides that the divorce or other judicial termination of the marriage of the settlor of a revocable trust will result in automatic revocation of trust provisions which relate to the settlor's former spouse. *See, e.g.*, Tex. Prob. Code § 472; Iowa Trust Code § 633A.3107; V.A.M.S. § 456.1-112.1; Mich.Comp.L.Ann. § 700.2807; Minn.Stat.Ann. § 501B.90; N.H.Rev.Stat. § 551:13; Ore.Rev.Stat. § 130.535; 20 Pa.C.S.A. § 6111.1; S.C. Code § 62-7-607; Utah Code 1953 § 75-2-804; Rev.Code Wash. § 11.07.010.

Notwithstanding the potential statutory revocation of certain trust provisions, courts may still need to determine the character of the property in the trust for division purposes. When separate property is transferred into a revocable trust, in some jurisdictions it may be inadvertently converted, or transmuted, into community or marital property. The law applicable to the transmutation of separate property is not at all uniform, and therefore estate planners must be mindful of the laws in each jurisdiction and carefully draft trust documents accordingly. *See* Michael Diehl, The Trust in Marital Law: Divisibility of a Beneficiary Spouse's Interests on Divorce, 64 Tex. L.Rev. 1301 (1986) ("The rules of trust divisibility vary widely from state to state."). While some courts have looked to the overall trust purpose in determining whether transmutation occurred, other courts have relied on the language of the trust documents or level of control and management powers retained over the trust corpus. Examples include the following:

In *Hoecker v. Hoecker*, 188 S.W.3d 497 (Mo.App. W.D. 2006), a Missouri court held that where the husband's separate property condominium was transferred into a revocable trust of which the wife was trustee and the trust was determined to be marital property, there was "evidence of an intent to contribute the condominium to the community" and a presumption arose that the condominium was transmuted into marital property. *Hoecker*, 188 S.W.3d at 501, *citing Cuda v. Cuda*, 906 S.W.2d 757, 759 (Mo.App.1995).

In *In re Marriage of Starkman*, 28 Cal.Rptr.3d 639 (Cal.App. 2 Dist 2005), a California court held that a provision in the spouse's family trust instrument that "Settlors agree that any property transferred by either of them to the Trust is the community

property of both of them," did not establish a transmutation of husband's substantial separate property into community property. The court reasoned that the trust's purposes were to avoid probate and provide for the orderly administration of property, and nowhere was there the required express declaration that husband was unambiguously effecting a change of ownership in the entirety of his significant separate estate.

In *Doerr v. Doerr*, 525 N.W.2d 745 (Wis.App. 1994), a Wisconsin court held that a husband's separate property inheritance transferred into a revocable trust was not transmuted where the trust was managed by the husband's father and the increase in the trust's value resulted from the father's efforts, notwithstanding the fact that the husband always had access to the trust, used money withdrawn from the trust to pay marital expenses, and had complete power to revoke or terminate the trust.

In *Kelln v. Kelln*, 515 S.E.2d 789 (Va.App.1999), a Virginia court held that marital property that parties divided into separate shares pursuant to terms of revocable inter-vivos trust agreement for estate planning purposes was separate property not subject to equitable distribution.

In *Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex.App.-Corpus Christi 1997), a Texas court held that the wife's separate property inheritance transferred into an income-producing trust during the marriage was not transmuted, and therefore at divorce the corpus of the trust was the wife's separate property.

In addition to the problem of characterization, set forth below are some problematic trust situations which spouses may encounter while the divorce is pending:

> EXAMPLE #9: During marriage, A and B set up a revocable trust and appoint A as trustee. A and B transfer virtually all of their community assets and accounts in the revocable trust. The trust document contains a provision limiting the trustee's power of

distribution, prohibiting the trustee from using trust distributions to satisfy any legal obligations (including any legal obligation of support). Several years later, B files for divorce. During the pendency of the divorce, the court orders A to pay temporary alimony to B in the amount of $3,500.00 per month.

A is prohibited by the terms of the trust from using trust monies to pay his legal obligation of support to B. However, every community account has been transferred into the revocable trust so A may have no other source of funds from which to pay his support obligation.

EXAMPLE #10: During marriage, A and B set up a revocable trust and appoint A as trustee. A and B transfer virtually all of their community assets and accounts to the revocable trust. The trust document contains a provision which requires the written consent of both settlors before distributions from the trust can be made. Several years later, B files for divorce. While the divorce is pending, B refuses to provide written consent for any distributions from the trust.

Because all community accounts have been transferred into the trust, A has no other source of funds from which he can pay his bills and expenses.

VII. Law Applicable to Community Property Survivorship Agreements

Community property with right of survivorship is recognized in most community property states. *See* Alaska Stat. § 34.77.110(e); Ariz. Rev. Stat. § 14-1201(28); Idaho Code § 15-6-201(a); Nev. Rev. Stat. § 111.064; N.M. Stat. §§ 40-3- 8(B), 45-2-805A; Tex. Prob. Code. § 451; Wash. Rev. Code §§ 26.16.120 and 64.28.040. The Uniform Marital Property Act also contains a comparable form of title. *See* Unif. Marital Property Act § 11.

Community property with right of survivorship is a hybrid of community property and joint tenancy with right of survivorship (JTWROS). *See* Jeremy T. Ware, Section 1014(B)(6) and the Boundaries of Community Property, 5 Nev. L.J. 704 (2005). Generally, the property is treated as standard community property during life, but at death

it passes to the survivor outside of the will just as it would with JTWROS property. *Id.* Thus, spouses obtain the benefits of community property ownership during life and then the property is transferred to the survivor "without incurring the costs of probate, while at the same time preserving the usual 'stepped up'[fair market value] date of death basis for the survivor's own one half interest." *Id.*, *citing* Arthur W. Andrews, Community Property with Right of Survivorship: Uneasy Lies the Head that Wears a Crown of Surviving Spouse for Federal Income Tax Basis Purposes, 17 Va. Tax Rev. 577, 582 (1998).

State laws vary on the availability and method of revocation of a community property survivorship agreement. For example, in Texas, a community property survivorship agreement may be revoked either in accordance with the terms of the agreement, or if the agreement does not provide for a method of revocation, by written agreement of both spouses or unilaterally by one spouse by delivering written revocation to the other spouse. *See* Tex. Prob. Code § 455. In California, a community property survivorship agreement may be terminated pursuant to the same procedures by which a joint tenancy is severed. *See* Cal.Civ. Code 682.1. The Washington statutes do not provide for revocation of such an agreement, but only provide for the agreement to be "altered or amended" in the same manner in which it was made. *See* Wash. Rev. Code §§ 26.16.120. However, Washington statutes do provide for the revocation of joint tenancies by either or both spouses. *See* Wash. Rev. Code 64.28.040 ("Either husband or wife, or both, may sever a joint tenancy."). In Idaho, survivorship agreements may be "altered or amended" in the same manner in which they were made. *See* Idaho Code §

15-6-201(c). The Idaho statute further provides that survivorship agreements "shall be revoked in the event husband and wife are subsequently divorced." *Id.*

As with revocable trusts and other non-testamentary transfers, the separate property of a spouse made part of or subject to a community property survivorship agreement may be transmuted into community property subject to division at divorce. *See, e.g., Lyon v. Lyon*, 100 Wash 2d 409, 670 P2d 272 (1983). It is incumbent therefore on each practitioner drafting a survivorship agreement to counsel the client on the availability and advisability of revocation in the event a divorce action is filed.

VIII. Creditor Protection Involving "Significant Recitals"

As discussed above, some states hold that a separate property presumption arises where a deed or contract contains a "significant recital." Recitals that separate property consideration was paid or that the property was taken as the grantee/spouse's separate property may give rise to an irrebutable presumption that a gift of separate property was made. *See Henry S. Miller Co. v. Evans*, 452 S.W.2d at 431.

Below are examples of problems that can result from significant recitals:

> EXAMPLE #11: A acquired substantial income producing assets prior to marriage worth $4 million. A also has many creditors pursuing him for unpaid bills arising out of prior business operations. Pursuant to the advice of his business lawyer, ostensibly to protect assets from A's creditors, A forms a corporation, transfers the entire $4 million in business assets to the corporation and names his wife, B, as the 100% shareholder of the corporation. The transfer documents contain a "significant recital" which states that the stock is being held as B's separate property.
>
> Several years later, B files for divorce. Under the state law of A and B's domicile, a "significant recital" raises an irrebutable presumption of A's intent to make a gift of separate property. A's separate property is now B's separate property.

> EXAMPLE #12: A is a doctor. A and B are married, and they are concerned about A's potential malpractice liability. For the purpose of asset protection in the event that A is sued for malpractice, A transfers every asset he owns, except his medical practice, to B with a significant recital evidencing his intent to make a gift of separate property to B.
>
> Several years later, B files for divorce. At divorce, the only asset to which A is entitled is his medical practice. Every other asset has become B's separate property.

In states which constitutionally protect separate property, the import of these "significant recitals" can be quite severe. Once a presumption of separate property arises (due to a "significant recital" or otherwise), the grantee spouse's separate property is statutorily and constitutionally protected from divestiture on divorce.

IV. Conclusion

Practitioners must be cognizant of the potentially severe consequences of estate planning and business planning arrangements for divorcing spouses and as a part of any estate or business plan advise the client of the impact of any proposed arrangement should the client be divorced. Given the divorce rate in this country, it is essential that estate and business lawyers recognize how their transactional documents may affect the character and value of their clients' properties and the overall division of the estate on divorce and/or the clients' access to resources while a divorce is pending.