DISTRIBUTIONS FROM BUSINESS ENTITIES: SIX POSSIBLE APPROACHES TO CHARACTERIZATION

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by

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I. INTRODUCTION. If a spouse has a separate property ownership interest in a business, issues can arise whether distributions from the business are community property or separate property. This paper explores six possible approaches to the issue: (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."

II. SEPARATE PROPERTY PRINCIPLES. Separate property consists of (i) property owned or claimed prior to marriage; (ii) property acquired during marriage by gift, devise, or dissent; (iii) recovery for personal injuries sustained durinjg marriage, except for loss of earning capacity during marriage; (iv) community property that is partitioned or exchanged into separate property; (v) income from separate property that the spouses agree is separate property; (vi) property acquired with separate property credit; and (vii) mutations of separate property. Tex. Const. art. XVI, § 15; Tex. Fam. Code §§ 3.001, 4.102, 4.103.

Community property is all property acquired by a spouse during marriage that is not separate property. Tex. Fam. Code § 3.002. Community property can also be created by agreement between spouses to convert separate property to community property. Tex. Fam. Code § 4.103.

All property possessed by a spouse during or on dissolution of marriage is presumed to be community property. Tex. Fam. Code § 3.003. To overcome this presumption, the party claiming separate property must prove that claim by clear and convincing evidence.

Tracing is the process of establishing the separate property character of property through evidence showing the time and means by which the spouse originally acquired the property. *In re Marriage of Everse*, 440 S.W.3d 749, 751 (Tex. App.--Amarillo 2013, no pet.). Tracing also involves following the separate property through its changes in form. Where distributions from business entities are received by a spouse, they are presumed to be community, and the party claiming separate property must fit the distributions into one of the categories of separate property.

A. OWNED OR CLAIMED PRIOR TO MARRIAGE. The concept of property "owned prior to marriage" is straightforward. Proof can include admission by the opposing spouse, supporting testimony, authenticated documents of title, photographs, proof of income received from the property prior to marriage, proof that the property was insured prior to marriage, etc. Oral testimony of separate property from a spouse that is not corroborated is often found to be insufficient to prove separate property. *See e.g., Graves v. Tomlinson*, 329 S.W.3d 128 (Tex. App.–Houston (14th Dist.) 2010,pet. denied).

The State Bar of Texas' Pattern Jury Charges (Family & Probate 2014) PJC 202-2 gives the following instruction regarding property claimed before marriage:

> Property is "claimed before marriage" if the right to acquire or own the property arises before marriage, even if title to the property is acquired during marriage.

B. ACQUIRED BY GIFT, DESCENT OR DEVISE. The State Bar of Texas' Pattern Jury Charges (Family &

Probate) PJC 202-3 gives the following definition of gift, devise and descent:

> "Gift" means a voluntary and gratuitous transfer of property coupled with delivery, acceptance, and the intent to make a gift.
>
> A third person may make a gift to one spouse or to both spouses. If the gift is made to one spouse, that spouse owns the gift as separate property. If the gift is made to both spouses, each spouse owns an equal undivided separate-property interest in the gift.
>
> A spouse may make a gift to the other spouse, in which event the gift includes all the income and property that may arise from that gift unless the evidence establishes a different intent of the donor at the time of the gift.
>
> "Devise" means acquisition of property by last will and testament.
>
> "Descent" means acquisition of property by inheritance without a will.

Delivery can sometimes be a problem. See *Marshall v. Marshall*, 786 S.W.2d 493, 493 (Tex. App.--Texarkana 1990, no writ) ("[d]elivery requires that the property be placed within the control of the donee with the intention that a transfer of the title becomes currently operative").

There is a presumption, with a gift of property from one spouse to the other, that the gift includes the future income and property that may arise from that property. Tex. Const. art. XVI, § 15, Tex. Fam. Code § 3.005.

Where a spouse transfers his or her separate property to the other spouse, there is a presumption of gift. *Roberts v. Roberts*, 999 S.W.2d 424, 432 (Tex. App.–El Paso 1999, no pet.).

C. PERSONAL INJURY RECOVERY. There is no likely instance in which a distribution from an entity would be part of a personal injury recovery.

D. PARTITION OR EXCHANGE. Persons about to marry and spouses can partition or exchange property on hand or to be acquired. Tex. Const. art. XVI, § 15; Tex. Fam. Code ch.4. Where a written premarital or marital partition of exchange agreement makes the distributions from a business the receiving spouse's separate property, proving the agreement establishes the separate property nature of the distribution. Sometimes partnership agreements or organizational documents for corporations or limited liability companies contain a paragraph that constitutes a partition or exchange of distributions from the entity.

E. AGREEMENT THAT INCOME FROM SEPARATE PROPERTY IS SEPARATE. Spouses can agree that income or property arising from separate property will be separate property. Tex. Const. art. XVI, § 15; Tex. Fam. Code §§ 4.102 (partition or exchange agreement) and 4.103 (spousal agreement concerning income or property from separate property). Where a written agreement makes income or property arising from a business entity separate, proving the agreement establishes the separate property character of the distribution. Sometimes partnership agreements or organizational documents for corporations or limited liability companies contain a paragraph that constitutes an agreement between spouses that distributions from the entity will be separate property. Proof of the agreement proves the separate property claim.

F. ACQUIRED WITH SEPARATE PROPERTY CREDIT. Property acquired using a spouse's separate property credit is his or her separate property. *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975). Proof that an interest in a business was acquired using separate property credit establishes that the interest in the business is separate property. However, proof that the interest in the business is separate property does not establish that distribution from the entity are separate property. It will require another rule of separate property to make distributions from the entity separate property.

G. MUTATIONS OF SEPARATE PROPERTY. The State Bar of Texas' Pattern Jury Charges (Family & Probate

2014) PJC 202-4 gives the following instruction regarding mutations:

> The character of separate property is not changed by the sale, exchange, or change in form of the separate property. If separate property can be definitely traced and identified, it remains separate property regardless of the fact that the separate property may undergo mutations or changes in form.

III. SEPARATE PROPERTY PRINCIPLES APPLIED TO BUSINESS ENTITIES.

A. WHEN THE INTEREST IS OWNED OR CLAIMED BEFORE MARRIAGE. When an ownership interest in a business is owned of claimed before marriage, it is separate property. Possible proof that an interest in a business was owned or claimed prior to marriage includes admission by the opposing spouse, testimony, executed contracts, stock certificates, stock transfer ledgers, partnership agreements, LLC company agreements, IRS Form 1040 Schedule A listings of dividends received, Schedule C listings of disregarded entities, Schedule E listings of partnerships and S corporations, K-1s, etc.

In *Carter v. Carter*, 736 S.W.2d 775 (Tex. App.--Houston [14th Dist.] 1987, no writ), the parties married on December 7, 1974. The 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. The reporting of dividends on the tax return was circumstantial evidence of ownership. Note that the tax return included 24 days of marriage, and tax returns don't specify the date that dividends were *received*, so the tax returns alone were not conclusive of separate property. But the husband testified that the dividend was *declared* in 1973, a date prior to marriage. The appellate Opinion does not reflect whether this testimony was corroborated. Possible corroboration would be testimony from the company's CPA, or another shareholder, or a bank record reflecting the deposit of dividends prior to the marriage date.

In the case of *Harris v. Harris*, 765 S.W.2d 798 (Tex. App.--Houston [14th Dist., 1989], writ denied), the lawyer-husband established that his partnership interest was acquired before marriage, and that the execution of two subsequent partnership agreements did not alter the fact that he maintained the same partnership interest throughout. *Harris* also involved the issue of whether an agreement signed by the husband during marriage, pertaining to the payment of a contingent fee earned by his law firm, was separate or community property. The jury found that the husband's interest in the agreement was his separate property. The appellate court reasoned that the new agreement did not create the husband's right to participate in the contingent fee, but rather clarified and defined each partner's share of the earlier fee agreement and the manner of distributing the fee. *Id.* at 804. The right to receive the fee had been established prior to marriage.

A case reflecting some of the difficulties that can arise in proving ownership of a business before marriage is the case of *Tucker v. Tucker*, No. 13-11-00056-CV, 2013 WL 268937 (Tex. App.–Corpus Christi 2013, pet. denied) (memo. opinion). In that case, the husband said he purchased 500 shares in his father's business prior to marriage, "as evidenced by a promissory note." However, the stock transfer from the father to the son was not recorded *until after the divorce was filed*, when the stock transfer ledger was updated *by the husband's mother*. *Id.* at *1. The husband admitted having met with a financial advisor and discussing how to hide money from his wife. *Id.* at *1. The corporate minutes showed an earlier transaction where the father bought out his partner, but not when the son supposedly purchased half of the company. *Id.* at *9. The company's tax returns showed that the father owned 100% of the company up until 2005, which is when he died, and thereafter the returns show the son owned 100% of the company. *Id.* The marriage occurred in 1993. Notwithstanding all these proof problems, the trial court found the son's ownership interest to be separate property and the court of appeals affirmed.

B. ACQUIRING AN OWNERSHIP INTEREST DURING MARRIAGE.

1. Acquired by Gift, Descent, or Devise. Business interests are sometimes acquired by gift or inheritance, in which event the interest is separate property.

Gift. Proof of gift requires proof of delivery, acceptance, and donative intent. Delivery and acceptance can be shown with evidence that the business interest was transferred by the donor, or by the business at the donor's direction, and received by the donee. A transfer of an interest in a business interest can be reflected in an executed document of conveyance (a written assignment), or by a transfer of shares on the corporate books, or by the retiring of the donor's shares and the issuance of new shares to the donee. Or organizational documents can be reflect the transfer, such as amending a partnership agreement to reflect the admission of the donee as a new partner or limited partner. Or the transfer can be proved with circumstantial evidence, such as the donee's tax return reflecting dividend income, or the reporting on Schedule E of income from a pass-through entity (i.e., a Subchapter S corporation, a partnership, or an LLC that elects to be taxed as a partnership), or the inclusion in the personal tax return of a Schedule C for an entity that is disregarded for Federal tax purposes. A frequent indicator of a transfer of ownership in a partnership is a Form K-1, issued by the partnership to each partner, because the K-1 shows the individual's ownership interest in the partnership.

Note: if the gift of the interest in the business was from one spouse to the other spouse, there is a rebuttable *presumption* that the gift included future income (i.e., distributions) from the property. Tex. Const. art. XVI, § 15; Tex. Fam. Code § 3.005. Additionally, a claim of gift in the transfer of a business interest to a child is aided by a rebuttable presumption that a transfer from a parent to a child is a gift. *See Bogart v. Somer*, 762 S.W.2d 577 (Tex. 1988) (per curiam) ("a presumption of gift exists when a father- and mother-in-law place property in their son-in-law's name, and the party seeking to disprove the presumption must prove lack of donative intent by clear and convincing evidence.).

Descent. Inheritance by intestate succession seldom occurs in a family with an interest in a business, since most people with wealth have a last will and testament or at least a revocable trust. Where an ownership interest is acquired by intestate succession, there may be a probate court record if the estate was formally administered. If not, then the accepted means of proof is an affidavit of heirship sworn to by a disinterested party, filed in the deed record office. A form affidavit of heirship is set out in Texas Estates Code § 203.002, and is available from the Texas Comptroller's Office's website, at <http://comptroller.texas.gov/taxinfo/taxforms/53-111-a.pdf>. Once filed with the clerk, the affidavit can be authenticated through a certified copy. An affidavit of heirship was excepted from the hearsay rule under the former Texas Probate Code § 52, which was carried forward in Texas Estates Code § 203.001, which says that "[a] court shall receive in a proceeding to declare heirship or a suit involving title to property a statement of facts concerning the family history, geneology, marital status, or the identity of heirs of a decedent as prima facie evidence contained in the statement is contained in an affidavit or other instrument legally executed and acknowledged of sworn to before, and certified by, an officer authorized to take acknowledgments or oaths, as applicable . . . ." One case says, however, that the declarant must be unavailable in order to be excepted from the hearsay rule under Tex. R. Evid. 804 (When the Declarant is Unavailable as a Witness). *Compton v. WWV Enters.*, 679 S.W2d 668, 671 (Tex. App.–Eastland 1984, no writ). The Opinion is qustionable.

Devise. Proof that an interest in a business was acquired through devise (i.e., under a will) starts with proof of the Will. If the business interest is described as part of a specific bequest, the Will should suffice to prove devise. If the business interest passed under a global award, or residuary clause, or if the division of assets is left to the discretion of the executor, then the Will will not tell the full story and further evidence will be needed to show that the business interest passed under a particular provision of the Will. If a Federal Estate Tax return Form 706 was filed, it will usually specify in detail what property each heir received. If there is no Form 706, then a sworn inventory and appraisement and list of claims may have been filed with the probate clerk and may identify the business interest as belonging to the decedent. Often there will be an assignment from the executor to the heir mentioning the business interest. If not, there may be a letter from the executor informing the person that s/he is receiving the business interest as part of the settlement of the estate. Testimony from the executor, or the accountant for the estate, or from other heirs, or from the heir, can further support a claim of devise.

2. **Acquired for Consideration.** Where a spouse acquires an interest in an existing business using separate property cash or credit, the business interest is separate property. This is nothing more than the principle of mutation. Where the business is starting up, and the spouse acquires an interest at the start-up, the interest is separate property if separate property capital is contributed in exchange for the business interest. This is nothing more than the principle of mutation.

However, some business entities require not only an initial contribution, but also require that owners, partners, or members agree at the outset to meet "capital calls" to contribute capital to the entity in the future. Questions:

1. Where a person acquires an interest in an entity that requires not only "up front" capital but also a commitment to make future capital contributions, what effect does this commitment to make future capital contributions have on the character of the ownership interest in the business?

2. If the commitment to make future capital contribution occurs before marriage, and the owner later marries, is the commitment a separate property obligation? What if the capital calls are met during marriage using community funds? Does that affect ownership or create a claim for reimbursement? If reimbursement, is it measured by the dollars contributed or the enhancement in value due to the contribution?

3. If the commitment is made during marriage, is it a community debt that imparts a community ownership interest? What happens at the time of divorce if the obligation to make capital calls extends out past the divorce? The business interest will become the separate property of the spouse who receives it in the divorce.

C. MUTATIONS OF AN EXISTING OWNERSHIP INTEREST. 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 *Horlock v. Horlock*, 533 S.W.2d 52, 59 (Tex. Civ. App.--Houston [14th Dist.] 1975, writ dism'd), the 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.

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.

D. SELLING AN OWNERSHIP INTEREST.

1. Character of Sales Proceeds. The proceeds from selling an interest in a business have the same character as the ownership interest. This is an application of the law of mutations. *Marriage of McNelly*, No. 14-13-00281-CV, 2014 WL 2039855 (Tex. App.–Houston [14th Dist.] 2014, pet. denied) (memo. opinion) (where husband owned a partnership interest prior to marriage, proceeds from sale of that interest were his separate property).

2. Delayed Payments From the Sale of a Business Before or During Marriage. Where an interest in a business is sold before marriage but payments are received during marriage, or where an interest in a community property business is sold during marriage with payments to be received after divorce, characterization issues can arise in allocating the sales proceeds between community and separate. If the purchase price is fixed and paid over time, all payments would seem to have the character of the underlying business interest. Any interest payments accruing during marriage would be community property and those accruing after divorce would be separate property. What if the agreement provides for the seller to continue to receive profits from the business after the sale, say for a period of 3 years? Undoubtedly, the post-sale profit distributions would reduce the amount of money paid up front. Are those distributions of profits to be considered income earned later or proceeds from sale? Does it matter whether it is reported on the seller's personal income tax return as income or capital gain?

3. Post-Sale Employment and Consulting Agreements. It is not uncommon, in the sale 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 agrees 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 immediately deductible to the business as an expense, sellers have a tax motive to move part of the purchase price into a compensation agreement, even if future services to be rendered are nominal or non-existent. 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 part of the purchase price is being disguised as compensation for future (i.e., post-divorce) employment. A reverse argument can arise when a separate property business is sold prior to marriage and payments are received during marriage.

4. 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.

Where a community property business is sold during marriage and a covenant not to compete, or covenant not to solicit customers, is signed during marriage, the covenant is a contract right/obligation arising during marriage, and payments received under the agreement could for this reason be characterized as 100% community. On the other hand, an argument can be made that the payments represent compensation for foregone wages, and that foregone wages after divorce are separate property. But the spouse is free to work in other areas outside the scope of the covenant not to compete, and those wages could be deemed to fully compensate the separate estate for the value of post-divorce services.

Another potential issue can arise regarding a covenant not to compete signed during marriage with payments that extend past the date of divorce. A buyer's covenant not to compete protects the buyer's investment in the business, by keeping the seller from luring 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 reciprocal argument can be made for payout received during marriage from a sale prior to marriage.

The contract for sale of a business can also impose other post-sale obligations on the seller, like a confidentiality agreement or a non-disparagement clause, that remain effective so long a post-sale payments are made. Are those portions of the payments allocable to the selling of a separate property business or to prohibited post-divorce activities, and what difference does it make?

E. ASSETS OF THE ENTITY. The assets of a corporation belong to the corporation and not the shareholders. So corporate assets are not marital property, and are neither separate nor community property. The same rule applied to partnerships. Tex. Bus. Code § 152.101 says:

> Sec. 152.101. NATURE OF PARTNERSHIP PROPERTY. Partnership property is not property of the partners. A partner or a partner's spouse does not have an interest in partnership property.
>
> Acts 2003, 78th Leg., ch. 182, Sec. 1, eff. Jan. 1, 2006.

See *McKnight v. McKnight*, 543 S.W.2d 863 (Tex. 1976) (trial court cannot award specific assets of a partnership to a spouse in a divorce). The same is true of LLCs, although no statute says so.

F. CORPORATE DIVIDENDS. The rules for characterizing corporate dividends are well-established, but they may need to be reexamined.

1. Stock Dividends. Stock dividends deriving from separate property stock are separate property. *See Duncan v. U.S.*, 247 F.2d 845, 855 (5th Cir. 1957). It follows that stock dividends deriving from community property stock are community. Stock dividends do not reduce the corporation's net worth, and are seen as merely changing the structure of the corporation's equity (i.e., ownership). *Tirado v. Tirado*, 357 S.W.2d 468, 473 (Tex. Civ. App.-Texarkana 1962, writ dism'd) (cash dividends are treated like income, while stock dividends are treated as a mutation of property and take the character of the stock from which they originated when they do not increase the value of the total stocks owned).

2. Cash Dividends. Cash dividends from corporate stock have been held to be 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). This view is probably 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. There is more to this than you might think.

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." The 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." Another IRS publication says this:

> 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.
>
> 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.

> You bought stock in 2001 for $100. In 2004, 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 2014. The first $20 of this amount reduced your basis to zero. You report the other $10 as a long-term capital gain for 2014. You must report as a long-term capital gain any nondividend distribution you receive on this stock in later years.[1]

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 (Sept. 2015) presents the following statement at its web site:

> Why does Mattel expect a portion of its future dividend to be a non-dividend distribution?
>
> The US federal income tax classification of dividends depends on the applicable "earnings and profits" of the entity paying the dividend. In general, dividends in excess of applicable "earnings and profits", as determined under U.S federal income tax laws, are generally classified as non-dividend distribution. Although Mattel has significant retained earnings, these earnings do not constitute as "earnings and profits" as defined in U.S. federal tax rules. 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.[2]

So not all dividends are taxable as distributions of corporate earnings. A little refinement of the state marital property rules regarding dividends may be needed.

G. RULES FOR DISTRIBUTIONS FROM ENTITIES. As noted above, it has long been established that stock dividends retain the character of the underlying stock, and that cash dividends received by a spouse from a corporation are community property. Beyond that, the law become murky. 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

[1] <http://taxmap.ntis.gov/taxmap/pub17/p17-039.htm>.

[2] <http://investor.shareholder.com/mattel/faq.cfm?faqid=7>.

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. *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), 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.

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 capital contribution, or that partnership distributions were a 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.

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).

An IRS publication says this about liquidating distributions:

> 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. . . [3]

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.) (memorandum opinion) ("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[4] 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:

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[3] <http://taxmap.ntis.gov/taxmap/pubs/p550-006.htm#TXMP3c376e13>.

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

> 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.

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.

<u>Allocation of Corporation Distributions for Tax Purposes.</u> 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 — Date	Distributions during 1955 — Amount	Portion out of earnings and profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and before the taxable year	Taxable amt. of each 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).

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?

IV. 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.

APPENDIX

1. No Preferential Return of Capital (Form).

The following form partnership agreement is taken from 19 TEX. PRAC., Business Organizations § 13:23 (3d ed.)

ARTICLE 8
DISTRIBUTIONS

8.1. Cash Distributions. Except as otherwise provided in this Article 8 and except as may be otherwise prohibited by any documentation or agreements between any third-party lender and the Partnership, Distributable Cash, if any, may be distributed by the General Partner, in its sole discretion, to all Partners based upon their Partnership Interests. No distributions in excess of Distributable Cash will be made without the approval of the General Partner and a Super Majority Interest. No General Partner or Limited Partner will be entitled to any priority or preference over any other Partner as to cash distributions. Any distribution made pursuant to the "good faith" direction set forth in Section 8.2 will be made pursuant to the authority and limitations of this Section 8.1 and will be considered a distribution pursuant to this Section 8.1 for purposes of this Agreement.

8.2. Distribution for Taxes. It is the intention of the General Partner to attempt in good faith to make cash distributions to the Partners each Fiscal Year in an aggregate amount equal to the estimated taxable income of the Partnership allocated pursuant to Article 7 for such Fiscal Year multiplied by the highest individual federal income tax rate in effect for such year; provided, however, that if for any Fiscal Year there is a special allocation of income (including allocations to a Partner pursuant to Section 704(c) of the Code), the General Partner will have the right to increase distributions to all the Partners such that the distributions are based on the highest amount of taxable income per one percent (1%) Partnership Interest allocated to a Partner. Such distribution is intended to be made on or before the filing date of such Partner's income tax return (without extensions). Notwithstanding the foregoing, the General Partner will have no obligation to make any such distributions; and the Partners recognize that the General Partner may be prevented from making such distributions as a result of the General Partner's determination, in its sole and absolute discretion, that such distribution would not be in the best interest of the Partnership.

8.3. Distribution in Kind. Distributions to be made pursuant to the provisions set forth in Section 8.1 may be satisfied by assets in kind instead of cash as determined by the General Partner. If any assets of the Partnership will be distributed in kind, the General Partner or the liquidator, as the case may be, will: (a) determine the value of such assets using appraisal techniques which are deemed to be appropriate by such Person, taking into account the nature of the assets; (b) immediately prior to any distribution of any property by the Partnership, adjust the Capital Accounts of all Partners to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in such assets (that has not been reflected in the Capital Accounts previously) would be allocated among the Partners if there were a taxable conveyance of such assets for their fair market value on the date of distribution; and (c) except as otherwise agreed to by the General Partner and the receiving Partners, such assets will be distributed to the Partners entitled thereto.

8.4. Liquidating Distributions. Notwithstanding this Article 8, liquidating distributions upon termination of the Partnership will be governed by Article 17.

*   *   *

ARTICLE 17
WINDING UP, LIQUIDATION, AND TERMINATION

17.1. Events Requiring Winding Up.

(a) Except as permitted by the Law, the Partnership must wind up the Business and affairs on the first to occur of the following:

(i) The written consent of the General Partner and a Super Majority Interest;
(ii) An entry of a judicial decree requiring the winding up of the Partnership under applicable law;
(iii) The happening of an event requiring the winding up of the Partnership pursuant to the terms of this Agreement; or
(iv) The happening of any other event that under the Law requires the winding up of the Partnership and such requirement is not validly waived by this Agreement.

(b) If an event requiring a winding up occurs and is not cancelled or revoked pursuant to Section 17.2, the Partnership will wind up its affairs until the assets of the Partnership have been distributed as set forth in Section 17.3 below. Notwithstanding the winding up of the Partnership, the affairs of the Partners and the Business, as such, will continue to be governed by this Agreement.

17.2. Revocation or Cancellation of Winding Up Event. To the extent permitted by law, the Partnership may revoke or cancel, as applicable, the event requiring the winding up of the Partnership upon the approval of the General Partner and a Super Majority Interest. In the event of such revocation or cancellation, the Business and affairs of the Partnership will continue without any winding up of the Partnership.

17.3. Liquidation Upon Event Causing Winding Up. Upon the occurrence of an event requiring the winding up of the Partnership pursuant to Section 17.1 above, the General Partner will diligently proceed to wind up the affairs of the Partnership, liquidate the assets of the Partnership, or appoint one (1) or more Person(s) to liquidate the Partnership, and apply and distribute the proceeds thereof in the following order of priority:

(a) To the payment of obligations of the Partnership (including to Partners), including the expenses of liquidation;
(b) To the setting up of any reserves for contingencies which the General Partner may consider necessary; and
(c) To the Partners in the following order of priority:
(i) To the Partners in accordance with the positive balances in their Capital Accounts; and
(ii) Any remaining assets will be distributed to the Partners in the same proportion as the Partners have agreed to share Profits pursuant to Article 7 at the time of such distribution, any cash to be distributed immediately, and the accounts receivable as they are collected.

17.4. Cancellation of Certificate of Formation. On completion of the winding up process (including the distribution of Partnership assets as provided in Section 17.3), the General Partner must cause the cancellation of the Partnership's Certificate by the filing of a Certificate of Termination with the Secretary of State of the State of Texas. Additionally, the General Partner will cause to be filed any and all documents necessary to terminate the Partnership as a foreign limited partnership where applicable.

17.5. Allocation of Gain or Loss Upon Winding Up. Any gain or loss on any transfer or conveyance of Partnership properties in the process of liquidation will be credited or charged to the Partners in the proportion of their interest in Profits or Losses, respectively, as determined under Article 7. Except as may be otherwise provided herein, any property distributed in kind in the liquidation will, to the extent practicable, be distributed in undivided fractional interests. Any property distributed in kind in liquidation will be valued and treated as though the property were sold and the cash proceeds were distributed. The provisions of this Section 17.5 will apply only to the accounting between the Partners on liquidation, and a distribution in kind pursuant to these provisions will not be treated as a sale for income tax purposes. The Partners (or their estates, as applicable) will continue to share Profits and Losses during the period of winding up in the same proportions as before winding up.

17.6. Discretion of General Partner Upon Winding Up. Notwithstanding the foregoing, in the event that the General Partner determines that an immediate sale of part or all of the Partnership assets would cause undue loss to the Partners, the General Partner, in order to avoid such loss, may after having given notification to all the Limited Partners, to the extent not then prohibited by the laws of any jurisdiction in which the Partnership is then formed or qualified and applicable in the circumstances, either defer liquidation of, and withhold from distribution for a reasonable time, any assets of the Partnership except those necessary to satisfy the Partnership's debts and obligations, or distribute the assets to the Partners in kind.

17.7. Recourse of Partner Upon Winding Up. Each Partner must look solely to the assets of the Partnership for all distributions with respect to the Partnership and his or her Capital Contribution thereto and share of cash, sale proceeds, and Profits or Losses thereof, and will have no recourse therefor (upon winding up or otherwise) against the General Partner or any Limited Partner, except as otherwise herein specifically provided.

17.8. Restoration of Deficit Capital Account. If, following the distribution of proceeds pursuant to Section 17.3 above, there is a deficit balance in the Capital Account of any General Partner (after giving effect to all contributions, distributions, and allocations for all taxable years, including the year during which such liquidation occurs), the amount of such deficit balance will be restored and repaid to the Partnership in compliance with Section 1.704-1(b)(2)(ii)(b)(3) of the Treasury Regulations, and such restoration or repayment will be distributed by the Partnership pursuant to Section 17.3 above.

17.9. Limited Partner's Deficit Capital Account. If any Limited Partner who is not a General Partner has a deficit balance in his or her Capital Account (after giving effect to all contributions, distributions, and allocations for all taxable years, including the year during which such liquidation occurs), such Limited Partner will have no obligation to make any contribution to the capital of the Partnership with respect to such deficit, and such deficit will not be considered a debt owed to the Partnership or any other Person for any purpose whatsoever, as tenants-in-common in the same proportions in which such Partners would have been entitled to cash distributions. Provided, however, that no distributions may be made pursuant to the provisions of this Section 8.3 (without the express written consent of the contributing Partner and/or the receiving Partner, as applicable, who is to recognize such gain or loss) if such distributions would result in gain or loss to the contributing Partner and/or the receiving Partner pursuant to the provisions of Sections 704(c) and/or 737 of the Code.

2. **Preferential Return of Distributions (Form).** The following form language is taken from Terence Floyd Cuff, *Some Observations on Drafting Distribution Provisions for Partnership Agreements*, Loeb & Loeb, LLP, Los Angeles, California Copyright © 2009, Terence Floyd.

Sample 1 The following clause splits cash in a fixed percentage:

Clause 8. Section x.x. Distributions of Distributable Cash.

Distributable Cash shall be distributed 70% to Fred and 30% to Don.

Sample 2 The following clause provides for the partners to recover the capital contributions before profits are distributed:

Clause 12. Section x.x. Distributions of Distributable Cash.

Distributable Cash shall be distributed in this order:

(a) First, to Fred and Don (between them in accordance with the ratio of their Net Unrecovered Capital Contribution) until distributions of Distributable Cash have returned Fred and Don's Net Unrecovered Capital Contribution, and then

(b) Second, the next seventy-five thousand dollars of Distributable Cash shall be distributed 70% to Fred and 30% to Don, and then

(c) Third, all remaining Distributable Cash shall be distributed 50% to Fred and 50% to Don.

The amounts distributable under each of the tiers of this Section x.x shall be measured cumulatively from the formation of the Company. Distributions of Distributable Cash shall be made annually, within thirty (30) business days after the end of the immediately previous calendar year.

"Net Unrecovered Capital Contribution" of a Member means the excess of –

(a) All Capital Contributions by the Partner to the Partnership over

(b) All distributions of Distributable Cash to the Partner under Section x.x(a).