ESTATE PLANNING FOR THE INCAPACITATED SPOUSE

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I. INTRODUCTION
The estate planning practitioner will face during his or her career a client's declining capacity to effectively participate in an estate planning program. This will be due to a mental or physical event. The disabling event may be slow, arising from old age or a disease such as Alzheimer's, or it may be very sudden due to an accident or traumatic physical illness.

Incacity of one's spouse during the marriage offers unique challenges for implementation of an estate planning program. These challenges arise in large part because of the marital property rules affecting ownership and management of the couple's collective assets.

The following discussions will address the procedures and conflicts that the competent spouse and the practitioner will face in regard to estate planning for the incapacitated spouse. The facts have been kept relatively simple. However, the complications can be obviously compounded if the following facts involved a second marriage, Subchapter S stock, a revocable trust, and other estate planning hurdles.

This paper does not discuss a program of impoverishment. It will consider only the use of typical estate planning tools for the marital situation.

II. THE FACTS
John and Mary King married in 1958 during their college days. They are each now sixty-one years old. They have three children, one daughter and two sons.

They began their marriage with little more than a hope of financial success. John's parents have died and left to John AT&T stock worth $500,000.

Mary's mother and father were quite successful, and when Mary's father died in 1994, he left a portion of his estate (his separate property that he inherited from Mary's grandfather) in two trusts for Mary. One trust is a generation-skipping trust over which Mary has a testamentary limited power of appointment exercisable in favor of her spouse (in trust only), her descendants, and charity. In default of the exercise of the power, the generation-skipping trust will pass to Mary's children. The other trust will terminate on Mary's death and is to be distributed to Mary's descendants unless she provides differently by the exercise of a testamentary general power of appointment.

John and Mary organized a retail business shortly after completion of college. The business is managed as a closely-held corporation, and it has been relatively successful. The business provides a qualified retirement plan program for its employees. Mary "retired" from the business five years ago. On her retirement, she withdrew her share from the plan and placed it in an individual retirement account.

Their daughter works in the business with John, and she owns five percent of the stock. Sons of Mary and John do not own any stock in the company, nor do they want to. Each son has a very successful medical practice, and neither intends to return to the family business.

It is expected that the daughter and her husband will carry on with the business after John's death or retirement. However, Mary has always been concerned about the ability of the daughter and son-in-law to manage the company, and she has never been convinced that their marriage will last.

John and Mary have accumulated a significant investment portfolio through a disciplined savings program. They likewise felt insurance was important, and each are insured for $500,000. Mary was designated as the owner of the policy insuring her life. John was designated as the owner of the policy insuring
his life, but his life insurance agent advised him
to gift the policy to Mary in order to avoid
estate taxes. He made this transfer in 1976.
Mary is the designated beneficiary.

John and Mary have well-prepared wills,
\textit{i.e.}, they were for a couple with no net worth
and three small children in 1964. The wills are
basic "Ma and Pa" wills, with guardian designa-
tions for the children and trusts for a child's
portion.

John and Mary have focused on new wills
and an overall estate plan for the past four
months. They have each told the other about
very definite plans they would like, and Mary
has been very specific about her jewelry to the
daughter, and the properties of her grandfather
(held in the trusts created by her father) pass-
ing to her children after her death.

The week before John and Mary are to go
to their attorney's office, Mary suffers a mas-
sive stroke. The effects are such that Mary is
unable to respond, and the doctors do not
expect a significant recovery. Her life expect-
tancy is undetermined. John visits the loc-
\textit{k} box to review the status of affairs, and discov-
ers an old durable general power of attorne-
y he had forgotten ab-
out. The general power of
attorney does not grant gifting powers to the
agent.

Their financial statement is as follows:

\begin{itemize}
  \item \textbf{John's separate property:}
    \begin{itemize}
      \item AT&T stock \hspace{1cm} $500,000
    \end{itemize}
  \item \textbf{Trusts for Mary:}
    \begin{itemize}
      \item GST Exempt trust \hspace{1cm} $1,000,000
      \item Non-exempt trust \hspace{1cm} $500,000
    \end{itemize}
  \item \textbf{Mary's separate property:}
    \begin{itemize}
      \item Life insurance on John's life for $500,000
    \end{itemize}
\end{itemize}

\textbf{Community property:}

\begin{itemize}
  \item Home \hspace{1cm} $250,000
  \item Personal effects \hspace{1cm} $50,000
  \item Retail business \hspace{1cm} $750,000
  \item John's retirement \hspace{1cm} $1,000,000
  \item Mary's IRA \hspace{1cm} $1,100,000
  \item Brokerage account \hspace{1cm} (JTWROS) \hspace{1cm} $1,500,000
  \item Life insurance on Mary's life for $500,000
\end{itemize}

\section*{III. BASIC CONCEPTS AND LAWS}

There are several concepts and rules of
law that directly affect estate planning for the
incapacitated spouse. The ownership and
management of property is a critical issue.
The legal processes available for one to man-
age the property of another and the limitations
thereof are discussed below. Also discussed
will be some "what if's." In other words, what
if Mary or John, or both, had planned their
estate management differently.

\textbf{A. Ownership of Marital Property}

A characterization of marital property as
either separate property of a spouse or com-
\textit{munity property belonging to the spouses has
a significant effect on the type of estate plan-
ing program that can be implemented.}

1. \textbf{Texas Constitution}

Article XVI, § 15 of the Texas Constitution
is the penultimate provision for the
definition of separate and community property.
It defines the separate property of a spouse as
that which is owned or claimed before mar-
rriage, and that which is acquired afterward by
gift, devise, or descent. The definition of
community property is by presumption, \textit{i.e.}, all
other property owned by the spouses during
the marriage that does not meet the definition
of separate property will be presumed commu-
nity property.

The Constitution allows the spouse to
partition and exchange their community prop-
erty by written agreement so that the portion
or interest set aside to each spouse will be that
spouse's separate property. Likewise, by
written agreement, the spouses may agree that
community income from a spouse's separate property shall be his or her separate property.

2. **Texas Family Code Provisions**

The Texas Family Code further defines separate property, community property, and the rights of the spouses in relation to the marital property. In addition, the Family Code delineates the rules regarding marital agreements that can affect the ownership and management of marital property as permitted by the Constitution.

a. **Separate Property**

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. **TEX. FAM. CODE § 3.001.**

b. **Community Property**

Community property is that property, other than separate property, which is acquired by either spouse during the marriage. **TEX. FAM. CODE § 3.002.** The property possessed by either spouse during or on dissolution of marriage is presumed to be community property. **TEX. FAM. CODE § 3.003.**

3. **Agreements Changing Community Property to Separate Property**

The spouses may enter into agreements which have the effect of redefining the marital character of their properties, and amending the management rights of the spouses. **TEX. FAM. CODE §§ 4.001 et seq.** (pre-marital agreements) and **4.101 et seq.** (post-nuptial agreements).

At any time, spouses may partition or exchange between themselves any part of their community property, then existing or to be acquired, as the spouses desire. **TEX. FAM. CODE § 4.102.** The resulting property held by a spouse following a partition or exchange agreement becomes that spouse’s separate property. **Id.** In addition, spouses may agree that income from separate property of either spouse shall be the separate property of the spouse owning the asset generating the income. **TEX. FAM. CODE § 4.103.**

A partition or exchange agreement must be in writing and signed by both parties. **TEX. FAM. CODE § 4.104.**

**Query:** Can an agreement affecting the marital property of the spouses be entered into on behalf of one spouse by an agent acting through a power of attorney? Can such an agreement be entered into on behalf of an incompetent spouse through the guardian of the spouse's estate?

The power of attorney held by John for the benefit of Mary creates a fiduciary relationship with all of the accompanying duties of loyalty and restraints on self-dealing. It is doubtful that John, on behalf of Mary, could enter into an agreement with himself, individually, to effect the marital property character of the community estate and the income therefrom. If Mary appointed her daughter as the attorney-in-fact under the power of attorney, could the daughter then enter into a marital agreement with John? Spousal rights may be deemed so personal that a spouse may not delegate these powers and decisions to a third party. If so, then it would seem impossible to effect a partition of the community estate upon the incapacity of one spouse.

4. **Transmutation of Separate Property to Community Property**

A pending amendment of Section 15, Article XVI, of the Texas Constitution will allow spouses to agree in writing that all or part of the separate property owned by a spouse shall be the spouses’ community property. **H.J.R. No. 36.** (See Appendix A.) This amendment will be submitted to the voters on November 2, 1999. Defining legislation adding proposed Section 4.201 et seq. to the Texas Family Code is contained in H.B. No. 734. (See Appendix B.) These amendments,
if the voters approve the constitutional amendment, will be effective January 1, 2000.

**Note:** At the time this paper went to press, final legislative action was not obtained to pass the proposed legislation into law. The reader must follow up to determine the final disposition of the proposed legislation discussed in this article.

**B. Management of Marital Property**

The Texas Family Code outlines the rights of parties regarding the management of marital property. The management rights depend on the characterization of the property as separate property, joint community property, and "special" community property.

1. **Separate Property Management**

Each spouse has the sole right to manage, control, and dispose of that spouse's separate property without the joinder of the other spouse. **TEX. FAM. CODE § 3.101.**

2. **Special Community Property**

There is no statutory term of "special community property," but this phrase has been commonly used as a short reference to community property which is subject to the sole management, control, and disposition of a spouse. The Texas Family Code § 3.102(a) provides that each spouse has the sole management, control, and disposition of the community property that the spouse would have owned if single. This special community property includes (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 a spouse's sole management, control, and disposition.

Gifts of special community property can be made by the controlling spouse. However, these transfers are subject to review because of the fiduciary relationship between the spouses. **See IV.A.2, infra.**

3. **Joint Community Property**

All other community property is subject to the joint management, control, and disposition of the spouses unless they have provided otherwise by power of attorney in writing or other agreement. **TEX. FAM. CODE § 3.102(c).** If the special community property of each spouse is mixed or combined, then the community property becomes joint community property subject to the joint management rules. **TEX. FAM. CODE § 3.102(b).**

**C. Powers of Attorney**

It is very important today that a person grant a power of attorney to an appropriate person, which power of attorney is carefully drafted to include the necessary language to permit the attorney-in-fact to engage in estate planning transactions on the principal's behalf.

The Texas statutory durable power of attorney offers little help in the estate planning realm. **TEX. PROB. CODE §§ 481 et seq.** There are some limited opportunities for estate planning techniques discussed below, but overall the statute is inadequate to permit sophisticated estate planning programs by the attorney-in-fact.

As noted above, Mary has an old durable general power of attorney without gifting powers. This power of attorney is a "generic" power of attorney that gives John broad authority to transact general business and financial affairs for Mary, but it does not give him the authority to make gifts or otherwise gratuitously dispose of her properties in trust or outright. Likewise, Mary's power of attorney does not grant her agent the power to change beneficiaries of insurance policies and retirement accounts.

**Observation:** John should also review any other agreement he and Mary may have signed in order to determine if certain powers are granted to him. For example, there may be a buy-sell agreement regarding his corporation, or a partnership agreement affecting his rights to manage partnership interests. Additionally, John and Mary may have signed agreements or limited powers of attorney with the brokerage house that may give him
management rights over the brokerage account which would supplement and extend the powers under the power of attorney.

D. Management of the Community Property Upon Incapacity of a Spouse

The Texas Probate Code abdicates the management of the community estate to the competent spouse upon the appointment of a guardian of the estate of the incompetent spouse. Unless the Probate Code finds that the competent spouse is not eligible for appointment as a guardian of the estate (within the requirements of TEX. PROB. CODE § 681), then a judicial declaration of incompetence of one spouse renders the competent spouse as the sole agent of all of the community estate.

1. TEX. PROB. CODE § 883

The Probate Code provides as follows:

When a husband or wife is judicially declared to be incapacitated, the other spouse, in the capacity of surviving partner of the marital partnership, acquires full power to manage, control, and dispose of the entire community estate, including the part of the community estate that the incapacitated spouse legally has the power to manage in the absence of incapacity, without an administration. If the court finds that it is in the best interest of the incapacitated spouse and that the other spouse would not be disqualified to serve as guardian under Section 681 of this Code, guardianship of the estate of the incapacitated spouse may not be necessary when the other spouse is not incapacitated unless the incapacitated spouse owns separate property, and the guardianship will be of the separate property only. The qualification of a guardian of the estate of an incapacitated spouse does not deprive the competent spouse of the right to manage, control, and dispose of the entire community estate as provided in this chapter.

TEX. PROB. CODE § 883 (emphasis added). This special power of management, control, and disposition by the competent spouse terminates upon a decree of the court that the mental capacity of the other spouse has recovered. TEX. PROB. CODE § 883A.

Query: What if John has borrowed money from Mary's separate estate? For example, he has borrowed money through a policy loan from the insurance policy owned by Mary as her separate property. Section 681(5) of the Probate Code disqualifies a person as guardian if he or she is indebted to the ward. Therefore, John might not be "qualified" to manage the community estate as prescribed by Section 883. Who will then have the power to manage, control, and dispose of the community property?

2. 1999 Proposed Legislation

House Bill No. 2893 before the 1999 Texas legislature would have amended Section 883 of the Texas Probate Code. The amendment would have required the guardian of an incapacitated spouse to administer "the part of the community estate that the incapacitated spouse legally has the power to manage in the absence of the incapacity," if the competent spouse is disqualified under Section 681. (See Appendix C.)

This proposed legislation would have greatly extend the jurisdiction of the probate court over the community property when the competent spouse is not disqualified under Section 681 of the Texas Probate Code. A new Section 883B and 883C would have (1) required the filing of an inventory and appraisal, (2) provided a procedure for forcing an accounting of the community administration, and (3) provided grounds and procedure for removing the competent spouse from the administration of the community assets. (See Appendix C.)

It appears unlikely this proposal will pass, but it may be a prediction of things to come.
Note: At the time this paper went to press, final legislative action was not obtained to pass the proposed legislation into law. The reader must follow up to determine the final disposition of the proposed legislation discussed in this article.

3. Sufficient Finding of Incapacity
   The court's finding of incapacity must be a final judgment, and a finding of complete incapacity. If the probate court determines that there is only a partial incapacity, and limits the scope and power of the guardian, the order should be explicit regarding the competent spouse's management, control, and disposition of the community estate. See Bernard E. Jones, Estate Planning for Incapacitated Individuals, 18th Annual Advanced Estate Planning and Probate Course, State Bar of Texas, June 1-3, 1994 (Outline Y, p. Y-14).

   Section 884 provides that an appointed guardian of the estate of an incapacitated married person shall deliver on demand the community property to the spouse who is not incapacitated. This delivery of the community estate to the competent spouse is mandatory regardless of the status of the judgment. Therefore, in a case involving the appointment of a temporary guardian, the court ordered that the community estate had to be delivered to the competent spouse notwithstanding the fact that the judgment of incapacity was not final. Houston Bank & Trust Co. v. Lee, 345 S.W.2d 320, 324 (Tex. Civ. App.--Houston 1961, writ dism'd).

   Observation: It would seem that if the judicial finding of incapacity is not a final judgment, or is a finding of partial incapacity, the joint community property and the special community property of the incapacitated spouse could be trapped in a situation where no one has the authority to manage the property. The competent spouse would not have the statutory authority of Section 883 to manage the entire community estate. The appointed guardian of the estate would likewise not have the authority to manage the community estate under the provisions of Sections 883 and 884.

5. Revocation of Power of Attorney
   Mary and John had executed "comprehensive" powers of attorney in 1974. The powers of attorney were durable powers in that they provided for continuation of the power in the event of incapacity of the principal. The power of attorney may be totally adequate insofar as management of the business and financial affairs of the family.

   Section 485 of the Texas Probate Code provides that upon appointment of a guardian of the estate of the principal, the powers of the attorney-in-fact terminate. The attorney-in-fact is required to deliver to the guardian the community estate all assets of the ward in the attorney's possession. The attorney-in-fact shall account to the guardian of the estate as he or she would to the principal.

   Query: Would the appointment of a guardian require the competent spouse to deliver to the guardian community property managed under the power of attorney? If so, wouldn't the guardian of the estate be required to re-deliver the community estate to the competent spouse as required by Section 884?

   Observation: If a guardian of the estate of Mary is appointed, it would terminate the power of attorney as to all property. Therefore, the separate property of Mary would become the corpus of the guardianship estate. The community property would be subject to John's sole management, control, and disposition.

   There are no provisions under the Texas Family Code which would permit the competent spouse to manage the separate property of the incapacitated spouse. Therefore, a guardianship of the estate is the appropriate procedure for the management of separate property.
The Family Code does have provisions which address the management of the joint community and the special community of the incapacitated spouse.

a. Petition to Manage Community Estate

Texas Family Code § 3.301(a)(1) provides that a spouse may file a sworn petition stating facts which make it desirable for the petitioning spouse to manage, control, and dispose of community property described or defined in the petition that would otherwise be subject to the sole or joint management, control, and disposition of the other spouse. This request for authority can be based on the physical or mental incapacity of the other spouse which renders him or her unable to manage, control, or dispose of the community property. The petition is to be filed in the district court of the county in which the petitioner resided at the time the incapacity began, and cannot be filed earlier than the sixtieth day after the date of the occurrence of the event. TEX. FAM. CODE § 3.301(b).

b. Appointment of Attorney Ad Litem and Notice

It is within the discretion of the court whether an attorney ad litem will be appointed for the incapacitated spouse. TEX. FAM. CODE § 3.303(a). However, it might be most prudent to have an ad litem appointed if the requested control over the community estate will extend beyond normal day-to-day financial and business management affairs. Not only would an ad litem protect the incapacitated spouse, but the appointment should reduce the problems caused by conflicts of interest.

Notice of the hearing is to be served on the attorney representing the incapacitated spouse, if one is appointed. TEX. FAM. CODE § 3.304(a). If an attorney has not been appointed for the incapacitated spouse, citation must be issued and served on the respondent. TEX. FAM. CODE § 3.304(b).

c. District Court Order for Management, Control, and Disposition of Community Property

The discretion of the court in determining the terms and authorities under this court order seems to be very broad. The court is directed by the statutes to render an order describing or defining the community property at issue that will be subject to the management, control, and disposition of each spouse during the marriage. TEX. FAM. CODE § 3.306(a). The terms of the court's order shall be on such basis as the court "considers just and equitable." Id.

The court may, in its order (1) impose any conditions and restrictions it deems necessary to protect the rights of the incapacitated spouse; (2) require bond; and (3) require delivery to the registry of the court of any portion of the proceeds of the sale of property to be managed in accordance with the court's further directions. TEX. FAM. CODE § 3.306(b).

d. Comments

Although there is not much guidance in Section 3.306 regarding the extent to which the court may grant authority, the lack thereof and broad language would indicate that the court's order could be very comprehensive.

For example, the court could possibly waive bond and grant that the powers over the community estate would include "all powers contained in Chapter XII of the Texas Probate Code (Durable Power of Attorney Act)." The court's order finding incapacity resulted in a revocation of Mary's 1974 power of attorney. Through the exercise of the court's discretion to grant John the full powers held by an attorney-in-fact under the statutory durable power of attorney would effectively rewrite Mary's power and extend its scope.

Observe: It would also seem that the court could grant appropriate gifting powers over the community estate. These gifting powers could be parallel to those permitted a guardian of the separate property estate. The court could further designate the potential
types of gifts, amounts of gifts, and beneficiaries. A gifting program should be approached with some caution because Section 3.306 is not as clearly worded as one would like in order to eliminate an IRS challenge. This challenge would be based on an IRS position that the statute is not so broad as to authorize gifting, and that a court's order in excess of that allowed by statute is not binding on the incapacitated spouse. Therefore, any gifts made under this order would be revocable. See Priv. Ltr. Rul. 9731003. See also R. Austin and J. Benson, Guardian's Change of Ward's Beneficiary Designation: A Breach of Your Fiduciary Duty?, Advanced Estate Planning and Probate Course, June 3-5, 1998.

e. Continuing Jurisdiction of the District Court

Texas Family Code § 3.307 provides that the court would have continuing jurisdiction over its order. Supposedly, the court could modify its order regarding the extent of management and control the competent spouse has. Likewise, the court might modify its order to require bond, accountings, and delivery of certain property or proceeds into the registry of the court. However, this is not clear by reading the statute.

The court may also vacate the original order after notice and hearing if it finds that the incapacitated spouse's capacity is restored. TEX. FAM. CODE § 3.307(b)(1).

f. Practical Application

There is very little authority interpreting the statute and the scope of practice under its provisions. It is difficult, if not impossible, to find forms and discussion in treatises. Likewise, the appellate courts have not addressed the statutory provisions. Appropriate orders regarding management and control of the community estate of the spouses would seem to clearly enhance the competent spouse's ability to manage the community assets. However, orders regarding disposition in the form of gifts, transfers to trusts, and other programs which would modify the incapacitated spouse's existing estate plan are not clearly blessed by the terms of the statute.

If the court under the provisions of Texas Family Code §§ 3.301 et seq. can permit a gifting program as suggested above, this could be a very viable and flexible program for management of the incapacitated spouse's interest in community property. It is very important that the competent spouse have the ability to dispose of community assets in an estate planning program so that the transfers will not be subject to attack by the incapacitated spouse or guardian of the estate. This is necessary to avoid attack by the Internal Revenue Service that such transactions are voidable.

E. Judicial Supervision of Separate Property

Texas Family Code § 3.101 provides that each spouse has the sole management, control, and disposition of that spouse's separate property. Only one exception to the rule requires the participation of both spouses upon the sale of a spouse's separate property that is used as the homestead of the couple. TEX. FAM. CODE § 5.101. See IV.A.1.a, infra.

1. Court-Approved Gifting of Separate Property

A guardianship may be preferable for estate planning purposes. A power of attorney or trust agreement executed prior to incapacity may not permit the agent or trustee to enter into estate planning transactions. At least the Texas Probate Code does have two programs which offer some opportunities for the implementation of estate planning transactions.

a. Tax-Motivated Gifts

Texas Probate Code § 865 addresses estate planning through tax-motivated gifts. This section permits the guardian of the estate or any interested person to petition the court for an order that authorizes the guardian to apply the principal or income of the ward's estate toward the establishment of an estate plan. The estate plan must be for the purpose
of minimizing income, estate, inheritance, or other taxes payable out of the ward's estate. It must be shown that the ward will probably remain incapacitated during the ward's lifetime.


The gifts permitted include gifts made outright or in trust. Tex. Prob. Code § 865(a).

The permissible beneficiaries of gifts from the ward's estate include the following:

- Qualified charitable organizations in which it is shown the ward would reasonably have an interest.
- The ward's spouse, descendant, or other person related to the ward by blood or marriage.
- A devisee under the ward's last validly executed will, trust, or other beneficial instrument.
- A person serving as guardian if the person is a spouse, descendant, or other person related to the ward by blood or marriage, or a devisee under the ward's will, trust, or other beneficial instrument.


The applicant must outline the proposed estate plan and set forth the benefits that are to be derived by the ward's estate. Tex. Prob. Code § 865(b). The application must indicate that the planned disposition is consistent with the ward's intentions if they can be ascertained, and if not, the ward will be presumed to favor reduction in the incidence of the various forms of taxation and a partial distribution of the ward's estate as provided in the Code. Id.

The court may appoint a guardian ad litem for the ward or any interested person at any stage of the proceedings. Tex. Prob. Code § 865(c). Notice of the application must be made to: (1) all devisees under a will, trust, or other beneficial instrument relating to the ward's estate; (2) the ward's spouse; (3) the ward's dependents; and (4) any other person as directed by the court.

b. Limitations Affecting Tax-Motivated Gifts

Section 865 of the Probate Code is relatively broad in scope. However, there are limitations that should be noted.

- This provision would not permit the court to order the exercise by the guardian of an inter vivos special power of appointment.
- The court's program could not authorize the exercise of a testamentary special or general power of appointment.
- Execution of an inter vivos general power of appointment could be made only if there was a method by which the guardian of the estate could withdraw the appointed property from the trust estate that is subject to the general power, and following withdrawal, the guardian placed the assets in the ward's estate for disposition under a Section 865 program.
- Must the estate plan reduce taxes payable by the ward's estate? For example, would a bypass trust program be permitted when the effective tax reduction occurs in the estate of the ward's spouse?

c. Charitable Gifts From Income

The guardian of an estate may file a sworn application requesting an order from the court for permission to contribute from the income of the ward's estate a specific amount of money to qualified charitable organizations. Tex. Prob. Code § 866(a). The court may authorize contributions from income to a particular donee designated in the application if the court finds that: (1) the contribution will not exceed 20% of the ward's net income; (2) the net income of the ward's estate probably will exceed $25,000 for the current calendar year; (3) the full amount of the contribution will be deductible from the ward's gross income; (4) the condition of the ward's estate justifies a contribution in the proposed amount; and (5) the proposed contribution is
reasonable in amount and for a worthy cause. 
TEX. PROB. CODE § 866(c).

2. Business Planning -- Section 867 Trust

The investments which a guardian is permitted to make with the funds of the ward's estate are significantly limited. TEX. PROB. CODE §§ 855 et seq. These investments are understandably conservative and would exclude opportunities for the guardian's estate to invest in programs that might reduce the estate tax liability. For example, it is doubtful that a guardian is permitted to invest corpus of the ward's estate in a limited partnership program or in undivided interests in real estate.

A method by which the ward's estate could be subject to a broader business planning and estate planning program would be to transfer the estate administration to a Section 867 Trust." This provision of the Texas Probate Code permits the court in which the guardianship proceeding is pending to enter an order that creates for the ward's benefit a trust for the management of guardianship funds if the court finds that the creation of the trust is in the best interest of the ward. TEX. PROB. CODE § 867. The order of transfer shall include terms, conditions, and limitations of the trust as specified in Texas Probate Code §§ 868. The trustee must be a trust company or state or national bank that has trust powers in Texas. Id.

Once the property is transferred to the Section 867 trust, the guardianship is effectively terminated. TEX. PROB. CODE § 868A. The court retains jurisdiction over the trust so that it may amend, modify, or revoke the trust at any time before the trust termination date. Once the trust is created, its administration is subject to the terms and provisions of the Texas Trust Code. TEX. PROB. CODE § 869B. The court creating the trust continues to have the same jurisdiction to hear matters relating to the trust as the court has with respect to the guardianship and other matters covered by the Texas Probate Code. TEX. PROB. CODE § 869C.

The trust terminates on the date the court determines that continuing the trust is no longer in the ward's best interest, or on the date of the ward's death. TEX. PROB. CODE § 870. The management trust program further includes requirements regarding (1) annual accountings and (2) formalities for distribution of the trust property upon termination of the trust. TEX. PROB. CODE §§ 871 and 873.

The proposed 1999 amendments to Section 867 are shown in Appendix D. These amendments allow the transfer of the ward's assets to a Section 867 Trust without first being placed in a guardianship proceeding.

Note: At the time this paper went to press, final legislative action was not obtained to pass the proposed legislation into law. The reader must follow up to determine the final disposition of the proposed legislation discussed in this article.

a. Loss of Power to Make Gifts

The management trust provisions regarding distributions from the Section 867 Trust do not include gifts to the ward's spouse and descendants. Distributions to these "beneficiaries" are limited to health, education, support, or maintenance of persons whom the ward is legally obligated to support. TEX. PROB. CODE § 868(b). Therefore, transfer of the ward's estate to a management trust may defeat the ability of the probate court to order gifts from the ward's estate, or otherwise authorize any estate planning transactions. The only alternative might be for the court to order a partial revocation of the trust and commit the removed assets to a tax-motivated gift program in the guardianship proceeding.

For further discussion of Section 867 management trusts, see Bernard E. Jones, Estate Planning for Incapacitated Individuals, 18th Annual Advanced Estate Planning and Probate Course, State Bar of Texas, June 1-3, 1994 (Outline Y, p. Y-14).

b. No Opportunities Upon Dissolution of Section 867 Trusts
The trust must terminate on the ward's date of death. Upon termination, the trust principal and undistributed income shall be distributed to the representative of the deceased ward's estate on the ward's death. TEX. PROB. CODE § 873(2)(c). Previously, this section indicated that the court could direct distribution and termination otherwise. However, this provision of the Code was amended effective September 1, 1995, and this discretionary language was deleted.

**F. Release of Powers of Appointment**

Section 181.051 et seq. of the Texas Property Code addresses the release of powers of appointment, and the requisite steps to be taken. If a person is under a disability, the guardian of the person's estate may release a power on the order of the court in which the guardian was appointed or in which the guardianship proceeding is pending. TEX. PROP. CODE § 181.053.

**IV. LIFETIME TRANSFERS**

The following discussion regarding gifts by the competent spouse and by the incompetent spouse's guardian or attorney-in-fact, will deal with the mechanical and substantive issues surrounding a gift. Difficult issues regarding conflicts of interest, fiduciary duties, and attorney-client relationships run rampant throughout. The following discussions will begin to highlight the obvious ethical questions for the family and for the attorney.

**A. Inter Vivos Gifts by the Competent Spouse**

A frequently employed estate planning program is the lifetime gift. These gifts may take many forms, but are most often by outright transfer or transfer to trust. Each inter vivos gift will be affected by the annual exclusions of the spouses, use of exemption equivalents, and possible allocation of generation-skipping tax exemptions.

Numerous issues arise in the marital setting, and they will obviously differ depending on whether the gift is of the separate property of the competent spouse, the separate property of the incapacitated spouse, or the community property of the couple.

1. **Gift of the Competent Spouse's Separate Property**

A gift by the competent spouse of his or her separate property appears to be free of legal impediments. This assumes that there is no agreement entered into by the spouses which would otherwise affect a transfer of either spouse's separate property.

The guardian of the incompetent spouse's estate or attorney-in-fact should not be able to complain or attack the transfer of the separate property of the competent spouse. The incompetent spouse would have no claim regarding ownership. All rights of reimbursement recognized under Texas law are equitable rights, and these rights would not be extinguished by a transfer of the separate property of the competent spouse. Therefore, this type of gift should be relatively free from question by persons interested in the incompetent spouse's estate, and by the taxing authorities.

a. **The Homestead Exception**

A transfer by the competent spouse of his or her separate property residence occupied by the couple as their homestead would require the participation of the incompetent spouse. TEX. FAM. CODE § 5.001. The Family Code does address a procedure for the sale, conveyance, or encumbrance of the homestead without the joinder of the incompetent spouse. TEX. FAM. CODE § 5.101. This provision allows the competent spouse to apply to the court for authority to "sell, convey, or encumber the homestead" which is the separate property of the competent spouse.

Query: Would the terms of the Texas Family Code proceeding allow a gratuitous transfer of the separate property homestead to an estate planning program? For example, an appropriate program for Mary and John might
be to (1) gift the homestead to the children or a trust for the children; (2) gift the homestead to charity with a retained life estate; or (3) gift the homestead to a qualified personal residence trust.

b. Guardianship Approval of Homestead Transfer

It would seem that the guardianship court would have authority to grant permission for the gift of the incompetent spouse's interest in the competent spouse's separate property homestead. However, it would be questionable whether the guardianship court could empower the guardian to make a conveyance of the property because there is no jurisdiction of the court over the competent spouse's separate property. Likewise, a similar question would arise if the homestead was community property. If John makes a gift of his separate property to the children, the gift can be effectively treated for gift tax purposes as if the incompetent spouse made one-half of the gift. This occurs because of the rules under Internal Revenue Code (IRC) § 2513, which permits the non-donor spouse to consent for gift tax purposes as having made one-half of the gift made by the donor spouse. This consent is reflected on a gift tax return, and the guardian for a legally incompetent spouse may sign the consent. Treas. Reg. § 25.6019-1(g).

c. Gift Splitting

If Mary's will gives all of her estate to John upon her death. Therefore, anything gifted to her by John will revert to his estate in the event Mary dies first. John can transfer his separate property to a QTIP trust for Mary, and provide that upon her death the trust will continue in the form of a bypass trust for the benefit of John which terminates upon his death and is distributed to the children. The initial transfer to trust by John would be followed by an election to treat the gift as qualified terminable interest property under IRC § 2523(f). Upon the death of the incompetent spouse, the QTIP trust property will be includable in the incompetent spouse's gross estate under IRC § 2044. As a result, Mary's exemption equivalent would be used as the transition is made from the QTIP trust to the bypass trust, and this very effective estate planning program would be implemented by John effectively creating his own deferred bypass trust. Because Mary is treated as the transferor of the property for estate tax purposes, the property of the bypass trust will not be subject to inclusion in John's gross estate under Section 2036 or 2038. Treas. Reg. § 25.2523(f)-1(f) example 11.

If the donor spouse retains an interest in a QTIP trust, any subsequent transfer by the donor spouse of the retained interest in the property is not treated as a transfer for gift tax purposes. Treas. Reg. § 25.2523(f)-1(d)(1). Therefore, John may not want his retained interest to be subject to a spendthrift clause during Mary's lifetime. The property would not be subject to estate tax in the event John predeceases Mary.

One potential problem is that the gift to the trust would generate an all-income requirement with the resulting payment of the income to Mary. This income would be Mary's separate property. TEX. FAM. CODE § 3.005. John should be able to manage this income for Mary under his power of attorney (assuming it has not been revoked by guardianship proceedings), or the income could be paid to the guardian of Mary's estate. If the income is managed under the power of attorney, there is no opportunity for gifting due to the lack of gift powers. Payment to the guardian of the estate could create a situation that would accommodate a gifting program.

Observation: If the bypass trust terms would qualify as a QTIP trust, the executor of Mary's estate could make an election under Section 2056(b)(7) of the Internal Revenue Code and cause the trust to be taxable in John's estate upon his death after Mary. This reversal of the trust corpus to John's estate for
estate tax purposes may be appropriate in the event John did not have an adequate estate to fully utilize his exemption equivalent at the time of his death.

e. IRC § 1014(e)

If appreciated property was acquired by gift by a decedent within one year of his or her date of death, and the donor of the gift acquires the property from the decedent, there is no "step-up" in basis. IRC § 1014(e)(1). The donor's basis will be the same as the basis in the hands of the decedent immediately before death. Id.

Query: Would this basis rule apply to the basis of a bypass trust of which the donor is a beneficiary?

2. Gift of Competent Spouse's Special Community Property

The competent spouse has the sole management, control, and disposition of the community property that the spouse would have owned if single, including personal earnings and revenue from separate property. Therefore, John has the power to make a gift of his special community property without the jointer of Mary. The obvious exception is that John would not be able to transfer a community property homestead without Mary's jointer.

Unlike the separate property of John, a gift of the special community property is subject to a potential attack by the incompetent spouse or her estate. Texas recognizes a trust relationship between husband and wife as to the special community property controlled by each spouse. 3 TEX. FAM. LAW SERV. Speers 6th ed., § 17:10 (1988). Constructive fraud is the breach of a fiduciary duty which the law declares fraudulent because it violates that fiduciary relationship. Id. Therefore, a presumption of constructive fraud arises when a spouse unfairly disposes of the other spouse's one-half interest in community property. If a spouse disposes of special community property in fraud of the other spouse's rights, the aggrieved spouse has the right of recourse, first, against the property or estate of the disposing spouse and then against the party to whom the funds were conveyed. Id.

Absent fraud on the community, a court cannot order reimbursement of gifts of community property made during the marriage. Id. at 17:11. However, if gifts are capricious, excessive, or arbitrary, the courts have found constructive fraud on the other spouse and set aside the gifts. The following factors have been used by the courts to determine whether a gift of community property constitutes constructive fraud:

- Relationship between the donor and donee.
- Whether special circumstances exist to justify the gift.
- Whether community funds used for the gift are reasonably proportionate to the community assets remaining.
- Adequacy of the estate remaining to support the spouse.

_Barnett v. Barnett_, 985 S.W.2d 520, 530 (Tex. App.--Houston [1st Dist.] 1998, no writ). It also appears clear that the donee's relationship to the non-donating spouse is of importance.

Query: Is a gift of the special community by the competent spouse complete if it remains subject to attack or revocation by the non-donor spouse?

Query: Is a gift of special community property subject to a _Street_ attack? See _Estate of Street v. United States_, 152 F.3d 482 (5th Cir. 1998). The ruling of the appellate court did not follow the tax court decision. However, the tax court decision should be noted for its renegade attitude toward Texas community property by holding that the disposition by the decedent of his special community property removes the community asset from the regime of community property laws. _Street_, 152 F.3d at 484.

The donating spouse of special community property may want to file a gift tax return and make a split gift election for the incompetent spouse. This would protect the gift under
the annual exclusion of both spouses notwithstanding which position the IRS might take.

3. **Voidable Gifts**

   The voidability doctrine is a serious problem insofar as completed gifts. For example, the IRS has ruled in a number of cases that a gift by an agent under a power of attorney without express authority for the making of gifts is revocable. Priv. Ltr. Rul. 9509034, 9410028, 9347003 (Texas), and 9342003. Because the transfers are revocable, the subject matter of the gift is includable in the gross estate of the principal under IRC § 2038.

   **Note:** If the property is includable in the estate of the principal as a revocable transfer, then property remaining in the hands of the donees is entitled to receive a stepped-up income tax basis under IRC § 1014. However, property transferred to the donee and sold by the donee before the decedent's death does not receive a stepped-up basis. IRC § 1014(a). The basis of this predisposed property would be determined under IRC § 1015(a) without an adjustment for gift tax paid as would normally be allowed under IRC § 1015(d)(1)(A). Priv. Ltr. Rul. 9509034.

   In the event there is a voidable transaction, it would be wise to review the possibility of obtaining a court order that would ratify and complete the gift during the ward's lifetime. The gift would be complete as of the date of ratification. That would be the date for valuation of the gift, as well as testing the gift for present interest status and any applicable three-year rule. This would also be the date for the making of a split-gift election by the competent spouse. Priv. Ltr. Rul. 923103.

4. **Gift of Joint Community and Incompetent Spouse's Special Community**

   It would appear that the competent spouse would have no power to gift joint community property, nor the incompetent spouse's special community property, until he or she obtains an order from the district court. Gifts through the probate court under a guardianship proceeding would not be possible because that court does not have jurisdiction to approve and order gifts of the incompetent spouse's community interest.

   Furthermore, it does not appear that the competent spouse can make a unilateral disposition of his or her interest in the joint community property and the special community property of the incompetent spouse. This would be in effect a partition which does not comply with the requirements of the Texas Constitution, and Texas Family Code §§ 4.102 and 4.104. See *Dalton v. Don J. Jackson, Inc.*, 691 S.W.2d 765 (Tex. App.--Austin 1985, no writ).

5. **Partition of Community Property**

   Partition is often a method by which separate property is created in the hands of each spouse, and then that property is used for some pertinent estate planning program, such as funding a life insurance trust. It is unclear whether community property may be partitioned when one spouse is incompetent. The Texas Family Code requires that both spouses must sign and enter into a written agreement in order to effect an enforceable partition of their community property assets.

   One possible procedure would be to start the guardianship of the estate of the incompetent spouse with seed separate property. The separate property would be either separate property already owned by the incompetent spouse or separate property which arises from a gift from the competent spouse. This would clearly give the probate court jurisdiction over appropriate property of the ward. The competent spouse could apply to the district court to begin a Family Code proceeding. The district court's order might include the authority of the competent spouse to manage, control, and dispose of the community estate by entering into a partition agreement with the guardian of the estate of the incompetent spouse.

   More specific statutes could support this type of program. However, the current state of the Texas rules regarding Family Code proceedings and probate court proceedings may leave one a little squeamish about the
effect and finality of a partition of community property under this procedure.

**B. Gifts of Incompetent Spouse's Separate Property**

It is clear that a guardianship of the estate of the incompetent spouse allows a specific process for the gift of separate property. **TEX. PROB. CODE §§ 865 and 866** permit effective substitution of judgment for the gifting of the incompetent spouse's separate property within a range of estate planning opportunities.

**C. Disclaimers**

In the event an incompetent person is receiving an inheritance from someone who dies, the guardian can disclaim with prior court approval. **TEX. PROB. CODE § 37A.** The Texas statutory durable power of attorney does permit a disclaimer by the agent unless the principal elects out of the broad powers given relating to estates, trusts, and other beneficiary transactions. **TEX. PROB. CODE §§ 499(1).** A power of attorney without provisions allowing disclaimer would likely be insufficient to permit an effective disclaimer by the agent.

**D. Release of General Powers of Appointment**

There are no statutory rules and procedures for the exercise of a general power of appointment. Therefore, the competent spouse, the guardian of the estate of the incompetent spouse, and the attorney-in-fact will not be able to exercise a general power of appointment unless the instrument creating the power may have provided otherwise.

In the scenario of John and Mary, the general power of appointment held by Mary presents a double problem. First, it cannot be exercised. Second, the tax allocation clause in Mary's will may well provide that all taxes attributable to her death be paid out of her probate estate. If the incompetent spouse's will gives everything to the surviving spouse, this type of tax allocation could reduce the amount of the marital deduction and trigger estate tax liability.

Therefore, it may be wise to release the general power of appointment during the incompetent spouse's lifetime. A person under a disability who holds a power may release the power through the guardian of the person's estate by order of the court. **TEX. PROP. CODE § 181.053.** The release of a general power of appointment is a taxable gift under the provisions of **IRC § 2514(b).** The release could also be a generation-skipping transfer depending on the terms of the trust instrument and the takers in default of the exercise of the power.

An inter vivos release of a general power of appointment would utilize the incompetent spouse's exemption equivalent. This may be prudent in the event the property subject to the power is appreciating in value and is otherwise an appropriate subject of an exemption equivalent gift.

An inter vivos release of a general power of appointment would potentially trigger the payment of transfer taxes. The source of funds for the payment of the transfer taxes raises some unique issues. For example, the tax apportionment statute under Texas Probate Code § 322A does not address inter vivos transactions, nor does **IRC § 2207** burden the property subject to the power with the applicable gift tax. Therefore, the release of a general power of appointment would result in the transfer tax being paid from the ward's estate or the community assets of the ward and the competent spouse.

**E. Revocation of Right of Survivorship**

If spouses have properly agreed to hold community property with right of survivorship (**TEX. PROB. CODE §§ 451 et seq.**), it may be appropriate to dissolve the right of survivorship program in order to make certain that the first spouse's estate has adequate assets to fund a bypass trust or other exemption equivalent gifts.

**Texas Probate Code § 455** addresses the method of revocation. First, revocation can occur by written agreement signed by both...
spouses. Secondly, a revocation can occur by a written instrument signed by one spouse and delivered to the other.

The first method of revocation would require the participation of a guardian. An attorney-in-fact could possibly execute this kind of an agreement.

The second type of revocation seems to be one which the competent spouse could instigate. However, is delivery of the instrument of revocation to the incompetent spouse adequate? Will it be adequate if it is delivered to the guardian of the person or estate of the incompetent spouse? The statute does not address the issues arising out of incompetency of one's spouse.

F. Charitable Remainder Trust

The charitable remainder trust offers significant estate and income tax planning opportunities. The competent spouse might consider establishing a charitable remainder trust with either his or her special community property, or his or her separate property. In either case, the trust could provide for the specific periodic payments to be made to the competent spouse for life. Upon death of the competent spouse, the payments could continue for the benefit of the incompetent spouse, if living, and upon the death of both, the trust would terminate and distribute to charity. The income stream to the incompetent spouse could be paid to a support trust established by the competent spouse. Priv. Ltr. Rul. 9831004. Payment to the support trust for the incompetent spouse's benefit would possibly avoid the necessity for a guardianship to receive these distributions.

The guardianship court could approve the gift of the incompetent spouse's separate property to a charitable remainder trust program. Whether the competent spouse should be included as a beneficiary raises the obvious ethical questions.

G. Charitable Lead Trust

The charitable lead trust offers the opportunity to substantially reduce the taxable value of a gift from Mary (the incompetent spouse) to the children. This would be accomplished by creating a charitable lead trust that would pay a unitrust or annuity amount to charity for Mary’s lifetime. If Mary’s illness is such that she will not live her normal life expectancy, the deferral time of the eventual gift to the family is reduced, however, the IRC § 7520 rates are still applicable if the individual who is a measuring life does not have a 50% probability of death within one year. Treas. Reg. § 200.7520-3(b)(3)(i). If the individual in fact survives for 18 months or longer after making the transfer, the individual is presumed not to have been terminally ill at the time of the transfer. *Id.*

H. Private Annuities

A private annuity is the transfer of assets in return for an unsecured contractual obligation to pay to the transferor a fixed periodic sum for the transferor's life. The actuarial rates of IRC § 7520 will apply. Because the private annuity contract terminates at the death of the transferor, there is no inclusion in the gross estate of the transferor. The good news/bad news is that the private annuity generates the most benefit when the actual life expectancy of the transferor is substantially less than the life expectancy reflected in the actuarial tables. T. Randolph Harris, *Wealth Transfer Planning for the Terminally Ill Client: Even the Blackest Cloud Has a Silver Lining*, 24 ACTEC Notes, 243, 245 (Winter 1998).

*Observation:* A private annuity is a "sale" of assets. The appropriate guardianship proceeding would be the process for sales of the ward's property. However, an abundance of caution would suggest that the tax-motivated gift procedure be incorporated.

I. Insurance Policy Management

The estate planning program for both the competent and incompetent spouse requires a review of policy beneficiaries and ownership. Additional consideration must be given to the payment of any estate taxes attributable to the policy proceeds.
1. **Competent Spouse’s Policy**
   The competent spouse may wish to make a gift of any insurance policy which is that spouse’s separate property or special community property. There should not be a problem with a gift of the separate property policy, but the attendant issues discussed above would affect a transfer of the community property policy.

   The competent spouse may also wish to change the beneficiary of the policy if it is currently payable to the incompetent spouse. Payment to the incompetent spouse would possibly compound the estate tax problems for the incompetent spouse’s estate at his or her death, and it would add funds to the guardianship proceeding. Therefore, the competent spouse may wish to make his or her policy payable to the competent spouse’s estate. This should be done only after careful consideration is given to the Fifth Circuit’s opinion in *Estate of Street v. United States*, 152 F.3d 482 (5th Cir. 1998). In order to avoid the effect of *Street*, the competent spouse should make the policy payable directly to children, or a trust for the intended beneficiaries.

   However, changing the beneficiary of a community property policy to the children or anyone other than the incompetent spouse or a trust for the incompetent spouse's benefit will raise issues regarding fraud. These circumstances create uncertainty and should be avoided if possible. See *Barnett v. Barnett*, 985 S.W.2d 520 (Tex. App.--Houston [1st Dist.] 1998, no writ).

2. **Incompetent Spouse’s Policy**
   The gift of a separate property policy could be managed through the guardianship court, and would obviously fit within the tax-motivated gifts provisions of the Texas Probate Code. The Family Code proceeding would seem to be necessary in the event the policy is the special community property of the incompetent spouse.

   It is not clear whether the guardianship court can authorize a change of beneficiary of the incompetent spouse’s policy under the tax-motivated gift program. Changing the beneficiary of an insurance policy held within the guardianship estate does not squarely fit within the terms of the tax-motivated gift provision. TEX. PROB. CODE § 865. *See also* the discussion at IV.I.3, *infra*.

   A power of attorney might contain a provision allowing change of beneficiary, but it is unlikely. If the incompetent spouse has executed a statutory durable power of attorney, there are powers to alter the beneficiary of insurance with limits regarding the attorney-in-fact. TEX. PROB. CODE § 498(4) and (10).

3. **Personal Elective Rights -- Non-Testamentary Transfers**
   A body of law has developed in the courts that prohibits the alteration by a guardian of the beneficiary of non-testamentary transfers created by the ward prior to incompetency. See Russell Austin & James C. Benton, *Guardian’s Change of Ward’s Beneficiary Designation: A Breach of Fiduciary Duty?*, Advanced Estate Planning and Probate Law Course, State Bar of Texas, June 3-5, 1998. The personal elective rights doctrine substantially restricts the guardian’s ability to alter the ward’s estate plan. In essence, this doctrine holds that the guardian does not have the power to exercise the discretion of the ward to designate, directly or indirectly, the beneficiary of non-testamentary transfers. *Id.* The incompetency of the ward does not invalidate prior beneficiary designations of non-testamentary transfers, for example, the designated joint tenants of a joint tenancy with rights of survivorship.

   Texas has recognized a contractual or third-party beneficiary right in similar situations. This right would allow the designated beneficiary to claim property from the ward’s estate which he or she was designated to receive under contract. *See Egenbacher v. Barnard*, 575 S.W.2d 630 (Tex. Civ. App.--Eastland 1978, no writ); and *Terrill v. Davis*, 418 S.W.2d 33 (Tex. Civ. App.--Eastland 1967, writ ref’d). Texas previously held that a guardian could not make gifts. *In re Guard-*
ianship of Neal, 406 S.W.2d 296 (Tex. Civ. App.--Houston [1st Dist.], writ ref'd, 407 S.W.2d 770 (Tex. 1966). The Neal case was abrogated with the subsequent enactment of the tax-motivated gifts provisions of the Texas Probate Code. Therefore, it is not clear whether a guardian can effectively change the beneficiary designation of the ward's insurance policy.

Query: Does the tax-motivated gift statute allow a court-authorized transfer of a non-testamentary program (such as a life insurance contract) which would in effect defeat the beneficiary designations by the donee's change of the beneficiary? If the guardian received permission to make a gift of the insurance policy to anyone other than the designated beneficiary, would this be a breach of fiduciary duty?

J. Exclusion From Probate Estate

Mary's will gives all of her property to John. The guardian of Mary's estate could create an effective bypass program. This would be accomplished by transferring assets to an irrevocable trust. The separate property assets of the ward would be given to a trust which would retain all benefits for the ward during her lifetime, and upon her death, the trust would be distributed according to the ward's exercise of a limited power of appointment. In default of the exercise of the power, the trust would continue for the benefit of the ward's husband in the form of a bypass trust program, with remainder to children.

This program would be consistent with the ward's intent and the statutory presumption that the ward intends to reduce taxes as much as possible. The retained power and interest would cause the trust to be includable in the ward's gross estate for estate tax purposes, and thereby receive the benefits of (1) the use of the ward's exemption equivalent, and (2) a stepped-up basis for the assets held in the trust at the ward's death.

Query: Is this going too far? Can the probate court authorize a giving program that effectively removes the assets from the court's administration in a manner that does not conform with the Section 867 trust rules? Will the creation of a bypass trust create tax savings for the "ward's estate" when the transfer under the will outright to the surviving competent spouse will not trigger the payment of transfer taxes by the ward's estate?

K. Revocation of Revocable Trusts

Significant complications arise if the incompetent spouse is a party to a revocable trust. The trust must be carefully reviewed regarding (1) the established estate plan; (2) the ability of the trustee to carry out estate planning programs, such as gifting; and (3) the ability of anyone other than the incompetent spouse to revoke the trust.

It is often the situation that a trust is created by a husband and wife with community property. Amendment and revocation of the trust requires some form of joint participation. A revocable trust funded with separate property will unlikely give revocation powers to anyone other than the settlor.

Revocation of an inter vivos trust may be necessary in order to remove assets from an inflexible estate planning forum. For example, the assets may be better managed within a guardianship because of the court's ability to approve tax-motivated transfers. However, the revocation of the trust must be ordered by a court of competent jurisdiction, and in many cases, the guardianship court would not be able to order the revocation. Weatherly v. Byrd, 566 S.W.2d 292 (Tex. 1978).

V. ETHICAL ISSUES

Fiduciary duty restrictions and legal ethical issues run amuck in the incapacitated spouse scenario. The problems are obvious and the following will highlight a few.

A. Fiduciary Representation of Incapacitated Spouse's Estate

Existing fiduciary relationships (trustee, attorney-in-fact, competent spouse) can create serious restrictions on the ability of the fiduciary to conduct estate planning programs for
the incapacitated spouse. For example, if the competent spouse's self-interest rises to the level of a fiduciary conflict of interest, the efficacy of the estate planning program initiated on behalf of the incompetent spouse could be called into question. If the transaction is legally questionable, then the transaction may also be void or voidable and result in an ineffective transfer.

B. Ethical Issues for the Attorney

The ethical issues for the attorney will differ depending on the underlying facts. For example, this may be a situation where the attorney is beginning to represent either or both of the spouses for the very first time. On the other hand, the attorney may have represented both of the spouses in the past in a mutual estate planning program, or he or she may have represented only the incompetent spouse regarding the separate property of that spouse. All of these scenarios present different possibilities for the extent of the past engagement of the attorney. In all of these cases, there will be issues arising regarding the attorney's obligations to communicate with the client, protect confidential information, avoid conflicts of interest, and assure the adequate representation of the incompetent spouse. For additional comments, see Rust E. Reid, Ethical Problems in Multi-Party Representation in Estate Planning, Probate and Fiduciary Matters, Annual Advanced Estate Planning and Probate Course, State Bar of Texas, June 5-7, 1996.

1. Duty to Seek Appointment of Guardian

Rule 1.02(g) of the Texas Disciplinary Rules of Professional Conduct provides that a lawyer shall take reasonable action to secure the appointment of a guardian or legal representative for, or seek other protective orders with respect to, a client whenever the lawyer reasonably believes that the client lacks legal competence and that such action should be taken to protect the client. Unless the lawyer is legally authorized to act on behalf of the client, no attorney-client relationship can be established with a person under disability. Comment 12, Disciplinary Rule 1.02(g).

This duty to seek protection of the client could arise out of a situation where the competent spouse has inquired about making gifts of community property subject to the competent spouse's control. The lawyer could advise the competent spouse that this is permitted under Texas law. However, once the lawyer learns that the gift is going to either jeopardize the economic security of the client, or be made to a questionable donee, then the lawyer may be required to (1) seek the appointment of a guardian for the incompetent client, and (2) withdraw from the representation of both spouses. Disciplinary Rule 3.08.

2. Client Communications

If a client is under disability, communicating with any legal representative of the client is required. Disciplinary Rule 1.03. Additionally, the lawyer should seek to maintain reasonable communications with the client under disability insofar as possible. The usual attorney-client relationship cannot be maintained, but regardless, the client may have the ability to understand, deliberate upon, and reach conclusions about some matters affecting the client's well-being. The law recognizes degrees of competency. The fact that a client is disabled does not diminish the desirability of treating the client with attention and respect. Comment 5, Disciplinary Rule 1.03.

3. Confidential Information

Disciplinary Rule 1.05 deals with the lawyer's obligation to not disclose any confidential communications and information received by the lawyer during the attorney-client relationship. It may well be necessary for the lawyer to withdraw from the representation of the couple; seek the appointment of a guardian for the incapacitated spouse's estate; and relate this information to the representative of the incapacitated spouse.

The duty to not misuse client information continues after the client-lawyer relationship has terminated. Comment 8, Disciplinary Rule
1.05. Comment 17 of Disciplinary Rule 1.05 addresses whether the client will be able to consent to the disclosure to the court of confidential information in a proceeding to appoint a guardian for the client. The lawyer is protected when the disclosure of confidential information is required for the appointment of a guardian and compliance with Rule 1.02(g).

An addition to the Texas Probate Code in 1999 will give some relief to the attorney regarding the duty to not disclose confidential information. If enacted, new Section 865A will permit the guardian to file an application to the court seeking an in camera inspection of true copies of the ward's estate planning documents. This inspection would occur at the time of filing an application to make tax-motivated gifts. An attorney who complies with the court's order does not violate the attorney-client privilege. (See Appendix D.)

Note: At the time this paper went to press, final legislative action was not obtained to pass the proposed legislation into law. The reader must follow up to determine the final disposition of the proposed legislation discussed in this article.

4. Conflicts of Interest
The conflict of interest rules under Disciplinary Rule 1.06 may prohibit an attorney from representing the competent spouse and the incompetent spouse's estate. The rule regarding conflicts and confidential communications may well present a difficult situation for the attorney to continue the representation of either or both spouses.

The lawyer may be able to represent two clients in a conflicts atmosphere, but this may occur only upon reasonable belief that the representation of both clients will not be materially affected, and both clients give informed consent after full disclosure. Disciplinary Rule 1.06(c). Obviously, the required dual informed consent would not be possible when one spouse is incapacitated.

5. Decline or Terminate Relationship
A lawyer shall decline or withdraw from the attorney-client relationship if the lawyer will be a witness, or representation would violate any other applicable rules of professional conduct or other law. Disciplinary Rule 3.08 provides that an attorney who will be called as a witness may have to decline to represent a party. If the attorney would be called to testify about Mary's intended estate plan, he or she must review whether this circumstance would violate the limits of Disciplinary Rule 3.08 regarding the lawyer acting as a witness, and if so, whether the lawyer would have to withdraw.

VI. WHAT CAN BE DONE FOR THE KING FAMILY?
The following are some thoughts about what the King family can consider. First and foremost will be how Mary should be represented in the estate planning program.

A guardianship for the separate property estate of Mary should be implemented. An impartial attorney ad litem should be appointed, and this person should be one knowledgeable in estate planning programs. Hopefully, the court would continue to consider this person to be the appointed ad litem to represent Mary in future tax-motivated gift applications.

The guardian of Mary's estate should be carefully considered, and her husband John may not be the best candidate. It might be better to consider one of the children or a totally independent guardian.

John should implement a district court proceeding under the Family Code which would give him clear, complete, and extensive powers over the community estate of John and Mary. This proceeding should also include the appointment of an attorney ad litem (although discretionary with the court) who would effectively represent Mary. This ad litem should also be knowledgeable in the estate planning programs so that appropriate actions can be recommended to the court. Likewise, the ad litem should consider recommending
appropriate supervision of the gifting programs.
The following are suggested considerations for particular assets.

- John's separate property AT&T stock
  - This stock is freely transferable, and a gift of this stock could use some of Mary's exemption through an election by Mary's guardian to treat Mary as the donor of one-half of the gift. (See IV.A.1.c.)
  - The stock could also be used by John as a gift to a QTIP trust for Mary with remainder to a bypass trust for John. This would likewise use Mary's exemption. (See IV.A.1.d.)
- Mary's limited power of appointment over the GST Exempt Trust
  - This limited power of appointment cannot be effectively exercised. (See IV.I.3.) Therefore, the takers in default must be reviewed in light of the other estate planning programs.
- Mary's general power of appointment over the non-exempt trust
  - This power cannot be effectively exercised. (See IV.I.3.)
  - This power may need to be released in order to (1) take advantage of Mary's exemption, and (2) reduce the tax impact on the marital gifts at Mary's death. (See III.F and IV.D.)
- Mary's separate property policy on John's life
  - This policy could be the subject of a court-approved tax-motivated gift to the children or a life insurance trust for Mary's descendants. This gift will avoid John becoming the owner at Mary's death under the terms of her Will. (See III.E.1, IV.B, and IV.I.2.)
- Mary's special community property policy on Mary's life
  - A difficult asset for this estate planning program. The guardianship court has no jurisdiction to approve a gift of this community property policy, although the guardian might seek approval as a "belt-and-suspenders" approach.
  - This policy could be gifted under the approval of a Family Code proceeding. (See IV.A.4.)
  - The guardianship court could not change the beneficiary of this policy. (See IV.I.3.)
- The closely-held corporate stock of John and Mary
  - This stock is in John's name and would be his special community property. Any gift of this stock to the children, or just to the daughter who works in the business with balancing gifts to the sons, would have the inherent problems of voidable gifts of community property. (See IV.A.2 & 3.)
- Mary's special community property IRA
  - The IRA should remain payable to the surviving spouse as the primary beneficiary. This would maintain the substantial tax benefits of this type of program. Otherwise, a change of the beneficiary to any other format of estate planning would be difficult, if not impossible. (See IV.I.3.)
  - John might be able to get management rights over the IRA through a district court proceeding under the Family Code.
- John's qualified plan account
  - Treas. Reg. § 1.401(a)-20, Q&A 27, allows the incompetent spouse's legal guardian to waive the QISA or QPSA, even if the guardian is the participant.
A change of the beneficiary from the surviving spouse to any other format should be carefully analyzed, particularly in light of substantial income tax benefits that may be lost.

- John and Mary's CPWROS
  - John may want to revoke the survivorship agreement. (See IV.E.)

VII. CONCLUSION

A number of issues arise in the estate planning program for the incompetent spouse. Likewise, a number of issues remain unanswered as to the scope and authority of the representatives of the incapacitated spouse and the agents for his or her property interests. The lawyer, the competent spouse, and family members, as well as the courts must consider the following when considering an estate planning program for the incapacitated spouse:

- What is the marital property characteristic of the assets subject to the plan?
- Is the proposed gift one which can be completed by the competent spouse alone?
- Is the proposed gift of property one which requires the joinder of both spouses, such as homestead property or joint community property?
- Is the proposed gift one that can be accomplished or facilitated through a power of attorney, and if so, is the existing power of attorney adequate?
- Is the proposed gift one that requires, or should involve, court approval?
- Are the proceedings under the Texas Probate Code and the Texas Family Code broad enough to clearly encompass the proposed program?
- What effect will court proceedings declaring the incapacity of a spouse have on existing estate planning documents such as the incapacitated spouse's will, power of attorney, or revocable inter vivos trust?
- What effect will a recovery of competency have on the programs established during incapacity of the spouse?
- What limitations will be caused by the creation of a fiduciary relationship between the ward and the donee; the ward and a fiduciary; the fiduciary and the donee?

Estate planning for the incapacitated spouse offers a number of challenges, and the current law and statutes offer significant opportunities. Clarification within the statutes, and expansion of the statutory scope would be helpful. In the meantime, this is an area that continues to have uncharted waters which should be navigated with careful and thorough planning.