Compensation, Return on Capital and Return of Capital

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Table of Contents

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by

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I. INTRODUCTION. Texas law is yet to fully form the way it treats different kinds of compensation for services rendered by a spouse. Where a spouse is both an owner and an employee of a business, there can be difficulties discerning whether money or assets received from the business are compensation, or a return *on* invested capital, or a return *of* invested capital. If the ownership interest in the business is separate property, issues arise whether distributions from the business are compensation (i.e., community property), or return *on* capital (i.e., community property), or return *of* capital (i.e., separate property). This paper explores some of these issues.

II. COMPENSATION. As used in this Article, "compensation" means earnings from employment. One perspective on compensation is the term "personal service income."

Personal Service Income. Personal service income is described in IRS Publication 570 (2011) in this way:

> Income from labor or personal services includes wages, salaries, commissions, fees, per diem allowances, employee allowances and bonuses, and fringe benefits. It also includes income earned by sole proprietors and general partners from providing personal services in the course of their trade or business.

<http://www.irs.gov/publications/p570/ch02.html#en_US_2011_publink1000221205>.

Earned Income. The IRS has another concept that applies to owners of sole proprietorships and partnerships, called "earned income." Earned income consists of "net earnings from self-employment" which is "your gross income from your trade or business (provided your personal services are a material income-producing factor) minus allowable business deductions." <http://www.irs.gov/publications/p560/ch01.html>. Earned income is probably synonymous with the second sentence in the definition of personal service income given above. Be that as it may, in this Article "compensation" includes both personal service income and earned income.

Current, Deferred, or Advance Income. Compensation can be current, deferred, or advanced. Current compensation is paid at the end of a pay-period, with no delay. When compensation is deferred or advanced, marital property disputes can arise. This Article suggests that there are three approaches to characterizing compensation: (i) the inception-of-title approach (with or without offsetting reimbursement); (ii) the time-allocation approach; and (iii) the valuation approach (on the date of divorce). The three approaches could be called the *Boden*, *Taggart*, and the *Berry* approaches, based on cases that espoused each approach. It must be noted that TEX. FAM. CODE § 3.007(c) adopts the time-allocation *Taggart* approach for employee stock options and restricted stock. However, other deferred compensation is not mentioned in the statue, so the proper characterization of those forms of compensation is a matter of common law.

A. WAGES, SALARY AND BONUSES. Current income for services rendered by an employee is normally paid as wages, salary, tips, and bonuses. The employer is supposed to issue a Form W-2, setting out the income and the employee is supposed to report such income on Line 7 of the IRS Form 1040 Personal Tax Return. Under Texas law, such income earned during marriage is community property.

B. DEFERRED COMPENSATION. The IRS defines "deferred compensation" as compensation that is earned in one tax year but is paid in another tax year. This definition is not very helpful in marital property analysis because deferred income in the marital property context causes problems not based on tax year or based on the date of marrieage or date of divorce. Under Texas marital property law, deferred compensation is compensation for labor that is not paid until some time after the services are rendered. Exactly how long a delay is required before the compensation is “deferred” is subjective. Deferred compensation could be deferred a few months, or until the next calendar year, or until retirement. And deferred compensation can be dependent upon, or contingent upon, subsequent events.

C. FRINGE BENEFITS. As noted above, the IRS considers fringe benefits as part of personal service income, and they are taxed as such. However, most employers treat fringe benefits differently from wages, salary, and bonuses. Some owner-employees cause the business to provide fringe benefits without reporting them as income for tax purposes. This violates tax law. Fringe benefits are addressed in the IRS publication *Executive Compensation - Fringe Benefits Audit Techniques Guide* (02-2005). <http://www.irs.gov/Businesses/Corporations/Executive-Compensation---Fringe-Benefits-Audit-Techniques-Guide-(02-2005)>.

Examples given in the Audit Techniques Guide of fringe benefits include:

- Athletic Skyboxes/Cultural Entertainment Suites
- Awards/Bonuses
- Club Memberships
- Corporate Credit Card (unreimbursed)
- Executive Dining Room
- Loans (No Cost/Low Cost)
- Outplacement Services
- Qualified Employee Discounts
- Security-Related Transportation
- Spousal/Dependent Life Insurance
- Transportation
- Employer-Paid Parking
- Transfer of Property
- Employee Use of Listed Property
- Relocation Expenses
- Non-Commercial Air Travel
- Employer-Paid vacations
- Spousal or Dependent Travel
- Wealth Management
- Qualified Retirement Planning

If such benefits are received incident to employment, they would belong to the community estate.

D. HOW IS CURRENT COMPENSATION CHARACTERIZED? Under Texas Family Code Section 3.001, separate property consists of “property owned or claimed by the spouse before marriage,” or “acquired by the spouse during marriage by gift, devise, or descent . . . .” Under Texas Family Code Section 3.002, “[c]ommunity property consists of all property, other than separate property, acquired by either spouse during marriage. “It is well settled that a person’s earnings after divorce are separate property and therefore not subject to division.” *Murray v. Murray*, 276 S.W.3d 138 , 147 (Tex. App.--Fort Worth 2008, no pet.).

As a general rule, current income, paid daily, weekly, bi-monthly, or monthly, is community property if received during marriage and separate property if received before marriage or after divorce. Uncertainty arises when a marriage or divorce occurs during a pay period. How do you characterize current compensation received just after marriage or just after divorce? The easy answer is to say that the characterization is determined by the date received: if received during marriage, the compensation is community property no matter when the work was done; if received after the divorce, the compensation is separate property no matter when the work was done. A more nuanced approach would say that such compensation should be allocated based on when the work was done. This is the approach taken by the Supreme Court in *Keller v. Keller*, 141 S.W.2d 308 (Tex. Comm'n App. 1940, opinion adopted), where the Supreme Court held that salary earned during marriage was community property, even though it was not paid until after the divorce. It seemed important to the Court’s decision that the salary was reported as income on the husband’s tax return during marriage, even though the salary was not actually paid until after the divorce. *Id.* at 311. The tax reporting established constructive receipt of the salary. Would the result have been different if the husband had not reported the salary as income until after the divorce? The Court said: “Whether the salaries were drawn during the current year is immaterial. When paid they were paid for that year and were paid as salaries.” *Id.* at 311. So *Keller* is a case of compensation paid after divorce for work done during marriage.

What about characterizing such payment based on time allocation? Time allocation has been applied to deferred compensation that vests over time (i.e., pension plans, employee stock option and restricted stock). The same principle could be applied to characterizing current compensation. Time allocation is a simple approach that has intuitive appeal.

E. HOW IS DEFERRED COMPENSATION CHARACTERIZED? The marital property character of deferred compensation differs, depending on the form of deferred compensation. Historically, Texas courts have used three different approaches to characterizing deferred compensation: (i) the inception of title rule (without reimbursement); (ii) time-allocation; and (iii) the valuation approach.

1. Defined Contribution Plans. Defined contribution retirement plans are not really deferred compensation. Rather they are vehicles (like IRAs) to defer tax on employment income that has been received. Under current law, defined contribution plans are characterized just like other financial accounts. The contents of the plan account are presumed to be community property. Tex. Fam. Code § 3.003(a). The burden to prove separate property is by clear and convincing evidence. Tex. Fam. Code § 3.003(b). Where the beginning balance of the account is known, the court subtracts the value in the account on the date of marriage from the value of the account on the date of divorce, and the difference is presumed to be community property, as having been earned or contributed during marriage. *See* e.g., *Iglinsky v. Iglinsky*, 735 S.W.2d 536, 538 (Tex. App.--Tyler 1987, no writ). Tex. Fam. Code § 3.007(c) permits a spouse to trace commingled assets in a defined contribution plan account, just like any other financial account. Because defined contribution plan assets have all been received, and they are characterized like regular financial accounts, defined contribution plans will not be further discussed in this Article.

2. Defined Benefit Plans. In *Baw v. Baw*, 949 S.W.2d 764, 768 n. 3 (Tex. App.--Dallas 1997, no writ), the court said that "[a] 'defined-benefit' plan promises employees a monthly benefit beginning at retirement. A 'defined-benefit' plan calculates benefits by plan-specific factors, such as years of service, age, and salary. Comment,*An Interdisciplinary Analysis of the Division of Pension Benefits in Divorce and Post–Judgment Partition Actions*, 37 BAYLOR L. REV. 106 at 115 (1985), cited in *May v. May* 716 S.W.2d 705, n 1 (Tex. App.--Corpus Christi 1986, no writ). Defined benefit plans (i.e., pensions) typically are a right of the employee to receive monthly payments in a set amount paid over the retiree's lifetime. Once set, the amount of each payment does not vary (except for a cost-of-living adjustments), and is determined according to the retirement plan's formula. The formula is usually the product of multiplying the number of months of total employment, times a set number (like 1, or 1.5, or 2, etc.), times average final compensation (as defined in the plan).

a. *Taggart* Time-Allocation. Under *Taggart v. Taggart*, 552 S.W.2d 422 (Tex. 1977), defined benefit pension plan benefits are characterized based on pure time-allocation alone. The community property interest in each pension payment is a fraction, in which the number of months that the pension benefit accrued during marriage is divided by the total number of months the pension benefit accrued overall. However, when the spouse will continue to accrue more pension benefit after divorce, it is necessary to do a "*Berry* valuation", which requires a different denominator for the fraction. See Section II.E.2.b below.

CAUTION: Many old cases, including *Taggart*, say that the denominator of the fraction is the total number of months worked. That was true when pension benefits accrued over an employee's entire period of employment. That is not a safe approach in recent times. Some defined benefit pension plans have been capped, or suspended, with no further benefits accruing even when the employee continues to work. So a better way to describe the components of the fraction is the "number of months during which the benefit accrued."

b. *Berry* Valuation. In *Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983), the Texas Supreme Court revisited the *Taggart* time-allocation formula and said that the *Taggart* formula could not be used to divide a pension where the employee spouse would continue to work after the divorce. The Court in *Berry* said that, in order to protect the employee's separate property interest resulting from post-divorce labors, the divorce court should divide only the value of the community estate's interest in the retirement benefits as of the time of divorce. *Id.* at 947. Under *Berry*, the time-allocation is as of the date of divorce, and the numerator of the fraction is the number of months that the retirement benefit accrued during marriage while the denominator of the fraction is the total number of months during which benefits have accrued through the date of divorce. That community fraction is multiplied times the retirement benefit that would be available if the employed spouse could retire on the date of divorce. The *Berry* court specifically said that it was not overruling a *Taggart* time-allocation formula "for determining the extent of the community interest in retirement benefits" for cases where the value of the community's interest at the time of divorce was not an issue, like when divorce follows retirement. *Id.* at 947. The following courts of appeals have said that the *Taggart* formula applies, without a *Berry* determination of value, when the spouse has retired before divorce: *May v. May*, 716 S.W.2d 705, 710 (Tex. App.--Corpus Christi 1986, no writ); *Hudson v. Hudson*, 763 S.W.2d 603, 605 (Tex. App.--Houston [14th Dist.] 1989, no writ); *Humble v. Humble*, 805 S.W.2d 558, 561 (Tex. App.--Beaumont 1991, writ denied); *Parliament v. Parliament*, 860 S.W.2d 144, 145-46 (Tex. App.--San Antonio 1993, writ denied); *Albrecht v. Albrecht*, 974 S.W.2d 262, 263-64 (Tex. App.--San Antonio 1998, no pet.); *Limbaugh v. Limbaugh*, 71 S.W.3d 1, 16 (Tex. App--Waco 2002, no pet.); *Stavinoha v. Stavinoha*, 126 S.W.3d 604, 616 (Tex. App.--Houston [14th Dist.] 2004, no pet.); *Prague* *v. Prague*, 190 S.W.3d 31, 39 (Tex. App.--Dallas 2005, pet. denied); *In re Marriage of Jordan*, 264 S.W.3d 850, 854 (Tex. App.--Waco 2008, no pet.).

c. Qualified vs. Non-Qualified Plans. The distinction between qualified and non-qualified retirement plans does not affect characterization. A retirement plan is "qualified" when it meets the requirements of ERISA and the Internal Revenue Code that allow the employer to deduct contributions to the plan as an expense during the year the contribution is made to the plan, while the employee is not taxed on the benefit until the benefit is distributed to the employee, sometimes years later. Additionally, the deferred payment is not subject to payroll tax. The IRS Publication *A Guide to Common Qualified Plan Requirements* discusses the criteria that make a plan qualified. *See* <http://www.irs.gov/Retirement-Plans/A-Guide-to-Common-Qualified-Plan-Requirements>.

Federal law caps the maximum amount that can be distributed to an employee under a qualified plan. Because these caps are too low to entice top executives, many companies offer benefits to high-ranking employees through non-qualified plans. An important part of designing a non-qualified plan is to avoid the Economic Benefit Doctrine. The Economic Benefit Doctrine is a tax law principle saying that a benefit is taxable to the employee when the economic benefit is conferred, even if the employee does not have actual or constructive receipt of the benefit. To avoid the Economic Benefit Doctrine, the deferred benefit must be subject to a substantial risk of forfeiture. This has been taken to mean that the non-qualified plan must be unfunded, and the employee must be a general creditor of the company.

3. Options/Restricted Stock. Initially, Texas courts characterized employee stock options using the inception of title rule. *See Boyd v. Boyd*, 67 S.W.3d 398, 410 (Tex. App.--Fort Worth 2002, no pet.) (recognizing that the ability to sell the options was limited); *Charriere v. Charriere*, 7 S.W.3d 217, 220 (Tex. App.--Dallas 1999, no pet.) (holding that the community property nature of employee stock options granted during marriage was not altered by the fact that vesting of the options was contingent on continued employment after divorce); *Kline v. Kline*, 17 S.W.3d 445, 446 (Tex. App.--Houston [1st Dist.] 2000, pet. denied) (holding that the stock options granted during marriage were community property even if not vested before divorce). Nowadays, employee stock options and restricted stock must be characterized under Tex. Fam. Code Sec. 3.007(d). Under this statute, employee stock options and restricted stock benefits are characterized on a time-allocation basis, as in *Taggart*, with no *Berry* valuation even where continued post-divorce employment is required for the stock options or restricted stock to vest. Under Section 3.007(c), the community interest in options or restricted stock is determined by a fraction, where the numerator is the portion of the vesting period that accrues during marriage, and the denominator is the entire vesting period for the benefit. Example: an unmarried employee receives an employee stock option on day 1. The option says that the employee must work at the company for a three year period before the option vests. Assume the employee marries at the start of year 2, and divorces on the last day of year 2. Section 3.007(d) says that the community interest in the option is 1/3, since only the middle year of the 3-year vesting period accrued during marriage, and the first and last years accrued outside the marriage. There is no perception, in dealing with options and restricted stock under Section 3.007(d), that a *Berry* valuation should be undertaken, when the employed spouse must continue to work after the divorce in order for the option or restricted stock to vest. Therefore stock options and restricted stock, which are a form of deferred compensation, are treated differently from pensions, which are another form of deferred compensation, in situations where the employee spouse will continue to work after the divorce. Does Section 3.007(d) violate the principle behind *Berry*? Should we be attacking Section 3.007(d) as unconstitutional? Should *Berry* be overruled based on the approach used in Section 3.007(d)? Would a *Berry* valuation approach even be possible, or fair, given that stock prices are volatile and no one (including Myron Scholes and Robert Merton) can calculate what an option or restricted stock will be worth in a year or two. And how would you discount for the risk of non-vesting?

a. Cliff Vesting vs. Vesting in Tranches. While there is no appellate caselaw on point, the language of Section 3.007(d) suggests that the calculation under the statute can be affected by the way that the benefit plan is constructed. "Cliff vesting" occurs when all of the benefit vests on the final day of the vesting period, rather than gradually vesting over time. Imagine two stock option plans, one with cliff vesting and one where the options vest in stages.

Hypothetical:

<u>The Plans</u>–Husband received two option grants on January 1 of Year 1. Option Plan No. 1 gives husband an option right to acquire 300 shares of the company's stock. The husband must be employed at the company for 3 years after the grant date, in order for the options to

vest, and they all vest on the last day. Option Plan No. 2 gives husband an option right to acquire 300 shares of the company's stock, with the first 100 shares vesting at the end of one year, another 100 shares vesting at the end of two years, and the last 100 shares vesting at the end of three years.

<u>The Marriage</u>–husband and wife marry on January 1 of the Year 2 of the Plans. They divorce on December 31 of Year 2. So they are married for one year.

<u>The Calculation</u>

Option Plan 1 (Cliff Vesting)--Under Section 3.007(d), when the husband divorces at the end of Year 2, his Option for 300 shares is 1/3 community property and 2/3 separate property. This is because 1/3 of the vesting period occurred prior to marriage, 1/3 during marriage, and 1/3 after divorce. The community total under Plan 1 is 100 shares.

Option Plan 2 (Staged Vesting)--Under Section 3.007(d), the first 100 shares that vest at the end of Year 1 are entirely husband's separate property because they were granted and vested before marriage. The second 100 shares that vest at the end of Year 2 are 50% separate property and 50% community, because ½ of the two-year vesting period occurred during marriage. The third 100 shares, which will vest one year after the divorce, are 1/3 community and 2/3 separate, because only 1/3 of the three-year vesting period occurred during marriage. Adding this up, at the time of divorce, of the 200 shares received during marriage, 150 are husband's separate and 50 are community property. Of the 100 shares that may vest in the future, 66-2/3 are husband's separate property and 33-1/3 are community property. The community total under Plan 2 is 83-1/3 shares.

4. Other Deferred Compensation. The characterization of pensions is controlled by common law principles stated in the *Taggart*/*Berry* line of cases. Employee stock options and restricted stock are governed by Family Code Section 3.007(c). Other forms of deferred compensation include delayed bonuses, phantom stock, performance units, stock appreciation rights, incentive payments, etc. Whether they fall under either approach is not explicitly governed by statute or case law. How should other forms of deferred compensation be characterized? Should we (i) time-allocate according to the total accrual period (*Taggart*)? Should we (ii) time allocate up to the date of divorce and multiply times the value on the date of divorce (*Berry*)? Or should we do a third thing, which is what the case law did with options before Section 3.007 was adopted, and that is to (iii) apply the inception of title rule (i.e., phantom shares, or PUs, or SARs granted before marriage are 100% separate, and those granted during marriage are 100% community, without regard to whether continued employment is required for vesting). If we go the inception-of-title route, is there a *Jensen*-like reimbursement claim for enhancement in value of separate property benefits due to work done during marriage, or for the enhancement of community property benefits due to work done after divorce? If there is reimbursement, is it measured by the amount of enhancement or by the value of the services contributed to increase the value of the benefit? If there is some enhancement measure, what if the value of the benefits drops after divorce, due to stock price going down, or performance targets not being met, etc.?

a. Bonuses. Bonuses can be deferred compensation if their payment is delayed for some time after the work was done. *Echols v. Austron, Inc.*, 529 S.W.2d 840, 846 (Tex. Civ. App.--Austin 1975, writ ref'd n. r. e.), held that a bonus received shortly after divorce is separate property, because the rights of the parties were fixed at the time the divorce judgment was rendered, which was before the bonus was received. On the other hand, in *Boyd v. Boyd*, 67 S.W.3d 398, 404 (Tex. App.--Fort Worth 2002, no pet.), the appellate court found that a bonus that was expected to be paid after the mediation settlement agreement was signed was community property that needed to be disclosed to the other spouse. The Court explained:

> Randall's receipt of a $60,000 bonus in 1996 was disclosed at mediation. He does not deny that he failed to disclose an additional $230,000 bonus—also earned during 1996—at the mediation, nor does he challenge the trial court's finding that the undisclosed bonus was community property. To the contrary, Randall testified as follows regarding the bonus:
>
> [Q] If someone had asked you during the time of that mediation what your incentive pay for that pay that you had earned for 1996 was, would you know what that amount of dollars would have been?
>
> [A] Yes, I could have. I had been paid the sixty and I knew the two thirty was coming. I just didn't know when, so—
>
> ....
>
> [Q] You knew that at the time of mediation?
>
> [A] Right.

> [Q] And you knew the specific dollar amount at the time of the mediation?
>
> [A] Yeah. I was pretty clear on the dollar amount, yes.

Should the character of the deferred bonus be determined by the employee's marital status on date the bonus is conceived or declared or received, or should it be characterized based on when the work was done? In some instances bonuses are paid before the work is done, which presents an analogous question. See Section II.G below.

b. Discretionary Bonuses. Some employers compensate employees through a bonus. In many (if not most) instances,, the declaration of a bonus is discretionary with employer. *Lewis v. Vitol*, No. 01-05-00367-CV (Tex. App.--Houston [1st Dist.] 2006, no pet.) (bonus was discretionary and employee could not sue employer for paying bonus). The issue of whether a discretionary annual bonus, declared after divorce, could contain a component of community property if the bonus was awarded for work done during the year of divorce, arose in *Loya v. Loya*, 473 S.W.3d 362 (Tex. App.--Houston [14th Dist.] 2015), *rev'd on other grounds*, No. 15-0763 (Tex. May 12, 2017) (motion for rehearing pending). In *Loya*, the Fourteenth Court of Appeals reversed a summary judgment dismissing an ex-wife's post-divorce suit claiming a community property interest in the bonus, saying that the ex-wife was entitled to a trial in which to prove whether any of the bonus paid to the ex-husband after the divorce constituted community property compensation for work done during marriage. *Loya*, *supra* at 369. The court relied upon its earlier decision in *Sprague v. Sprague*, 363 S.W.3d 788, 801-02 (Tex. App.--Houston [14th Dist.] 2012, pet. denied), where the court had ruled that a bonus awarded during a marriage for work performed at least partially before the marriage could be established as a spouse's separate property. In the *Loya* appeal to the Supreme Court, the parties briefed and argued whether a bonus declared and paid after divorce could be community property to the extent it compensated work done during marriage. However, the Supreme Court's Opinion avoided the question, by ruling that the bonus had been partitioned to the husband in the MSA under a clause setting aside to each spouse "future earnings." So the law now stands that the Fourteenth Court of Appeals ruled that a post-divorce bonus can be community property, but that opinion was reversed on other grounds. The Supreme Court briefing is available on-line for anyone wishing to raise the issue in another case. http://www.search.txcourts.gov/Case.aspx?cn=15-0763&coa=cossup. A video of the oral argument is at http://www.texasbarcle.com/CLE/SCPlayer.asp?sCaseNo=15-0763.

c. Delayed Payments Based on Performance. A number of highly-compensated employees are given deferred compensation that is dependent on economic performance of the business. These include bonuses, performance units, stock appreciation rights, and phantom stock, to name a few. Some bonuses are purely discretionary. Some publicly-traded corporations peg the benefit to the increase in price of the company's stock. Performance units might be measured against a benchmark that involves profitability, or might be measured against the performance of competing companies in the same industry. Generally they all require that the employee continue to be employed by the company up to the time the benefit matures or vests. Sometimes you can say that the individual's performance influenced the outcome, but in some organizations there may be too many employees to tie the outcome to the spouse's individual labors.

d. Is a *Berry* Valuation Appropriate? The values of stock options and restricted stock and phantom stock and stock appreciation rights are derivative of the underlying value of the company's stock. If the court wants to value non-vested benefits not governed by *Taggart/Berry* or Section 3.007, as of the date of divorce, who can predict the value of a company's stock 1 year, or 2 years, or 3 years in the future? Should you use the Black-Scholes Method (designed for short term European options traded on an open market), or the binomial or "lattice" binomial method, or should you gut a goose and read the entrails? The same problem exists for performance awards that are based on meeting profitability targets, etc.

A *Berry* approach would have the court value the deferred benefit as if it were vested on the day of divorce. In *Berry* that approach worked because the employed spouse's post-divorce earnings invariably caused the pension account to increase. However, using a *Berry* valuation-on-the-day-of-divorce approach on other deferred compensation leads to trouble if the value of the benefit actually declines after divorce, due to market forces, or poor performance. In that situation, valuing the benefit as if it could be converted to cash on the date of divorce would give too much value to the community's interest. In actuality, if the value is to be determined by stock price on the date of divorce, there should be a discount for the time value of money, a discount for lack of liquidity, a discount for possible reduction in value of the underlying stock, and a discount for the possibility of forfeiture of the benefit, applied to whatever value is proposed.

Applying a *Berry* approach to valuing stock options was addressed in *Boyd v. Boyd*, 67 S.W.3d 398, 411-12 (Tex. App.--Fort Worth 2002, no pet.) . The Court said this:

> Randall also contends that the trial court should have valued the stock options as of the date of divorce rather than giving Ginger the benefit of the value of the options attributable to his post-divorce employment. Thus, Randall lodges the same complaint regarding the stock options as he did concerning the retirement benefits: Ginger was not entitled to 50% of the future increases in the value of the stock options.
>
> Randall's company was privately held, not publicly traded. If Randall left his employment before he was 100% vested in his stock options, he could sell the options to the company for the price he paid for them. But Randall's ability to exercise his stock options for a profit was contingent upon his employer becoming a publicly traded company or being wholly or partially acquired by a third party. In either of these circumstances, Randall would have the opportunity to sell his stock options for the price the company received for its shares.
>
> Randall's stock options vested at the rate of 1% per year from 1998 through 2006, after which they became entirely vested. However, if Randall's company went public or was substantially acquired by a third party, vesting was accelerated to 20% per year. If there was a total sale of the company, Randall would be treated as if he were 100% vested.
>
> The trial court determined that Randall's fair value stock options had a contingent value at divorce of $5,628,776. This value was determined by using a formula that did not take into account Randall's post-divorce work for his company or the company's future productivity. The formula was fixed at the time of the divorce.
>
> The contingent value of the stock options could not be realized, however, until between 2002 and 2004, during which time a third-party corporation had the option to acquire all of the remaining stock in Randall's company. If Randall was not employed by the company at that time, he would not make any more profit on his fair value stock options because he would no longer be a company stockholder. In addition, even if his employment continued after divorce, Randall would not make any more profit on the stock options if the sale did not occur or if his company's stock did not become publicly traded after 2004.
>
> To date, no Texas court has considered how to determine the community property value of stock options at divorce. The cases have only addressed whether stock options are community property. See *Kline*, 17 S.W.3d at 446; *Bodin*, 955 S.W.2d at 381; *Demler*, 836 S.W.2d at 699; *see also Charriere*, 7 S.W.3d at 220 n. 6 (holding that stock options that could be purchased but not sold without company consent during marriage were community property, even though value of options was dependent upon employee spouse's post-divorce employment). The factors presented here cause us to conclude that the contingent value of the stock options was community property. The method for calculating this contingent value was fixed at divorce, and the minimum price for the stock options was also fixed. Randall would either be able to exercise the stock options in the future for their contingent value (if he was employed and the stock sale took place or the company went public), or he would only be able to recover what he paid for them. Further, the contingent value of the options was not dependent on Randall's post-divorce work for his company, even though he had to be employed to receive it.
>
> The trial court awarded Ginger one half of the contingent value of the stock options as her 50% share of the community estate. If Randall is no longer employed when the stock options are sold, Ginger's contingent community property interest will be extinguished. Any post-divorce increases or decreases in the value of these stock options that are not attributable to Randall's post-divorce work will not be his separate property. Ginger will be entitled to 50% of the increases, and the contingent value of her interest will be reduced by any decreases. Ginger will not be entitled to any post-divorce increases in the value of these stock options that are attributable to Randall's post-divorce work for the company because these post-divorce increases will be his separate property. However, the divorce decree does not contain any language purporting to give Ginger an interest in these latter post-divorce increases. Therefore, the trial court's division of the contingent value of the stock options was not an abuse of discretion. We overrule point nine.

e. How Would *Jensen* Reimbursement be Calculated? If a deferred compensation benefit is received before marriage, and the inception of title rule is applied to make the benefit separate property, but community labor is expended during marriage that enhances the value of the benefit, is a *Jensen* reimbursement claim available? How do you prove a causal link between the services and the increase in value? What if the value of services exceeds the increase in value of the deferred benefit? Is the increase in value during marriage a cap on a *Jensen* claim? What if the benefit actually declines in value, due to a drop in stock prices, poor performance, or whatever? Is a *Jensen* claim extinguished if the asset value drops below the value on the date of marriage.

Similar questions can be asked about a "reverse" *Jensen* claim for post-divorce labor enhancing the value of a community property benefit. An even bigger problem is the fact that the added value would have to be determined prospectively, not retrospectively as in the *Jensen* case. How can someone determine at the time of divorce what value will be added by post-divorce labors?

For Courts wondering where to go on this issue: A time-allocation approach, although arbitrary and crude, leads to a simple answer that approximates rough justice at a low cost.

F. POST-DIVORCE INCOME FROM PRE-DIVORCE WORK. Complications can arise with income received after divorce that compensates work done during marriage. As noted in *Murray*: "It is well settled that a person's earnings after divorce are separate property and therefore not subject to division." *Murray v. Murray*, 276 S.W.3d 138, 147 (Tex. App.--Fort Worth 2008, no pet.). Is it really that clear?

1. Bonus. The problem of the post-divorce bonus is discussed in Section II.E.4.b above.

2. Future Personal Earnings. In *Smith v. Smith*, 836 S.W.2d 688, 692 (Tex. App.--Houston [1 Dist.] 1992, no pet.), the appellate court rejected the valuation testimony of an expert who valued an unincorporated business by determining the present value of future after-tax earnings. The court held this was a measure of the husband personal future earning capacity, not the value of the business. *Id.* at 692. The court said: "A spouse is not entitled to a percentage of his or her spouse's future income. A spouse is only entitled to a division of property that the community owns at the time of the divorce. " *Id.*

In *Loaiza v. Loaiza*, 130 S.W.3d 894 (Tex. App.--Fort Worth 2004, no pet.), the court of appeals considered a major league baseball pitcher who signed a lucrative employment agreement during his marriage that required him to perform services after divorce. *Id.* at 906–07. The appellate court held that, despite the fact that the employment agreement was signed during marriage, and despite the fact that future payments were guaranteed if the player is cut from the team for lack of "sufficient skill or competitive ability," the post-divorce payments constituted compensation for future services that did not accrue until he performed those services. They were, therefore, his separate property.

3. Personal Goodwill. In *Nail v. Nail*, 486 S.W.2d 761, 764 (Tex.1972), the Supreme Court considered whether the goodwill of a sole proprietor doctor was an asset to be divided upon divorce. The Court said:

> In any event, it cannot be said that the accrued good will in the medical practice of Dr. Nail was an earned or vested property right at the time of the divorce or that it qualifies as property subject to division by decree of the court. It did not possess value or constitute an asset separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in event of his death, or retirement, or disablement, as well as in event of the sale of his practice or the loss of his patients, whatever the cause. *Cf. Busby v. Busby*, 457 S.W.2d 551 (Tex.1970), and the cases there referred to with approval, where the husband's existing entitlement to future military retirement benefits was held to constitute a vested property right. The crucial consideration was the vesting of a right when the husband reached the requisite qualifications for retirement benefits; the fact that the benefits were subject to divestment under certain conditions did not reduce the right to a mere expectancy. The good will of the husband's medical practice here, on the other hand, may not be characterized as an earned or vested right or one which fixes any benefit in any sum at any future time. That it would have value in the future is no more than an expectancy wholly dependent upon the continuation of existing circumstances. Accordingly, we hold that the good will of petitioner's medical practice that may have accrued at the time of the divorce was not property in the estate of the parties; and that for this reason the award under attack was not within the authority and discretion vested in the trial court by Section 3.63 of the Texas Family Code.

The Court went on to say that "we are not concerned with good will as an asset incident to the sale of a professional practice, or that may exist in a professional partnership or corporation apart from the person of an individual member . . . ." *Id.*

In *Salinas v. Rafati*, 948 S.W.2d 286 (Tex.1997), a non-family law case, the Supreme Court considered the question of whether the value of a partnership being dissolved included the future profits of a successor partnership. The Court wrote: "The value that the Rafatis attributed to the partnership was largely based on the talents and abilities of the individual physicians and their ability to generate income in the future. To the extent that the valuation of the dissolved partnership was based on the goodwill attributable to the personal skills and talents of the former partners, it improperly took into account intangibles that were not partnership assets." The Court went on to discuss *Nail* and how personal goodwill can be differentiated from enterprise goodwill. The Court cited *Geesbreght v. Geesbreght*, 570 S.W.2d 427 (Tex. Civ. App.-Fort Worth 1978, writ dism'd), as an instance where goodwill existed in a medical business separate and apart from personal goodwill. *Salinas*, 948 S.W.3d at 290-91.

4. Contingent Fee Contracts. In *Licata v. Licata*, 11 S.W.3d 269 (Tex. App.--Houston [14 Dist.] 1999, pet. denied), a divorcing lawyer complained about the court awarding his wife an interest in money to be received in the future as referral fees on cases the lawyer had referred out to other lawyers. The appellate court said:

> here the trial court made an implied finding that Joseph's right to receive amounts under the referral agreements had fully vested based on the evidence introduced at trial. Joseph has not referred us to any record evidence which contradicts or rebuts that implied finding. Without any clear and convincing evidence to overcome the trial court's implied finding regarding the vesting of the right to the income under the referral contracts, we do not find the trial court abused its discretion in awarding Linda a percentage of Joseph's income from referred cases. It is undisputed that the benefits from a vested property right are community property even though they may be paid after divorce.

Id. at 279.

In *Von Hohn v. Von Hohn*, 260 S.W.3d 631, 642 (Tex. App.--Tyler 2008, no pet), the appellate court found that a plaintiff's-lawyer-husband's right to receive money from cases that had been settled but not funded constituted divisible community property, because "Edward's right to receive these proceeds is contractual and the amounts to be received are fixed or readily ascertainable . . . ." *Id.* at 642. The appellate court found no community interest in pending but unsettled cases, saying that "[r]evenue from these cases is no more than an expectancy interest and any money to be received constitutes future earnings to which Susan is not entitled." *Id.*

5. Renewal Commissions. Insurance agents are typically compensated based on a percentage of the premiums the insurance company receives from the agent's sale of insurance policies. The percentage applies not only to initial premiums, but also premiums generated by the renewal of existing policies. In *Cunningham v. Cunningham*, 183 S.W.2d 985 (Tex. Civ. App.--Dallas 1944, no writ), the agent's wife claimed that the community estate upon divorce included the husband-agent's right to receive a percentage of future renewal premiums on policies sold by the husband during marriage. The court of civil appeals rejected that argument, based on two considerations: (i) the decision to renew would be made by customers at some time in the future; and (ii) the husband's agency agreement with the insurance company provided that his right to receive renewal commissions would terminate if the agency relationship terminated. Because the right to receive commissions was contingent on the customers renewing their policies and the husband's continued employment by the agency, the renewal commissions were not a vested right, but instead were a mere expectancy. *Id.* at 986. Under Texas law at the time, only vested rights could be divided on divorce–law that changed in *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976).

The later case of *Vibrock v. Vibrock*, 549 S.W.2d 775 (Tex. Civ. App.–Fort Worth), *writ ref'd n.r.e.*, 561 S.W.2d 776 (Tex. 1977), involved another divorcing insurance agent. The husband's agreement with the insurance company provided:

> On provisions of Vibrock's contracts with Fidelity Union Life Insurance Company: After the portion thereof which set forth the Agent's entitlement (Vibrock's) on "first year commissions on premiums"; the same for "second year commissions"; and the same for "subsequent years" was a provision as follows: "Agent agrees that for so long as this contract shall remain in force and effect, he will not enter the service of any other insurance company . . .."

> Further contractual provisions: "No renewal commission shall be payable on the business produced during any contract year not fully completed by the Agent while in the service of the Company. . . . Renewal commissions are paid in recognition of continuous full time service and as compensation for services rendered in keeping the business in force." Further, "If for any reason this contract should be terminated within three (3) years, no renewal commissions shall be paid to the Agent thereafter."

Id. at 778. The court of civil appeals concluded:

> We are of the opinion that by the contract of Vibrock with Fidelity Union Life Insurance Company the liability of the latter was made contingent upon conditions precedent as applied to Vibrock's entitlement to any renewal premiums, both before and after date of the parties' divorce; that by contract not only would Vibrock be obliged to continue this contract itself in force, but also to service the business he had placed on the books. The contract provided that his entitlement was (or would be) ". . . in recognition of continuous full time service and as compensation for services (to be) rendered in keeping business in force." (Emphasis supplied.)
>
> For the trial court to award plaintiff the interest she sought would be to award her a personal judgment which would not be referable to property in existence upon divorce.

Id. at 778.

What is very, very interesting is that the Supreme Court denied review of the court of civil appeals' decision in *Vibrock,* but they said this in a per curiam opinion:

> PER CURIAM.
>
> The application for writ of error is refused, no reversible error.
>
> Wendell Vibrock sold insurance policies for Fidelity Union during his marriage to Lynda Vibrock. Under his employment contract with Fidelity Union, Wendell Vibrock was to receive renewal commissions when these policies were renewed. Lynda Vibrock sued Wendell Vibrock claiming an interest in certain of these renewal commissions. She asserts these commissions are community property which were not considered in the partition of the parties' property upon divorce. The court of civil appeals reversed the summary judgment rendered by the trial court in favor of Wendell Vibrock and remanded the cause for trial. 549 S.W.2d 775.
>
> The disposition of this case by this court indicates neither approval nor disapproval of the language contained in the opinion of the court of civil appeals which suggests that these renewal commissions are not community property. *See Cearley v. Cearley,* 544 S.W.2d 661 (Tex.1976).

Vibrock v. Vibrock, 561 S.W.2d 776, 776-77 (Tex. 1977).

6. Residual Income. Residual income is a term that is sometimes used to describe income that is to be received in the future based on work done in the past. The issue of residual income was addressed in *Murray v. Murray*, 276 S.W.3d 138 (Tex. App.–Fort Worth 2009, pet. denied). This post-divorce case involved a husband who worked as an independent broker for a multi-level marketing company that provided discount health services. *Id.* at 141. His job involved getting customers to sign up for monthly memberships and to enlist brokers to sign up members, and he received a percentage of the membership fees generated by himself and by brokers he originally enlisted. *Id.* In the divorce decree, the wife was awarded 60% of residual income based on business generated prior to the date of divorce and upon the book of business as of the date of divorce. *Id.* at 143. On appeal from a post-divorce law suit, the appellate court said that the former wife was entitled to continue to receive 60% of the money that comes in from the members and brokers who were in place on the date of divorce, but not from members or brokers added after the date of divorce. *Id.* The members and brokers in place were called the "downline." The Court said: "Whereas, the monthly income from the downline in existence at the time of divorce is already earned, the income resulting from new members and brokers being added after divorce is not." *Id.* at 147. Note that the Court said the income from the existing downline was "already earned," even though the future membership fees were not yet due or received. Importantly, the appellate court was not influenced by the fact that the former husband had to recruit one new member or broker each month in order to receive the income from the downline. Even though the future income had not yet been *received*, it had already been *earned*. *Id.* at 147. The former husband got to keep 100% of income from members or brokers added after divorce. The Court said: "Because the addition of new members and brokers is not a guarantee, the growth in income resulting from new member and brokers is merely an expectancy." *Id.* at 148.

7. Disability Payments. The case of *Simmons v. Simmons*, 568 S.W.2d 169, 170 (Tex. Civ. App.–Dallas 1978, pet. dism'd), held that long-term monthly disability benefits provided by an employer and payable to a former husband after divorce are community property, because the right to the payments was part of the husband's compensation for services during marriage. That law was overturned by the adoption of Texas Family Code Section 3.008(b), which characterizes disability payments based on whether the lost income being replaced occurred during marriage or not. The question remains whether other contractual rights arising from employment during marriage are community property. This is sort of an inception-of-title approach.

G. HOW SHOULD WE CHARACTERIZE COMPENSATION PAID IN ADVANCE? Characterization problems can arise when compensation is paid in *advance* for future services. Sometimes an employee is paid a "signing bonus" for agreeing to come to work. This happens often with professional athletes. If the signing bonus is received during marriage, but is contingent upon continued employment after the divorce, is the signing bonus entirely community property or entirely separate property or is it to be pro rated between community and separate according to the number of months of employment during marriage vs. the number of months after divorce? In *Loaiza v. Loaiza*, 130 S.W.3d 894 (Tex. App.--Fort Worth 2004, no pet.), the spouse-athlete received such a signing bonus about a year before divorce. Unfortunately for us, no contention was raised that the signing bonus should be prorated between separate and community property.

An article from the Journal of the American Academy of Matrimonial Lawyers presented this analysis of the issue:

> The argument that a signing bonus actually constitutes future income is based on equitable considerations. The court then must be persuaded to recognize the realities of the NFL salary cap. In other words, the argument is one of substance over form.
>
> First, it must be conceded that a court is likely to consider a signing bonus that has already been received by the parties a vested marital property right. A Texas court has defined the word "vested" as "a fixed right of present or future enjoyment." [FN23] Therefore, although the court is going to view the signing bonus as a vested asset, it is up to the advocate to show the court that this should be characterized as future income. In the case of a retirement benefit, courts often look to see if the benefit was earned during the course of the marriage to determine if it is divisible. [FN24] The court must be shown that the signing bonus was not earned during the marriage. Although the signing bonus actually may be received during the marriage, it may be in exchange for the athlete agreeing to take less salary in the future. The NFL's own salary cap policy takes this into consideration and distributes the signing bonus salary cap impact over the lifetime of the contract.
>
> This kind of reasoning might appeal to a court. Ask the court to consider applying the effect of the signing bonus the same way it is calculated by the NFL. If this argument were successful, only a portion of the signing bonus would be divisible marital property. The remainder of the signing bonus would be allocated over the remaining years of the contract as future income, just as the base salary is allocated.
>
> Acceptance of a signing bonus in return for accepting a lower base salary during the early years of the contract can be compared to a corporation offering employees a lump sum payment to retire early. Often a company will offer a highly compensated employee some type of subsidy to induce the employee to take an earlier retirement. This is not a mere altruistic gesture by the company, but an attempt to induce a highly compensated employee to retire early, so a less costly employee can replace him or the position can be eliminated altogether.
>
> Similarly, NFL teams do not pay players large signing bonuses because they want to reward the player for signing the contract. They pay a signing bonus to maneuver around the NFL salary cap and free up more money to sign other skilled players, thereby making the team more competitive. The player has to forgo the right to earn more money under the base salary because he accepted the signing bonus. Texas case law supports the position that a payment to induce an employee to retire early is not a benefit which is earned or accrued during the employee's tenure, but is merely an incentive to get the employee to retire early, thereby benefitting the company financially. [FN25] The court may be persuaded to view a signing bonus the same way.

> The player is giving something up in the future to get the bonus. The court needs to understand that the signing bonus was not to reward past or current services, but actually to compensate the athlete for future services.
>
> The main obstacle in successfully arguing that a signing bonus is not marital property is the fact that the marital estate has already received payment. Even if a signing bonus is subject to forfeiture, a court is likely to still view the bonus as a vested property right. A Texas court has stated "the possibility that a property right may be subject to total or partial forfeiture, does not destroy its character as a vested property right for the purposes of division on divorce."

Katherine A. Kinser & R. Scott Downing, *Family Law Issues That Impact the Professional Athlete*, 15 J. Am. Acad. Matrim. Law. 337, 345-47 (1998). The authors note possible complications if the bonus can be forfeited at a later time. *Id.* at 347.

H. COMPENSATION RECEIVED IN CONNECTION WITH SELLING THE BUSINESS. In some business sales, the buyer pays not only a purchase price, but also agrees to pay the selling owner to continue to work for, or consult with, the business. If such payments exceed the value of services to be rendered, they might be disguised sales proceeds to the extent of the excess. Covenants not to compete are discussed in Section III.C. below.

III. SELLING AN OWNERSHIP INTEREST.

A. CHARACTER OF SALES PROCEEDS. The proceeds from selling a business have the same character as the ownership interest. This is an application of the law of mutations.

B. POST-SALE EMPLOYMENT AND CONSULTING AGREEMENTS. It is not uncommon, in the purchase of a business, for the buyer and seller to agree for the seller to remain employed by the business for a period of time after the purchase/sale. This facilitates the transfer of goodwill, and makes for a smoother transition to new ownership with customers, suppliers, and employees. Sometimes the seller agree to a consulting agreement as an alternative to an employment agreement. Because money paid to buy a business must be capitalized over time, whereas compensation paid to an employee or consultant is deductible to the business as an expense when paid, buyers have a tax motive to move part of the purchase price into a compensation agreement. In any sale of a closely-held business, the terms of the sale and any related payments or agreements should be scrutinized to see if purchase price is being disguised as compensation for future employment.

C. COVENANTS NOT TO COMPETE. The right to compete after divorce is a separate property right. *See Ulmer v. Ulmer*, 717 S.W.2d 665, 667 (Tex. App.--Texarkana 1986, no writ), which held:

> An individual's ability to practice his profession does not qualify as property subject to division by decree of the court. *Nail v. Nail*, 486 S.W.2d 761 (Tex.1972). Thus, the trial court further erred in enjoining Rufus Ulmer from engaging in his chosen profession as part of the property division.

A covenant not to compete signed during marriage, is a contract right arising during marriage, and payments received under the agreement could be characterized as 100% community. On the other hand, an argument can be made that the payments represent foregone wages, and that foregone wages after divorce are separate property.

Another potential concern can arise with a covenant not to compete that extends past the date of divorce. When a business is sold, they buyer wants to get the seller's covenant not to compete, since it protects the buyer's investment in the business, assuring the buyer that the seller will not try to lure away suppliers, customers, or employees. Some have argued that the covenant not to compete represents the embodiment of the seller's personal goodwill, and as such all payments attributable to the covenant not to compete are separate property under *Nail v. Nail*, whether received before or after divorce.

A similar issue arises when a deferred compensation benefit, to be paid after retirement, is conditioned upon the retiring employee not competing against the company. Some have argued that, since the covenant not to compete would prohibit post-divorce employment, the deferred benefit is not entirely attributable to pre-retirement employment, but is also attributable to post-retirement foregone employment, and thus has a separate property component.

IV. RETURN ON CAPITAL/RETURN OF CAPITAL.

A. STOCK SPLITS & EXCHANGES. Shares of stock acquired through stock splits have the same character as the original stock. *Harris v. Harris*, 765 S.W.2d 798, 803 (Tex. App.--Houston [14th Dist.] 1989, writ denied); *Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Civ. App.--Houston [14th Dist.] 1975, writ dism'd).

In *Carter v. Carter*, 736 S.W.2d 775 (Tex. App.--Houston [14th Dist.] 1987, no writ), the parties married on December 7, 1974. Husband testified that in 1970 he received 159 shares of stock in MPI, a family-owned business, as a gift from his father. He corroborated this testimony by showing dividends reflected on his 1974 tax returns, coupled with his testimony that MPI declared dividends at the end of the year and paid them in the following year. In 1976, MPI was acquired by Stauffer Chemical Company, and husband received 4,645 shares of Stauffer in exchange for his MPI stock. In 1979, Stauffer had a 2-for-1 split, raising husband's shares to 9,290 in number. In 1981, husband sold 1,156 plus 1,000 shares of Stauffer, and expended the proceeds. Husband acquired 166 shares of Stauffer stock as a Christmas gift from his father in 1981 which he later sold, and participated in six short sales in 1982 and 1983. The trial and appellate courts held that the stock was proven to be husband's separate property.

In *Horlock v. Horlock*, 533 S.W.2d 52, 59 (Tex. Civ. App.--Houston [14th Dist.] 1975, writ dism'd), husband owned stock in a corporation prior to marriage. During marriage, that corporation merged with two other corporations to create yet another corporation. The court found that the new stock was husband's separate property--this despite the fact that he and the other owners of the old corporation put $200,000 into the merger.

B. STOCK DIVIDENDS. "A stock dividend normally is separate if the stock ownership out of which it springs is separate." *Wohlenberg v. Wohlenberg*, 485 S.W.2d 342, 347 (Tex. Civ. App.--El Paso 1972, no writ), citing *Tirado v. Tirado*, 357 S.W.2d 468 (Tex. Civ. App.--Texarkana 1962, writ dism'd); *Duncan v. United States*, 247 F.2d 845 (5th Cir. 1957). Stock dividends arising from community property stock are community.

C. CORPORATE CASH DISTRIBUTIONS. Cash dividends from corporate stock are community property. *See Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex. App.--Dallas 1985, no writ); *Bakken v. Bakken*, 503 S.W.2d 315, 317 (Tex. Civ. App.--Dallas 1973, no writ). "Interest and dividends paid on investments, whether the investments are separate property or not, are income under Texas law and are generally community property." *Asafi v. Rauscher*, No. 14-10-00606-CV, 2011 WL 4031015, at *7 (Tex. App.--Houston [14th Dist.] Sept. 13, 2011, pet. denied) (mem. op.); citing *Fischer-Stoker v. Stoker*, 174 S.W.3d 272, 279 (Tex. App.--Houston [1st Dist.] 2005, pet. denied), and *Alsenz v. Alsenz*, 101 S.W.3d 648, 653 (Tex. App.--Houston [1st Dist.] 2003, pet. denied). This view is based on the assumption that cash dividends paid by a corporation constitute a distribution of profits (i.e., income) and not a distribution of capital. However, not all cash distributions from corporations are dividends.

Bittker, Streng & Emory, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS (1995) says:

> Nondividend Distributions
>
> If a corporation has neither accumulated nor current E&P ["earnings and profits"], a distribution to its shareholders (as shareholders) will not be a “"dividend” includable in their gross income under IRC § 61(a)(7). This assumes that the distribution itself (e.g., of appreciated property) will not trigger gain that will generate current E&P. As specified in IRC § 311(b), the distribution of appreciated property will cause gain recognition of that appreciation to the corporation, and that gain (after applicable income tax) is includable in E&P. This treatment results because of the repeal of the General Utilities doctrine in the Tax Reform Act of 1986. Of course, the risk of increasing E&P does not exist if cash (at least in the form of U.S., not foreign, money) is being distributed. Furthermore, if gain is realized on a property distribution, E&P may still not result if the gain would be absorbed by, and be less than the net operating loss accumulated for, that year.
>
> Under IRC § 301(c)(2), a nondividend distribution is applied against, and reduces the adjusted basis of, the shareholder's stock. If the distribution is greater than the adjusted basis of the stock, the excess is subject to IRC § 301(c)(3) and will be treated as gain from the sale or exchange of property (and, therefore, capital gain, assuming the stock is a capital asset).
>
> Of course, to have nondividend treatment, the absence of E&P must be demonstrated by the recipient or the payor.

The IRS recognizes what it calls "nondividend distributions." One IRS publication on the matter says: "A nondividend distribution is a distribution that is not paid out of the earnings and profits of a corporation or a mutual fund. You should receive a Form 1099-DIV or other statement showing the nondividend distribution. On Form 1099-DIV, a nondividend distribution will be shown in box 3. If you do not receive such a statement, you report the distribution as an ordinary dividend." IRS Publication 17, "Your Federal Income Tax" Guide 2016, ch. 8, p. 66, says:

> **Nondividend Distributions**
>
> A nondividend distribution is a distribution that is not paid out of the earnings and profits of a corporation or a mutual fund. You should receive a Form 1099-DIV or other statement showing the nondividend distribution. On Form 1099-DIV, a nondividend distribution will be shown in box 3. If you do not receive such a statement, you report the distribution as an ordinary dividend.
>
> **Basis adjustment.** A nondividend distribution reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. This nontaxable portion is also called a return of capital; it is a return of your investment in the stock of the company. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the nondividend distribution, reduce the basis of your earliest purchases first.When the basis of your stock has been reduced to zero, report any additional nondividend distribution you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See Holding Period in chapter 14.
>
> Example. You bought stock in 2003 for $100. In 2006, you received a nondividend distribution of $80. You did not include this amount in your income, but you reduced the basis of your stock to $20. You received a nondividend distribution of $30 in 2016. The first $20 of this amount reduced your basis to zero. You report the other $10 as a long-term capital gain for 2016. You must report as a long-term capital gain any nondividend distribution you receive on this stock in later years.

This IRS approach suggests two things: a taxable dividend comes from earnings and profits; a non-taxable dividend is a return of capital. Tax law does not control state property law, but it is suggestive.

On June 6, 2009, Time Warner Inc. spun off Time Warner Cable to shareholders and paid a $10.27 per share dividend in the process. Time Warner estimated that just 30% to 35% of the dividend was an actual dividend out of earnings and profits and the rest was a return of capital based on an adjustment to cost basis.

Mattel, Inc. currently (July 2017) presents the following statement at its web site <http://investor.shareholder.com/mattel/faq.cfm?faqid=8>:

> In 2014, based on reasonable assumptions by Mattel, 80% of the distribution is a non-dividend distribution for U.S. federal income tax purposes.
>
> Under U.S. federal income tax rules, corporate dividends are designated as a dividend or a non-dividend distribution based on the applicable "earnings and profits" of the entity paying dividend. Although Mattel has significant retained earnings, these earnings do not constitute as "earnings and profits" as defined in U.S. federal tax rules.
>
> Non-dividend distributions are considered a return of capital and are generally not taxable; however, the recipient must adjust their cost basis to reflect the distribution.
>
> Going forward, assuming no changes in current business operations or current tax laws, Mattel expects more than 50% of future dividends to be designated a non-dividend distribution.
>
> The Company's Form 1099-DIV, will be distributed in early 2015, will reflect the tax treatment.

The Mattel, Inc. web site goes on to explain:

> What is a non-dividend distribution?
>
> A non-dividend distribution represents a return of a portion of the shareholder's original investment in the stock of a corporation. Generally, for U.S. federal income tax purposes, a non-dividend distribution is first treated as a reduction in the shareholder's tax basis in the stock held, and when the basis in the stock is reduced to zero, a non-dividend distribution is then treated as a capital gain to the shareholder. Mattel does not provide tax advice. Please consult your tax advisor to determine how non-dividend distributions are taxed in your specific situation.

While this type of non-dividend distribution is not frequent among extremely large companies, this example does establish that not all cash distributions from corporations are taxable as dividends. Whether a cash distribution comes from earnings and profits or is a return of capital for tax purposes may affect the decision of whether a cash distribution from a separate property corporation is separate or community property.

D. PARTNERSHIP DISTRIBUTIONS. Partnership profits distributed to a partner during marriage are community property, regardless of whether the partnership interest is separate or community property. *Harris v. Harris*, 765 S.W.2d 798, 804 (Tex. App.--Houston [14th Dist.] 1989, writ denied); *Marshall v. Marshall*, 735 S.W.2d 587, 594 (Tex. App.--Dallas 1987, writ ref'd n.r.e.). In *York v. York*, 678 S.W.2d 110, 113 (Tex. App.--El Paso 1984, no writ), the court held that post-divorce distributions, received on account of a community property partnership interest that was undivided in the divorce, belonged half to former husband and half to the former wife. Determining the law that applies to distributions of capital from a separate property partnership is more complicated. See Section IV.E below.

E. A NEW APPROACH TO CHARACTERIZING DISTRIBUTIONS FROM ENTITIES. It may be more conducive to understanding if we change the way we approach the characterization of distributions from entities. It has long been said that stock dividends retain the character of the underlying stock, and that dividends received by a spouse from a corporation are community property. This approach may be too simplistic. The following explanation discusses six different approaches that could be taken for characterizing distributions from separate property business entities. The six approaches are: (i) distributions of profits are community property; (ii) tracing through the entity; (iii) the "liquidation approach"; (iv) the "exhaustion of earnings approach;" (v) the "return of capital approach;" and (vi) the "proportionality rule."

1. Distributions of Profits are Community Property. Under the community property presumption, all property possessed by a spouse during or on dissolution of marriage is presumed to be community property, and the party claiming separate property has the burden of proof on clear and convincing evidence. Tex. Fam. Code § 3.003. One possible rule for distributions from entities would be that there is no path to proving that the distributions are separate property, so all such distributions fall into the community estate. Considering the three leading cases in the area of distributions from entities, this "all community property" approach was not suggested in *Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.–Dallas 1987, writ ref'd n.r.e.), nor was it suggested in *Lifshutz v. Lifshutz*, 199 S.W.2d 9 (Tex. App.–San Antonio 2006, no pet.) ("Lifshutz II"), and it was rejected in *Legrand-Brock v. Brock*, 246 S.W.3d 318 (Tex. App.–Beaumont 2008, pet. denied) ("*Brock II*").

Marshall v. Marshall, 735 S.W.2d 587 (Tex. App.–Dallas 1987, writ ref'd n.r.e.), supports an argument that distributions of *profits* from a separate property entity are community property. In *Marshall*, the husband owned an interest in a partnership at the time of marriage. The partnership owned mineral interests that were acquired prior to husband's marriage. The court of appeals held that the mineral interests were not separate property, because they belonged to the partnership and had no marital property character. The court rejected the idea that the husband retained an ownership interest in his capital contribution, or that partnership distributions were a mutation of his capital contribution. *Id.* at 594. The court also rejected the idea that the partnership's production of oil and gas was subject to characterization as either separate or community property. *Id.* at 594-95. Under the partnership agreement, it was agreed that all distributions to the husband in excess of his salary "shall be charged against any such distributee's share of the profits of the business." *Id.* at 595. On its books, the partnership allocated husband's draws that were in excess of the other partner's draws to husband's salary, and on the partnership tax returns the excess draws were reported as "guaranteed payments for partners." *Id.* at 594. The husband reported the distributions as ordinary income on his personal tax return. *Id.* The court noted that "all monies disbursed by the partnership were made from current income." *Id.* at 595. The court concluded:

> The withdrawals nevertheless were distributions of partnership income or profits and, thus, community. We hold that all distributions by the partnership to Woody during the course of the second marriage were community property.

Id. at 595 (emphasis added). *Marshall* clearly states that the husband's distributions were community property because they were from the partnership's income or profits. The significance of *Marshall* to a great degree depends on which statements in the Court's Opinion you read as broad principles of law, or which statements you read to be as conclusions drawn from the facts in the particular case (such as the language of the partnership agreement that the distributions were charged against profits and the fact that all distributions were from current income and the fact that the husband reported the distributions as ordinary income (not capital gains) on his personal tax return).

Harris v. Harris, 765 S.W.2d 798, 802 (Tex. App.--Houston [14th Dist. 1989], writ denied) (emphasis added), said:

> Distributions of the partner's share of profits and surplus (income) received during marriage are community property even if the partner's interest in the partnership is separate property. TEX. FAM. CODE, § 5.01(b); *Arnold v. Leonard*, 114 Tex. 535, 273 S.W.2d 799 (1925); *Marshall v. Marshall*, 735 S.W.2d at 594.

In *Lifshutz v. Lifshutz*, 199 S.W.2d 9, 27 (Tex. App.–San Antonio 2006, no pet.) ("*Lifshutz II*"), a subsidiary corporation was transferred directly from a separate property family partnership to a separate property family corporation in a tax-free business recapitalization. *Id.* at 24-28. The trial court found this to be a "non-liquidating community distribution" from the partnership, and held the stock of the subsidiary to be community property of the husband. *Id.* at 24. After an extensive analysis of the facts and citation to *Marshall*, a 2-to-1 majority of the court of appeals wrote:

> Accordingly, since partnership property does not retain a separate character, distributions from the partnership are considered community property, regardless of whether the distribution is of income or of an asset.

The court recognized that a Louisiana appellate court had "drawn a distinction between distributions of income and distributions of a capital asset," but commented the Louisiana court did not analyze the effect of the entity theory of partnerships and further noted that in the present case, "the accumulated profits of [the partnership] exceeded the aggregate distributions, which included the [subsidiary] stock distribution." *Id.* at 27 n. 4. This last comment suggests that the Majority applied the rule that distributions of profits are community property. But it also implies recognition of an "exhaustion of earnings" approach, like the one discussed in Section IV.D.4 below.

2. Tracing Through the Entity. The idea of tracing a separate property capital contribution into an entity and back out again was rejected in *Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.–Dallas 1987, writ ref'd n.r.e.). In *Marshall*, the husband owned an interest in a partnership at the time of marriage. The partnership owned mineral interests that were acquired prior to husband's marriage. The Dallas Court of Appeals held that the mineral interests were not separate property, because they belonged to the partnership and had no marital property character. The Dallas Court rejected the idea that the husband had an ownership interest in his contributed capital, or that partnership distributions were a traceable mutation of his capital contribution. *Id.* at 594. The Court also rejected the idea that the distributions were a mutation of the husband's capital account. *Id.* at 594. The Court of Appeals said:

> Woody apparently relies on the rule that mutations of separate property remain separate if properly traced. *Norris*, 260 S.W.2d at 679. However, a withdrawal from a partnership capital account is not a return of capital in the sense that it may be characterized as a mutation of a partner's separate property contribution to the partnership and thereby remain separate. Such characterization is contrary to the UPA and implies that the partner retains an ownership interest in his capital contribution. He does not; the partnership entity becomes the owner, and the partner's contribution becomes partnership property which cannot be characterized as either separate or community property of the individual partners. TEX. REV. CIV. STAT. ANN. art. 6132b, §§ 8, 25, & 28–A(1) (Vernon 1970); Bromberg, 17 TEX. REV. CIV . STAT.ANN. at 300–01. Thus, there can be no mutation of a partner's separate contribution; that rule is inapplicable in determining the characterization of a partnership distribution from a partner's capital account.

Marshall, at 594. The *Marshall* court said that the separate property identity of separate property assets contributed to an business entity is lost because ownership by the entity destroys any marital property character. Following this logic to an extreme, tracing would not be allowed even if the entity were to distribute the same asset back out to the spouse that was separate property when it was contributed. Based on this analysis, it is sometimes said that you cannot trace inside an entity. It should be noted, however, that the partnership agreement in *Marshall* specified that the distributions were to be charged against the husband's share of profits. *Marshall*, at 595. Another partnership agreement might say something different that would change the outcome.

The court of appeals in *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex. App.--Houston [14th Dist. 1989], writ denied), adopted *Marshall*'s view, saying:

> Under the entity theory of partnership, adopted by Texas in the Uniform Partnership Act, TEX. REV. CIV. STAT. ANN. art. 6132b (Vernon 1970), partnership property is owned by the partnership entity, not the individual partners. *Marshall v. Marshall*, 735 S.W.2d 587, 593–594 (Tex. App.—Dallas 1987, writ ref'd n.r.e.). A partner's rights in specific partnership property are wholly subordinated to the rights of the partnership entity as owner of the property. He may possess the property only for partnership purposes. See TEX. REV. CIV. STAT. ANN. art. 6132b § 1; Bromberg, Source and Comments, (Vernon 1970). Partnership property is therefore neither separate nor community in character. *Marshall* at 594. The only partnership property right the partner has which is subject to a community or separate property characterization is his interest in the partnership, that is his right to receive his share of the partnership profits and surplus. *Marshall* at 594; *McKnight v. McKnight*, 543 S.W.2d 863, 867–868 (Tex.1976).

And the view was endorsed in *Lifshutz II*. There are still eleven courts of appeals yet to weigh in on the subject, and the Supreme Court has not addressed the notion of tracing into and out of an entity. Additionally, courts should recognize that a partnership agreement might establish that the distribution of a specific asset is a return of capital and not a distribution of profits. So advocates should not abandon the tracing concept in their trials and appeals.

3. The "Liquidation Approach." Several cases support the view that proceeds received in liquidation of an ownership interest in a business have the same character as the interest itself. It is not clear whether it is necessary to surrender some or all of the ownership interest as part of the liquidation process, or whether a business with current or retained earnings can liquidate a capital asset and then preferentially distribute those proceeds to the owners and have the transaction treated as a distribution of capital. Nor is it clear whether such a liquidation must be a total liquidation of all assets, or whether instead be a sale of less than all of the assets can be treated as a partial liquidation.

Tex. Bus. Organization Code § 21.002 defines "distribution" in this way:

> (6) (A) "Distribution" means a transfer of property, including cash, or issuance of debt, by a corporation to its shareholders in the form of:
>
> > (i) a dividend on any class or series of its outstanding shares;
> > (ii) a purchase or redemption, directly or indirectly, of any of its own shares; or
> > (iii) a payment by the corporation in liquidation of all or a portion of its assets.
>
> > (B) The term does not include:
> >
> > > (i) a split-up or division of the issued shares of a class of a corporation into a larger number of shares within the same class that does not increase the stated capital of the corporation; or
> > > (ii) a transfer of the corporation's own shares or rights to acquire its own shares.

Note that dividends are listed in (i) while a liquidating distribution "of all or a portion of its assets" is listed in (iii).

IRS publication 550 says this about liquidating distributions: ch. 1, p. 22

> Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive Form 1099-DIV from the corporation showing you the amount of the liquidating distribution in box 8 or 9.
>
> Any liquidating distribution you receive is not taxable to you until you have recovered the basis of your stock. After the basis of your stock has been reduced to zero, you must report the liquidating distribution as a capital gain. Whether you report the gain as a long-term or short-term

> capital gain depends on how long you have held the stock. . . .

<https://www.irs.gov/pub/irs-pdf/p550.pdf>.

a. Complete Liquidation. In *Fuhrman v. Fuhrman*, 302 S.W.2d 205, 212 (Tex. Civ. App.–El Paso 1957, writ dism'd), the court held that stock issued to a married shareholder upon dissolution of the holding corporation was received by the spouse as separate property. However, the character of distributions in complete liquidation of a corporation was questioned in *Legrand-Brock v. Brock*, 2005 WL 2578944, *2 (Tex. App.–Waco 2005, no pet.) (mem. op.) ("Brock I"), where a divided court suggested that payments in complete liquidation of a corporation might be community property to the extent that the distributions represent retained earnings[1] and profits. In his dissent, Chief Justice Grey cited three cases indicating that proceeds from the liquidation of an ownership interest in a business have the same character as the ownership interest. The view of the Waco majority was ignored on appeal after remand by the Beaumont Court of Appeals in *Legrand-Brock v. Brock*, 246 S.W.3d 318 (Tex. App.–Beaumont 2008, pet. denied) ("*Brock II*"), which held that all distributions by a corporation in exchange for surrender of all outstanding stock in a complete liquidation of separate property shares were received by the spouse as separate property.

b. Partial Liquidation. Given that distributions received in complete liquidation of an ownership interest have the same marital property character as the ownership interest itself, the question arises whether the rule applies to distributions that represent the proceeds from sale of only part of the company's assets, rather than all of them. A follow-on question arises whether the concept of partial liquidation requires that part of the ownership interest be surrendered to the company in exchange for the distribution.

The case of *Legrand-Brock v. Brock*, 246 S.W.3d 318 (Tex. App.--Beaumont 2008, pet. denied) ("*Brock II*"), involved payments made pursuant to a plan of complete liquidation of a corporation's assets. However, the court of appeals in *Brock II* mentioned "partial liquidations":

> A liquidating distribution includes a transfer of money by a corporation to its shareholders in liquidation of all or a portion of its assets. See BLACK LAW'S DICTIONARY 508 (8th ed. 2004) (A "liquidating distribution" is "[a] distribution of trade or business assets by a dissolving corporation or partnership."); see also TEX. BUS. CORP. ACT. ANN. art. 1.02(A)(13)(c) (Vernon Supp. 2007) (" 'Distribution' means a transfer of money ... by a corporation to its shareholders ... in liquidation of all or a portion of its assets.").

Brock II, at 323. The *Brock II* court also cited the U.S. Supreme Court in *Hellmich v. Hellman*, 276 U.S. 233, 235, 48 S.Ct. 244, 72 L.Ed. 544 (1928), a tax case:

> A distribution in liquidation of the assets and business of a corporation, which is a return to the stockholder of the value of his stock upon a surrender of his interest in the corporation, is distinguishable from a dividend paid by a going corporation out of current earnings or accumulated surplus when declared by the directors in their discretion, which is in the nature of a recurrent return upon the stock.

Brock II, 246 S.W.3d at 324. Note that the Supreme Court described two extremes: "Upon a surrender of his interest" on the one hand and on the other hand a dividend "out of current earnings or accumulated surplus . . . in the nature of a recurrent return upon the stock." This statement of extremes does not help much with situation that falls between the two extremes, such as when there is no "surrender of interest" or when the distribution is not "out of current earnings or accumulated surplus" or when the transaction is not "recurrent."

4. The "Exhaustion of Earnings" Approach. Several cases say that partnership profits distributed to a married partner are community property, regardless of whether the spouse's partnership interest is separate or community property. *Harris v. Harris*, 765 S.W.2d 798, 804 (Tex. App.–Houston [14th Dist.] 1989, writ denied); *Marshall v. Marshall*, 735 S.W.2d 587, 594 (Tex. App.–Dallas 1987, writ ref'd n.r.e.). This is consistent with the fundamental community property principle in Texas that income earned on separate property is community property. What if a distribution occurs when there are no profits to distribute? If the underlying principle is that only distributed profits are community property, then evidence showing that there were no profits to distribute would rule out a community component to the distribution, and would by process of elimination establish that the distribution must be of capital.

[1] Retained earnings consist of net income, less net losses, less dividends paid.

The *Barrington* Case.

This exhaustion of earnings approach was used in *Barrington v. Barrington*, 290 S.W.2d 297 (Tex. Civ. App.–Texarkana 1956, no writ). The issue was the husband's unincorporated business established prior to marriage. There being no entity, the issue was the characterization of cash and individual assets in the business. Using the community-out-first rule applied to bank accounts, the appellate court held that all of the assets were the husband's separate property at the time of divorce. The husband commingled the proceeds from the sale of his date-of-marriage inventory and equipment with profits in one bank account, but he regularly withdrew more money from that account than he earned. The appellate court described the situation in this way:

> Plaintiff had on hand $4,254.29 worth of new and used tires at the time of his marriage as his separate property and in his business he sold new and used tires and serviced tires. As he sold these tires and serviced tires in his business he deposited the proceeds in his one bank account and he would use the money he received in his business to buy new stock. His stock turned over about five times during his coverture with defendant. On February 28, 1955, a few days before the divorce suit, his stock of merchandise of new and used tires on hand was of the value of $2,700, which was a decrease of $1,554.29 from his original stock. He also sold some of his old equipment and bought new equipment which was necessary in his business of remolding and recapping tires-however, he kept accurate records of all of these transactions as hereinafter more fully shown. During the marriage he sold two re-tread molds (which was his original separate property) for $1,050 which money was placed in his business bank account. During the marriage he bought a new re-tread mold, paid $160 down on it from the bank deposit and paid a few (8 or 9) monthly payments of $68 per month from his business bank account and owed a balance on it at the time of the dissolution of the marriage. During the marriage he also bought a tire changer for $189, paying for same out of the business bank account check, also paid $75 out of said account on a cement spray machine, with an indebtedness still due against it at the time of the divorce, bought an air compressor on credit and made a few payments on it out of the business bank account as shown by the accountant's statement, and with an indebtedness still due against it at the time of the divorce, and also paid $350 out of said business account for a matrice. Mr. Barrington caused to be kept a complete and correct set of books with reference to such business by T. C. Wilson, Tax Service and Accounting Office, certified public accountants in Jacksonville, Texas. This office prepared inventory of this business in March 1954, five days after the marriage and another inventory as of February 28, 1955, the closing month immediately preceding the trial of March 5, 1955. The accountants also prepared a profit and loss statement in detail covering from March 1, 1954, through *304 March 1, 1955, and also prepared a net worth statement of Elray Barrington during a like period of time. All of these inventories, profit and loss statement and net worth statement, were introduced in evidence. The operation of the business of the Barrington Tire Shop and the income and disbursement of its earnings was at no time invested, mixed or mingled with income or monies derived from any other source as only one bank account was maintained.
>
> * * *
>
> Unquestionably the real estate and the original tools, appliances, office furniture, and certain other original property of the Barrington Tire Shop owned by Mr. Barrington prior to his marriage and still on hand at the dissolution of the marriage had in no way changed their form and were and still remained the unquestioned separate property of Mr. Barrington.
>
> It is our further view that the other remaining property of the Barrington Tire *305 Shop, consisting of the new re-tread mold, tire changer, cement spray machine, air compressor and matrice purchased out of the bank account of Barrington Tire Shop during the marriage (which was subject to various indebtedness as shown by the record) and other property on hand in the Tire Shop including the $2,700 worth of stock of new and used tires on hand in Barrington Tire Shop at the dissolution of the marriage, under the undisputed facts in this case, and under the authorities cited in the Farrow and Sibley cases, supra, were in law the separate property of appellee, Elray Barrington.

Allocation of Corporation Distributions for Tax

Purposes. From an accounting or financial standpoint, corporate distributions are treated as coming first out of current earnings, then out of retained earnings, and finally out of capital. Under Internal Revenue Code § 316 and Treasury Regulation 1.316-2, a corporate distribution is deemed to come from current earnings first, and then from accumulated earnings from prior years. *Id.* After current and retained earnings are exhausted, what is left, by process of elimination, must be a distribution of capital, and for this reason it reduces the tax basis in the corporate stock. This hierarchy is a model for how distributions from corporations or other entities could be distinguished for marital property characterization purposes. This "income-out-first" principle is an entity-related rule analogous to the community-out-first rule applied to bank accounts, or applied in the *Barrington* case.

Treas. Reg. § 1.316-2(a) provides:

> § 1.316-2 Sources of distribution in general.
>
> (a) For the purpose of income taxation every distribution made by a corporation is made out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits. In determining the source of a distribution, consideration should be given first, to the earnings and profits of the taxable year; second, to the earnings and profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings and profits of that year; third, to the earnings and profits accumulated before March 1, 1913, only after all the earnings and profits of the taxable year and all the earnings and profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings and profits only after the earnings and profits have been distributed.
>
> (b) If the earnings and profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings and profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. See § 1.316-1. If the distributions made during the taxable year consist only of money and exceed the earnings and profits of such year, then that proportion of each distribution which the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year. The portion of each such distribution which is not regarded as out of earnings and profits of the taxable year shall be considered a taxable dividend to the extent of the earnings and profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings and profits accumulated since February 28, 1913, and the actual earnings and profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made.
>
> (c) The provisions of the section may be illustrated by the following example:
>
> Example.
>
> At the beginning of the calendar year 1955, Corporation M had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1955 amounted to $30,000. During the year it made quarterly cash distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and before the taxable year, as follows:

Distributions during 1955		Portion out of earnings and profits of the	Portion out of earnings accumulated since Feb. 28, 1913, and before	Taxable amt. of each
Date	Amount	taxable year	the taxable year	distribution
March 10	$15,000	$7,500	$7,500	$15,000
June 10	15,000	7,500	4,500	12,000
September 10	15,000	7,500		7,500
December 10	15,000	7,500		7,500
Total amount taxable as dividends				$42,000

(d) * * *

(e) A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or a depreciation reserve based upon the cost or other basis of the property will not be considered as having been paid out of earnings and profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which ___ declared. If such a distribution is in excess of the basis, the excess shall be taxed as a gain from the sale or other disposition of property as provided in section 301(c)(3)(A). A distribution from a depletion reserve based upon discovery value to the extent that such reserve represents the excess of the discovery value over the cost or other basis for determining gain or loss, is, when received by the shareholders, taxable as an ordinary dividend. The amount by which a corporation's percentage depletion allowance for any year exceeds depletion sustained on cost or other basis, that is, determined without regard to discovery or percentage depletion allowances for the year of distribution or prior years, constitutes a part of the corporation's "earnings and profits accumulated after February 28, 1913," within the meaning of section 316, and, upon distribution to shareholders, is taxable to them as a dividend. A distribution made from that portion of a depletion reserve based upon a valuation as of March 1, 1913, which is in excess of the depletion reserve based upon cost, will not be considered as having been paid out of earnings and profits, but the amount of the distribution shall be applied against and reduce the cost or other basis of the stock upon which declared. See section 301. No distribution, however, can be made from such a reserve until all the earnings and profits of the corporation have first been distributed.

A law review Comment published in 1962 described the operation of this tax rule:

A. *Tax Treatment of Corporate Distributions*

Historically the concept of earnings and profits first entered the tax statute to exempt the distribution of pre-1913 earnings from taxation; now it is the chief statutory basis for exempting return of contributed capital. Generally, a non-liquidating corporate distribution of cash is treated for tax purposes either as a dividend or a return of capital. Depending upon the source of the distribution, it may be treated as ordinary income, as a return of capital, as a gain from the sale or exchange of property, or as a distribution specially exempt from tax. Section 316 of the Code defines a dividend as "any distribution . . . by a corporation to its shareholders, (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year...." If the source of the distribution is from either of the above, it is a dividend and is taxed as such to the recipient. The regulations recognize four basic possible sources

1. Earnings and profits of the taxable year;

> 2. Earnings and profits accumulated since February 28, 1913;
> 3. Earnings and profits accumulated before March 1, 1913;
> 4. Sources other than earnings and profits.
>
> Each of these sources is chargeable only to the extent that a distribution exceeds the source mentioned in the preceding class or classes. Thus, if the corporation has current year's earnings and profits (irrespective of a deficit in accumulated earnings and profits) or accumulated earnings and profits since February 28, 1913 (irrespective of a lack of earnings and profits in the current year), a distribution is taxable to the shareholder as a dividend.
>
> The source of the distribution is determined by specific statutory rules not affected by statements or designations as to the source made by corporate directors or by entries upon the corporation's books. A corporation cannot control the taxability of distributions by designating them to be from some specific fund such as accumulated earnings prior to February 28, 1913, or paid-in surplus. There is a conclusive presumption that all such distributions are made from the most recent earnings and profits.
>
> A dividend declared by a corporation which does not have current earnings and profits or accumulated earnings and profits after February 28, 1913 will be treated as a return of capital and therefore tax exempt until it exceeds the stockholder's tax basis for his stock. Any amount received in excess of the stockholder's tax basis is given capital gain treatment. [Footnotes omitted.]

Comment, 46 MARQUETTE L. REV. 104, 104-05 (1962) (emphasis added).

5. The "Return of Capital" Approach. Another possible approach would be to determine whether a distribution is a "return of capital" as that term is used in the Texas Business Organization Code.

The Texas Legislature believes that partial distributions from a limited partnership can be a return of capital, even outside the winding up of the business, because Section 153.208 of the Texas Business Organization Code specifically recognizes distributions that are a return of capital, and liquidation of the entity is not a required condition. The statute says:

> § 153.208. Sharing of Distributions
>
> (a) A distribution of cash or another asset of a limited partnership shall be made to a partner in the manner provided by a written partnership agreement.
>
> (b) If a written partnership agreement does not provide otherwise, a distribution that is a return of capital shall be made on the basis of the agreed value, as stated in the partnership records required to be maintained under Section 153.551(a), of the contribution made by each partner to the extent that the contribution has not been returned. A distribution that is not a return of capital shall be made in proportion to the allocation of profits as determined under Section 153.206.
>
> (c) Unless otherwise defined by a written partnership agreement, in this section, "return of capital" means a distribution to a partner to the extent that the partner's capital account, immediately after the distribution, is less than the amount of that partner's contribution to the partnership as reduced by a prior distribution that was a return of capital.

Some analysis of Section 153.208 is in order. First off, Chapter 153 applies to limited partnerships, not corporations, general partnerships, or limited liability companies.

Second, Section (a) says that a *written* partnership agreement controls the manner in which a distribution of cash or other assets of a *limited* partnership are distributed. This would seem to include the allocation of a distribution to capital or to profits. This is an important point to remember: any bright line or even statutory rule on whether a limited partnership distribution is capital or profits must be subordinated to what the *written* partnership agreement provides.

Third, Section (b) provides a default rule for valuing limited partners' capital contributions for purposes of making a distribution of capital, provided that the partnership agreement does not say otherwise. Section (b) says that the amount of capital allocated to each partner "shall be made" on the basis of the *agreed* value of the contribution made by each partner, to the extent that capital has not already been returned. This statutory provision is potentially significant in cases where the default rule applies.

Fourth, Section (c) measures a return of capital based on (i) the agreed value of capital (ii) minus prior distributions that were a return of capital. No express mention is made of the partner's share of profits and losses. *However, for reasons external to Section 153.208(c), a partner's capital account is increased by profits and reduced by losses.* So, does the calculation of "return of capital" implicitly require that prior profits and losses be taken into account, or are profits and losses to be ignored? Note that a written partnership agreement can vary this rule.

6. The "Proportionality Rule." The "proportionality rule" is taken from Tex. Bus. Org. Code § 153.208, Sharing of Distributions, which in Subsection (b) provides:

> (b) . . . A distribution that is not a return of capital shall be made in proportion to the allocation of profits as determined under Section 153.206.

Since a distribution that is *not* a return of capital must be made in proportion to the allocation of profits, logic (i.e., the contrapositive) requires that a distribution that is *not* in proportion to the allocation of profits *must* be a return of capital, regardless of other considerations. On the other hand, it does not logically follow that a distribution made in proportion to the allocation of profits is necessarily a distribution of profits, because either a distribution of profits or a return of capital could be in proportion to the allocation of profits. Stated differently, a distribution made in proportion to the allocation of profits could be either a return of capital or a distribution of profits, but a distribution that is not in proportion to the allocation of profits cannot be a distribution of profits (and thus must be a distribution of capital).

QUESTION: What happens under this default rule when the liquidity event giving rise to the distribution is a borrowing, not income and not capital? Are the borrowed funds income or capital or something else?

V. PARTNERSHIP ACCOUNTING. It is important to consider partnership accounting in the discussion about whether partnership distributions from a separate property partnership are separate or community property. The key concept is the partner's "capital account."

A. WHAT IS A PARTNER'S CAPITAL ACCOUNT?

There are many descriptions of a capital account available on the internet. This one, from www.accountingtools.com, is serviceable:

> ### What is the partnership capital account?
>
> The partnership capital account is an equity account in the accounting records of a partnership. It contains the following types of transactions:
>
> - Initial and subsequent contributions by partners to the partnership, in the form of either cash or the market value of other types of assets
> - Profits and losses earned by the business, and allocated to the partners based on the provisions of the partnership agreement
> - Distributions to the partners
>
> The ending balance in the account is the undistributed balance to the partners as of the current date.
>
> For example, if Partner Smith originally contributed \$50,000 to a partnership, was allocated \$35,000 of its subsequent profits, and has previously received a distribution of \$20,000, the ending balance in his account is \$65,000, calculated as:

\$50,000 initial contribution + \$35,000 profit allocation - \$20,000 distribution

> A partnership can maintain a single partnership capital account for all partners, with a supporting schedule that breaks down the capital account for each partner. However, it is easier over the long term to instead maintain separate capital accounts within the accounting system for each partner; by doing so, it is easier to determine the amount to be distributed to each partner in the event of a liquidation of the business or the departure of a partner, which in turn reduces the amount of discussion over payments and liabilities amongst the partners.

<http://www.accountingtools.com/questions-and-answers/what-is-the-partnership-capital-account.html>.

The capital accounts of partners in a Texas general partnership are maintained in accordance with Section 152.202 of the Tex. Bus. Organizations Code, which provides:

Sec. 152.202. Credits of and Charges to Partner.

(a) Each partner is credited with an amount equal to:

(1) the cash and the value of property the partner contributes to a partnership; and
(2) the partner's share of the partnership's profits.

(b) Each partner is charged with an amount equal to:

(1) the cash and the value of other property distributed by the partnership to the partner; and
(2) the partner's share of the partnership's losses.

(c) Each partner is entitled to be credited with an equal share of the partnership's profits and is chargeable with a share of the partnership's capital or operating losses in proportion to the partner's share of the profits.

Acts 2003, 78th Leg., ch. 182, Sec. 1, eff. Jan. 1, 2006.

Thus, a partner's capital account, in a Texas general partnership, reflects four things:

(i) capital contributed by the partner, plus
(ii) the partner's share of profits; less
(iii) distributions to the partner; less
(iv) the partner's share of losses.

Tex. Bus. Organizations Code § 153.003 provides that the terms of Chapter 152, which apply to general partnerships, also apply to limited partnerships, except where it would violate the principle of limited liability of limited partners.

Tex. Bus. Organizations Code § 153.206 sets out the rule for allocation of profits and losses in a Texas limited partnership:

Sec. 153.206. ALLOCATION OF PROFITS AND LOSSES.

(a) The profits and losses of a limited partnership shall be allocated among the partners in the manner provided by a written partnership agreement.

(b) If a written partnership agreement does not provide for the allocation of profits and losses, the profits and losses shall be allocated:

(1) in accordance with the current percentage or other interest in the partnership stated in partnership records of the kind described by Section 153.551(a); or

(2) if the allocation of profits and losses is not provided for in partnership records of the kind described by Section 153.551(a), in proportion to capital accounts.

Acts 2003, 78th Leg., ch. 182, Sec. 1, eff. Jan. 1, 2006.