PROPERTY PUZZLES:

30 CHARACTERIZATION RULES, EXPLANATIONS & EXAMPLES

Presented by:
R. SCOTT DOWNING
McCurley, Orsinger, McCurley,
Nelson & Downing, L.L.P.

Written by:
R. SCOTT DOWNING
RICHARD R. ORSINGER
STEPHEN ORSINGER
McCurley, Orsinger, McCurley,
Nelson & Downing, L.L.P.
5950 Sherry Lane, Suite 800
Dallas, Texas 75225
(214) 273-2400 : telephone
(214) 271-2470 : facsimile

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CHAPTER 31.1

The law progresses slowly, it is true, but the times progress in spite of the law, and it must at least mildly progress whether under protest or not.

– W.C. Rodgers, "Principle v. Precedent,"Report of the Proceedings of the Bar Association of Arkansas, 1900

I.
HISTORY & SCOPE OF ARTICLE

The present article is the third version and second revision of a paper originally written by Richard R. Orsinger for the Advanced Family Law Course in 1995. Entitled *Characterization: 20 Rules, 20 Examples and More*, the first version sought to condense the basic principles of characterization of marital property contained in the statutory and common law into a set of twenty comprehensive rules that, if comprehended and assimilated, would prepare a practitioner for all but the most enigmatic marital property puzzles.

The first revision to this article was made by Scott Downing, et al, for the Marriage Dissolution Institute in 2006, which updated the legal authorities, expanded the scope beyond characterization into tracing and valuation, and added five more rules. This second version was entitled *Property Puzzles: Characterization, Tracing, 25 Rules and More*, and was awarded Best Family Law CLE Article for 2006 by the State Bar of Texas.

This second revision represents a significant emendation to the previous two versions. A selective catalogue of changes includes:

- the rules have been reorganized and their number increased (again);
- several new cases and concepts have been added as supporting authorities;
- several new valuation methods have been addressed;
- the section discussing corporations partnerships and other entities has been entirely rewritten, adapted, in part, from the article written by Richard R. Orsinger and Stephen Orsinger for the Advanced Family Law Course in 2008, *Effect of Choice of Entities: How Organizational Law, Accounting, and Tax Law for Entities Affect Marital Property Law*;
- the section discussing trusts has been entirely rewritten, adapted, in part, from the article written by Stephen Orsinger for the Marriage Dissolution Institute in 2009, *Trusts, Family Law, & the Contract-Property Dichotomy*; and
- sections covering marital property issues related to limited liability partnerships, limited liability companies, professional corporations, professional associations, and sole proprietorships have been added.

While the law governing characterization of marital property has progressed slowly over the last 14 years, the times continue to progress forward forcefully, and the law has been forced to follow. This article, along with its subsequent revisions, follows the law's progression over that time.

II.
30 RULES
FOR CHARACTERIZING
MARITAL PROPERTY

The following 30 rules can be used to determine the character of marital property as either separate or community property under Texas law.

RULE 1 - Marital Property

All property owned by either spouse is marital property. Marital property can be either separate property or community property, or a mixture of the two.[1] Property owned by someone other than a spouse is not marital property, and is neither separate nor community property.[2]

RULE 2 - Inception of Title

The character of marital property as separate[3] or community[4] or mixed[5] is determined at the time of "inception of title." Inception of title occurs when a party first has a right of claim to the property by virtue of which title is finally vested.[6]

RULE 3 - Property Acquired Before Marriage

Property that has its inception of title before marriage is separate property.[7]

RULE 4 - Property Acquired During Marriage

Property that has its inception of title[8] during marriage is community property unless it is acquired in one of the following ways:

(1) by gift;[9]
(2) by devise or descent;[10]
(3) by partition or exchange;[11]
(4) as income from separate property made separate by a spousal separate income agreement;[12]
(5) by survivorship;[13]
(6) in exchange for other separate property (also referred to as "mutation");[14] or
(7) as recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage.[15]

RULE 5 - Property Acquired After Dissolution

Property which has its inception of title after the marriage is dissolved is not marital property.[16]

RULE 6 - Property Acquired in Another State

Property acquired by one spouse while domiciled in another state that would have been community property under these rules had it been acquired at the same time had the spouse been domiciled in Texas is called *quasi-community* property, and is subject to division by the trial court.[17]

Property acquired by one spouse while domiciled in another state that would have been separate property under these rules had it been acquired at the same time had the spouse been domiciled in Texas is called *quasi-separate* property, and is subject to confirmation by the trial court.[18]

RULE 7 - Presumption of Community & Burden of Persuasion

Property *in the possession of* either spouse during or on dissolution of marriage is presumed to be community property. A spouse seeking to establish the separate character of marital property must prove that character by clear and convincing evidence.[19]

RULE 8 - Characterization Determined by Judge and Jury

Characterization is a mixed question of law and fact, and thus is decided in part by the judge and part by the fact-finder. Despite the general prohibition on testimony regarding legal issues, expert witnesses may state opinions on mixed questions of law and fact as long as the opinion is confined to the relevant issues and is based on proper legal concepts.[20]

RULE 9 - Commingling

When separate and community property have become so commingled as to defy resegregation and identification, the burden of persuasion to overcome the presumption of community is not discharged, and the assets in question are treated as entirely community property.[21]

RULE 10 - Mutation & Tracing

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 undergoes mutations or changes in form.[22]

"Tracing" involves establishing the separate property origin of the property through evidence showing the time and means by which the spouse originally obtained possession of the property.[23]

RULE 11 - Divestiture of Separate Property

In a divorce, a court cannot divest a spouse of his or her separate property, except under very limited circumstances.[24]

RULE 12 - Changes in Value

The natural increase or decrease in the value of a separate asset does not affect its character.[25]

RULE 13 - Credit Obtained During Marriage

Credit obtained by a spouse during marriage is community credit unless the lender agrees to look solely to the borrowing spouse's separate estate for repayment.[26] Property acquired with community credit is community property, and property acquired with separate credit is separate property.[27] Credit during marriage is presumptively community, and the burden is on the proponent to prove separate credit.[28] Even property acquired with community credit can become separate property by interspousal gift, partition, etc.

RULE 14 - Presumption Arising From Deed Recitals

When a deed recites that separate property was paid for the property, or that the property is taken as the receiving spouse's separate estate, a rebuttable presumption of separate property arises.[29] Where the other spouse is grantor or otherwise chargeable with causing or acquiescing in the recital, the presumption become irrebuttable, absent fraud.[30]

RULE 15 - Presumption Arising From Interspousal Conveyance

Where one spouse conveys property to the other spouse, there is a rebuttable presumption of gift, even absent a recital in the instrument of conveyance.[31]

RULE 16 - Presumption From Including Other Spouse's Name in Title

Where one spouse furnishes separate property consideration and title is taken in the name of the other spouse, a rebuttable presumption of gift arises.[32] Where one spouse uses separate property to acquire property during marriage and takes title to that property in the names of both spouses, a rebuttable presumption arises that the purchasing spouse intended to make a gift of a one-half separate property interest to the other spouse.[33]

RULE 17 - Presumption Regarding Income From Interspousal Gift

When one spouse makes a gift of property to the other spouse, that gift is presumed to include all the income or property which might arise from the property given.[34]

RULE 18 - Presumption Regarding Withdrawal of Commingled Funds

Where an account contains both community and separate moneys, it is presumed that community moneys are withdrawn first.[35]

RULE 19 - Putting Separate Property Money in Joint Account

The act of placing separate property funds into an account under the control of both spouses does not make the funds community property.[36]

RULE 20 - Fixtures

Since, under the law of fixtures,[37] whatever is affixed to the land becomes part of the land,[38] improvements to realty take the character of the land, regardless of the character of the funds or credit used to make the improvements.[39]

RULE 21 - Wages

The character of wages is determined by a conceptually modified form of the inception of title rule; wages earned during marriage are community property, and wages earned before or after marriage are separate, regardless of when they are received.[40] However, if wages were earned partly during and partly before or after the marriage, the time at which they are received then determines their character.[41] An employment contract does *not* establish inception of title to future wages.[42]

RULE 22 - Goodwill

"Personal" or "professional" goodwill is not marital property, and thus has no value, no character, and cannot be divided by the court.[43] "Business" or "commercial" goodwill is marital property, and thus may be characterized using standard rules of characterization.[44]

RULE 23 - Corporate Assets

Since a shareholder owns shares in the corporation and not the assets of the corporation, corporate assets are neither separate nor community property,[45] unless the court pierces the corporate veil.[46] The increase during marriage in value of a separate property corporation belongs to the separate estate.[47]

RULE 24 - Partnership Rights of a Spouse

Texas has adopted the entity theory of partnerships. Partnership property is owned by the partnership and not the partners, and in the absence of fraud, is not the separate or community property of individual partners.

Thus, a partner has three main fundamental property rights with regards to the partnership;[48] two of these cannot be community property (*viz.* rights in specific partnership property and the right to participate in the management of the partnership).[49] The remaining right can be community property (*viz.* the partner's interest in the partnership).[50]

RULE 25 - Partnership Assets and Distributions

If a partner receives a share of profits during the marriage, they are community, even if the partner's interest in the partnership is his separate property.[51]

RULE 26 - Trust Holdings and Distributions

Property held by a trustee for the benefit of a spouse is not owned by a spouse, and cannot be marital property.[52] However, where the spouse-beneficiary has an unconditional right to have the property free of trust, then the property is treated as if it is owned by the spouse, even though still in the hands of the trustee. Where the spouse is both settlor and beneficiary of the trust, the income of the trust property is likely community income.[53] Where the trust is established by gift or will, case law is conflicting as to whether trust distributions are separate or community property.[54]

RULE 27 - Preemption of Texas Marital Property Law

Federal law sometimes preempts Texas marital property law (e.g. social security and railroad workers' benefits). In those circumstances, the federal law must be consulted to determine the rights of spouses in the property in question.[55]

RULE 28 - Employment Benefits

A. Defined Benefit Plans

A participant spouse will have a separate property interest in a defined benefit retirement plan equal to the monthly accrued benefit the spouse had a right to receive at normal retirement age as of the date of the marriage, regardless of whether the benefit is vested.[56]

The community property interest will be determined as if the spouse participant began his/her participation on the date of the marriage, regardless of whether the benefit had vested.[57]

B. Defined Contribution Plans

Separate property interests in defined contribution retirement plans are traced in the same manner and using the same principles as nonretirement assets.[58]

C. Stock Options/Stock Plans

The separate or community interest in employer provided stock/stock option plans are now determined using a formula set forth in the statute.[59]

RULE 29 - Insurance Proceeds

Casualty loss insurance proceeds take on the character of the asset that suffered the casualty.[60]

Disability payments and worker's compensation payments are community property to the extent they are payments to replace earnings during the marriage. To the extend they are payments to replace income while the participant is not married, they are separate property.

RULE 30 - Default Rules May Be Altered By Agreement

Spouses may alter any of these default rules of characterization by means of a premarital or marital property agreement.[61] The only limitations on this ability are that spouses may not agree to follow rules of characterization of property that violate public policy, commit a crime, or adversely affect a right to child support.[62]

III. EXPLANATIONS & EXAMPLES

A. Gift

A gift is a transfer of property made voluntarily and gratuitously. *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565, 568 (Tex. 1961). A gift requires:

1) intent to make a gift;
2) delivery of the property; and
3) acceptance of the property.

See Grimsley v. Grimsley, 632 S.W.2d 174, 177 (Tex. App.–Corpus Christi 1982, no writ). The burden of proving a gift is on the party claiming the gift. *Woodworth v. Cortez*, 660 S.W.2d 561, 564 (Tex. App.–San Antonio 1983, writ ref'd n.r.e.).

1. Lack of Consideration

Lack of consideration is an essential characteristic of a gift; an exchange of consideration precludes a gift. *Pemelton v. Pemelton*, 809 S.W.2d 642, 647 (Tex. App.–Corpus Christi 1991), *rev'd on other grounds sub nom. Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992); *Kunkel v. Kunkel*, 515 S.W.2d 941 (Tex. Civ. App.–Amarillo 1974, writ ref'd n.r.e.). "Gift" and "onerous consideration" are exact antitheses, and a recital of onerous consideration "negatives the idea of a gift." *Pemelton*, 809 S.W.2d at 647; *Ellebracht v. Ellebracht*, 735 S.W.2d 658, 659 (Tex. App.–Austin 1987, no writ); *Kitchens v. Kitchens*, 372 S.W.2d 249, 255 (Tex. Civ. App.–Waco 1963, writ dism'd). An exchange of consideration precludes a gift. *Williams v. McKnight*, 402 S.W.2d 505, 508 (Tex. 1966); *see also Saldana v. Saldana*, 791 S.W.2d 316, 319 (Tex. App.–Corpus Christi 1990, no writ) (Wife's testimony that she paid $10.00 to Husband's mother in exchange for real estate was sufficient to support the trial court's finding that the property was community property and not gift).

2. Donative Intent

A gift cannot occur without the intent to make a gift. *Campbell v. Campbell*, 587 S.W.2d 513, 514 (Tex. Civ. App.–Dallas 1979, no writ). A controlling factor in establishing a gift is the donative intent of the grantor at the time of the conveyance. *Ellebracht*, 735 S.W.2d at 659. In *Scott v. Scott*, 805 S.W.2d 835, 839-40 (Tex. App.–Waco 1991, writ denied), the jury found that Wife did not make a gift of money to Husband, even though she put a $100,000.00 certificate of deposit in his name alone. In *Scott*, Wife testified she had no donative intent, the jury believed her, and the appellate court affirmed.

See Haile v. Holtzclaw, 414 S.W.2d 916, 927 (Tex. 1967) (proper to find gift based on circumstances, despite transferor's testimony of no donative intent.)

3. Transfer From Parent to Child Presumptively Gift

A conveyance of title from parent to child is presumed to be a gift, but the presumption is rebuttable by evidence showing the facts and circumstances surrounding the deed's execution in addition to the deed's recitations. *Woodworth v. Cortez*, 660 S.W.2d 561, 564 (Tex. App.–San Antonio 1983, writ ref'd n.r.e.). *In re Royal*, 107 S.W.3d 846 (Tex. App.– Amarillo 2003, no pet.) (donor grandparent testimony regarding gift to Husband rebutted by contrary evidence of gift to couple).

4. Gift to Both Spouses

A gift made by a third party to both spouses leaves the spouses owning the gifted asset in equal undivided one-half separate property interests. *Roosth v. Roosth*, 889 S.W.2d 445, 457 (Tex. App.–Houston [14th Dist.] 1994, writ denied) (engagement gifts and wedding gifts to both spouses were one-half the separate property of each); *Kamel v. Kamel*, 721 S.W.2d 450, 452 (Tex. App.–Tyler 1986, no writ) (where Husband's father made payments on a liability owed by both spouses, the payments were a gift one-half to each spouse).

5. Gift Between Spouses

A spouse can make a gift of community property to the other spouse. *See Pankhurst v. Weitinger & Tucker*, 850 S.W.2d 726, 730 (Tex. App.–Corpus Christi 1993, writ denied) (Husband gave one-half of his community property interest in a cause of action to Wife, to hold as her separate property).

6. Gift of Encumbered Property

A grantor may make a gift of encumbered property and the conveyance may be a gift even if the grantee assumes an obligation to extinguish the encumbrance. *Taylor v. Sanford*, 108 Tex. 340, 193 S.W. 661, 662 (1917); *Kiel v. Brinkman*, 668 S.W.2d 926, 929 (Tex. App.–Houston [14th Dist.] 1984, no writ) (no showing that parents transferred land to son in exchange for his extinguishing the debt); *Van v. Webb*, 237 S.W.2d 827, 832 (Tex. Civ. App.–Amarillo 1951, writ ref'd n.r.e.).

B. Devise and Descent

Tex. Const. art. XVI, § 15, and Tex. Fam. Code § 3.001 prescribe that property acquired during marriage by devise or descent is separate property. Pattern Jury Charge 202.3 defines "devise" as "acquisition of property by last will and testament. This charge also defines "descent" as "acquisition of property by inheritance without a will."

Under Texas law, legal title vests in estate beneficiaries immediately upon the death of the donor. Tex. Prob. Code § 37; *Dyer v. Eckols*, 808 S.W.2d 531, 533 (Tex. App.–Houston [14th Dist.] 1991, writ dism'd by agr.). An argument can therefore be made that income of an estate is community property of the married heirs or devisees, even though the assets are titled in the decedent and the income arising from the assets may still be in the hands of the executor.

EXAMPLE 1

Wife's mother dies on 1/1/08. Wife receives substantial assets under her mother's will. The estate is open for a year and then the unspent accumulated income and assets left to Wife are distributed to her. Wife presents the will, order admitting the will to probate, the inventory, appraisement, and list of claims, an approving order, and a copy of the check from the independent executor, as proof that the cash she received from her mother's estate was acquired by devise, and is her separate property. Husband presents the independent executor's testimony that the estate earned the income, a portion of which was included in Wife's check. Does Wife have a commingling problem?

C. Land

1. Title Acquired Before Marriage

In *Hopf v. Hopf*, 841 S.W.2d 898, 900 (Tex. App.–Houston [14th Dist.] 1992, no writ), proof that Husband acquired his interest in a building before marriage established that the interest was his separate property. In *Murray v. Murray*, 15 S.W.3d 202, 205 (Tex. App.–Texarkana 2000, no pet), the spouses purchased and received title to real estate prior to marriage. The court found that the spouses owned the property as separate property in proportional percentages to what they contributed to the total purchase price.

2. Contract For Deed Before Marriage

In *Riley v. Brown*, 452 S.W.2d 548 (Tex. Civ. App.–Tyler 1970, no writ), where realty was acquired under a contract for deed, or installment land contract, inception of title occurred when the contract was entered into, not when title was ultimately conveyed. In *Welder*

v. Lambert, 91 Tex. 510, 44 S.W. 281, 284-85 (1898), land was put under contract for colonization with Husband and Wife; after Wife died, despite Husband's remarriage, that contract right still belonged to the first marriage, so that title ultimately acquired during the second marriage was not community property of the second marriage. Such a contract may be oral. *Evans v. Ingram*, 288 S.W. 494 (Tex. Civ. App.–Waco 1926, no writ). In *Dawson v. Dawson*, 767 S.W.2d 949 (Tex. App.–Beaumont 1989, no writ), realty placed by Husband under contract for deed prior to marriage was his separate property, despite the fact that title was taken during marriage in the name of both spouses, there being no evidence that a gift to Wife was intended. In *In re Marriage of Read*, 634 S.W.2d 343, 347 (Tex. App.–Amarillo 1982, writ dism'd), an oral agreement for mineral lease made prior to marriage did not establish inception of title because the oral agreement was not enforceable due to the Statute of Frauds.

3. Lease/Option with Deed in Escrow Before Marriage

In *Roach v. Roach*, 672 S.W.2d 524 (Tex. App.–Amarillo 1984, no writ), where an unmarried man entered into a lease-option agreement pertaining to land, but the deed was placed into escrow, and delivered after marriage, inception of title occurred at the time of the original agreement, not when the deed was removed from escrow and delivered to Husband. The land was his separate property.

4. Earnest Money Contract Before Marriage

In *Wierzchula v. Wierzchula*, 623 S.W.2d 730 (Tex. App.–Houston [1st Dist.] 1981, no writ), where Husband entered into an earnest money contract to purchase realty shortly before marriage, but the deed was received during marriage, inception of title occurred when the earnest money contract was signed, so that the property was Husband's separate property.

In *Carter v. Carter*, 736 S.W.2d 775 (Tex. App.–Houston [14th Dist.] 1987, no writ), Husband signed an earnest money contract and paid $1,000.00 in earnest money, shortly before marriage. The deed was received during marriage in the name of both Husband and Wife, and both signed the note and deed of trust. Citing *Wierzchula*, the court of appeals held that, under the inception of title rule, title related back to the date the earnest money contract was signed and, since that date predated marriage and only Husband had signed the earnest money contract, the realty was his separate property.

In *Duke v. Duke*, 605 S.W.2d 408, 410 (Tex. Civ. App.–El Paso 1980, writ dism'd), an earnest money contract entered into prior to marriage provided that the deed would be conveyed to "James H. Duke and Wife, Barbara J. Duke." Title was taken during marriage in the name of Husband and Wife. It was held that the earnest money contract merged into the deed, and that the property was received by the spouses as community property.

5. Earnest Money Contract During Marriage

Where spouses enter into an earnest money contract to purchase land during marriage, the land is community property. *Leach v. Meyer*, 284 S.W.2d 164 (Tex. Civ. App.–Austin 1955, no writ). Where the purchase price paid for the real estate is separate property, the land is separate property.

In *Winkle v. Winkle*, 951 S.W.2d 80, (Tex. App.–Corpus Christi 1997, pet. denied), a couple entered into an earnest money contract to purchase a vacant lot and put use community funds for the down payment. Tied to the purchase of this lot was the sale of Husband's separate property house. The proceeds received from the sale of the separate house was applied at closing by the same title company to the balance due on the vacant lot. The Court, following the reasoning *Wierzchula*, *infra*., held that the house was community property because the down payment at the time the earnest money was entered was community property. The Court then awarded Husband a reimbursement claim for the separate property contribution of the proceeds from the sale of the house. Can this result be reconciled with the court's holding in *Gleich v. Bongio*, 128 Tex. 606, 99 S.W.2d 881 (Tex. 1937)?

EXAMPLE 2

Husband enters into earnest money contract to buy a house, made contingent upon sale of his separate property house. The contract is placed with a local title company. Some months later, the separate property house closes at the same title company, and the proceeds from sale of the separate property house are applied directly to the new house, without ever leaving the title company. Wife contends that the house is community property because the earnest money contract created a community contractual liability, and under the inception of title rule the consideration for the new house was community credit and not separate property cash. Is she right? Under the reasoning in *Winkle* and *Wierzchula* she would be.

6. Purchase During Marriage for Cash

Land purchased during marriage has the character of the consideration furnished for the land. Property purchased with separate and community funds is owned as tenants in common by the separate and community estates. *Cockerham v. Cockerham*, 527 S.W.2d 162, 168 (Tex. 1975). Percentages of ownership are determined by the amount of funds contributed by each estate to the total purchase price. *Gleich v. Bongio*, 128 Tex. 606, 99 S.W.2d 881, 883 (1937).

D. Funds on Deposit

One of the most significant issues with funds on deposit is the commingling of separate and community funds. The situation is well-described in the following language from *Welder v. Welder*, 794 S.W.2d 420 (Tex. App.–Corpus Christi 1990, no writ):

> [U]nder Tex. Fam. Code Ann. Sec. 3.003 (Vernon 2005), property possessed by either spouse during or on dissolution of marriage is presumed to be community property, and the party claiming it as separate has the burden to overcome this presumption by clear and convincing evidence. *Estate of Hanau v. Hanau*, 730 S.W.2d 663, 667 (Tex. 1987); *Tarver v. Tarver*, 394 S.W.2d 780, 783 (Tex. 1965); *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex. App.–Houston [14th Dist.] 1989, writ denied). To discharge this burden a spouse must trace and clearly identify the property claimed as separate. If separate property and community property have been so commingled as to defy resegregation and identification, the statutory presumption prevails. However, when separate property has not been commingled or its identity as such can be traced, the statutory presumption is dispelled. *Hanau*, 730 S.W.2d at 667; *Tarver*, 394 S.W.2d at 783; *Harris*, 765 S.W.2d at 802. As long as separate property can be definitely traced and identified, it remains separate property regardless of the fact that it may undergo mutations and changes. *Norris v. Vaughan*, 260 S.W.2d 676, 679 (Tex. 1953).
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> Specifically, our courts have found no difficulty in following separate funds through bank accounts. *Sibley v. Sibley*, 286 S.W.2d 657, 659 (Tex. Civ. App.–Dallas 1955, writ dism'd). A showing that community and separate funds were deposited in the same account does not divest the separate funds of their identity and establish the entire amount as community when the separate funds may be traced and the trial court is able to determine accurately the interest of each party. *Holloway v. Holloway*, 671 S.W.2d 51, 60 (Tex. App.–Dallas 1983, writ dism'd); *Harris v. Ventura*, 582 S.W.2d 853, 855 (Tex. Civ. App.–Beaumont 1979, no writ). One dollar has the same value as another and under the law there can be no commingling by the mixing of dollars when the number owned by each claimant is known. *Trawick v. Trawick*, 671 S.W.2d 105, 110 (Tex. App.–El Paso 1984, no writ); *Farrow v. Farrow*, 238 S.W.2d 255, 257 (Tex. Civ. App.–Austin 1951, no writ).
>
> In addition, when separate funds can be traced through a joint account to specific property purchased with those funds, without surmise or speculation about funds withdrawn from the account in the interim, then the property purchased is also separate. *See McKinley v. McKinley*, 496 S.W.2d 540, 543-44 (Tex. 1973); *DePuy v. DePuy*, 483 S.W.2d 883, 887-88 (Tex. Civ. App.–Corpus Christi 1972, no writ).

Welder, 794 S.W.2d 420, 424-25.

1. Showing Only Separate Funds in Account

In *Padon v. Padon*, 670 S.W.2d 354 (Tex. App.–San Antonio 1984, no writ), Husband successfully traced separate property funds into the parties' home. The parties agreed that Husband received $160,000.00 by way of inheritance, which he deposited into an account in the name of Husband and Wife. The parties further agreed that they acquired a home in "early 1977," for $89,900.00. The March 1977 bank statement showed an initial deposit of $160,490.00 on February 25, 1977. The statement reflected no further deposits into the account until March 4, 1977. However, the statement reflects that a check for $89,900.00 cleared the account on March 1, 1977. The appellate court held that Husband had established that the house was his separate property, as a matter of law. *Id.* at 357.

2. Uncorroborated Assertion of Spouse

Several courts have held that the uncorroborated assertion that property is separate property can support a finding of separate property in some situations. *See Holloway v. Holloway*, 671 S.W.2d 51, 56 (Tex. App.–Dallas 1983, writ dism'd) ("We know of no authority holding that a witness is incompetent to testify concerning the source of funds in a bank account without producing bank records of the deposits."); *Faram v. Gervits-Faram*, 895 S.W.2d 839, 843 (Tex. App.–Fort Worth 1995, no writ) (testimony of Wife that investment

accounts and T-bill were either gifts from her father or proceeds from sale of separate real estate was, standing uncontradicted, at least some evidence of the character of the property); *Peterson v. Peterson*, 595 S.W.2d 889, 892 (Tex. Civ. App.–Austin 1980, writ ref'd n.r.e.) (Husband's testimony that realty was purchased with separate property cash supported finding of separate property, even without evidence of activity in the account, where transaction occurred less than one month after marriage).

An uncorroborated assertion by a spouse as to separate property may not be enough to reverse a contrary finding in the trial court. In *Klein v. Klein*, 370 S.W.2d 769 (Tex. Civ. App.–Eastland 1963, no writ), Wife testified that she made a $3,000.00 separate property cash payment for a house acquired during marriage. She said that she got the money from a safety deposit box in an unnamed bank. The trial court nonetheless found that the house was community property. The appellate court affirmed, concluding that Wife's testimony was not binding. *Id.* at 773.

3. Separate Funds Out First

In *McKinley v. McKinley*, 496 S.W.2d 540 (Tex. 1973), the Supreme Court ruled on the tracing of funds in bank accounts. Husband had $9,500.00 of separate property money on deposit in a savings and loan account. By year end, it had earned $472.03 in interest. On January 5, Husband withdrew $472.03. The Supreme Court wrote that "the $9,500.00 originally deposited remained in the account and continued to earn interest, until on December 31 of the following year [1967], the account balance was $10,453.81. There were no withdrawals after the one mentioned above. All deposits were deposits of interest. On January 2 of 1968, $10,400.00 was withdrawn and used to purchase a CD. The Court concluded that the $9,500.00 originally on deposit had been "traced in its entirety" into the CD. Thus, $9,500.00 of the $10,400.00 CD was separate property. No explanation is provided by the Court as to why all of the separate property was deemed withdrawn from the savings account to purchase the CD before the $953.81 in community funds were tapped. Thus, it appears that separate came out first.

In *McKinley*, tracing failed as to another bank account for lack of evidence as to "the nature of funds deposited or withdrawn."

4. Community Funds Out First

In *Sibley v. Sibley*, 286 S.W.2d 657 (Tex. Civ. App.–Dallas 1955, writ dism'd) (per curiam), Husband mixed community funds in a bank account with $3,566.68 of Wife's separate funds. There were a number of deposits and withdrawals to the account. However, the account never dropped below $3,566.68. Seeing Husband as a trustee of Wife's separate property funds that were in his care, the appellate court invoked a rule of trust law, that where a trustee mixes his own funds with trust funds the trustee is presumed to have withdrawn his own money first, leaving the beneficiary's on hand. Since Husband owned none of Wife' separate funds, and half of the community funds, it was presumed that the community moneys in the bank account were withdrawn first, before Wife's separate moneys were withdrawn. When the account had a balance of $4,009.46 (i.e. $442.78 more than the original $3.566.68), the sum of $1,929.08 was withdrawn to buy a farm. The appellate court held that all $442.78 in community property came out, and the rest of the withdrawal was separate property, making the farm 11% community property and 89% Wife's separate property. The court wrote:

> The community moneys in the joint bank account of the parties are therefore presumed to have been drawn out first, before the separate moneys are withdrawn.

Id. at 659; s*ee also Farrow v. Farrow*, 238 S.W.2d 255 (Tex. Civ. App.–Austin 1957, no writ) (although Husband commingled his separate, his Wife's separate, and community funds, Husband did not do so wrongfully, and the amounts of each could be calculated, so that the trust principle that all mixed funds belong to the beneficiary did not apply); s*ee Trevino v. Trevino*, 555 S.W.2d 792, 798 (Tex. App.–Corpus Christi 1977, no writ) (where Husband managed community estate, a trust relationship existed between him and Wife).

EXAMPLE 3

In *Sibley*, Husband mixed community property with Wife's separate property, so he was deemed to be a de facto trustee of her funds. What if it was Wife who mixed her separate funds with community funds, in an account under Wife's control? Using *Sibley*'s trust law analogy, Wife would be the trustee of Husband's 50% interest in the community property. Would it be presumed that Wife drew out her own separate property (100% owned by her) first, leaving community funds (50% owned by Husband)?

In *Barrington v. Barrington*, 290 S.W.2d 297, 304 (Tex. Civ. App.–Texarkana 1956, no writ), Sibley was cited for the proposition that community funds in a joint bank account are as a matter of law presumed to have been

withdrawn before separate moneys are. Then in *Horlock v. Horlock*, 533 S.W.2d 52, 59 (Tex. Civ. App.–Houston [14th Dist.] 1976, writ dism'd), another court cited *Sibley* for the rule that "where a bank account contains both community and separate moneys, it is presumed that community moneys are drawn out first." *See also Harris v. Ventura*, 582 S.W.2d 853, 855-56 (Tex. Civ. App.–Beaumont 1979, no writ) ("Where the checking account contains both community and separate funds, it is presumed that community funds are drawn out first," citing *Horlock* and *Sibley*.); *Smith v. Smith*, 22 S.W.3d 140, (Tex. App.–Houston [14th Dist.] 2000, no pet.) ("We assume without deciding that the community-out-first presumption is a rebuttable one.").

EXAMPLE 4

Husband puts $10,000.00 of his own separate property funds into an account with $10,000.00 in community property funds. During the entire marriage, money comes in and money goes out, but the balance never drops below $10,000.00. Is the $10,000.00 on hand at the time of divorce Husband's separate property or community property? Under the community out first rule, the remaining $10,000.00 is Husband's separate property.

However, applying the trustee's money out first principle mentioned in *Sibley*, and subsequently used as the inception of the community out first rule, it would be presumed that Husband withdrew his own wholly-owned separate property funds first, leaving community funds in which Wife has a one-half interest. On these facts, the *Sibley* rationale would lead to a "separate out first" rule. Perhaps it would be better to have a "trustee's money out first" rule as a vehicle for better achieving justice under the facts of a particular case.

5. Minimum Balance Method

As the *Sibley* progeny demonstrate, the courts have applied the community out first rule to trace separate property in a mixed-funds account that never went below a certain balance. In *Snider v. Snider*, 613 S.W.2d 8 (Tex. App.–Dallas 1981, no writ), at the time of marriage, the balance in Husband's savings account exceeded $27,000.00. During marriage, interest was added to the account, and withdrawals were made, reducing the balance to $19,642.45. More activity ensued, but the balance of the account never dropped below $19,642.45. Later, a deposit of $10,000.00 in separate property was made to the account, raising the separate property balance to $29,642.45. The court held that this evidence established that the $29,642.45 balance in the account at the time of Husband's death was his separate property. *Id.* at 11.

EXAMPLE 5

Husband and Wife have a joint account into with they each deposit their own separate property funds. Both spouses write checks on the account. Since there is no community property in the account, the community out first rule does not apply. Since the account is jointly controlled, and both spouses write checks on the account, the trustee's money out first rule also does not apply. What about a pro rata rule? What about letting the withdrawing spouse's intent control?

6. Pro Rata Approach

An argument can be made that, where mixed funds are withdrawn from an account, the withdrawal should be pro rata in proportion to the respective balances of separate and community funds in the account. A pro rata rule was used to achieve equity in an embezzlement case, *Marineau v. General American Life Ins. Co.*, 898 S.W.2d 397, 403 (Tex. App.–Fort Worth 1995, writ denied). There Husband had embezzled $349,077.32 from his employer, and put that money into an account where deposits totaled $512,594.32. Husband purchased a life insurance policy, which he paid incrementally out of the account. He later committed suicide, and the employer and the widow litigated who owned the policy proceeds. It was the employer's burden to trace its money into a specific asset. Having done that, the burden shifted to the widow (claiming through the wrongdoer) to prove what funds of the Husband flowed into the asset. The employer claimed that the wrongdoer had to show the proportion of each type of funds in each payment, failing which the entire payment would be deemed to belong to the employer. The appellate court rejected this contention, relying on an Oklahoma Supreme Court case to hold that each party was entitled to a pro rata share of each payment, in the same proportion as the total embezzled deposits bore to total deposits of Husband's money. The court used a "global average," as opposed to trying to calculate the respective components of each premium payment, in contradistinction to the tracing approach of some family law cases that analyze the character of each withdrawal. Perhaps the "broad overview" approach used in *Marineau* would more effectively, and certainly more inexpensively, accomplish equity.

EXAMPLE 6
PART I

Husband puts $10,000 of community property funds into an account with $10,000 of Wife's separate property funds. During the marriage, Husband withdraws $10,000 to buy stock, which is still owned at the time of divorce. The rest of the money in the account is spent by Husband. Is the stock community property or is it Wife's separate property? Applying the community out first rule, the stock would be community property, and Wife's separate funds were spent. Under the trustee's money out first rule, the stock would be Wife's separate and the Husband spent community funds.

EXAMPLE 6
PART II

Same facts as Part 1, except $5,000 is spent by the Husband, then $10,000 in stock is purchased, then the remaining $5,000 is spent. Is the stock half community and half separate? Perhaps we should have an equitable principle that the presumption applied is one that will favor the party to whom equity should be done. That may be separate out first sometimes, community out first other times, but always a presumption in favor of whatever gives greatest advantage to the party deserving equitable relief. Under such a rule, the trial court could find that the stock was entirely Wife's separate property.

7. "Borrowing" Between Separate and Community Funds

In *Newland v. Newland*, 529 S.W.2d 105 (Tex. Civ. App.–Fort Worth 1975, no writ), Husband maintained distinct bank accounts, the "general account" being for community deposits and expenditures, and the "separate account" being for business transactions relating to his separate estate. On occasion the balance of one account would run low, and Husband would "borrow" from the other account, for "short terms." Husband treated such transactions as loans, and repaid the borrowed funds "so that the two accounts were restored to the condition which would have obtained had there not been necessity for any transfer." *Id.* at 109. There was documentary proof of this type of activity for most of the 20-plus year period involved. The trial court found, and the appellate court affirmed, that Husband's methods avoided commingling of the funds, since "there was always ability to compute correct balances for purposes of resegregation." *Id.* at 109.

8. Clearing-house method; Deposit Followed by Withdrawal in Close Proximity

In *Higgins v. Higgins*, 458 S.W.2d 498 (Tex. Civ. App.–Eastland 1970, no writ), the jury found that, where Husband deposited $71,200.00 of separate funds in a joint bank account and shortly thereafter drew out $70,000.00 to purchase a ranch, the ranch was Husband's separate property. That finding was affirmed by the appellate court.

In *Beeler v. Beeler*, 363 S.W.2d 305 (Tex. Civ. App.–Beaumont 1962, writ dism'd), the spouses purchased real property, partly with a separate property down payment made by Husband, and partly with a community loan. The collateral for the loan was a separate property promissory note of Husband. Payments on the community loan were made to coincide with payments received by Husband on the separate property note, in time and amount. During the marriage, Husband deposited his separate property note payments into a joint account, then wrote checks to make the payments on the community note. Husband sought reimbursement for his separate funds used to pay a community debt. Wife opposed the reimbursement claim, saying that the payments from the separate property note were commingled when they were deposited into the bank account. The trial court found, however, that the parties had agreed to pay the new note with the proceeds from the old note, and that "it was not the intention of the parties to commingle such funds with the community funds of the parties." The appellate court held that the momentary deposit of such funds into a joint bank account did not convert "the $2,500.00, plus interest" into community funds. "Such sum, in each instance, was, in effect, earmarked a trust fund, in equity already belonging to the bank from the moment collected by appellee. . . .This being so, the installments paid upon the bank note were paid from the separate funds of appellee and his separate estate is therefore entitled to reimbursement therefor." *Id.* at 308.

In *McKinley v. McKinley*, 496 S.W.2d 540 (Tex. 1973), as explained above, a savings account containing $9,500.00 of separate property earned $472.03 in interest at year end. On January 2, that $472.03was withdrawn. The Supreme Court held that the interest had been withdrawn, leaving the separate property balance of $9,500.00.

In *Estate of Hanau v. Hanau*, 730 S.W.2d 664, (Tex. 1987), the court approved of the clearinghouse

method of tracing. In *Hanau*, the court allowed tracing of several same day transactions involving sales of stock and immediate repurchase of other stock.

9. Intent

While the mechanical application of a "default" rule, such as the community out first rule, has led to successful tracing, so too has evidence of intent that separate funds would be taken from a commingled account. For example, in *In re Marriage of Tandy*, 532 S.W.2d 714, 717 (Tex. Civ. App.–Amarillo 1976, no writ), the evidence showed that Husband mixed community proceeds from grain sales in an account with $25,000.00 in proceeds from the sale of land which was half-owned by Husband as separate property. After the $25,000.00 was received, Husband paid $6,250.00 to each of his sons for their ownership interests in the land, and then paid $12,500.00 on Husband's separate property debt. The appellate court, without using a mechanical rule regarding withdrawals, held that this evidence traced the separate property. The court upheld a finding, however, that another account had been hopelessly commingled. *Id.* at 718-19.

10. Recap

Gibson v. Gibson, 614 S.W.2d 487, 489 (Tex. Civ. App.–Tyler 1981, no writ), contains a good recapitulation of the law in the area:

> Courts dealing with the tracing of separate property commingled with community funds have required varying degrees of particularity in identifying separate property. *See* 6 St. Mary's L. J. 234 (1974). Many Texas cases have been strict in demanding a "dollar for dollar" accounting of separate funds used to purchase an asset, the ownership of which is in dispute. *E. g.*, *Schmeltz v. Gary*, 49 Tex. 49 (1878); *Latham v. Allison*, *supra*; *West v. Austin National Bank*, 427 S.W.2d 906 (Tex. Civ. App.–San Antonio 1968, writ ref'd n. r. e.); *Stanley v. Stanley*, 294 S.W.2d 132 (Tex. Civ. App.–Amarillo 1956, writ ref'd n. r. e., *cert. den'd* 354 U.S. 910, 77 S.Ct. 1296, 1 L.Ed.2d 1428).
>
> Certain other courts have been more lenient in their treatment of the tracing problem. The philosophy prompting these decisions was expressed in *Farrow v. Farrow*, 238 S.W.2d 255, 257 (Tex. Civ. App.–Austin 1951, no writ): "One dollar has the same value as another and under the law there can be no commingling by the mixing of dollars when the number owned by the claimant is known." In *Sibley v. Sibley*, 286 S.W.2d 657 (Tex. Civ. App.–Dallas 1935, writ dism'd), the court allowed appellee to trace her separate property through a series of transactions, including the deposit of the proceeds from a sale of her separate realty into a joint account containing a substantial amount of community funds and separate funds belonging to the other spouse. According to *Sibley*, community funds will be presumed to have been drawn out before separate funds from a joint bank account.
>
> In still other cases, spouses have been permitted to distinguish their separate funds commingled in a bank account with community money by proving that community withdrawals, e. g. for living expenses, equalled or exceeded community deposits. For example, in *Coggin v. Coggin*, 204 S.W.2d 47, 52 (Tex. Civ. App.–Amarillo 1947, no writ), evidence was presented to show that income from Wife's property totaled approximately $1,000 per year, while family living expenses were $200-$500 monthly. The court found that such community funds could not have been used to pay for the property in question since they had already been depleted in paying for the living expenses. *See DePuy v. DePuy*, 483 S.W.2d 883, 888 (Tex. Civ. App.–Corpus Christi 1972, no writ).

Gibson, 614 S.W.2d at 489.

E. Mineral Interests: Royalties, Bonuses & Delay Rentals

The character of a mineral interest is determined according to general marital property rules. *See In re Marriage of Read*, 634 S.W.2d 343, 346 (Tex. App.–Amarillo 1982, writ dism'd) (working interest was community property). Income from a community property mineral interest is community property. Where the mineral interest is separate property:

(1) royalty income is separate property; *Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676, 679 (1953) (this is so because a royalty payment is for the extraction or waste of the separate estate, as opposed to income from the separate estate); *Welder v. Welder*, 794 S.W.2d 420, 425 (Tex. App.–Corpus Christi 1990, no writ);

(2) lease bonuses are separate property; *Lessing v. Russek*, 234 S.W.2d 891, 894 (Tex. Civ. App.–Austin 1950, writ ref'd n.r.e.); and

(3) delay rentals are community property. *Id.*; *McGarraugh v. McGarraugh*, 177 S.W.2d 296, 300-301 (Tex. Civ. App.–Amarillo 1943, writ dism'd).

F. Passive Income (Dividends, Interest, Rentals)

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). However, stock dividends deriving from separate property stock are separate property. *See Duncan v. U.S.*, 247 F.2d 845, 855 (5th Cir. 1957). Interest income is community property. *Braden v. Gose*, 57 Tex. 37 (1882). Rentals from real estate are community property. *Arnold v. Leonard*, 114 Tex. 535, 273 S.W. 799, 802 (1925); *Coggin v. Coggin*, 204 S.W.2d 47, 52 (Tex. Civ. App.–Amarillo 1947, no writ) (rents and crops from separate property are community property).

EXAMPLE 7

Wife owns, with her two brothers, equal undivided shares of mineral interests that they inherited from their father. The siblings put the mineral interests into a closely-held corporation which is owned 1/3 by each of them. The corporation collects the royalty income and distributes it in thirds. The oil royalties were received by Wife as her separate property before the transfer to the corporation. The corporate dividends, however, are received by Wife as community property, even though they are traceable to the royalty income. *See Marshall v. Marshall*, 735 S.W.2d 587, 592-93 (Tex. App.–Dallas 1987, writ ref'd n.r.e.) (revenues from oil and gas leases owned by partnership at time Husband married were community property when distributed to Husband as partnership profits).

G. Patent Royalties

Royalties received by a spouse during marriage from patents they had obtained prior to marriage are characterized as community property. *Alsenz v. Alsenz*, 101 S.W.3d 648 (Tex. App.–Houston [1st Dist.] 2003, pet. denied). In *Alsenz*, the Court rejected Husband's argument that patents were equivalent to mineral royalties because their value diminished over time. The Court viewed the royalties as revenue from separate property and therefore characterized them as community property.

H. Wages

Wages earned during marriage are community property, while wages earned before marriage or after dissolution of marriage are separate property. The fact that a spouse may have entered into an employment agreement prior to marriage does not cause the wages of that spouse earned during marriage to be separate property. *See Dessommes v. Dessommes*, 543 S.W.2d 165 (Tex. Civ. App.–Texarkana 1976, writ ref'd n.r.e.); *Moore v. Moore*, 192 S.W.2d 929 (Tex. Civ. App.–Fort Worth 1946, no writ).

Concordantly, the fact that an employment agreement is contracted during marriage does not make wages earned after the end of the marriage community property. *See Echols v. Austron*, Inc., 529 S.W.2d 840 (Tex. Civ. App.–Austin 1975, writ ref'd n.r.e.) (bonus paid to Husband after divorce was his separate property).

Wages received after dissolution are not community property, even if those monies are derived in part from work done during the marriage; the fact that further work must be done for the spouse to be entitled to those wages creates merely an "expectancy" during marriage which is not a property right that can be characterized or divided by the court. *Cunningham v. Cunningham*, 183 S.W.2d 985, 986 (Tex. App.–Dallas 1944, no writ).

EXAMPLE 8

Husband is a professional athlete. He signs a 3-year contract, to be paid $30,000 per month, plus a "signing bonus" of $600,000, to be paid in installments of $200,000, at the beginning of the first, second, and third years. Payments are guaranteed as long as Husband reports for work, even if Husband is injured, unless the injury is self-inflicted, or unless Husband is convicted of a felony or drug violation, in which event the Team can cancel the contract and no further payments will be due. The divorce is tried just before the second $200,000 installment is due. What payments are community property? What if the entire signing bonus was paid up front?

In *Loaiza v. Loaiza*, 130 S.W.3d 894, 906 (Tex. App.–Fort Worth 2004, pet. denied), post-divorce payments to Husband, made under his contract with professional baseball team, were his separate property, where Husband's performance was a condition precedent to payment, so Husband's right to payment under the contract did not accrue until he performed his services. The contract's guarantee provisions did not excuse him from performance of his contractual obligation, but only

existed to provide Husband with financial security in the event he sustained injury or the ball club decided that his services were no longer needed.

I. Retirement Benefits & Fringe Benefits

Retirement benefits, to the extent they derive from employment during marriage, constitute a community asset. *Cearley v. Cearley*, 544 S.W.2d 661, 662 (Tex. 1976).

1. Defined Benefit Plans

Retirement benefits are considered by Texas courts to be "a mode of employee compensation earned during a given period of employment." *Cearley v. Cearley*, 544 S.W.2d 661, 662 (Tex. 1976). Thus, retirement, annuity and pension benefits earned during marriage are part of the community estate, *id.* at 662, while benefits earned before and after the marriage are the employee spouse's separate property. *See Berry v. Berry*, 647 S.W.2d 945, 947 (Tex. 1983). As with wages, the character of the retirement benefits is not determined by the circumstances surrounding the inception of the employment relationship, or the inception of the right to receive retirement benefits. Under the old case law, benefits are broken down into monthly increments, each of which is separate or community, depending upon whether the increment arises before, during or after marriage. *Taggart v. Taggart*, 552 S.W.2d 422, 424 (Tex. 1977), established that the extent of the community interest is determined by a fraction, the numerator of which represents the number of months the parties were married while the retirement plan was in effect, and the denominator of which represents the total number of months the employee spouse was employed under the plan. In a divorce, the fraction is applied to a figure representing the value of the benefits as of the date of divorce. *See Berry v. Berry*, 647 S.W.2d 945, 947 (Tex. 1983). The product of the two figures gives the community interest subject to division by the court.

On September 1, 2005, section 3.007 of the Family Code went into effect. Subsections (a) and (b) govern defined benefit plans:

> (a) A spouse who is a participant in a defined benefit retirement plan has a separate property interest in the monthly accrued benefit the spouse had a right to receive on normal retirement age, as defined by the plan, as of the date of marriage, regardless of whether the benefit had vested.
>
> (b) The community property interest in a defined benefit plan shall be determined as if the spouse began to participate in the plan on the date of marriage and ended that participation on the date of dissolution or termination of the marriage, regardless of whether the benefit had vested.

Tex. Fam. Code § 3.007.

Subsection (a) defines the separate property interest in a defined benefit plan with regards to the "monthly accrued benefit," while subsection (b) defines the community property interest with regards to the plan itself.

EXAMPLE 9

Husband works for an employer who has a defined benefit plan with the following terms:

1) On the sixth year of your employment you vest 20% in the plan, with an additional 20% vesting on the 7, 8, 9, 10th years at which time you are fully vested

2) The plan pays 50% of your 3 years highest salary averaged. Husband works for the employer 3 years prior to marriage. He gets married and subsequently divorced in year 4 of the marriage.

Under the statute, how is the plan characterized?

2. Defined Contribution Plans

In *Iglinsky v. Iglinsky*, 735 S.W.2d 536, 538 (Tex. App.–Tyler 1987, no writ), the appellate court held that it was improper to apply the time apportionment formula to a contribution retirement account. Instead, the court should have determined the community interest in the funds on the basis of contributions of earnings during marriage. *Id.* at 538 n. 2. The community share of a defined contribution plan is calculated by subtracting value at date of marriage from value at divorce. *Smith v. Smith*, 22 S.W.3d 140, (Tex. App.–Houston [14th Dist.] 2000, no pet.); *accord*, *McClary v. Thompson*, 65 S.W.3d 829 (Tex. App.–Fort Worth 2002, pet. denied).

Subsection (c) of Family Code section 3.007 governs defined contribution plans:

> (c) The separate property interest of a spouse in a defined contribution retirement plan may be traced using the tracing and characterization principles that apply to a nonretirement asset.

Tex. Fam. Code § 3.007. This provision has a significant impact on plans that invest in assets that appreciate (e.g., stocks).

EXAMPLE 10

The balance on the day of marriage in Husband's defined contribution plan account was $50,000. During marriage he and his employer made contributions to the plan account. The funds in the plan account also earned interest during the marriage, which was deposited into the account. Should the community share be all additions to the account between the date of marriage and the date of divorce, regardless of whether they are contributions or earnings? Assume that the funds in the account were invested in company stock, and that all contributions to the account are automatically invested in company stock, whose value fluctuates with the market. Would it be improper to compare the value of the stock on the date of marriage against its value on the date of divorce?

3. Stock Options

In *Bodin v. Bodin*, 955 S.W.2d 380, 381 (Tex. App.–San Antonio 1997, no pet.), Husband contended that employee stock options granted during marriage were his separate property because the options were not vested by the time of divorce. The appellate court rejected this argument, saying that the fact that the options had not vested by the time of divorce did not make the options entirely separate property. The court analogized the options to non-vested military retirement benefits, which were declared to be divisible upon divorce in *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976). Husband did not argue that a *Taggart* pro rata allocation rule should apply to the stock options. Therefore *Bodin* does not address pro rata allocation.

Farish v. Farish, 982 S.W.2d 623, 625 28 (Tex. App.–Houston [1st Dist.] 1998, no pet.), addressed stock options granted as an incentive for future employment. The court cited cases holding that the characterization of options granted for work done outside of marriage requires an allocation between compensation for past work and incentives for future service. However, this portion of the *Farish* opinion was not designated for publication, and while some courts may consider it to be persuasive authority, it has no precedential value. Tex. R. App. P. 47.7; *but see Sledge v. Mullin*, 927 S.W.2d 89, 93 (Tex. App.–Fort Worth 1996, no writ) ("[W]e find no statute, rule, or case law that forbids our taking judicial notice of our own unpublished opinion....Accordingly, the unpublished opinion contains the 'law of the case.'").

In *Charriere v. Charriere*, 7 S.W.3d 217 (Tex. App.–Dallas 1999, no pet.), the court rejected an argument that employee stock options were governed by a time-allocation rule. The employee-spouse's stock options were both received and had become exercisable during the parties' marriage, so they were deemed to be community property divisible upon divorce.

Kline v. Kline, 17 S.W.3d 445 (Tex. App.–Houston [1st Dist.] 2000, pet. denied), addressed unvested stock options. Husband argued that if the options were awarded for past services, they would be community property. However, if they were awarded to induce future employment after the divorce, they should be entirely his separate property. The options themselves recited that they were granted for services during marriage, so the appellate court rejected Husband's contention, citing (among other cases) *Cearley v. Cearley*, 544 S.W.2d 661 (Tex. 1976). Husband did not argue for a pro-rata allocation of the options, so that argument was not ruled on by the appellate court.

In *McClary v. Thompson*, 65 S.W.3d 829, 834 (Tex. App.–Fort Worth 2002, pet. denied), the court of appeals wrote that "[m]ost forms of property, including real estate, life insurance policies, and stock options, have been characterized as community or separate based upon their character at inception."

In *Boyd v. Boyd*, 67 S.W.3d 398 (Tex. App–Fort Worth 2002, no pet.), explained this point concisely:

> Texas courts have consistently held that stock options acquired during marriage are a contingent property interest and a community asset subject to division upon divorce.
>
> . . .
>
> Because [Husband's] fair value stock options were acquired during the marriage, they were a contingent community property interest, and the trial court did not abuse its discretion by dividing all of the options between [Husband] and [Wife].

Boyd v. Boyd, 67 S.W.3d at 410-11 (internal citations omitted).

Matter of Marriage of Joiner, 755 S.W.2d 496, 498 (Tex. App.–Amarillo 1988), *motion for rehearing overruled*, 766 S.W.2d 263 (no writ), stands in contrast to the cases focusing solely on the date the option was granted. In *Joiner*, the court considered the proper characterization and division of Husband's stock plan. Under the terms of the plan, a 20% interest in the employee's account vested after six years of service, i.e.,

after the first fiscal year of participation in the plan, and a 20% interest vested each year thereafter until the tenth year of service, i.e., the fifth fiscal year of participation in the plan, when the account became 100% vested. Prior to marriage, Husband had worked six and one-half years for his employer. *Id*.

On appeal, the appellate court distinguished Husband's stock plan from military retirement or pension plans (under which benefits are earned by reason of years of service), on the grounds that Husband's stock plan provided that benefits were not earned during the five-year period of employment required for participation in the plan, but rather provided that an employee first acquired a vested interest in the benefits of the plan at the end of the sixth fiscal year of employment. *Id*. at 698. Thus, according to the Amarillo Court of Appeals, the initial five-year employment period only generated a mere *expectancy* which, by not fixing any benefit in any sums at any future date, was not a property interest to which property laws apply. *Id*. Since the character of property as separate or community is fixed at the very time of acquisition, the appellate court continued, the crucial time for determining the character of interests in and benefits of the plan was the time when the vested interests were acquired. *Id*.

Thus, the court held that a 20% interest in the benefits of Husband's plan was acquired and vested at the end of Husband's sixth year of employment (prior to marriage), and a similar 20% interest was acquired and vested on each year thereafter for four more years, at which time the plan account was fully vested. *Id*. Because the initial 20% interest was acquired and vested before marriage, it was his separate property, and the remaining 80%, which was acquired and vested during the marriage, was community property. *Id*.

In *Joiner*, then, the appellate court adopted and advocated a time rule formula to determine the community's interest in a profit-sharing stock plan. On rehearing, Wife attacked the application of the inception of title doctrine, which established that the character of property interests in the plan as separate or community was fixed at the time the vested interests were acquired. Wife argued that this doctrine was not applicable to situations involving retirement or pension benefits. *Joiner*, 766 S.W.2d 263. Rejecting Wife's argument, and reaffirming that the inception of title doctrine was applicable to Husband's stock plan, the Amarillo Court of Appeals noted that its focus was on the characterization of the separate property-community property interests in Husband's plan, which was relevant to the trial court's decision in dividing the community estate in a manner deemed just and right. *Id*. The appellate court stated that it did not measure the monetary value of the interests, a matter to be proved in the trial court, nor did it prejudge an apportionment of the value of the community interest, a matter reserved to the discretion of the trial court. *Id*. at 263-264. The Amarillo court also stated that its decision did prevent a party from offering proof that under the peculiarities of the plan (which included the provision that the amount of annual contributions was dependent on the company's profits and Husband's salary, as well as on the performance of the stock purchased with the contributions) there was an increase in the value of Husband's separate property interest which was attributable to his employment during marriage, giving the community an interest in the increased value which was subject to division by the trial court. *Id*. at 264.

Since these cases were decided, the Family Code has been amended to add section 3.007:

> (d) A spouse who is a participant in an employer-provided stock option plan or an employer-provided restricted stock plan has a separate property interest in the options or restricted stock granted to the spouse under the plan as follows:
>
> (1) if the option or stock was granted to the spouse before marriage but required continued employment during marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which the numerator is the period from the date the option or stock was granted until the date of marriage and the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed; and
>
> (2) if the option or stock was granted to the spouse during the marriage but required continued employment after marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which the numerator is the period from the date of dissolution or termination of the marriage until the date the grant could be exercised or the restriction removed and the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed.

Tex. Fam. Code. § 3.007(d). The effect of this statute on the existing case law remains to be seen.

EXAMPLE 11

Company stock options are received by the employee as a benefit of employment, but they can be exercised only after 5 years, and provided that the employee is employed with Employer at the end of the 5 year period. Wife receives Grant One of 1000 options in July of 2000. Wife marries in January of 2003. Wife receives Grant Two of 1000 options in January 2004. Wife received Grant Three of 1000 options in November of 2007, with the employer expressly stating it is a bonus for work performed in 2007. Parties divorce in December of 2007. What is the characterization of each grant?

4. Keoghs, SEPs, and IRAs

Self-created trust tax-sheltered accounts such as Keoghs, SEPs and IRAs, though technically trusts, are treated like regular accounts for tracing purposes. Where the trust funds are invested in cash or CDs, the balance in the account on the date of marriage is separate property, and all interest accumulated during marriage is community property. Where the trust corpus is invested in assets with fluctuating value, a more complicated effort to trace each individual asset may be required. In *Hopf v. Hopf*, 841 S.W.2d 898, 900 (Tex. App.–Houston [14th Dist.] 1992, no writ), tracing as to an IRA or Keogh account failed because the spouse presented no evidence showing the amount of the plan before marriage, on the date of marriage, or deposits and withdrawals during marriage.

5. Texas Government Retirement Benefits

A spouse's right to Texas government employee retirement benefits are community property according to ordinary principles of retirement benefits. *Irving Fireman's Relief and Retirement Fund v. Sears*, 803 S.W.2d 747, 749 (Tex. App.–Dallas 1990, no writ) (firemen's retirement benefits divisible upon divorce); *Morgan v. Horton*, 675 S.W.2d 602, 604 (Tex. App.–Dallas 1984, no writ) (teacher retirement funds divisible upon divorce); *Collida v. Collida*, 546 S.W.2d 708, 710 (Tex. Civ. App.–Beaumont 1977, writ dism'd) (firemen's retirement benefits divisible on divorce).

6. Federal Civil Service Retirement

Civil service retirement benefits earned during marriage are community property. *Hoppe v. Godeke*, 774 S.W.2d 368, 370 (Tex. App.–Austin 1989, writ denied); *see* 5 U.S.C.A. § 8331 et seq. (West 1980 & Pam. Supp. 1995).

7. Federal Railroad Retirement Benefits

The United States Supreme Court, in *Hisquierdo v. Hisquierdo*, 439 U.S. 572, 99 S.Ct. 802, 59 L.Ed.2d 1 (1979), held that retirement benefits payable under the federal Railroad Retirement Act were not subject to division by a state court on divorce, by virtue of § 231m of the Act. *See Eichelberger v. Eichelberger*, 582 S.W.2d 395, 401 (Tex. 1979) ("the [Supreme Court's] opinion makes it clear that such benefits are not to be treated as 'property' and future benefits are not subject to division upon divorce as property"). However, with the Railroad Retirement Solvency Act of 1983, Congress added a subsection to § 231m, expressly permitting state courts to characterize certain components of the benefits as community property. *See* 45 U.S.C.A. § 231m(b)(2) (West 1986). Under the new statute, railroad retirement benefits involve several statutory components. *See* 45 U.S.C.A. § 231b (West 1986). The "basic component" is described in § 231b(a), and is designed to provide benefits equivalent to those under social security. *See* H.R.Rep. No. 30(I), 98th Cong., 1st Sess., reprinted in 1983 U.S.Code Cong. & Ad. News 729, 730-34. Section 231m of the statute provides that "[N]o annuity or supplemental annuity shall be assignable or be subject to any tax or to garnishment, attachment, or other legal process under any circumstances whatsoever, nor shall the payment thereof be anticipated." Thus, state courts still cannot divide the basic component of railroad retirement benefits in a divorce. *See Kamel v. Kamel*, 721 S.W.2d 450, 452 (Tex. App.–Tyler 1986, no writ).

8. U.S. Military Retirement Benefits

Military retirement benefits earned from service during the marriage are community property. *Cearley v. Cearley*, 544 S.W.2d 661, 662 (Tex. 1976); *Taggart v. Taggart*, 552 S.W.2d 422 (Tex. 1977); *Busby v. Busby*, 457 S.W.2d 551 (Tex. 1970). In *McCarty v. McCarty*, 453 U.S. 210, 101 S.Ct. 2728, 69 L.Ed.2d 589 (1981), the U.S. Supreme Court declared that federal law preempted the division of military non-disability retired pay in a divorce. Congress later passed a statute permitting divorce courts to divide military retired pay, provided that the state had sufficient jurisdictional ties specified in the statute. 10 U.S.C. § 1408 et seq. (the USFSPA). Military retirement benefits remain preempted except to the extent that division is permitted under the USFSPA. *Mansell v. Mansell*, 490 U.S. 581, 109 S.Ct. 2028, 104 L.Ed.2d 675 (1989).

Any portion of the military retirement attributable to employment prior to marriage is the employee spouse's

separate property. *Bloomer v. Bloomer*, 927 S.W.2d 118 (Tex. App.–Houston [1st Dist.] 1996, writ denied) (involving retirement which included time in military reserves). Any portion of the retirement attributable to employment after divorce is not community property. *Berry v. Berry*, 647 S.W.2d 945, 947 (Tex. 1983). The right to receive post-divorce cost-of-living increases on the non-employed spouse's share of the retirement is community property that can be awarded on divorce. *Sutherland v. Cobern*, 843 S.W.2d 127, 131 (Tex. App.–Texarkana 1992, writ denied).

9. Social Security Benefits

State courts have no power to divide Social Security disability benefits in a divorce, due to preemption by federal law. *Richard v. Richard*, 659 S.W.2d 746, 748-49 (Tex. App.–Tyler 1983, no writ) (citing California cases, and relying upon the analysis in the *Hisquierdo* case).

J. Disability Benefits

1. Federal Military Disability Retirement

Prior to the *Mansell* decision mentioned *supra*, Texas courts were divided on whether military disability retirement benefits were divisible on divorce. *Conroy v. Conroy*, 706 S.W.2d 745, 748 (Tex. App.–El Paso 1986, no writ) (are divisible); *Patrick v. Patrick*, 693 S.W.2d 52, 54 (Tex. App.–Fort Worth 1985, writ ref'd n.r.e.) (are not divisible). However, after the United States Supreme Court's decision in *Mansell v. Mansell*, 490 U.S. 581, 109 S.Ct. 2028, 104 L.Ed.2d 675 (1989), it seems certain that military disability retirement benefits are not divisible on divorce. *See Wallace v. Fuller*, 832 S.W.2d 714, 717-18 (Tex. App.–Austin 1992, no writ).

2. Veteran's Benefits

According to federal statute, veteran's benefits are not property. 38 U.S.C.A. § 101 (West 1991). They are not community property, and cannot be divided upon divorce. *Ex parte Burson*, 615 S.W.2d 192, 194-95 (Tex. 1981); *Kamel v. Kamel*, 721 S.W.2d 450, 453 (Tex. App.–Tyler 1986, no writ); *Ex parte Johnson*, 591 S.W.2d 453, 454 (Tex. 1979); *Ex parte Pummill*, 606 S.W.2d 707, 709 (Tex. Civ. App.–Fort Worth 1980, no writ); *see Mansell v. Mansell*, 490 U.S. 581, 109 S.Ct. 2028, 104 L.Ed.2d 675 (1989) (veteran's disability payments are not divisible on divorce, due to preemption).

3. Workers Compensation Benefits

a. Under State Law

The character of workers' compensation benefits is not controlled by the circumstances surrounding the inception of the right to these benefits. *See Hicks v. Hicks*, 546 S.W.2d 71, 73 (Tex. Civ. App.–Dallas 1977, no writ) (compensation for disability for a period after divorce is not community even though the injury may have occurred when the parties were married); *accord*, *Bonar v. Bonar*, 614 S.W.2d 472, 473 (Tex. Civ. App.–El Paso 1981, writ ref'd n.r.e.) ("The law of the State is clear that workers' compensation benefits received after a divorce are not community property, even in those instances where the injury was received during the marriage.").

This rule was codified in the Family Code:

> (b) If a person becomes disabled or is injured, any disability insurance payment or workers' compensation payment is community property to the extent it is intended to replace earnings lost while the disabled or injured person is married. To the extent that any insurance payment or workers' compensation payment is intended to replace earnings while the disabled or injured person is not married, the recovery is the separate property of the disabled or injured spouse.

Tex. Fam. Code § 3.008(b).

Workers' comp. claims may also include an award for medical expenses. In *Graham v. Franco*, 488 S.W.2d 390, 396 (Tex. 1972), the Supreme Court concluded that a recovery for medical and related expenses incurred during marriage belongs to the community, since the community is responsible for these expenses. Under this analysis, medical payments recovered through a comp. claim would belong to the community, to the extent that the community estate was liable for them.

According to *York v. York*, 579 S.W.2d 24, 26 (Tex. Civ. App.–Beaumont 1979, no writ), workers' comp. benefits received during marriage are presumed to be community property, and the burden is on the spouse asserting a separate property interest to establish what portion of the workers' comp. award is separate property.

In *Hicks v. Hicks*, 546 S.W.2d at 74, Husband's comp. claim was pending and unsettled at the time of divorce. The appellate court held that, in a post-divorce partition suit regarding the comp. claim settled after divorce, the non-injured spouse has the burden to show what part of the comp. claim was community property. One commentator has suggested that the burden of proving the existence of undivided community property is on the spouse seeking to recover an interest in such

property. Smith, Characterization of Property, 1 KAZEN, FAMILY LAW AND PROCEDURE § 11.21 (1990).

b. Under Federal Law

In *Bonar v. Bonar*, 614 S.W.2d 472 (Tex. Civ. App.–El Paso 1981, writ ref'd n.r.e.), the Wife brought a partition case, arguing that her Husband's federal comp. award was community property, even though her Husband's injury occurred after divorce, because the right to receive the award constituted an earned property right which accrued by reason of Husband's employment during marriage, and also because the Husband had elected to receive the comp. benefits in lieu of disability retirement, a portion of which had been awarded to the Wife in their divorce. The El Paso Court of Civil Appeals indicated that benefits under the Federal workers' comp. statute were divisible in a Texas divorce only to the extent the award represented lost earning capacity during marriage.

In contrast, in *Anthony v. Anthony*, 624 S.W.2d 388 (Tex. App.–Austin 1981, writ dism'd), the appellate court held that federal workers' comp. benefits were not analogous to Texas workers' comp. benefits, in that the federal benefits were funded out of the wages of the worker, and served as a substitute for Civil Service Disability Retirement benefits, whereas Texas workers' comp. benefits are unrelated to retirement rights, and do not replace them, and are not paid out of a fund created with the wages of the worker. In *Anthony*, the appellate court held that federal worker's comp. benefits were divisible in the same manner as retirement benefits or disability retirement benefits.

If *Bonar* is correct, then federal workers' comp. benefits will be treated just like Texas workers' comp. benefits. If *Anthony* is correct, then federal workers' comp. benefits will be treated like retirement benefits.

4. Contractual Disability Payments

The courts have applied the inception of title rule to contractual disability payments, in contrast to the treatment of wages, retirement benefits, and state workers' comp. benefits. In *Simmons v. Simmons*, 568 S.W.2d 169 (Tex. Civ. App.–Dallas 1978, writ dism'd), where the right to receive disability benefits arose incident to employment during marriage, that right, and any benefits received, whether during marriage or after divorce, were held to be community property. *Accord, Andrle v. Andrle*, 751 S.W.2d 955, 955-56 (Tex. App.–Eastland 1988, writ denied) (disability insurance policy purchased with community funds gave rise to community payments, even after divorce; they are not separate property on the theory that they replace post-divorce income); *Copeland v. Copeland*, 544 S.W.2d 183 (Tex. Civ. App.–Amarillo 1976, no writ) (disability retirement benefits were not an award of damages but rather a property right earned during marriage). In *Rucker v. Rucker*, 810 S.W.2d 793, 794-95 (Tex. App.–Houston [14th Dist.] 1991, writ denied), the divorce decree awarded Wife a portion of Husband's police department retirement benefits. Six years after the divorce, Husband became disabled and started receiving disability benefits. Wife was entitled to her portion of these benefits, because they were in the nature of retirement benefits.

Under Family Code section 3.008(b), discussed *supra*, the result from *Rucker* might be different since the disability benefits Husband received were intended to replace *post*-divorce earnings. *See* Tex. Fam. Code § 3.008(b).

K. Life Insurance & Contractual Rights

1. Private Life Insurance

McCurdy v. McCurdy, 372 S.W.2d 381 (Tex. Civ. App.–Waco 1963, writ ref'd), established that the inception of title rule applies to life insurance. The court rejected the so-called "apportionment method," under which the character of the policy would be directly proportional to the amount of premiums paid by each marital estate. *Accord Pritchard v. Snow*, 530 S.W.2d 889, 893 (Tex. Civ. App.–Houston [1st Dist.] 1975, writ ref'd n.r.e.). Camp v. Camp, 972 S.W.2d 906, (Tex. App.–Corpus Christi 1998, pet. denied).

2. Casualty Insurance

While one would think that a community property casualty insurance policy would give rise to community funds upon a casualty loss, one case says that the insurance proceeds have the character of the asset insured, regardless of the character of the policy. *Rolator v. Rolator*, 198 S.W. 391, 393 (Tex. Civ. App.–Dallas 1917, no writ); *followed by Ginsberg v. Goldstien*, 404 So2d 1098 (Fla. 3d DCA 1981); *Smith v. Eagle Star Insurance Co.*, 370 S.W.2d 448 (Tex. 1963).

The *Rolator* rule has been codified in Family Code section 3.008:

> (a) Insurance proceeds paid or payable that arise from a casualty loss to property during marriage are characterized in the same manner as the property to which the claim is attributable.

Tex. Fam. Code § 3.008(a).

L. Federal Military Insurance

1. National Service Life Insurance

Military personnel can obtain insurance pursuant to the National Service Life Act, 38 U.S.C.A. § 1901 et seq. (West 2005). That statute contains nonassignability language that has been held to preempt the power of state courts to award the insurance coverage to the non-military spouse in a divorce. *See Kamel v. Kamel*, 721 S.W.2d 450, 453 (Tex. App.–Tyler 1986, no writ) (improper for court to award 60% of cash value of National Service Life Insurance policy to other spouse due to preemption); *followed by Belt v. Belt*, 398 N.W.2d 737 (ND 1987).

2. Servicemen's Group Life Insurance

In *Ridgway v. Ridgway*, 454 U.S. 46, 102 S.Ct. 49, 70 L.Ed.2d 39 (1981), the U.S. Supreme Court held that provisions of the Servicemen's Group Life Insurance Act of 1965, which give an insured service member the right to freely designate and alter the beneficiaries named under the life insurance contract, prevail over and displace a constructive trust for the benefit of the service member's children imposed upon the policy proceeds by a state court divorce decree. *See* 38 U.S.C.A. §§ 1965 et seq. (West 2005); *Prudential Ins. Co. of America v. Goodman*, 895 F. Supp. 137 (S.D. Tex. 1995).

M. Money Loaned

A debt for money loaned by a spouse before marriage is separate property. The character of a loan made during marriage depends on the character of the funds loaned. *See Snider v. Snider*, 613 S.W.2d 8, 11 (Tex. Civ. App.–El Paso 1981, no writ) (a claim against a third party existing on the day of marriage is separate property); *Mortenson v. Trammell*, 604 S.W.2d 269, 275-76 (Tex. Civ. App.–Corpus Christi 1980, writ ref'd n.r.e.) (where Wife borrowed $3,500 using her separate credit and loaned the money to her daughter, the loan owed by Daughter was Wife's separate property). In *Snider*, proof that during-marriage credits exceeded debits to the balance of the debt successfully proved separate character to the extent of the balance on date of marriage. *Id.* Of course, interest earned on a debt during marriage is community property.

EXAMPLE 12

Husband sold land before marriage, taking back a promissory note and deed of trust. Some years into marriage, the buyer defaults and Husband forecloses on the property, buying it in at the sale for the amount due on the note, including principal and unpaid interest earned during marriage. Since Husband's inception of title to the land (i.e., the deed of trust) arose prior to marriage, would the land be his separate property? Or would the land be a mixture of separate and community property, in proportion to the unpaid principal vs. unpaid interest as of the date of purchase in foreclosure? Would the answer be different if the property were sold for cash to a third party, and the proceeds paid to Husband?

N. Crops, Timber, Livestock, and Other Chattels

Crops grown during marriage, even on separate property land, are community property: *DeBlane v. Hugn Lynch & Co.*, 23 Tex. 25 (1859); *Coggin v. Coggin*, 204 S.W.2d 47, 52 (Tex. Civ. App.–Amarillo 1947, no writ); *McGarrangh v. McGarrangh*, 177 S.W.2d 296, 300 (Tex. Civ. App.–Amarillo 1944, writ dism'd). Timber produced from trees grown on separate real property is community property. *White v. Lynch & Co.*, 26 Tex. 195 (1862). *McElwee v. McElwee*, 911 S.W.2d 182 (Tex. App.–Houston [1st Dist.] 1995, writ ref'd). Bricks produced from a spouse's separate property are community property. *Craxton, Wood & Co. v. Ryan*, 3 Willson 439 (Tex. Ct. App. 1888). Offspring of livestock born during marriage are community property. *Blum v. Light*, 81 Tex. 414, 16 S.W. 1090, 1092 (1891); *Gutierrez v. Gutierrez*, 791 S.W.2d 659, 665 (Tex. App.–San Antonio 1990, no writ) (offspring of separate property cattle is community property; over time, herd became commingled); *Beaty v. Beaty*, 186 S.W.2d 88, 90 (Tex. Civ. App.–Eastland 1945, no writ).

O. Gains and Acquets

Another way of looking at community property is the principle that property which is the fruit of the work, efforts, or labors of the spouses is community property, and property acquired otherwise is separate property. In *Norris v. Vaughan*, 152 Tex. 491, 260 S.W.2d 676, 682 (1953), the Court reiterated its statement from the *DeBlane* case:

> The principle which lies at the foundation of the whole system of community property is, that whatever is acquired by the joint efforts of Husband and Wife, shall be their common property.

This is the so-called "affirmative test; i.e., that property is community which is acquired by the work, efforts or labor of the spouses or their agents, as income from their property, or as a gift to the community. Such property, acquired by the joint efforts of the spouses, was regarded as acquired by 'onerous title' and belonged to the community." *Graham v. Franco*, 488 S.W.2d 390, 392 (Tex. 1972).

EXAMPLE 13

Wife buys a lottery ticket using $1.00 of separate property money. She wins. Are the winnings her separate or community property? According to *Dixon v. Sanderson*, 72 Tex. 359, 10 S.W. 535, 536 (1888), the winnings are community property. *Accord, Stanley v. Riney*, 907 S.W.2d 636 (Tex. App.–Tyler 1998, no writ).

P. Goodwill

1. Legal Definition of Goodwill

The classic American legal definition of goodwill was given by Justice Story in his treatise on partnership law:

> the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.

Story, Commentaries on the Law of Partnership § 99 (1841). This definition was cited by the U.S. Supreme Court in *Metropolitan Nat. Bank v. St. Louis Dispatch Co.*, 49 U.S. 436, 446, 13 S.Ct. 944, 948 (1893).

The U.S. Supreme Court later described goodwill as "that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business." *Des Moines Gas Co. v. City of Des Moines*, 238 U.S. 153, 165, 35 S.Ct. 811, 814 (1915).

More recently, the U.S. Supreme Court refined its perspective on goodwill:

> Although the definition of goodwill has taken different forms over the years, the shorthand description of good-will as "the expectancy of continued patronage," *Boe v. Commissioner*, 307 F.2d 339, 343 (CA9 1962), provides a useful label with which to identify the total of all the imponderable qualities that attract customers to the business. *See Houston Chronicle Publishing Co. v. United States*, 481 F.2d, at 1248, n. 5.

Newark Morning Ledger Co. v. U.S., 507 U.S. 546, 555-56, 113 S.Ct. 1670, 1675 (1993).

The U.S. Court of Claims wrote:

> Goodwill sometimes is used to describe the aggregate of all of the intangibles of a business....Since a normal rate of return usually is calculated on tangible assets only, goodwill has been used as a synonym for the return on all the intangibles of a business. In a more restricted sense, goodwill is the expectancy that the old customers will resort to the old place. It is the sum total of all the imponderable qualities that attract customers and bring patronage to the business without contractual compulsion. Another definition equates goodwill with a rate of return on investment which is above normal returns in the industry and limits it to the residual intangible asset that generates earnings in excess of a normal return on all other tangible and intangible assets.

Richard S. Miller & Sons, Inc. v. United States, 537 F.2d 446, 450-51 (Ct. Cl. 1976) (citations omitted).

Other federal courts have also provided various descriptions of goodwill: *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1248 (5th Cir. 1973) (the "ongoing expectation that customers would utilize [a company's] services in the future"), *cert. denied*, 414 U.S. 1129 (1974); *Grace Bros., Inc. v. Commissioner*, 173 F.2d 170, 175-76 (9th Cir. 1949) ("the sum total of those imponderable qualities which attract the customer of a business–what brings patronage to the business"); *Dodge Bros., Inc. v. United States*, 118 F.2d 95, 101 (4th Cir. 1941) ("reasonable expectancy of preference in the race of competition"); *Ithaca Industries*, 97 T.C. 253 (slip op. at 17-18), 1991 WL 151392 (1991) ("While goodwill and going-concern value are often referred to

conjunctively, technically going-concern value is the ability of a business to generate income without interruption, even though there has been a change in ownership; and goodwill is a 'preexisting' business relationship, based on a continuous course of dealing, which may be expected to continue indefinitely"), *aff'd*, *Ithaca Industries, Inc. v. Commissioner*, 17 F.3d 684 (4th Cir. 1992).

In *Canterbury v. Commissioner*, 99 T.C. 223, 247 (1999), the Tax Court wrote:

> The essence of goodwill is a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely. *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 233 (1975). Goodwill is characterized as 'the expectancy of continued patronage, for whatever reason.' *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962), *affd.* 35 T.C. 720 (1961); *see Philip Morris, Inc. v. Commissioner*, 96 T.C. 606, 634 (1991), *affd.* 970 F.2d 897 (2d Cir., June 25, 1992).

Rev. Rul. 59-60, § 4.02(f), 1959-1 C.B. 237, 241 states:

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

2. Goodwill in Texas Commercial Cases

"A distinction can be drawn between the goodwill that attaches to a professional person because of confidence in the skill and ability of the individual and the goodwill of a trade or business that arises from its location or its well established and well recognized name." *Swinnea v. ERI Consulting Engineers, Inc.*, 236 S.W.3d 825, 837 (Tex. App.–Tyler 2007, pet. filed). The Texas Supreme Court addressed personal goodwill in the dissolution of a medical partnership under TUPA in *Salinas v. Rafati*, 948 S.W.2d 286 (Tex. 1997). The Court zeroed-out a $1,428,000.00 jury verdict for an expelled partner, holding that the recovery consisted entirely of personal goodwill of the two remaining partners who continued in business as a new partnership, and that that personal goodwill was not an asset of the partnership to be divided.

3. Goodwill in a Texas Divorce

The Texas Supreme Court wrote of goodwill in a Texas divorce:

> [I]t 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.

Nail v. Nail, 486 S.W.2d 761, 764 (Tex. 1972). This case is widely viewed as a comment on "personal goodwill," as distinguished from entity goodwill or enterprise goodwill.

Commercial goodwill was commented on in *Geesbreght v. Geesbreght*, 570 S.W.2d 427, 435-36 (Tex. Civ. App.–Fort Worth 1978, writ dism'd):

> "Good will" is sometimes difficult to define. In a personal service enterprise such as that of a professional person or firm, there is a difference in what it means as applied to "John Doe" and as applied to "The Doe Corporation" or "The Doe Company". If "John Doe" builds up a reputation for service it is personal to him. If "The Doe Company" builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business but the sale of such business naturally involves the right to continue in business as "The Doe Company". The "good will" built up by the company would continue for a time and would last while the new management, performing the same personal services, would at least have the opportunity to justify confidence in such management while it attempted to retain the "good will" of customer

> clients of the former operators. At least the opportunity to have time to try to preserve the "good will" already existent and to use it as an entrance into the identical field of operations in a personal service type of business would be present where the name of the business is a company name as distinguished from the name of an individual. Therein does it have value, plus the value of the opportunity to justify confidence in the new management by the customer/clients of the predecessor owner(s). It is as applied to the foregoing that we consider Emergency Medicine to possess what we treat as "good will" as part of its worth and value under the circumstances of this case, and therefore an asset which would have value to some extent apart from John's person as a professional practitioner.

In *Salinas v. Rafati*, the Supreme Court favorably cited both *Nail* and *Geesbreght*, but wrote:

> *Geesbreght* and *Nail* illustrate the considerations involved in determining whether an estate includes goodwill. Neither establishes an absolute rule.

Salinas, at 291.

In *Austin v. Austin*, 619 S.W.2d 290, 291-92 (Tex. Civ. App.–Austin 1981, no writ), the court wrote the following about goodwill listed as an asset in a contract to purchase the business, which made a specific allocation of the sales price to goodwill:

> The good will of an ongoing, noncorporate, professional practice is not the type of property that is divisible as community property in a divorce proceeding. [*citing Nail*] ...When good will is not attached to the person of the professional man or woman, it is property that may be divided as community property. [*citing Geesbreght*.]...Once a professional practice is sold, the good will is no longer attached to the person of the professional man or woman. The seller's actions will no longer have significant effect on the good will. The value of the good will is fixed and it is now property that may be divided as community property.

The case of *Nowzaradan v. Nowzaradan*, 2007 WL 441709 (Tex. App.–Houston [1st Dist.] 2007, no pet.) (mem. op.), closely examined personal goodwill in the valuation of a medical clinic in a divorce. Both experts testified to a value of personal goodwill that was excluded, and the court said that "the record reflects that the BCC clinic had significant commercial goodwill, due to its name, location, extended hours, client base, and "walk-in" practice, all of which could potentially carry over to any new owner." *Id*. *8.

The case of *Geaccone v. Geaccone*, 2005 WL 1774964 (Tex. App.–Houston [1st Dist.] 2005, no pet.) (mem. op.), involved the important conceptual question of whether a business can be valued for purposes of divorce on the assumption that the seller will sign a covenant not to compete in connection with the sale. Husband's brief (available on Westlaw) stated the issue thus:

> This appraisal was based in part on the assumption that GASPER would enter into a limited covenant not to compete with any new purchaser of his practice (R.R. Vol. 3, p. 52). According to this same valuation expert, if GASPER's dental practice was appraised without assuming that GASPER would be willing to enter into a limited covenant not to compete, the practice would be "unsalable."

Husband was arguing that the difference between the price with a covenant not to compete and the price without one is entirely attributable to personal goodwill. Unfortunately, the appellate court did not address the complaint, citing a failure to object when the valuation report was offered and then failing to pin the trial court down sufficiently at the findings of fact/conclusions of law stage. The question is an important one that needs to be answered definitively.

Given this case law, an issue can arise as to whether an unincorporated business can have goodwill that is characterized as marital property for the purposes of a divorce. Since there is no entity, is all goodwill "personal" to the owner, or can goodwill exist that will transfer with the "business" if it is sold? Is goodwill of a partnership any different from goodwill of a corporation?

4. Commercial Goodwill and the Applicability of Buy-Sell Agreements in Texas Divorces

A split in the Courts of Appeal has left conflicting opinions on the effect of buy-sell agreements on commercial goodwill during a divorce. Compare *Finn v. Finn*, 658 S.W.2d 735 (Tex. App.–Dallas, 1983, writ ref'd n.r.e.) (court held that a law firms commercial goodwill was not divisible upon divorce because the partnership agreement does not provide any compensation for accrued goodwill to a partner who ceases to practice law with the firm, nor does it provide any mechanism to realize the value of the firm's goodwill) with *Keith v. Keith*, 763 S.W.2d 950 (Tex. App.–Fort Worth 1989, no writ) (court held that the formula set forth in the partnership agreement with

respect to death or withdrawal of the partner is not necessarily determinative of a spouses interest in the ongoing partnership as of the time of trial in a divorce).

The issue before the court in *R.V.K. v. L.L.K.*, 103 S.W.3d 612 (Tex. App.–San Antonio 2003, no pet.) concerned the valuation of a medical practice and whether *Finn* or *Keith* should be used to determine whether a buy-sell agreement controls the valuation of stock. *Id*. at 617. The court, in a plurality opinion, did not address the question of whether it would follow *Keith* or *Finn* because the parties' differences in valuation did not concern commercial goodwill. The plurality reversed and remanded the case, concluding that the trial court failed to consider the buy-sell agreement to be a significant restriction on the marketability of the stock. *Id.* at 619. The court expressly noted that the divorce had not triggered the buy-sell agreement. *Id.* at 618.

Justice Opez wrote a concurring and dissenting opinion. Justice Opez agreed with the dissent that the court needed to address the different methods of valuation in *Finn* and *Keith* and should follow *Keith*, but agreed with the plurality that the case should be remanded. *Id.* at 619-21. The dissenting opinion authored by Justice Marion and joined by Justice Stone would have affirmed the trial court ruling. The dissenters believed that the court should follow *Keith* and "hold that the value of R.V.K.'s interest should be based on the present value of the entities as ongoing businesses, which would include such factors as limitations associated with the buy/sell agreement and consideration of commercial goodwill." *Id.*

Q. Corporations

1. Acquisition

If a spouse owns stock in a corporation at the time of marriage, the stock is that spouse's separate property. *Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex. App.–Dallas 1985, no writ). Any increase in value of the separate property corporation is the owning spouse's separate property, and the community estate has no ownership claim over that increase in value. *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984). However, the community estate may have an equitable right of reimbursement if the increase in value is attributable to undercompensation of the spouse for labor during marriage. *Id*. at 110; *Gutierrez v. Gutierrez*, 791 S.W.2d 659 (Tex. App.–San Antonio 1990, no writ); *Lucy v. Lucy*, 162 S.W.3d 770 (Tex. App.–El Paso 2005, no pet. hist.).

If shares are acquired during marriage, the character of the stock depends upon the consideration furnished to the corporation in exchange for the stock (i.e., the character of the assets contributed during the formation of the corporation). *Id*. at 604; *Hunt v. Hunt*, 952 S.W.2d 564, 567 (Tex. App.–Eastland 1997, no pet.) ("When a corporation is funded with separate property, the corporation is separate property."). Tracing through the incorporation of a going business was successful in: *Vallone v. Vallone*, 618 S.W.2d 820 (Tex. Civ. App.–Houston [1st Dist.] 1981), *rev'd on other grounds*, 644 S.W.2d 455 (Tex. 1982); *In re Marriage of Morris*, 12 S.W.3d 877 (Tex. App.–Texarkana 2000, no pet.); *Marriage of York*, 613 S.W.2d 764, 769-70 (Tex. Civ. App.–Amarillo 1981, no writ). Tracing failed in: *Allen*, 704 S.W.2d at 603-04; and *Hunt v. Hunt*, 952 S.W.2d 564 (Tex. App.–Eastland 1997, no writ). Separate property capitalization of a new corporation was established in *Holloway v. Holloway*, 671 S.W.2d 51, 56-57 (Tex. App.–Dallas 1983, writ dism'd).

2. Merger & Mutation

If a spouse sells shares of a corporation, the proceeds from sale will have the same character as the shares. Character will also follow the interest through a merger or conversion of the corporation. Under the applicable statutes, an ownership interest in a business is traceable through mergers, conversions, and stock swaps, which are all mutations of the original business interest.

However, uncertainty arises when, instead of a merger or conversion, the business reorganization involves, for example, the owner of a separate property corporation founding a limited partnership and then transferring all the corporation's assets to the limited partnership. Would that situation be a mutation of the original interest, or is it instead a distribution from the corporation that makes all the assets community property? Should the form of the business reorganization change the character of the new business?

In Hasselbalch v. Hasselbalch, 2002 WL 188826 (Tex. App.–Houston [1st Dist.] 2002, no pet.) (unpublished), Wife failed in an effort to recover for an allegedly wrongful restructuring of a corporation into a limited partnership.

In Fazakerly v. Fazakerly, 996 S.W.2d 260, 265 (Tex. App.–Eastland 1999, pet. denied), a Wife who owned two separate property corporations created two new leasing corporations, then transferred the assets of the first two corporations to the second two corporations at book value, and those assets were leased back to the first two corporations. The books of the new corporations reflect $1,000 capital contributions from Wife, but no checks could be found. The jury found the leasing companies to be Wife's separate property, and the appellate court affirmed.

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, increasing 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, despite the fact that he and the other owners of the old corporation put $200,000 into the merger.

In Lifshutz v. Lifshutz, 199 S.W.3d 9, 22 (Tex. App.–San Antonio 2006, pet. denied) (Lifshutz II), during a corporation recapitalization, a separate property partnership transferred an asset directly to a separate property corporation. The trial court found that the asset had been "distributed" to Husband-partner, and thus was community property that was contributed to the corporation, giving rise to a community property reimbursement claim for contributing community capital to a separate property business.

3. 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).

4. Redemption

A good definition of a stock redemption could not be found in Texas case law, American Jurisprudence succinctly describes what constitutes a redemption for tax purposes:

> A stock redemption is the acquisition by a corporation of its own stock from a shareholder in exchange for cash or property..., whether or not the stock so acquired is cancelled, retired or held as treasury stock....If the distribution isn't made in connection with a complete liquidation of a corporation, it is a nonliquidating redemption distribution.

33A Am. Jur.2d ¶ 4952.

A stock redemption resembles a simple mutation of interest. However, redemptions can present a problem in the marital property context.

EXAMPLE 14

Husband and Friend each own 50% of Corporation at time of marriage. After some years, Friend decides to sell out to Husband. Instead of Husband buying Friend's stock, they agree that Corporation will redeem Friend's stock using retained earnings of Corporation. After the redemption, Husband owns 100% of corporation, but he still has only the shares of stock he owned prior to marriage. Is Husband's interest in the corporation all his separate property, or half separate and half community? Note that the value of Husband's 100% interest in the corporation after the redemption is worth the same as his 50% interest immediately prior to redemption.

5. Liquidation

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 liquidation of a corporation was recently disputed 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 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 rejected 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 liquidation of separate property shares were received by the spouse as separate property.

b. Partial Liquidations

A controversy exists today as to whether a business entity, like a corporation or a partnership, can make a

partial liquidating distribution that has the same character as the spouse's ownership interest in the entity. The TBCA recognizes that a corporation may distribute a "payment . . . in liquidation of all *or a portion* of its assets." TBCA art. 1.02A(13) (emphasis added); TBOC § 21.002(6)(A)(iii). This definition seems to recognize a partial liquidation by corporations.

In practice, some lawyers and some forensic CPAs have taken the position that a different rule applies to distributions in partial liquidation of a corporation as distinguished from distributions in complete liquidation. They reason that it is improper to distinguish a distribution of profits of an ongoing business from a distribution of the proceeds from sale of a capital asset of an ongoing business. They reason that, because corporate assets are not owned by the shareholders, they cannot be separate or community property, and that it is impossible to trace inside the corporation and differentiate between income and the proceeds from sale of capital assets. They also argue that, if tracing is permitted, it should be presumed that income (i.e. current earnings and retained income) is distributed before the proceeds from capital assets are distributed. The contrary position is defended by arguments that the directors are free to distribute profits or capital as they see fit and that the directors' decision that it is capital and not profits that will be distributed is determinative. A fall-back argument is that, once current income and retained earnings have been exhausted (using an income-out-first assumption), all remaining distributions by necessity must come from capital, and must therefore be in partial liquidation and have the same character as the ownership interest. Here is what Brock II said:

> 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. Note that two cited authorities speak of "liquidation of all or a portion of its assets." This suggests that there can be a liquidating distribution that is in liquidation of only a portion of the corporations' assets. 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.

EXAMPLE 15

Husband's separate property Corporation is a Subchapter S corporation, so that all corporate profits are reported on his tax return, regardless of whether profits are distributed. Undistributed profits are accumulated during marriage, and at the time of divorce Wife claims that such undistributed profits, already taxed on their joint tax returns, are community property. Are they? Not according to *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. Civ. App.–Houston [1st Dist.] 1987, writ denied).

EXAMPLE 16

Husband owns 1000 shares of Corporation X (a Nevada corporation) prior to marriage. Corporation X has a net value of $10,000,000.00. During the marriage, Corporation Y (a Texas corporation) is created. It is capitalized with $1,000.00 of community property and Husband is issued 1000 shares. Immediately following the creation of Corporation Y, Corporation Z (a Texas Corporation) is created. Husband exchanges his 1000 shares of Corporation X and 1000 shares of Corporation Y for 1000 shares of Corporation Z. How are the 1000 shares of Corporation Z characterized?

6. Piercing the Corporate Veil

A corporation exists as a separate entity from its shareholders. However, this distinction can be ignored for certain purposes. Under the old case law, the separate identity of a corporation, or "corporate fiction," will be ignored (i.e., the corporate veil will be pierced) when:

the corporate form has been used as part of a basically unfair device to achieve an inequitable result...even though corporate formalities have been observed and corporate and individual property have been kept separately. *Bell Oil & Gas Co. v. Allied Chemical Corp.*, 431 S.W.2d at 340. Specifically, we disregard the corporate fiction:

> (1) when the fiction is used as a means of perpetrating fraud;
>
> (2) where a corporation is organized and operated as a mere tool or business conduit of another corporation;
>
> (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation;
>
> (4) where the corporate fiction is employed to achieve or perpetrate monopoly;
>
> (5) where the corporate fiction is used to circumvent a statute; and
>
> (6) where the corporate fiction is relied upon as a protection of crime or to justify wrong.
>
> . . .
>
> Many Texas cases have blurred the distinction between alter ego and the other bases for disregarding the corporate fiction and treated alter ego as a synonym for the entire doctrine of disregarding the corporate fiction. However, as *Pacific American Gasoline Co. of Texas v. Miller* indicates, alter ego is only one of the bases for disregarding the corporate fiction: "where a corporation is organized and operated as a mere tool or business conduit of another corporation."
>
> Alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice. It is shown from the total dealings of the corporation and the individual, including the degree to which corporate formalities have been followed and corporate and individual property have been kept separately, the amount of financial interest, ownership and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes. Alter ego's rationale is: "if the shareholders themselves disregard the separation of the corporate enterprise, the law will also disregard it so far as necessary to protect individual and corporate creditors."
>
> The basis used here to disregard the corporate fiction, a sham to perpetrate a fraud, is separate from alter ego.

See Castleberry v. Branscum, 721 S.W.2d 270, 271-72 (Tex. 1986) (internal citations and footnotes omitted); *see also Southwest Livestock & Trucking Co. v. Dooley*, 884 S.W.2d 805, 809 (Tex. App.–San Antonio 1994, writ denied); *Humphrey v. Humphrey*, 593 S.W.2d 824, 826 (Tex. Civ. App.–Houston [14th Dist.] 1980, writ dism'd); *Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.–Fort Worth 1985, writ dism'd) (corporate veil pierced in a divorce).

Thus, under *Castleberry*, alter ego and sham to a perpetrate a fraud are *two different theories* under which a court is allowed to ignore the corporate fiction and pierce the corporate veil. *Id*. With regards to alter ego, the court must find, at a minimum, that:

> (1) unity between the separate property corporation and the spouse such that the separateness of the corporation has ceased to exist, and
>
> (2) the spouse's improper use of the corporation damaged the community estate beyond that which might be remedied by a claim for reimbursement.

Lifshutz v. Lifshutz, 61 S.W.3d 511, 517 (Tex. App.–San Antonio 2001, pet. denied) (discussed more thoroughly *infra*). In *Lifshutz*, the court specifically declined to rule on the question of whether a third requirement that the spouse be the sole shareholder of the corporation was also required for a finding of alter ego, but cited several sources that seem to suggest it is. *Id*. at 517 n. 4.

With regards to sham to perpetrate a fraud, *Castleberry* recognizes the principle that a shareholder may be liable for the debts of a corporation on a theory of "constructive fraud," which has been defined as any act, omission or concealment that involves a breach of legal duty, trust or confidence, and that is injurious to or misleads another person or by which an undue and unconscionable advantage is taken. *See Castleberry*,721 S.W.2d at 273 ("to prove there has been a sham to perpetrate a fraud, tort claimants and contract creditors must show only constructive fraud")*; Speed v. Eluma Int'l. Inc.*, 757 S.W.2d 794 (Tex. App.–Dallas 1988, writ denied), *disapproved of on other grounds, Donwerth v. Preston II Chrysler-Dodge, Inc.*, 775 S.W.2d 634 (Tex. 1989) (Ray, J., concurring).

However, in 1989, the Texas Legislature amended TBCA to provide that a shareholder will not be liable for any contractual obligation of a corporation on the basis of fraud, or a sham to perpetrate a fraud, unless the obligee demonstrates that the shareholder caused the corporation to be used for the purpose of perpetrating, and did perpetrate, an ***actual*** fraud on the obligee for the shareholder's personal benefit. *See* TBCA art. 2.21A(2). The effect of this addition was to "eliminate constructive fraud as a basis for imposing personal liability on shareholder for corporate obligations." *See* Bill Analysis of S.B. 1427 of the 71st Legislature (1989) (Ch. 217), *O'Connor's Business Organization Code Plus* (2008-09) at 1149. Additionally, TBCA art. 2.21A(3) has eliminated piercing the corporate veil for any "obligation of the corporation" based on "failure of the corporation to observe any corporate formality." Note that, under *Castleberry*, failing to observe corporate formalities is one of the factors to consider when determining whether the total dealings of the corporation and the individual indicate such unity between the two that piercing is proper. *Castleberry*, 721 S.W.2d at 272. However, a spouse asserting a sham to perpetrate a fraud claim is usually not a contract creditor, and there is no appellate opinion addressing whether the piercing claim of a spouse in a divorce is an "obligation of the corporation" for purposes of Article 2.21A(3). Thus, the amendments to TBCA apply to both alter ego and sham to perpetrate a fraud, but those amendments have uncertain application to spouses seeking to pierce the corporate veil. *See also* TBOC § 21.223.

A "reverse piercing" is when a spouse requests that the court pierce the corporate veil and rule that assets ostensibly owned by the corporation are in fact either the separate property of one of the spouses (and thus subject to a reimbursement claim) or the community property of both spouses. A standard piercing, like the one described in *Castleberry*, is used to hold the *shareholder* liable for the *corporation's* debts, while a reverse piercing is used to hold the *corporation* liable for one of its *shareholder's* debts. The Pattern Jury Charges recognize such a claim. Texas Pattern Jury Charges-Family PJC 205.1-205.4 (2008). This method was summarized:

> Under certain circumstances, a spouse may be able to reach the assets of the other spouse's separately owned corporation. A finding of alter ego allows piercing of the corporate veil. Piercing the corporate veil, in turn, allows the trial court to characterize as community property assets that would otherwise be the separate property of a spouse. *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 516 (Tex. App.–San Antonio 2001, pet. denied). In the divorce context, piercing the corporate veil allows the trial court to achieve an equitable result. *Id.*

Young v. Young, 168 S.W.3d 276, 281 (Tex. App.–Dallas 2005, no pet.).

One classic example of piercing the corporate veil in a divorce is *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 955 (Tex. App.–Fort Worth 1985, writ dism'd). Husband had a separate property corporation, which held title to the couple's home, and which paid for and owned the couple's furniture. *Id.* at 947. Husband's income came from the corporation and he deposited his earned income into a corporate account. *Id.* at 955. The trial court pierced the corporate veil, and the appellate court wrote that "to uphold the fiction of [the corporation] as an entity separate from [Husband] would be a clear and material prejudice to the rights of [Wife] and the community estate and an evasion of an existing legal obligation of [Husband] to devote his time, talent, and industry to the community." *Id.*; *see also Parker v. Parker*, 897 S.W.2d 918, 928 (Tex. App.–Fort Worth 1995, writ denied) (where corporation was found to be alter ego of Husband, corporate assets could become part of community estate; assets owned by corporation at the time of marriage were Husband's separate property, but assets acquired by the corporation during marriage were community property, absent tracing). Note that the events giving rise to a claim for piercing may occur well after the date of marriage. In that situation it would seem that the acquisition of community assets would begin on the day that the wrongful events occurred, which would, in most cases, be after the date of marriage.

7. Stock Splits

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).

8. Tracing Through Purchases and Sales

In *Carter v. Carter*, 736 S.W.2d 775 (Tex. App.–Houston [14th Dist.] 1987, no writ), Husband testified that in he received shares of stock in a family-owned business before marriage as a gift from his father. *Id.* at 777. He corroborated this testimony by showing dividends reflected on his tax returns for the year of the marriage, coupled with his testimony that the business declared dividends at the end of the prior year and paid them in the following year. *Id.* at 778. During the marriage, the business was acquired by a large company, and Husband received shares of that large company in exchange for his stock in the family-owned business. *Id.* at 777. A few years later, the company had a 2-for-1 stock split, increasing the number of Husband's shares. *Id.* Husband then sold a portion of these shares and spent the proceeds. *Id.* Husband acquired more

shares as a Christmas gift from his father which he later sold, and also subsequently participated in several short sales. *Id*. at 778. Upon divorce, the trial and appellate courts held that, despite these vicissitudes, the stock was proven to be Husband's separate property. *Carter*, 736 S.W.2d at 779.

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, despite the fact that he and the other owners of the old corporation contributed $200,000 to the merger.

EXAMPLE 17

Husband and Friend each own 50% of Corporation at time of marriage. After some years, Friend decides to sell out to Husband. Instead of Husband buying Friend's stock, they agree that Corporation will redeem Friend's stock using retained earnings of Corporation. After the redemption, Husband owns 100% of corporation, but he still has only the shares of stock he owned prior to marriage. Is Husband's interest in the corporation all his separate property, or half separate and half community? Note that the value of Husband's 100% interest in the corporation after the redemption is worth the same as his 50% interest immediately prior to redemption.

9. Securities Registered in Brokerage Account

In *Estate of Hanau v. Hanau*, 730 S.W.2d 663 (Tex. 1987), the Supreme Court considered several stock transactions inside a brokerage account. On the date of marriage, Husband had 200 shares of Texaco stock. That stock was later sold for $5,755.00, and on the same day 200 shares of City Investing stock were purchased for $5,634.00. The City Investing stock was later sold for $6,021.00, and on that same day 200 shares of TransWorld stock were purchased for $6,170.00. One hundred forty-nine dollars in cash was supplied to complete this purchase. The trial court found that Husband's tracing had failed. The Court of Appeals affirmed, on the grounds that Husband had shown merely the possibility that separate property could have been the source of funds for the purchases of stock. The Supreme Court reversed, holding that the presumption of community had been overcome as a matter of law. The Court wrote:

> [T]he petitioner has shown the chain of events leading from the Texaco stock to the TransWorld purchase and shown that no other transactions occurred on the days in question, which would have planted the seeds of doubt upon the possible source of the funds used to buy the stocks.

Id. at 666. Thus, judgment was rendered that the stock was Husband's separate property.

Tracing failed in *Merrell v. Merrell*, 527 S.W.2d 250 (Tex. Civ. App.–Tyler 1975, writ ref'd n.r.e.), where Husband asserted a separate property interest in real property premised upon his use of the proceeds from sale of separate stock to purchase the land. The Court wrote:

> Appellant testified that he inherited some corporate stocks from the estate of his mother, and that he sold stocks worth approximately $100,000.00, and that such funds were used to finance the purchase of the duplexes. Under the record we are unable to conclude that such funds were properly traced as appellant's separate property and not commingled with appellee's separate property or the community property.
>
> The record shows that appellant had many stock and bond transactions during the marriage. He bought and sold many shares of stock and some were bought short or on margin. Bonds were also bought on margin. Sometimes he would owe his brokerage firm several thousand dollars, and at other times he would have a credit with them.

Id. at 255.

EXAMPLE 18

Wife has securities registered in "street name" at her broker's office. She buys 100 shares of stock using her separate property. Later she buys 100 more shares of stock using community funds. Her brokerage house statements now reflect 200 shares. Wife later sells 100 shares of stock. Did she sell her separate shares, the community shares, a pro rata amount of half of each, or some other mix? Assume now that the community shares were purchased on margin (i.e., using community credit), and that the proceeds from sale of the 100 shares were used to pay Wife's margin loan. If Wife's separate property shares are deemed sold, would the remaining 100 shares be community property with Wife's separate estate being entitled to reimbursement for paying a community debt?

R. Partnerships

1. Revised Partnership Act & and Business Organizations Code

The Texas Revised Partnership Act (TRPA) became effective on September 1, 1994, and replaced the long-standing Texas Uniform Partnership Act (TUPA). *See* Tex. Rev. Civ. Stat. art. 6132b. The Texas Business Organizations Code (TBOC), enacted in 2003 and effective January 1, 2006, did more than just recodify TRPA; it significantly revised large portions of it. *See* Tex. Bus. Orgs. Code.

Title IV (chapters 151-154) of TBOC covers partnerships, and TBOC applies to any partnership formed on or after the effective date of the Code. Tex. Bus. Orgs. Code § 402.001(a)(1). Partnerships formed prior to that date are governed by TRPA ***until January 1, 2010***, when TRPA becomes ineffective and all domestic entities are governed by TBOC, regardless of when they were formed. Tex. Bus. Orgs. Code § 402.005(a).

As of the date of this writing, TRPA still governs many of the general partnerships family law practitioners are likely to encounter, so TRPA provisions and the case law interpreting them are mentioned throughout. Where applicable, the TBOC provisions governing the same topic are also referenced. Keep in mind that, as with any significant change in the law, some of the legal principles that have guided Texas courts in the past may no longer be applicable under the new statutory regime.

Under TRPA, a partnership is an entity separate and apart from the partners. TRPA art. 2.01; Tex. Bus. Orgs. Code § 152.056. In all but a few areas, the partnership agreement controls the relations of the partners. TRPA art. 1.03(a) & (b) (e.g. cannot unreasonably restrict partner's right to look at books and records, can't eliminate duty of loyalty, etc.); Tex. Bus. Orgs. Code § 152.002(a) & (b). Where the partnership agreement is silent, the TRPA applies. TRPA art. 1.03(a); Tex. Bus. Orgs. Code § 152.002(a). TRPA applies to general partnerships, as well as to limited partnerships to the extent the Texas Revised Limited Partnership Act (TRLPA) does not apply. *See* Tex. Rev. Civ. Stat. art. 6132a-1, § 13.03(a). Chapter 152 of the TBOC covers general partnerships, while Chapter 153 covers limited partnerships. Conversions from general to limited partnerships, and mergers of partnerships, are discussed in TRLPA art. 6132-b, art. IX, and generally in TBOC §§ 10.101 et seq.

2. General Partnerships, Community Property, and Divorce

A partnership interest can be community property, but specific assets of the partnership cannot, and the partner's right to participate in management cannot. TRPA art. 4.01, 5.02(a), 5.03(a)(4); Tex. Bus. Orgs. Code §§ 152.203, 154.001, 152.402(3), respectively; *In re SWEPI, L.P.*, 85 S.W.3d 800, 807 (Tex. 2002) ("in the Texas Revised Partnership Act, which applies to all partnerships after December 31, 1998, a partner is not a co-owner of partnership property"); *see also* Statutes and Case Law subsection, *infra*. The court in a divorce cannot award a community property partnership interest to the non-partner spouse. *McKnight v. McKnight*, 543 S.W.2d 863, 868 (Tex. 1976). The court can, however, give the non-partner spouse a community property assignee's interest in the partnership. Even where the spouse's partnership interest is community property, the court in a divorce cannot award specific partnership assets to the non-partner spouse.

3. Amendment of Partnership Agreement During Marriage

The fact that the partners amend the partnership agreement during marriage does not establish that an interest in the partnership was acquired during marriage and is thus community property. Unless the partnership dissolved, the same partnership interest continues through the amendment. *See Harris v. Harris*, 765 S.W.2d 798, 803 (Tex. App.–Houston [14th Dist.] 1989, writ denied) (relying on the entity theory of partnership codified in TRPA art. 2.01 and maintained in TBOC § 152.056).

4. Profits Distributed From Partnership

Partnership profits and surplus received by 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.) (also relying on the entity theory of partnership codified in TRPA art. 2.01 and maintained in TBOC § 152.056).

5. Nature and Transferability of Partner's Interest in Partnership Property

For general partnerships under TRPA:

> A partner is not a co-owner of partnership property and does not have an interest that can be transferred, either voluntarily or involuntarily, in partnership property.

. . .

> A partner's partnership interest is personal property for all purposes. A partner's partnership interest may be community property under applicable law.

TRPA art. 5.01, 5.02(a). For limited partnerships under TRLPA:

> A partnership interest is personal property. A partner has no interest in specific limited partnership property.

TRLPA art. 7.01. TBOC synthesizes these two provisions into one and applies it to both general and limited partnerships:

> (a) A partner's partnership interest is personal property for all purposes.
>
> (b) A partner's partnership interest may be community property under applicable law.
>
> (c) A partner is not a co-owner of partnership property.
>
> . . .
>
> A partner does not have an interest that can be transferred, voluntarily or involuntarily, in partnership property.

Tex. Bus. Orgs. Code §§ 154.001, .002.

The bar committee's comment on TRPA art. 5.01 helps explain the San Antonio Court of Appeals' holding in *Lifshutz*, discussed *supra*:

> This section provides that a partner is not a co-owner of partnership property and has no interest in partnership property that can be transferred, either voluntarily or involuntarily. This abolishes the TUPA § 25(1)'s concept of tenants in partnership and reflects the adoption of the entity theory of partnership. Partnership property is owned by the entity and not by the individual partners. This is consistent with Section 2.04, which states that partnership property is not property of the partners. TRPA also deletes the references contained in TUPA §§ 24 to 25 to a partner's "right in specific partnership property." Although Section 5.01 uses significantly different language and concepts from those of TUPA §§ 24 to 25, there is no significant substantive change from TUPA; the TRPA language primarily simplifies and clarifies the results under TUPA.
>
> This section also has the effect of protecting partnership property from execution or other process by a partner's personal creditors. These creditors may seek to enforce any rights they may have against the partner's partnership interest, but not against partnership property.
>
> A corollary of this section is that a partner's spouse has no community property right in partnership property, the same as in TUPA § 28-A(1).
>
> . . .
>
> [Article 5.02] subsection (a) states that a partner's partnership interest is personal property for all purposes (as in TUPA § 26) and retains the concept of TUPA § 28-A(2) that the partnership interest may be community property. The extent of a partner's partnership interest is defined in Section 1.01(12) and includes the partner's share of profits and losses, or similar items, and the right to receive distributions. A partner's partnership interest does not include the partner's right to participate in management of the partnership. It follows that a partner's right to participate in management is not community property, the same as in TUPA § 28-A(3)....

TBCA art. 5.01 cmt, 5.02 cmt.

In proving the existence of a partnership, the mere fact of "co-ownership of property, whether in the form of joint tenancy, tenancy in common, tenancy by the entireties, joint property, community property, or part ownership, whether combined with sharing of profits from the property...by itself, does not indicate that a person is a partner in the business." TRPA art. 6132b-2.03(b)(2); Tex. Bus. Orgs. Code § 152.052(b)(2).

6. Piercing the Partnership Veil

Two relatively recent cases establish that you cannot "pierce the veil" of a partnership, like you can with a corporation. In *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex. App.–San Antonio 2001, pet. denied), the trial court found that several separate property entities under the control of Husband were his alter ego, and thus pierced the corporate veil in order to characterize those separate property assets as community property. *Lifshutz*, 61 S.W.3d at 514, 517. These entities included several corporations and one partnership. *Id*. at 514. On appeal, the court concluded that it was improper for the trial court to pierce the partnership because "a trial court may not award specific partnership assets to the non-partner spouse in the event of a divorce." *Id*. at 518 (citing TRPA art. 5.01, 5.02, 5.03, 5.04; 5.01 cmt.; *McKnight v. McKnight*, 543 S.W.2d 863, 867-68 (Tex. 1976)). The appellate court also determined that the trial court erred in applying the veil-piercing standards with regards to the

corporations for unrelated reasons. *Id*. at 517-18.

Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Ass'n, 77 S.W.3d 487 (Tex. App.–Texarkana 2002, pet. denied) presented a different situation from *Lifshutz*, and the court of appeals used a different rationale to justify the rule that partnerships cannot be pierced. *Pinebrook* was the culmination of a labyrinthine array of prior law suits that had been concluded or consolidated. The fact of central importance to the alter ego issue was that a limited liability company was the general partner of the Pinebrook Properties Limited Partnership. *Pinebrook*, 77 S.W.3d at 499. The trial court found that both the LLC and the LP were the alter ego of the director of the LLC, and assessed liability against the director. *Id*. at 494. The court of appeals, however, concluded that the trial court erred in finding that the LP was the alter ego of the director of its general partner LLC, writing that:

> [I]n a limited partnership, the general partner is always liable for the debts and obligations of the partnership.
>
> . . .
>
> Under corporation law, officers and shareholders are not liable for the actions of the corporation absent an independent duty. Because officers and shareholders may not be held liable for the actions of the corporation, the theory of alter ego is used to pierce the corporate veil so the injured party might recover from an officer or shareholder who is otherwise protected by the corporate structure. *Alter ego is inapplicable with regard to a partnership because there is no veil that needs piercing, even when dealing with a limited partnership, because the general partner is always liable for the debts and obligations of the partnership to third parties.*

Pinebrook, 77 S.W.3d at 499-500 (emphasis added) (internal citations omitted). Thus, in *Pinebrook*, the court applied principles of corporate law and determined that the "veil" of a partnership may not be pierced because there actually is no veil; a party injured by a partnership is able to seek restitution from someone who is *not* protected by the structure of the entity, *viz*., the general partner. *Lifshutz*, on the other hand, arrived at the same conclusions by applying the specific dictates of TRPA and TRLPA, determining that partnership property was not owned by the individual partners, and therefore, could not be used to satisfy the debts of those partners, including debts to a spouse or the community estate in a divorce. So, while *Pinebrook* applies to piercing through the entity to get to the partner, *Lifshutz* applies to piercing through the partner to get to the entity.

EXAMPLE 19

Husband is a partner of Partnership before marriage. During marriage, Partnership liquidates a building owned by the Partnership before marriage. The proceeds from that liquidation are distributed to the partners. Are those distributions community property despite the fact that they are not profits?

7. Limited Partnerships

The Texas Revised Limited Partnership Act (TRLPA), came into effect on September 1, 1997. *See* Tex. Rev. Civ. Stat. art. 6132a-1. Chapter 153 of TBOC governs limited partnerships.

Under these statutes, a partner's interest in a limited partnership can be assigned. TRLPA art. 7.02; Tex. Bus. Orgs. Code § 153.251. An assignee can become a limited partner (1) if the partnership agreement so provides, or (2) if all partners consent. TRLPA art. 7.04(a); Tex. Bus. Orgs. Code § 153.253. Permissible contributions to acquire an interest in a limited partnership consist of any tangible or intangible benefit to the limited partnership or other property of any kind or nature, including: cash; a promissory note; services performed; a contract for services to be performed; and interests in or securities of the limited partnership, any other limited partnership, domestic or foreign, or other entity. TRLPA art. 5.01; Tex. Bus. Orgs. Code § 153.201.

8. Limited Liability Partnerships

Unlike general and limited partnerships, there is no statute separate and distinct from TRPA and TRLPA that governs limited liability partnerships. Either a general or a limited partnership may be formed as a limited liability partnership, the type of underlying partnership determines which of those two statutes applies. *See* TRPA art. 3.08, TRLPA § 2.14; TBOC §§ 152.801, 153.351, 153.352; *see also* TBOC § 1.002(47) (definition of limited liability limited partnership).

As a result, many of the marital property issues encountered with limited liability partnerships will be determined by whether it is a general or limited partnership, and thus which rules will govern it. It is worth noting that, unlike PAs and PCs, discussed *infra*, there is no express statutory prohibition against awarding an interest in an LLP to a spouse who is not a member of the profession which is the focus of the partnership.

S. Other Entities

1. Professional Corporations

The Texas Professional Corporation Act (TPCA) went into effect on January 1, 1970. *See* Tex. Rev. Civ. Stat. art. 1528e. TPCA governs PCs formed before January 1, 2006–except for LLCs that elect coverage by TBOC–until January 1, 2010, at which time, TPCA will be supplanted by TBOC. TPCA § 21; TBOC § 402.005. Title VII (chapters 301 & 303) of TBOC covers professional corporations.

A PC may issue shares only to individuals or professional legal corporations (PLCs) that are licensed to render professional services of the kind stated in the articles of incorporation. TPCA § 12; TBOC §§ 1.002(80), 301.003, et seq. Shares may be transferred to other licensed professionals or PLCs, subject to restrictions on transfer imposed by the articles of incorporation, bylaws, or stock purchase or redemption agreements. *Id.* A PC can redeem the shares of any shareholder or deceased shareholder, as the board of directors may provide, or as may be provided in the articles of incorporation, bylaws, or stock purchase or redemption agreement. TPCA § 13; TBOC § 303.004. If an owner becomes legally disqualified to render professional services, his/her shares must be redeemed. TPCA § 14; TBOC § 301.008. A spouse who owns an interest in a PC does not own the assets of the PC, so those assets cannot be awarded in a divorce. *Siefkas v. Siefkas*, 902 S.W.2d 72, 79 (Tex. App.–El Paso 1995, no writ). A married professional's interest in a PC cannot be awarded to a non-professional spouse, as that would violate the TPCA and, as far as lawyers are concerned, would collide with the spirit if not the letter of Rule 5.04(b) of the Texas Rules of Disciplinary Conduct, Tex. Rev. Civ. Stat., Govt. Code T. 2, Subt. G App. A, Art. 10, § 9, Rule 5.04 ("A lawyer shall not form a partnership with a non-lawyer if any of the activities of the partnership consist of the practice of law.").

2. Professional Associations

Professional associations were introduced along with professional corporations by the Texas Professional Association Act (TPAA) on January 1, 1970. *See* Tex. Rev. Civ. Stat. art. 1528e. The TPAA will be replaced by the TBOC on January 1, 2010. Chapters 301 & 302 of TBOC cover professional associations.

A PA is not legally considered to be a corporation, but it has many of the procedural and structural elements of a corporation. The TPAA lists several professions whose practitioners may form PAs, including podiatry, dentistry, optometry, therapeutic optometry, chiropractic, medicine, osteopathy, mental health, and veterinary medicine. TPAA § 2(A), 2(B)(2)-(3); TBOC § 301.003(2). This list is interpreted to be the exclusive list of professionals that may form a PA because the TPCA and TPAA are mutually exclusive. *See* Op. Tex. Att'y Gen. No. M-551 at 4 (1970); *Welmaker v. Cuellar*, 37 S.W.3d 550, 551 (Tex. App.–Austin 2001, pet. denied). These same sources state that those particular professionals may elect to form either a PC or a PA. *Id.* However, medical doctors are only allowed to form PAs, not PCs. TPCA § 3(a); *Rockett v. Tex. State Bd. of Med. Exam'rs*, 287 S.W.2d 190, 191-92 (Tex. Civ. App.–San Antonio 1956, writ ref'd n.r.e.). Furthermore, professionals not explicitly enumerated in the TPAA may not form PAs. *Welmaker*, 37 S.W.3d at 551 (attorneys not permitted to form PAs).

An interest in a PA may be owned only by practitioners licensed in the particular area of practice of the PA. TPAA § 2(B)(1); TBOC §§ 301.006, .007. These interests, which may be either shares or "units of ownership," are transferable only to other licensed practitioners in that field. TPAA § 10; TBOC §§ 301.009, .004. In divorces where one spouse is a licensed professional with an ownership interest in a PA and the other spouse is unlicensed in that field, this provision could generate confusion over the division of the asset.

Texas courts have recognized that they cannot award an unlicensed spouse an ownership interest in a community property PA upon divorce. *See, e.g., Eikenhorst v. Eikenhorst*, 746 S.W.2d 882, 887 (Tex. App.–Houston [1st Dist.] 1988, no writ). However, the *Eikenhorst* court's solution to this prohibition was an anomaly; it awarded the unlicensed spouse an interest in the cash assets of the PA. *Id.* Despite the fact that this solution functionally pierces the veil of the PA, it does not fulfill the standards for piercing the entity veil established by the Texas Supreme Court in *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986). Furthermore, it is unclear whether TBCA's limited codification of limits on the piercing the corporate veil doctrine from *Castelberry* applies to entities created under TPAA. *See* TBCA art. 2.21. Concordantly, it is also unclear whether TBOC's adoption of a substantially similar limitation affects PA's created under the new Code. *See* TBOC 21.223.

Six months after *Eikenhorst* was decided, the crosstown court indicated that the unlicensed spouse may receive other property equivalent to their community interest in the P.A. Morris v. Morris, 757 S.W.2d 466 (Tex. App.–Houston [14th Dist.] 1988, writ denied), ("[W]e see no reason appellee should not have been required to buy-out appellant's interest in this valuable community asset.").

3. Sole Proprietorship Businesses

A sole proprietorship is a business, operated by an individual, that is not a legal entity. The business is not

a creature of the state, and does not require any certificate from the Secretary of State. Business equipment, inventory, furnishings, and other items of a sole proprietorship on hand at the time of divorce, are presumptively community property, and will be divisible unless traced. *Hopf v. Hopf*, 841 S.W.2d 898, 900 (Tex. App.–Houston [14th Dist.] 1992, no writ) (CPA's practice). If a sole proprietorship is started during marriage, then the community presumption applies to all assets of the business, and they would be separate property only if they can be traced. If the owner of a going business marries, the inventory and equipment and receivables in the business on the day of marriage are separate property. Problems arise in tracing these separate assets if they are commingled with new assets.

A spouse who incorporates a going sole proprietorship cannot argue that inception of title in the corporation arose with the unincorporated business. *Allen v. Allen*, 704 S.W.2d 600, 604 (Tex. App.–Fort Worth 1986, no writ). A corporation comes into existence when the Secretary of State issues a certificate of incorporation, but an ownership interest in the corporation is acquired when the corporation's shares are issued. The character of the stock depends upon the consideration furnished to the corporation in exchange for the stock (i.e., the character of the assets contributed during the formation of the corporation). *Id.* at 604; *see also* Corporations, *supra*.

Profits from operating a sole proprietorship during marriage are community property. "The increase from a spouse's operation of a business always has been considered community property, even when the business itself was owned by one spouse prior to the marriage and thus was the separate property of that spouse." *Vallone v. Vallone*, 644 S.W.2d 455, 462 (Tex. 1982) (Sondock, J., dissenting); *accord, Zisblatt v. Zisblatt*, 693 S.W.2d 944 (Tex. App.–Fort Worth 1985, writ dism'd); *see also Epperson v. Jones*, 65 Tex. 425 (1886). In *Epperson*, the Supreme Court held that profits from the operation of a business are "community property, and cannot, therefore, be said to increase...[spouse's] separate estate to the extent of a single dollar." *Id.* at 428; *see Moss v. Gibbs*, 370 S.W.2d 452 (Tex. 1963).

Note that in a merchandise business owned at the time of marriage, it is the profit from the sale of the inventory that is community. That means that the portion of the receipts representing a return of separate property inventory is separate property. *See Yaklin v. Glusing, Sharpe & Krueger*, 875 S.W.2d 380, 385 (Tex. App.–Corpus Christi 1994, no writ) (in an unincorporated used car dealership, of the $3.3 million in outstanding promissory notes, only the profit in the notes was community property); *Meshwert v. Meshwert*, 543 S.W.2d 877, 879 (Tex. Civ. App.–Beaumont 1976) (profits from heating and air conditioning business were community property), *aff'd*, 549 S.W.2d 383 (Tex. 1977). There can, of course, be a commingling problem, as over time profits are reinvested in inventory and new profits are generated. *Smith v. Bailey*, 66 Tex. 553, 1 S.W. 627, 627-28 (1886). In *Farrow v. Farrow*, 238 S.W.2d 255 (Tex. Civ. App.–Austin 1957, no writ), Husband thoroughly documented receipts and expenditures connected with buying and selling real estate and livestock, and the separate funds of both spouses which were commingled in accounts with business receipts did not lose their separate identity.

The Supreme Court has recognized the power of the court in a divorce to award reimbursement to a spouse whose separate property was commingled with profits in a sole proprietorship. *Schmidt v. Huppman*, 73 Tex. 112, 11 S.W. 175 (1889); accord, Hartman v. Hartman, 253 S.W.2d 480 (Tex. Civ. App.–Austin 1952, no writ).

A sole proprietorship, despite not being an entity, can have a fair market value. *See e.g.*, Treas. Reg. § 20.2031-3, relating to Federal estate taxation ("The fair market value of any interest of a decedent in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."); Treas. Reg. § 25.2512-3 (the equivalent gift tax regulation).

Finally, the topic of unincorporated business ventures overlaps with an older form of reimbursement. When a spouse takes a separate property asset and works it with community labor to the degree that it is significantly enhanced in value, old cases say that the end product may be transmuted into community property. For example, in *Craxton, Wood & Co. v. Ryan*, 3 White & W 439 (Tex. Ct. App. 1888), Wife made a business of working her separate property clay soil into bricks, which were held to be community property. Similarly, in *DeBlane v. Hugh Lynch & Co.*, 23 Tex. 25 (1859), Wife grew crops on her separate property land, using her separate property slaves. The crops were held to be community property. Again, in *White v. Hugh Lynch & Co.*, 26 Tex. 195 (1862), where a Wife took trees from her separate property land and worked them into sawed lumber, the sawed lumber was held to be community property.

T. Trusts

The term "trust" is defined as:

> ...a fiduciary relationship with respect to property which arises as a manifestation by the settlor of an intention to create the relationship and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another person.

Tex. Prop. Code § 111.004(4). This definition applies only to an express trust, which does not include resulting trusts, constructive trusts, business trusts, or security instruments such as deeds of trust. Tex. Prop. Code § 111.003.

The definition also recognizes four distinct aspects of this relationship: the settlor, the trustee ("person holding title"), the beneficiary ("another person"), and the trust property.

More fundamentally, this concept of trusts explicitly recognizes that the trust itself is a relationship, not an entity. The common parlance of courts, commentators, and scholars alike frequently refers to trusts as if they are entities, but such usage is more likely for ease of speech than an implicit recognition of an entity aspect of a trust. *See Ray Malooly Trust v. Juhl*, 186 S.W.3d 568, 570 (Tex. 2006) (Section 111.004(4) "explicitly defines a trust as a relationship rather than a legal entity"). Thus, under Texas law, a trust is not an entity, like a corporation, but is instead a relationship between two individuals (i.e. the trustee and beneficiary) and certain property. As a result, it is not accurate to speak of "commingling inside of a trust," or "character of distributions from a trust." Instead, we should refer to the commingling of property held by a trustee, or the character of distributions made by a trustee of property held in trust.

1. "Trusts"

a. Trust Accounts

In Texas, the act of depositing funds in an account designated as a "trust account" for another person does not necessarily establish an express trust for the other person's benefit. Recitals on the bank signature card that the funds are held "in trust" for another are evidentiary only, and do not give rise to a presumption that a trust was intended. *Fleck v. Baldwin*, 141 Tex. 340, 172 S.W.2d 975, 978 (1943). In connection with a "trust account," the law requires that the settlor demonstrate the intent to create a trust "by a larger number of acts than in the case of an ordinary trust." *Frost Nat. Bank of San Antonio v. Stool*, 575 S.W.2d 321, 322 (Tex. Civ. App.–Beaumont 1978, writ ref'd n.r.e.). If a trust is found to have been intended, it is a revocable inter vivos trust, which terminates upon the death of the sole settlor/trustee and the proceeds are payable to the beneficiary. *See Citizens Nat. Bank of Breckenridge v. Allen*, 575 S.W.2d 654, 657 (Tex. Civ. App.–Eastland 1978, writ ref'd n.r.e.) (involving certificate of deposit held "in trust"). However, such a trust does not become irrevocable upon the death of a single settlor where there are multiple settlors because there are purposes of the trust yet unfulfilled while any settlor is living. *Ayers v. Mitchell*, 167 S.W.3d 924, 931 (Tex. App.–Texarkana 2005, no pet.).

b. Securities Held in Settlor's Name "as Trustee"

The rules discussed above for funds on deposit "in trust" for another also apply to securities held "in trust" for another. In *Citizens Nat. Bank of Breckenridge v. Allen*, 575 S.W.2d 654 (Tex. Civ. App.–Eastland 1978, writ ref'd n.r.e.), the issue was whether the settlor/trustee intended to create a trust when she acquired a certificate of deposit in her own name, "as Trustee for" another person. The jury found, and judgment was rendered, that the settlor/trustee intended to establish a revocable trust for the benefit of the third person. The Court of Civil Appeals affirmed the judgment, finding that such an inter vivos revocable trust is permissible under Texas law, and that it becomes irrevocable and payable upon the death of the settlor/trustee. The Court also extended the rule to stock certificates held in the name of the purchaser in trust for another, where the purchaser so intends. As stated by the Court:

> The ultimate and controlling question is the intent of the purchaser. The recitals on the certificate that such is held "in trust" for another are evidentiary only, and do not give rise to a presumption that a trust was intended.

Id., at 658.

2. Acquisition of Trust Property

With most forms of property, acquisition of title occurs simultaneously with the acquisition of possession. However, the term "acquisition," as it relates to marital property, extends beyond mere possession. Under the inception of title rule, the status of property is determined by the date of origin of the title to the property, and not by the date final title is acquired. *See Jensen*, 665 S.W.2d at 109. The date of acquiring the ownership right, rather than the date of acquiring possession or final vesting of title, is the determinative date in establishing the inception of title. Speer, Marital Rights in Texas § 388 (4th ed. 1961).

The acquisition of ownership rights by a beneficiary who may not compel the trustee to distribute income derived from the corpus of the trust has a dual nature.

These different conceptions of "acquisition" have bearing on the rules that govern the character of trust property, both corpus and income, and distributions of that property, both potential and actual.

In one sense, a beneficiary has an equitable right to the income from the corpus of the trust whenever it is earned, regardless of whether she has a right to compel distribution of that income. If the trustee mismanages the trust, he will be liable to the beneficiary for that property,

both corpus and income, that was lost. Tex. Prop. Code § 114.001. One of the many definitions given by Black for the term "right" is "a demand inherent in one person and incident upon another." Black's Law Dictionary 1324 (Joseph R. Nolan ed., 6th ed., West 1990). This conception of "right" is an *in personam* right, i.e. a right which imposes an obligation on a definite person. In this case, one person–the beneficiary–has a right to demand that another person–the trustee–compensate them for damages caused by the illegitimate actions of that person. The beneficiary's equitable right to that income is recognized by allowing her to recover it if the trustee breaches the trust, even if she may not compel distribution of the income under the terms of the trust until the trust itself terminates. Under this interpretation, the beneficiary acquires a particular kind of right at the moment that the income is earned.

But in another sense, a beneficiary who cannot compel distribution of the income earned by trust property does not have a right to that income. Another definition Black provides for "right" is a "claim to hold, use, or enjoy [property], or to convey or donate it, as he may please." Id. This conception of "right" is an *in rem* right, i.e. a right which imposes an obligation on persons generally. In this case, a beneficiary does *not* have a right to freely dispose of the income of the trust as she wishes, and may not prevent the trustee from disposing of it in legitimate ways. Because the beneficiary may not compel distribution of the income free of trust to herself, her right to that income is not manifested in an ability to personally use it or spend it, to convey it or donate it, as she may please. Under this interpretation, the beneficiary does not acquire a right until the income is distributed to her and she can personally control that property.

3. Property Held in Trust May Be Separate Property

In Texas, it is this second sense of the right which governs acquisition for the purposes of marital property law. Many cases stand for the principle that property held in trust for a spouse may be separate property, including: *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App.–Fort Worth 1967, writ dism'd) (undistributed income in a spendthrift trust not part of the estate of the parties, where distribution of such income was discretionary with the trustee); *In re Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.–Texarkana 1978, writ dism'd) (undistributed income inside discretionary distribution trust not "acquired" by the spouse during marriage, and was therefore not part of the community estate); *Currie v. Currie*, 518 S.W.2d 386 (Tex. Civ. App.–San Antonio 1974, writ dism'd) (property inside of discretionary distribution trust was not community property of Husband; property inside another trust, as to which Husband was remainder beneficiary, was not "acquired" by the spouse, and was therefore not part of the community estate); *Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. App.–Corpus Christi 1997, no pet.).

4. Income from Separate Property Trust is Community Property in Most Cases

This general rule interacts with the rule that income derived from separate property is community property in three distinct situations, invoking different conceptions of "acquisition."

a. Undistributed Income Earned by Separate Property Trust without Right to Compel Distribution

The first situation arises when income from property held in trust is not distributed to the spouse-beneficiary, and that beneficiary does not have the right to compel the trustee to distribute the income.

Income derived from separate property is community property. But undistributed income derived from the corpus of a separate property trust in which the spouse-beneficiary has no right to compel distribution of that income is separate property. *In re Marriage of Burns*, 573 S.W.2d 555, 557 (Tex. Civ. App.–Texarkana 1978, writ dism'd); *see also Lemke v. Lemke*, 929 S.W.2d 662, 664 (Tex. App.–Fort Worth 1996, writ denied); *Lipsey v. Lipsey*, 983 S.W.2d 345, 351 (Tex. App.–Fort Worth 1998, no pet.). The *Burns* court concluded that, because the spouse-beneficiary did not have "a present or past right to require [the income's] distribution so as to compel a finding that there was a constructive acquisition...neither spouse actually or constructively acquired the undistributed...income." *Id.* The court reasoned that, in such a situation, "[t]he [undistributed] income was actually acquired by the trust and estates and not by either Mr. or Mrs. Burns." *Id.*

Not only did the *Burns* Court state that the trust *acquired* the undistributed income, it also wrote that "such income, though earned during the marriage, remained *a part of* the respective trust...and was not subject to division by the [trial] court." *Burns*, 573 S.W.2d at 557-58 (emphasis added). This articulation seems incommensurate with a fundamental tenet of trust law, *viz.* a trust is a relationship and ***not*** a legal entity. *See Ray Malooly Trust v. Juhl*, 186 S.W.3d 568, 570 (Tex. 2006); Tex. Prop. Code § 111.004(4). It is axiomatic that an *entity* can acquire property, but a *relationship* cannot. Therefore, perhaps a more accurate way to articulate the *Burns* holding is that "*legal* title to the income was acquired by the trustee, and *equitable* title to the income was acquired by the beneficiary, but ***full*** title to the income was not acquired by either spouse during marriage, so Family Code Section 3.002 does not apply."

However, this modified notion of acquisition of title by the beneficiary during marriage invalidates the principle, discussed *infra*, that income earned by a trust where the beneficiary has the power to compel distribution is *community* property. The power to compel distribution does not, under any rubric of trust law, alter the acquisition of the beneficiary's equitable ownership interest in the property. But the power to compel distribution under marital property law transforms separate into community, acquisition by "the trust" into acquisition by the spouse-beneficiary.

Unfortunately, the concept of "constructive acquisition" does not resolve this quandary, since that concept, as stated by *Burns*, perceives ***no*** acquisition by the spouse-beneficiary, and instead allocates the acquisition entirely to the trust.

Regardless of these pedantic details, according to *Burns*, "acquisition," for the purposes of income derived from a separate property trust, is determined by whether the beneficiary has the power to compel the trustee to distribute that income.

b. Constructive Acquisition: Undistributed Income Acquired from Separate Property Trust with Present Possessory Interest in Corpus

The second situation where the general rule that trust property may be separate interacts with the income-from-separate-is-community rule is when the spouse-beneficiary constructively (as opposed to actually) "acquires" the earned income, either by having a present possessory interest in the corpus on which it is earned, possessing the power to compel distribution, or being entitled to mandatory distributions under the trust instrument. Each of these methods of constructive acquisition will be addressed in turn.

In *In re Marriage of Long*, 542 S.W.2d 712 (Tex. App.–Texarkana 1976, no writ), the trust instrument provided that half of the corpus would be distributed to the beneficiary upon reaching the age of 25. *Id.* at 715. However, the instrument also allowed the beneficiary to elect that the corpus continue to be held in trust until he reached the age of 30, at which point the trust would terminate and the entire corpus would be distributed. Id. The beneficiary turned 25 during marriage and elected that his interest in half of the corpus remain in trust, where continued to earn income. *Id.* The Court held that the beneficiary had a "present possessory interest" in the corpus, and therefore, the income earned on it during marriage was community property. *Id.* at 717.

Unlike *Burns*, *Lemke*, and *Lipsey*, the character of the income in *Long* did not depend on the nature of the interest in the income, but rather on the nature of the interest in the corpus. The *Long* court held that only income earned on one-half of the corpus from the date the beneficiary turned 25 to the date of trial was community property. *Id.* at 718. Furthermore, the beneficiary in *Long* had the right to compel retention of the property, not distribution. The *Long* court concluded that the beneficiary acquired the corpus functionally free of trust when he was entitled to receive it under the terms of the instrument; the fact that he elected for the trust to nominally hold it for him was not controlling.

c. Constructive Acquisition: Undistributed Income Acquired from Separate Property Trust with Right to Compel Distribution

Transposing the components of the rule announced in *Burns*, *Lemke*, and *Lipsey*, income derived from a separate property trust where the spouse-beneficiary does have a right to compel distribution is "constructively acquired" by that spouse, and therefore is community property.

Frequently, *In re Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.–Texarkana 1976, no writ), is cited in support of this principle. However, as discussed *infra*, this case applies to different situations and relies on a different conception of acquisition. *Mercantile National Bank at Dallas v. Wilson*, 279 S.W.2d 650 (Tex. Civ. App.–Dallas 1955, writ ref'd n.r.e.), on the other hand, does establish the rule that "the undistributed profits or income from the trust in the hands of the trustee is community property." *Id.* at 653-54. However, the analysis in *Mercantile Bank* does not address whether distributions could be compelled or were mandatory, and does not invoke the theory of constructive acquisition.

d. Constructive Acquisition: Undistributed Income Acquired from Separate Property Trust with Mandatory Distribution

Long is also frequently cited to support the principle that a mandatory distribution of income from a separate property trust is community property. *See, e.g., Sharma v. Routh*, No. 14-06-00717-CV, 2008 WL 5443213, at *5 (Tex. App.–Houston [14th Dist.] Dec. 31, 2008, no pet. h.). *Sharma* also cites *Ridgell v. Ridgell*, 960 S.W.2d 144, 148 (Tex. App.–Corpus Christi 1997, no pet.), and *Mercantile Nat'l Bank at Dallas v. Wilson*, 279 S.W.2d 650, 654 (Tex. Civ. App.–Dallas 1955, writ ref'd n.r.e.) for the same principle. However, neither of these cases addresses mandatory distributions of income.

Conceptually, mandatory distributions of income from a trust settled by a third party where the beneficiary has a separate property interest in the corpus could be looked at in two different ways. On the one hand, as in *Burns*, the beneficiary does not have the right to compel distribution of the income, but unlike *Burns*, the trustee does not have discretion to distribute it either. Instead, the settlor decided that income derived from the corpus would be received by the beneficiary at particular

delineated times, and this schedule was part of the original gratuitous transfer into trust. Thus, the right to receive distributions of income could be seen to vest at the moment the trust was settled; while the amounts of those periodic, mandatory distributions were unknown at the time the right vested, the beneficiary was assured at the time of settling that any income would be distributed upon the occurrence of a stated event, just as they were assured that the trust would terminate all trust property would be distributed upon the occurrence of a stated event. When viewed in this way, the inception of title of mandatorily distributed income would occur at the same time the beneficial interest in the trust accrued, and under the inception rule, would be separate property.

On the other hand, mandatory distributions could be viewed as simple acquisitions of property during marriage, falling squarely under the ambit of Family Code Section 3.002 and *Ridgell*, discussed *infra*. In a trust where the beneficiary had any interest at all in the corpus, such distributions would always be community property.

This situation presents an example of a potentially irreconcilable conflict between the inception-of-title rule and the income-from-separate-is-community rule as applied to trusts using a particular theory of "acquisition."

Many courts, commentators and practitioners rely on *Long* and its progeny (and its progenitors) to classify this type of income as community property, so the weight of the authority supports the latter perspective.

EXAMPLE 20

Settlor settles a Trust for the benefit of Beneficiary on 1/1/2005. The trust instrument provides that the trustee will manage the trust corpus so as to accumulate income, and that $5,000 of this income must be distributed to the Beneficiary on 1/1/2010, her 25th birthday. Beneficiary marries Husband on 1/2/2005, and thus, under fundamental marital property rules, the corpus of the Trust is Wife-Beneficiary's separate property. If the parties were to divorce before 1/1/2010, the issue of the character of the $5,000 mandatory income distribution would arise. Is the $5,000 community property? *See generally* Tex. Fam. Code § 3.002; *Moss v. Gibbs*, 370 S.W.2d 452, 455 (Tex. 1963). Or is the $5,000 separate property? *See generally Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984); *Camp v. Camp*, 972 S.W.2d 906, 908 n.1 (Tex. App.–Corpus Christi 1998, pet. denied). In other words, was the income ***acquired*** during marriage when it was actually earned, or before marriage when the right of claim to that property first came into being?

e. Actual Acquisition: Distributed Income Acquired from Trust with Interest in Corpus

The third situation where the general rule that trust property may be separate interacts with the income-from-separate-is-community rule is when the spouse-beneficiary actually (as opposed to constructively) "acquires" the earned income. Any income earned by a separate property trust that is actually distributed to the spouse-beneficiary is community property. *Ridgell v. Ridgell*, 960 S.W.2d 144, 149 (Tex. App.–Corpus Christi 1997, no pet.); *see also Commissioner of Internal Revenue v. Porter*, 148 F.2d 566 (5th Cir. 1945) (while the income remains in the hands of the trustee, it is "protected," but once it is distributed it becomes subject to the "ordinary impact of the law"). The applicability of the basic rules of marital property law is clear in such a case; any property interest that is actually first acquired during marriage is community property.

5. Income from Separate Property Trust Can Be Separate

In contrast to the principle that income derived from a separate property trust is community property, there is a line of older cases that recognizes that this income may be separate property in more situations than just the limited case where the spouse-beneficiary has no right to compel distribution of income as in *Burns*.

McClelland v. McClelland, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd), is probably the most often-quoted of these older cases. *McClelland*, which involved a testamentary trust created for Husband by his father, presented the issue as being a contest between the intent of the testator and community property claims of Wife. In *McClelland*, the intent of the testator won out. Thus, a monthly allowance paid by the trustee to Husband, pursuant to a provision in the will, as well as other discretionary distributions made by the trustee under the will, were held to be Husband's separate property. *See Sullivan v. Skinner*, 66 S.W. 680 (Tex. Civ. App. 1902, writ ref'd) (where Wife received a life estate in land under her father's will, which provided that she was to receive the income for her sole and separate use, the rentals from the land were Wife's separate property).

Several other old cases, involving a conveyance by one spouse into trust for the benefit of the other spouse, held that income from the property held in trust was also separate property. *See Hutchinson v. Mitchell*, 39 Tex. 488 (1873) ("We can find nothing in any of the Constitutions or laws of the state or republic which would prevent a man from declaring an express trust in favor of his Wife, and giving her the exclusive use and enjoyment of all the rents, revenues and profits of the trust estate, provided there is no fraud in the transaction against creditors . . ."); *Shepflin v. Small*, 23 S.W. 432

(Tex. Civ. App.–El Paso 1893, no writ) (where Husband and Wife joined in conveyance of Wife's separate property to trustee, to collect the income and use it to support Wife and children, the income was withdrawn from the community estate).

In the case of *In re Marriage of Thurmond*, 888 S.W.2d 269, 272-75 (Tex. App.–Amarillo 1994, no writ), the court of appeals without explanation treated a trust distribution from a testamentary trust as entirely separate property, even though the distribution included interest earned by the trust.

A more recent Tax Court case has reviewed the broad panorama of Texas cases on marital property law and trusts, and concluded that, where a trust is established by gift, the correct view is that distributions from the trust to a married beneficiary are the beneficiary's separate property, notwithstanding some authorities to the contrary. *See Wilmington Trust Co. v. United States*, 83-2 USTC (1983). The Court stated:

> It is concluded that, under the law of Texas, as developed and expounded by the Texas courts, the income derived during the marriage of [the spouses] from the seven trusts that are involved in the present case constituted the separate property of [Wife], and was not community property of [the spouses]. [Wife] never "acquired"–and she will never acquire–the corpus of any of these trusts. The corpus of each trust is to be held and controlled by the trustee or trustees during [Wife's] lifetime, and, upon [Wife's] death, the corpus will pass to her issue. Accordingly, the corpus of each trust was not [Wife's] separate property, and the trust income was not from [Wife's] separate property.
>
> What [Wife] "acquired"–and what she used to purchase the stocks and establish the bank accounts that are involved in the litigation–was the income from the trust property. As the income resulted from the gifts made to trustees for [Wife's] benefit, the income necessarily constituted her separate property under section 15 of article XVI of the Texas Constitution.

Id.; *see also Taylor v. Taylor*, 680 S.W.2d 645, 649 (Tex. App.–Beaumont 1984, writ ref'd n.r.e.) (trust distributions held to be separate property where trust instrument said that income of trust became part of the corpus and the parties had stipulated that corpus was separate property).

6. Spouse as Income Beneficiary (Income Acquired from Trust with no Interest in Corpus)

Where the spouse is an income beneficiary of the trust but has no interest in its corpus, any *undistributed* income earned during marriage is that spouse's separate property. *Cleaver v. Cleaver*, 935 S.W.2d 491, 493 (Tex. App.–Tyler 1996, no writ). Because the corpus is not the property of the spouse, income derived from it is not "income arising from separate property," and is therefore considered to be a gift.

For the same reasons, in a situation where the spouse is an income beneficiary of the trust but has no interest in its corpus, any *distributed* income acquired during marriage is that spouse's separate property. *See Wilmington Trust Co. v. United States*, 4 Cl.Ct. 6, 12 (1983), aff'd, 753 F.2d 1055 (1985) (reviewing Texas cases in which trust income to a married beneficiary is separate property).

7. Mutation, Tracing and Trusts

All property owned by either spouse upon dissolution of the marriage is presumed to be community property. Tex. Fam. Code § 3.003. Clear and convincing evidence which proves that the source of the funding of a spouse's beneficial interest in the corpus of the trust was separate property will establish that the trust is, as it was referred to in the previous section, a "separate property trust." Property acquired in exchange for separate property or using separate property funds is separate property. *Dixon v. Sanderson*, 10 S.W. 535, 546 (Tex. 1888).

The rule that separate property is any property owned prior to marriage, or property acquired during marriage by gift, devise or descent, also applies to trusts. In *Burns*, the trusts were separate property because the corpi were funded prior to marriage. *Burns*, 573 S.W.2d at 556. In *Ridgell*, the trust was separate property because the corpus was funded during marriage with one spouse's separate property. *Ridgell*, 960 S.W.2d at 149-50. And in *Hardin v. Hardin*, 681 S.W.2d 241, 242-43 (Tex. App.–San Antonio 1984, no writ), the trust was separate property because the corpus was funded by a gift to one of the spouse.

If a distribution of corpus is made during marriage, the character of property is determined by the character of the corpus. *Taylor v. Taylor*, 680 S.W.2d 645, 649-50 (Tex. App.–Beaumont 1984, writ ref'd n.r.e.). Thus, distributions of separate property corpus are separate property, and distributions of community property corpus are community property. In other words, for the purposes of marital property law, the spouse's property interest in the corpus is acquired at the time and in the manner the trust was settled, not at the time or in the manner that the distribution was made.

Commissioner of Internal Revenue v. Wilson, 76 F.2d 766 (5th Cir. 1955), involved a separate property trust with income of both separate and community character that was required to be traced. The Fifth Circuit held that income from property held in a separate property trust for Husband was received by him as community property. However, some of the distributed trust income derived from royalties and bonuses on the separate property corpus. Also, delay rentals were received by the trustee. According to the Fifth Circuit, the delay rentals would be community property, while the royalties and bonuses would not; therefore, whatever portion of the trust income could be shown to be derived from royalties and bonuses would be separate property when received by the beneficiary. This analysis required tracing of the distributions to income received by the trust. In this regard, the Court said:

> In the accounting, outlays by the trustee specially connected with [royalties] are to be considered, and also a fair proportion of the general expenses of the trust, so as to ascertain what part of the net payment to the beneficiaries really came from royalties.

Id. at 770.

8. Commingling Inside a Trust

In *McFaddin v. Commissioner*, 148 F.2d 570 (5th Cir. 1945), a tax case, a trust was created by the mother and father of the McFaddin children. The parents conveyed two large cattle ranches into trust, subject to the debts secured by the properties and further subject to an annual payment to the mother of $30,000 per year, payable from income or, if insufficient, from the corpus.

The Tax Court ruled that children who are beneficiaries of a trust, which is created by gift of their parents, hold that interest as separate property. The Tax Court further found that the rights of the beneficiaries did not attach to the gross income, but rather to the distributable net income, of the trust, and that the gross income of the trust used by the trustees to purchase additional property could not be community income of the beneficiaries. The Tax Court further held that the fact that the property was conveyed into trust subject to debts and liens did not convert what was otherwise a gift into a transfer for onerous consideration. And oil royalties and bonuses distributed by the trustee remained the beneficiaries' separate property.

The Fifth Circuit agreed that the res of the trust was a gift, and thus separate property. *Id.* at 572. Therefore, the oil royalties, bonuses and profits from the sale of the land "came to" the McFaddin children as separate property, taxable as separate income.

Nonetheless, the Court held that property acquired by the trust during the beneficiaries' marriages was community because separate and community funds had been commingled within the trust. The Court stated:

> The theory of the Tax Court that none of the commingled property with which the after acquired property was purchased was community property because, under the terms of the trust instrument, gross income was treated as corpus, the rights of the beneficiaries did not attach to gross income but only to the distributable net income, and the gross income used by the trustees was, therefore, not community property, will not at all do. The taxpayers were the beneficial owners of the trust properties, and every part and parcel of them, including income from them, belonged beneficially to them, either as separate or as community property, in the same way that it would have belonged to them had the property been deeded to the taxpayers and operated by themselves. The greater part of the normal income from the property during the years preceding the tax years in question was community income. When it was commingled in a common bank account with other funds of the trust so that the constituents had lost their identity, the whole fund became community; and when it was used by the trustees to purchase additional properties, those properties, taking the character of the funds which bought them, were community property.

Id. at 573 (footnotes omitted).

The Fifth Circuit Court of Appeals also rejected the Commissioner of Internal Revenue's argument that because the trusts were spendthrift trusts, they were in effect conveyances of income to the separate use of the beneficiaries. *Id.* at 574.

In sum, *McFaddin* stands for the proposition that income received by a trust is community or separate by the same rules as would apply had the income been received outside of trust. And if those funds are commingled, then the separate corpus of the trust can be lost to the community, upon subsequent distributions to the beneficiaries.

This rule was applied to the gross income of the trust, not just to the distributable net income. *Id.* at 573. Since the gross income was commingled in trust bank accounts with separate property receipts, the whole fund became community property, and the subsequently-acquired property was community in nature, and the oil income therefrom was similarly community.

9. The Illusory Trust Doctrine

The illusory trust doctrine is not a rule of characterization as much as a means to challenge the validity of a trust settled in an improper way using community funds. In that way, and that way only, the illusory trust doctrine is akin to the fraud on the community doctrine. Fraud on the community ultimately impacts only the court's just and right division of the parties' marital property, and thus is not covered explicitly in this article. The illusory trust doctrine, on the other hand, is addressed because of its ability to change the character of property held in trust from non-marital back into community.

The doctrine first took root in Texas in 1968 in the landmark case of *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968). In *Marshall*, Husband funded a trust using community property under his sole management and control without the consent of his Wife. *Id*. at 842-43. The trust instrument provided for distribution of the corpus to the spouses' children upon the death of both of the spouses. *Id*. However, Husband-settlor retained exclusive control over the trustee's powers of management and distribution of the corpus during his lifetime. *Id*. The two essential components of this trust were (1) that it was settled with community property without both spouses' consent, and (2) the settlor spouse retained extensive powers over trust property.

The Texas Supreme Court examined this trust and announced the first clear articulation of the doctrine in Texas:

> [U]nder the doctrine, Husband has the power to create an inter vivos trust as part of his managerial powers over Wife's share; but when her share is involved, Wife can require the trust to be real rather than illusory, genuine rather than colorable.

Id. at 846. [The Court explained on its use of the term colorable thus:

> The term 'colorable,' as used herein, indicates a transfer which may be absolute on its face, but which, actually, is not a transfer at all because, through some secret or tacit understanding, the parties intended that ownership is to be retained by the donor.

Id. at n. 4. The "colorable trust doctrine" has not been advanced by any other Texas court since *Marshall*, although it may prove to be fertile ground for challenging the validity of a trust.] The Court invoked this doctrine in order to resolve "the question [of] whether Husband can accomplish by inter vivos trust what he could not do by a will." *Marshall*, 426 S.W.2d at 846. The Court applied the illusory trust doctrine, concluded that Husband may not exercise such extensive control over Wife's community property, and held that the Marshall trust was invalid. Id.

Four years later, the Supreme Court explained its holding in *Land v. Marshall*:

> [T]he illusory trust doctrine, as enunciated in *Land v. Marshall*, 426 S.W.2d 841 (Tex. 1968), is limited to instances in which a non-consenting spouse's property is used to fund a trust...The *Marshall* trust did not fail because Husband reserved too much control over his own property.

Westerfeld v. Huckaby, 474 S.W.2d 189, 191-92 (Tex. 1972). The Court upheld the validity of the *Westerfeld* trust.

The trust in *Westerfeld* also had a quasi-testamentary component, so the Court focused on the aspect of *Marshall* addressing how the trust was funded, rather than how much control was reserved by the settlor. The Court recognized that it "could not look solely to Husband's reservation of powers over his own property but had to bring additional policy considerations to bear." *Id*. at 191. The Court cited a number of cases upholding the validity of trusts even though the settlor retained extensive powers of control, and stated:

> Our question is whether [the settlor], dealing with her own property, could create valid trusts even though she reserved in herself broad beneficial rights, as well as the right to revoke the trusts and the right to control or manage the acts of the trustee. The trusts were not fatally defective by reason of her power to revoke them, because the Texas Trust Act has foreclosed that objection. Art. 7425b-41, Vernon's Ann. Tex. Civ. Stats. Land v. Marshall, 426 S.W.2d at 844. The trust act also permits the settlor to hold property as trustee for another, or for himself and another. Art. 7425b-7 Vern. Ann. Tex. Civ. Stats. See Restatement (Second) of Trusts §§ 17, 28, 57 (1959); 2 A. Scott, The Law of Trusts § 127.1 (3d ed. 1967).

Westerfeld, 474 S.W.2d at 192. Therefore, *Westerfeld* clarified the illusory trust doctrine first announced in *Marshall*: a trust may be rendered invalid if a spouse uses community property to settle a trust without the consent of the other spouse. The element of consent is emphasized, while the element of control is underplayed.

10. Alter Ego and Piercing the Veil of a Trust

In the context of entities, an alter ego claim is founded on the principle that, if there is such unity between the entity and the spouse that the separateness of the two has ceased, and the spouse's improper use of the entity has damaged the community estate, the distinct identity of the entity may be disregarded. *See Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986); *Lifshutz v. Lifshutz*, 61 S.W.3d 511 (Tex. App.–San Antonio 2001, pet. denied); *see also Texas Pattern Jury Charges–Family* PJC 205.1 (2008).

Alter ego, by its own terms, is a claim founded upon the unity between a spouse and an ***entity*** under their control. Once again, a trust is not an entity, but a relationship. Tex. Prop. Code § 111.004(4); *see also Ray Malooly Trust v. Juhl*, 186 S.W.3d 568, 570 (Tex. 2006) (The Trust Code "explicitly defines a trust as a relationship rather than a legal entity."). While there may be some similarities between the amount of control that a spouse may exercise over an entity like a closely-held corporation on the one hand and a trust on the other, one of the bedrock principles upon which the entire edifice of Trust Law is built is the notion of a trust as a ***relationship*** between several different parties.

No reported appellate case has specifically endorsed the application of the alter ego theory to trusts. However, multiple cases have mentioned alter ego arguments made against trusts. *See e.g. Lemke*, 929 S.W.2d at 664; *Burns*, 573 S.W.2d at 557.

The trial court in a divorce case is necessarily vested with broad powers and discretion in making a division of the community property and in adjusting the equities between the parties. *Elliott v. Elliott*, 422 S.W.2d 757, 758 (Tex. Civ. App.–Fort Worth 1967, writ dism'd w.o.j.).

The concept of a "sham" entity is an adjunct to the "alter ego" theory, and the same arguments for and against application of the later theory apply to the former as well.

U. Tort Recovery for Injuries

1. Prior to Marriage

Recovery for a personal injury claim that arose prior to marriage would be the injured spouse's separate property under Family Code § 3.001(1) (property owned or claimed by the spouse before marriage). Note, however, that under Family Code § 3.001(3), recovery for loss of earning capacity during marriage is not a spouse's separate property. Does that mean that a recovery for loss of earning capacity of a spouse who is injured and then marries becomes partially community property upon marriage? Under Family Code § 3.002, community property can only be property acquired during marriage, so that if the claim arose prior to marriage, under the inception of title rule it could not be community property.

> **EXAMPLE 21**
>
> Prior to marriage, Husband suffers permanent impairment of his right hand and arm in an automobile accident. He recovers a judgment for $750,000. $500,000 was to compensate for diminished earning capacity for the balance of his life. A year later, Husband marries. Is any portion of the $500,000 community property? What if the case had been settled before marriage for $200,000, plus $3,000 per month for life? What if the case is settled after marriage for the $750,000?

2. During Marriage

a. Physical Pain and Mental Anguish (Past & Future)

Under *Graham v. Franco*, 488 S.W.2d 390 (Tex. 1972), and Section 3.001 of the Texas Family Code, a recovery for physical pain and mental anguish is separate property. Tex. Fam. Code Ann. § 3.001 (Vernon 2005).

b. Loss of Consortium

A spouse's recovery for loss of consortium (i.e., loss of the other spouse's affection, solace, comfort, companionship, society, assistance, and sexual relations necessary to a successful marriage) is the recovering spouse's separate property. *Whittlesey v. Miller*, 572 S.W.2d 665, 666 & 669 (Tex. 1978).

c. Loss of Services

A recovery for loss of the other spouse's services (i.e., performance of household and domestic duties) is community property. *Whittlesey v. Miller*, 572 S.W.2d 665, 666 n. 2 (Tex. 1978).

d. Lost Earning Capacity

A recovery for lost earning capacity during marriage is community property, and a recovery for lost earning capacity before marriage or after divorce is separate property. Tex. Fam. Code § 3.001. A panel of the Dallas Court of Appeals, in *Dawson v. Garcia*, 666 S.W.2d 254 (Tex. App.–Dallas 1984, no writ), interpreted this language to be an "all or none" proposition. That is,

under the reasoning in Dawson, if the claim for lost earning capacity arises during marriage, it is entirely community property, and if it arises before marriage or after divorce it is entirely separate property. *Id.* at 267. Thus, the recovery was not prorated over time, as are retirement benefits or worker's compensation benefits.

An important realization eluded the panel of Justices in *Dawson*: in Texas, the character of employment income is not governed by the inception of title rule. Instead, employment is divided into components of time (typically monthly), and the income deriving from employment during that time period (be it immediate or deferred) is separate or community according to whether you are married or not during that time period.

e. Disfigurement (Past & Future)

Under the reasoning of Graham v. Franco, and Section 3.001 of the Texas Family Code, a recovery for disfigurement is separate property.

f. Physical Impairment (Past & Future)

Under the reasoning of *Graham v. Franco* and Section 3.001 of the Texas Family Code, a recovery for physical impairment, past and future, is separate property.

g. Medical Expenses (Past & Future)

Under *Graham v. Franco*, a recovery for medical expenses incurred during marriage is community property to the extent that the community estate has incurred liability for such expenses. *Graham v. Franco*, 488 S.W.2d at 396; *accord*, *Gracia v. RC Cola-7-Up Bottling Co.*, 667 S.W.2d 517, 520 (Tex. 1984). By extension, a recovery for medical expenses incurred before marriage or after divorce should be separate property.

h. Exemplary Damages

The Texas Supreme Court has held that a recovery of exemplary damages by a spouse for a wrong committed during marriage is community property. *Rosenbaum v. Texas Building & Mortgage Co.*, 140 Tex. 325, 167 S.W.2d 506, 508 (1943); *see generally* Hennis, Punitive Damages: Community Property, Separate Property, or Both, 14 Com. Prop. J. 51 (1987).

i. Injury to Child

Any recovery for loss of earnings or earning capacity of a child during minority belongs to the parents. Tex. Fam. Code § 151.001(5); *Bolling v. Rodriguez*, 212 S.W.2d 838, 841-42 (Tex. Civ. App.–Galveston 1948, writ ref'd n.r.e.). One case has said that such a recovery is the community property of the parents. *Hawkins v. Schroeter*, 212 S.W.2d 843, 845 (Tex. Civ. App.–San Antonio 1948, no writ). However, if a managing conservator has been appointed for the child, that conservator has the right to the services and earnings of the child. Tex. Fam. Code § 153.132(7). A recovery for loss of the child's consortium is also available. One case held that this recovery is separate property. *Williams v. Steves Industries, Inc.*, 678 S.W.2d 205, 211 (Tex. Civ. App.–Austin 1984), *aff'd*, 699 S.W.2d 570 (Tex. 1985). And the Supreme Court has held that a recovery for loss of spousal consortium is separate property. *Whittlesey v. Miller*, 572 S.W.2d 665, 669 (Tex. 1978).

j. Tracing the Personal Injury Claim

Where a personal injury recovery is partly separate property and partly community property, the party claiming separate property must prove what portion of the recovery is separate and what portion is community. Tex. Fam. Code § 3.003(a). Failing that, the presumption of community will cause the entire recovery to be treated as community property. *See Kyles v. Kyles*, 832 S.W.2d 194, 198 (Tex. App.–Beaumont 1992, no writ). *Licata v. Licata*, 11 S.W.3d 269 (Tex. App.–Houston [14th Dist.] 1999, no pet.); *see* McKnight, Family Law, 28 SW L J 66, 71-72 (1974) (discussing a federal district court proceeding which found that sixty percent of Husband's personal injury recover was attributable to bodily loss, thirty percent to lost wages, earnings and earning capacity during marriage, and ten percent to future medical expenses).

V. Contract Damages

The character of contract damages is determined by the loss being compensated by the damages. For example, a claim for lost profits from a family business is community property. *Brazos Valley Harvestore Systems, Inc. v. Beavers*, 535 S.W.2d 797, 799 (Tex. Civ. App.–Tyler 1976, writ dism'd).

W. Community Property Held by Spouses With Right of Survivorship

Article XVI, section 15 of the Texas Constitution and section 451 of the Probate Code permit spouses to hold community property with a right to survivorship in the surviving spouse. Tex. Const. art. XVI, § 15, and Tex. Prob. Code Ann. § 451; *see also* Tex. Rev. Civ. Stat. Ann. art. 852a, § 6.09 (Savings and Loan Act provision permitting spouses to have survivorship accounts at savings and loan institutions). The

Constitution states that the spouses "may agree in writing." The Probate Code provides that an agreement between spouses creating a right of survivorship in community property "must be in writing and signed by both spouses." Tex. Prob. Code Ann. § 452 (Vernon Supp. 2005). Upon death, the transfer to the surviving spouse occurs as a result of the agreement, and is not considered to be a testamentary transfer. *Id*. at § 454.

EXAMPLE 22

Husband opens an IRA account using community funds, designating Wife as beneficiary to receive the contents upon Husband's death. Wife does not sign any of the IRA papers. Is this a valid survivorship arrangement? No, because the Constitution and statutes require a written agreement between the spouses, signed by both spouses.

X. Assets Partitioned or Exchanged; Separate Property Income Agreement

The Texas Constitution and the Texas Family Code permit spouses to partition community assets into separate assets, and to exchange the interest of one spouse in particular community property for the interest of the other spouse in other community property. Assets partitioned or exchanged in this manner become the separate property of the receiving spouse. Tex. Const. art. XVI, § 15, Tex. Fam. Code§ 4.102. The partition and exchange can be applied to community property on hand and community property to be acquired. *Id*. Persons about to marry can also partition and exchange community property to be acquired during marriage. Tex. Const. art. XVI, § 15. The relevant Family Code provision regarding premarital agreements, being from a uniform law, does not expressly mention partition and exchange by premarital agreement. Tex. Fam. Code § 4.102. Additionally, spouses (not persons about to marry) can agree that income arising from separate property will be separate property of the owner. Tex. Const. art. XVI, § 15, Tex. Fam. Code§ 4.103.

EXAMPLE 23
PART I

Husband purchases a car on credit, with no agreement by the lender to look solely to Husband's separate estate for repayment. The car is therefore community property. After the car is acquired, the spouses enter into a partition agreement which, among other things, sets the car aside to Husband as his separate property. The car is now Husband's separate property, despite the fact that it was acquired with community credit.

EXAMPLE 23
PART II

Assume the same facts, except that the parties agree by premarital agreement that all assets acquired through a note signed only by one spouse is partitioned to that spouse as his or her separate property. When the car is purchased by community credit, is it not received by Husband as his separate property by virtue of partition?

Y. Funds Borrowed During Marriage

Debts contracted during marriage are presumed to be on the credit of the community, unless it is shown that the creditor agreed to look solely to the separate estate of the borrowing spouse for repayment. *Cockerham v. Cockerham*, 527 S.W.2d 162, 171 (Tex. 1975). Property purchased on credit during the marriage is community property unless there is an express agreement on the part of the lender to look solely to the purchasing spouse's separate estate for satisfaction of the debt. *Glover v. Henry*, 749 S.W.2d 502, 503 (Tex. App.–Eastland 1988, no writ).

In *Jones v. Jones*, 890 S.W.2d 471, 475-76 (Tex. App.–Corpus Christi 1994, writ requested), the appellate court overturned a jury finding of separate credit, because the record contained no evidence that the lender agreed to look solely to the borrowing spouse's separate estate for repayment.

In *Holloway v. Holloway*, 671 S.W.2d 51, 57 (Tex. App.–Dallas 1983, writ dism'd), an implied agreement of separate credit was inferred by the court where loan proceeds were deposited into an account designated as Husband's separate property account, and Husband alone signed the loan papers "Pat S. Holloway, Separate Property," and only Husband's separate property was used as collateral.

In *Wierzchula v. Wierzchula*, 623 S.W.2d 730 (Tex. Civ. App.–Houston [1st Dist.] 1981, no writ), the court found an implied agreement, with the creditor, of separate credit where Husband had signed earnest money contract to buy a home prior to marriage, and had applied for credit prior to marriage, and the loan papers were in Husband's name alone, despite the fact that the note was signed by Husband during marriage and contained no terms restricting liability to Husband's separate estate.

In *Brazosport Bank of Texas v. Robertson*, 616 S.W.2d 363, 366 (Tex. Civ. App.–Houston [14th Dist.] 1981, no writ), the court held that a bank's loaning money to Wife over Husband's objection, where the note was signed by Wife alone and title to automobile taken in Wife's name alone, constituted an implied agreement by the lender to look to Wife alone for satisfaction of the debt.

In *Mortenson v. Trammell*, 604 S.W.2d 269, 275-76 (Tex. Civ. App.–Corpus Christi 1980, writ ref'd n.r.e.), the fact that Wife took a loan out in her name alone, and put up her separate property CD as collateral, was sufficient to support a jury finding of separate credit.

In *Broussard v. Tian*, 295 S.W.2d 405 (Tex. 1956), evidence that the down payment for land was made with Husband's separate property, and that all payments on the note secured by the land were also made with Husband's separate property, and that the deed ran to Husband alone, and that Husband alone signed the note and deed of trust, and that the spouses were separated at the time of the transaction, and that the banker and Husband discussed payment of the note with Husband's separate property royalty income, was still not enough to support a jury finding of an agreement that the note would be paid out of Husband's separate estate.

A question arises whether such an agreement between the lender and the borrowing spouse can be proved by parol evidence. The Supreme Court expressly reserved judgment on that question in *Broussard v. Tian*, 295 S.W.2d 405 (Tex. 1956); *see Jones v. Jones*, 890 S.W.2d 471, 477 (Tex. App.–Corpus Christi 1994, writ denied) (Hinojosa, F.G., J., dissenting) (contents of promissory notes cannot be supplemented or varied by parol evidence of separate credit agreement without proof of fraud, mistake, or accident).

Z. Economic Contribution

1. General Considerations

In 2001, the Legislature amended the Family Code by adding new Sections 3.401 through 3.410, eliminating "equitable interests" and creating in their stead a "claim for economic contribution" against a spouse's estate. The Legislature also added Family Code § 7.007, which requires the court in a divorce to determine claims for economic contribution, divide community property claims in a manner that is just and right, and order a claim for economic contribution in favor of a separate estate to be awarded to the owner of that estate. It would be unconstitutional under *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977), for the Legislature to purport to empower a trial court to take separate property of one spouse and give it to the other upon divorce. The economic contribution statute attempts to circumvent this prohibition by reaffirming the inception of title rule on the one hand while on the other hand making inroads in the rule by creating a claim for economic contribution that is tantamount to an ownership interest in the property which the trial court must award, *Eggemeyer* notwithstanding. Whether the distinction between a legal "taking" and an "equitable" taking has sufficient substance to withstand constitutional attack remains to be seen.

The scheme of economic contribution claims replaces the cost or enhancement model of equitable reimbursement, and instead substitutes a monetary claim, to be secured by a lien upon dissolution of marriage, for what amounts to pro rata "ownership" of the benefitted asset. This new approach is a radical departure from marital property reimbursement concepts, and it requires close attention.

2. Practical Considerations

As of the time of this writing, the 2003 amendment to the economic contribution statutes was still in effect. That amendment raises several interesting practical questions.

Economic contribution claims exist only as to debts secured by liens in property of another marital estate, not unsecured debts of another estate. Tex. Fam. Code §3.402. Economic contribution claims also apply to property receiving capital improvements paid by another marital estate. *Id.* Economic contribution claims, when available and proven, supplant reimbursement claims for reimbursement. Tex. Fam. Code §3.408(a).

If the property made the basis of an economic contribution claim is owned by a spouse at the time of marriage, the proponent of the claim must prove the value of the property on the date of the first economic contribution. Attorneys sometimes overlook getting this

historical fair market value of the property.

The economic contribution claim is calculated as a fraction of the equity in the property on the date of divorce, or date of disposition. Thus, the economic contribution concept makes the contributing estate a sort of "partner" in ownership of the property. Tex. Fam. Code §3.403(b)(1).

Economic contribution claims for paying debt includes only reduction in principal and not payment of interest. Economic contribution claims also do not include payment of property taxes or insurance. Tex. Fam. Code §3.402(b).

Making "capital improvements" can give rise to a claim for economic contribution, but the term "capital improvements" is not defined. Tex. Fam. Code §3.402(a)(6). Also, the measure of the economic contribution claim for making capital improvements is based on the cost of the improvements, and not any enhancement in value resulting from the improvements. Tex. Fam. Code §3.402(a)(6). However, if capital improvements are financed during marriage by a loan secured by lien in the property, only the reduction in principal of the improvement loan is included in the claim for economic contribution. Tex. Fam. Code §3.402(3) & (6). There appears to be a "gap" for capital improvements made to property by incurring debt that is not secured by lien in the property being improved. Those capital improvements do not fall under either Tex. Fam. Code §3.402(3) or (6). Presumably a traditional reimbursement claim could be made, based on enhancement.

"Use and enjoyment" of property is not an offsetting benefit to a claim for economic contribution. Tex. Fam. Code §3.403(e).

If the property giving rise to a claim for economic contribution is disposed of during marriage, the amount of the claim for economic contribution is fixed at the time the property is disposed of. Tex. Fam. Code §3.403(b)(1).

A divorce court is required to impose a lien on property of the benefitted estate to secure a claim for economic contribution. This is not discretionary with the court. Tex. Fam. Code §3.406(a). The lien is not restricted to the specific property benefitted, but can instead be placed on any other property of the benefitted estate, subject only to homestead protection of such assets. Tex. Fam. Code § 3.406(c). This suggests that other exemption statutes in the Texas Property Code will not protect exempt property from such a lien.

The trial court must offset claims for economic contribution running between estates. Tex. Fam. Code §3.407.

Marital property reimbursement principles still apply to payment of unsecured debt, and whenever someone fails to prove up an economic contribution claim. Tex. Fam. Code §3.408(a). Economic contribution claims also do not apply to Jensen claims for undercompensation from a separate property corporation that is enhanced due to community labor. Tex. Fam. Code §3.408(b)(2). See Tex. Fam. Code §3.402(b)(2) (economic contribution does not include time, toil, talent or effort).

The statute does not say who must plead and prove offsetting benefits.

Reimbursement is not available for: (a) child support or alimony; (b) paying living expenses of a spouse or step-child; (c) contributing property of nominal value; (d) paying liabilities of nominal value; (e) paying student loans of a spouse. Tex. Fam. Code §3.409.

In *LaFrensen v. LaFrensen*, 106 S.W.3d 876, 879 (Tex. App.–Dallas 2003, no pet.), the appellate court described an economic contribution claim in the following terms:

> According to the family code, the amount of the claim is derived by multiplying the equity in the residence on the date of the divorce by a fraction. The fraction's numerator is the amount of the economic contribution by the community. Its denominator is equal to the sum of that same economic contribution, plus the equity in the residence on the date of the marriage, plus any economic contribution to the residence by Husband's separate estate. See Tex. Fam. Code § 3.403(b).

This description is now slightly inaccurate because of the 2003 amendments.

In *Langston v. Langston*, 82 S.W.3d 686, 689 (Tex. App.–Eastland 2002, no pet.), the court of appeals in dicta defended the constitutionality of imposing a lien in one spouse's separate property to secure an economic contribution claim, and later subjecting the property to foreclosure for failure to pay the claim. The court commented:

> The underlying but ultimate issue in this case is whether the imposition and foreclosure of an equitable lien against a spouse's separate property is tantamount to divesting that spouse of his separate property. It is not. Although a court cannot divest a spouse of his separate property, the trial court must impose an equitable lien on that spouse's separate property to secure the other spouse's claim for economic contribution. That lien, if not satisfied, is subject to foreclosure as any other judgment lien. [FN1] However, the court cannot abrogate the safeguards provided by the procedures to foreclose a judgment lien by directly divesting title to one's separate property and vesting title in another.

AA. Legislative Update

On June 19, 2009, Governor Perry signed Senate Bill 866, substantially changing the law in Texas with regards to stock options, economic contribution, and defined benefit plans. Act of June 1, 2009, 81st Leg., R.S. (unpublished, available at http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=81R&Bill=SB866).

1. Section 3.007(d) - Employer-Provided Stock Plan

Old section 3.007(d) and the new statute are compared below (amendments in bold, deletions struck out):

> A spouse who is a participant in an employer-provided stock option plan or an employer-provided restricted stock plan has a separate property interest in the options or restricted stock granted to the spouse under the plan as follows:
>
> (1) if the option or stock was granted to the spouse before marriage but required continued employment during marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which the numerator is the period from the date the option or stock was granted until the date of marriage and the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed; and
>
> (2) if the option or stock was granted to the spouse during the marriage but required continued employment after marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which the numerator is the period from the date of dissolution or termination of the marriage until the date the grant could be exercised or the restriction removed and the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed.

> A spouse who is a participant in an employer-provided stock option plan or an employer-provided restricted stock plan has a separate property interest in the options or restricted stock granted to the spouse under the plan as follows:
>
> (1) if the option or stock was granted to the spouse before marriage but required continued employment during marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which**:**
>
> **(A)** the numerator is the sum of:
>
> **(i) the** period from the date the option or stock was granted until the date of marriage**; and**
>
> **(ii) if the option or stock also required continued employment following the date of dissolution of the marriage before the grant could be exercised or the restriction removed, the period from the date of dissolution of the marriage until the date the grant could be exercised or the restriction removed;** and
>
> **(B)** the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed; and
>
> (2) if the option or stock was granted to the spouse during the marriage but required continued employment **following the date of dissolution of the** ~~after~~ marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which**:**
>
> **(A)** the numerator is the period from the date of dissolution ~~or termination~~ of the marriage until the date the grant could be exercised or the restriction removed**;** and
>
> **(B)** the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed.

Two main changes were made to the old statute, one formalistic, the other substantive. First, the statute was restructured to segregate the numerators and denominators of the two different formulae into different subsections. Second, the method for calculating the numerator of stock options granted prior to marriage now takes into account any period of time that would need to be worked ***after*** the dissolution of the marriage in order to exercise the grant or remove the restriction. By adding this provision, the Legislature ensured that courts would not unconstitutionally divest a spouse of their separate property by applying a formula that did not assign any value to work done after dissolution that was necessary for the employee-spouse to receive the grant or option.

Ironically, the old statute regarding stock options suffered the same practical problems that the old statute regarding defined benefit plans did: failure to recognize the value of work done ***after*** divorce in the calculation of the separate and community property proportions.

2. Sections 3.007(a) & (b) - Defined Benefit Plans

The Legislature also repealed the oft-maligned sections of the Family Code ostensibly codifying the *Taggart*/*Berry* formula described *supra*. In some cases, this statute created, by some accounts, an unallocated or "phantom" benefit that, by the terms of the statute, was neither community nor separate property. *See O'Connor's Texas Family Law Handbook* (2009) at 92. Other commentators have challenged the existence of the phantom benefit. *See* Phillips, Philip D., *Defined Benefit Valuation Issues and Section 3.007*, 34th Annual Advanced Family Law Course (2008). Regardless, the Legislature summarily repealed sections 3.007(a) and (b) with this new legislation. Act of June 1, 2009, 81st Leg., R.S., § 11(1). Presumably, the common law in effect prior to the codification of the repealed statute in 2005 is resurrected, and the *Taggart*/*Berry* formula applies to all defined benefit plans. *See* section III.I.1 *supra* for further discussion.

3. Sections 3.402 & 7.007 - Economic Contribution

Finally, the Legislature altered the economic contribution schema, resuscitating "equitable reimbursement" and replacing the former term with the latter:

> Section 3.402. **Claim for Reimbursement; Offsets** ~~Economic Contribution~~
>
> (a) For the purposes of this subchapter, **a claim for reimbursement includes**:
>
> **(1) payment by one marital estate of the unsecured liabilities of another marital estate;**
>
> **(2) inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse;**
>
> **(3)** ~~"economic contribution" is the dollar amount of: (1)~~ the reduction of the principal amount of a debt secured by a lien on property owned before marriage, to the extent the debt existed at the time of marriage;
>
> **(4)** ~~(2)~~ the reduction of the principal amount of a debt secured by a lien on property received by a spouse by gift, devise, or descent during marriage, to the extent the debt existed at the time the property was received;
>
> **(5)** ~~(3)~~ the reduction of the principal amount of that part of a debt, including a home equity loan:
>
> (A) incurred during marriage;
>
> (B) secured by a lien on property; and
>
> (C) incurred for the acquisition of, or for capital improvements to, property;
>
> **(6)** ~~(4)~~ the reduction of the principal amount of that part of a debt:
>
> (A) incurred during marriage;
>
> (B) secured by a lien on property owed by a spouse; and
>
> (C) for which the creditor agreed to look for repayment solely to the separate marital estate of the spouse on whose property the lien attached; and
>
> (D) incurred for the acquisition of, or for capital improvements to, property;
>
> **(7)** ~~(5)~~ the refinancing of the principal amount described by Subdivisions **(3)-(6)** ~~(1)-(4)~~, to the extent the refinancing reduces that principal amount in a manner described by the **applicable** ~~appropriate~~ subdivision~~; and~~
>
> **(8)** ~~(6)~~ capital improvements to property

other than by incurring debt**; and**

(9) the reduction by the community property estate of an unsecured debt incurred by the separate estate of one of the spouses.

(b) The court shall resolve a claim for reimbursement by using equitable principles, including the principle that claims for reimbursement may be offset against each other if the court determines it to be appropriate.

(c) Benefits for the use and enjoyment of property may be offset against a claim for reimbursement for expenditures to benefit a marital estate, except that the separate estate of a spouse may not claim an offset for use and enjoyment of a primary or secondary residence owned wholly or partly by the separate estate against contributions made by the community estate to the separate estate.

(d) Reimbursement for funds expended by a marital estate for improvements to another marital estate shall be measured by the enhancement in value to the benefitted marital estate.

(e) The party seeking an offset to a claim for reimbursement has the burden of proof with respect to the offset

~~"Economic contribution" does not include the dollar amount of:~~

~~(1) the expenditures for ordinary maintenance and repair or for taxes, interest, or insurance, or~~

~~(2) the contribution by a spouse of time, toil, talent, and effort during the marriage.~~

...

Section 7.007. Disposition of Claim for ~~Economic Contribution or Claim for~~ Reimbursement

~~(a) In a decree of divorce or annulment, the court shall determine the rights of both spouses in a claim for economic contribution as provided by Subchapter E, Chapter 3, and in a manner that the court considers just and right, having due regard for the rights of each party and any children of the marriage, shall:~~

~~(1) order a division of a claim for economic contribution of the community marital estate to the separate marital estate of one of the spouses;~~

~~(2) order that a claim for an economic contribution by one separate marital estate of a spouse to the community marital estate of the spouses be awarded to the owner of the contributing separate marital estate; and~~

~~(3) order that a claim for economic contribution of one separate marital estate in the separate marital estate of the other spouse be awarded to the owner of the contributing marital estate.~~

~~(b)~~ In a decree of divorce or annulment, the court shall determine the rights of both spouses in a claim for reimbursement as provided by Subchapter E, Chapter 3, and shall apply equitable principles to:

(1) determine whether to recognize the claim after taking into account all the relative circumstances of the spouses; and

(2) order a division of the claim for reimbursement, if appropriate, in a manner that the court considers just and right, having due regard for the rights of each party and any children of the marriage.

These changes do not simply repeal economic contribution and return to equitable reimbursement as the prevailing law. Instead, the statute *replaces* economic contribution with reimbursement, preserving the statutory grounds for economic contribution claims, but placing them under the ambit of reimbursement. However, the statute does repeal the formula for calculating these claims under section 3.403, and also eliminates much of the mandatory language for making awards under these claims. Because the statute does not categorically repeal economic contribution, it remains to be seen whether or not the old common law for equitable reimbursement is fully resurrected.

4. Effective Date

Under the statute, the changes made to economic contribution and reimbursement apply to cases filed on

or after September 1, 2009. Act of June 1, 2009, 81st Leg., R.S., § 13(a). However, the changes made to defined benefit plans and employer-provided stock plans apply to any suit filed on or after ***or pending*** on September 1, 2009. Act of June 1, 2009, 81st Leg., R.S., § 12(1).

ENDNOTES:

[1] This assumes that Texas marital property law applies. Texas marital property law applies to property acquired by spouses while domiciled in Texas, regardless of where they married. Tex. Fam. Code §1.103. For non-domiciliaries, conflict of law rules apply. *See Ossorio v. Leon*, 705 S.W.2d 219, 223 (Tex. App.–San Antonio 1985, no writ). In a Texas divorce or annulment, property is treated as if Texas marital property law controls, even where it does not. Tex. Fam. Code § 7.002

[2] *See Gutierrez v. Gutierrez*, 791 S.W.2d 659, 664 (Tex. App.–San Antonio 1990, no writ) (portion of rental payments belonging to Husband's brother were not community property).

[3] The controlling definition of separate property is contained in the Texas Constitution, article 15, Section 15, which reads as follows:

> Sec. 15. Separate and community property of Husband and wife
>
> All property, both real and personal, of a spouse owned or claimed before marriage, and that acquired afterward by gift, devise or descent, shall be the separate property of that spouse; and laws shall be passed more clearly defining the rights of the spouses, in relation to separate and community property; provided that persons about to marry and spouses, without the intention to defraud pre-exist ing creditors, may by written instrument from time to time partition between themselves all or part of their property, then existing or to be acquired, or exchange between themselves the community interest of one spouse or future spouse in any property for the community interest of the other spouse or future spouse in other community property then existing or to be acquired, whereupon the portion or interest set aside to each spouse shall be and constitute a part of the separate property and estate of such spouse or future spouse; spouses also may from time to time, by written instrument, agree between themselves that the income or property from all or part of the separate property then owned or which thereafter might be acquired by only one of them, shall be the separate property of that spouse; if one spouse makes a gift of property to the other that gift is presumed to include all the income or property which might arise from that gift of property; and spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse.

The Family Code definition of separate property comports with the constitutional definition, except that Section 3.001 says that "the recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage" is separate property. Tex. Fam. Code § 3.001. This personal-injury related category of separate property, which is not in the Constitution, was validated in *Graham v. Franco*, 488 S.W.2d 390 (Tex. 1972). Section 4.102 provides that "[p]roperty or a property interest transferred to a spouse by a partition or exchange agreement becomes his or her separate property." Tex. Fam. Code§ 4.102.

[4] The definition of community property is set out in Section 3.002 of the Texas Family Code: "Community property consists of the property, other than separate property, acquired by either spouse during marriage." Tex. Fam. Code § 3.002.

[5] Property may be partly separate and partly community property, in proportion to the portion of the purchase price paid with separate and community property. *Gleich v. Bongio*, 99 S.W.2d 881, 883 (Tex. 1937). *See* State Bar of Texas Pattern Jury Charges-Family PJC 202.16 (2002). In the case of *In re Marriage of Thurmond*, 888 S.W.2d 269, 272-73 (Tex. App.–Amarillo 1994, writ denied), the court reviewed various descriptions of "mixed" ownership as being "pro tanto ownership," "equitable title," and "separate interest." The court felt that the most viable characterization of the interest of the spouse's separate estate in a mixed asset is one of "equitable title." *Id*. at 273. Tex. Fam. Code §3.006.

[6] *Welder v. Lambert*, 91 Tex. 510, 22 S.W. 281, 284-86 (1898); *Henry S. Miller Co. v. Evans*, 452 S.W.2d 426, 430 (Tex. 1970); *Saldana v. Saldana*, 791 S.W.2d 316, 319 (Tex. App.-_Corpus Christi 1990, no writ) (*citing Strong v. Garrett*, 148 Tex. 265, 224 S.W.2d 471 (1949)).

[7] Tex. Const. art. XVI, § 15; *Parnell v. Parnell*, 811 S.W.2d 267, 269 (Tex. App.–Houston [14th Dist.] 1991, no writ) (real estate owned by Husband prior to marriage was his separate property); *Gutierrez v. Gutierrez*, 791 S.W.2d 659, 665 (Tex. App.–San Antonio 1990, no writ) (car purchased by Husband prior to marriage was his separate property).

[8] *See Allen v. Allen*, 751 S.W.2d 567, 572 (Tex. App.–Houston [14th Dist.] 1988, writ denied), *overruled on other grounds by Formosa Plastics Corp. USA v. Presidio Eng'rs and Contractors, Inc.*, 960 S.W.2d 41 (Tex. 1998) (mineral interest received by former Husband after divorce was community property because his inception of title to the interest arose during marriage).

[9] Tex. Const. art. XVI, § 15; Tex. Fam. Code § 3.001. One consequence of this rule is that there can be no gift to the community estate. *Tittle v. Tittle*, 148 Tex. 102, 220 S.W.2d 637, 642 (1949); *Celso v. Celso*, 864 S.W.2d 652, 655 (Tex. App.–Tyler 1993, no writ). Note that when one spouse gives property to the other spouse a presumption arises that the gift includes all income or property arising from the property transferred. Tex. Const. art. XVI, § 15; Tex. Fam. Code § 3.005. "Gift" means "a voluntary and gratuitous transfer of property coupled with delivery, acceptance, and the intent to make a gift." State Bar of Texas Pattern Jury Charges-Family PJC 202.3 (2002); *see Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565, 569 (1961) ("When an inter vivos transfer is made to either or both of the spouses during marriage, the separate or community character of the property is determined by looking to the consideration given in exchange for it. Any right, title or interest acquired for a valuable consideration paid out of the community necessarily becomes community property....").

[10] Tex. Const. art. XVI, § 15; Tex. Fam. Code § 3.001. "Devise" means acquisition of property by last will and testament. State Bar of Texas Pattern Jury Charges-Family PJC 202.3 (2002). "Descent" means acquisition of property by inheritance without a will. State Bar of Texas Pattern Jury Charges-Family PJC 202.3 (2002).

[11] Tex. Const. art. XVI, § 15. Family Code § 4.102 provides that "[p]roperty or a property interest transferred to a spouse by a partition or exchange agreement becomes his or her separate property." Tex. Fam. Code § 4.102.

[12] Tex. Const. art. XVI, § 15. See Tex. Fam. Code § 4.103.

[13] Tex. Const. art. XVI, § 15; Tex. Prob. Code§ 451. *See Banks v. Browning*, 873 S.W.2d 763 (Tex. App.–Fort Worth 1994, writ denied) (signature card indicating survivorship by "X" in a box was sufficient to establish survivorship agreement as to community property); *Haynes v. Stripling*, 812 S.W.2d 397 (Tex. App.–Austin 1991, no writ) (constitutional amendment retroactively validated survivorship agreement, signed prior to effective date, that was invalid under prior law).

[14] *McKinley v. McKinley*, 496 S.W.2d 540, 543 (Tex. 1973); *Tarver v. Tarver*, 394 S.W.2d 780, 783 (Tex. 1965).

[15] "[T]he recovery for personal injuries sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage" is separate property. Tex. Fam. Code§ 3.001. Note, however, in *Graham v. Franco* 488 S.W.2d 390, 396 (Tex. 1972), the Supreme Court held that a recovery for medical and related expenses incurred during marriage belongs to the community, since the community is responsible for these expenses.

[16] *See Burgess v. Easley*, 893 S.W.2d 87, 90-91 (Tex. App.–Dallas 1994, no writ) (although deed was executed by Husband's father during marriage, it was not delivered to Husband until after divorce; since a conveyance is not effective until delivery, the property was not community property); *Snider v. Snider*, 613 S.W.2d 8, 11 (Tex. Civ. App.–El Paso 1981, no writ) (dividend declared after death of Husband belonged to his heirs, not the community estate); *Berry v. Berry*, 647 S.W.2d 945, 948 (Tex. 1983).

[17] Tex. Fam. Code § 7.002(a).

[18] Tex. Fam. Code § 7.002(b).

[19] Tex. Fam. Code§ 3.003; *Tarver v. Tarver*, 394 S.W.2d 780, 783 (Tex. 1965) (all property possessed at the time of dissolution of marriage is presumed to be community property). The uncorroborated testimony of a spouse is sufficient to support a finding of separate property, but is not binding on the fact finder. *Hilliard v. Hilliard*, 725 S.W.2d 722 (Tex. App.–Dallas 1985, no writ) ("Husband's uncorroborated testimony...is not conclusive as to whether the house was separate or community."); *see Zagorski v. Zagorski*, 116 S.W.3d 309 (Tex. App.–Houston [14th Dist.] 2003, pet. denied) (community presumption rebutted by testimony and circumstantial documentary evidence).

[20] *Welder v. Welder*, 794 S.W.2d 420, 423 (Tex. App.–Corpus Christi 1990, no writ).

[21] *McKinley v. McKinley*, 496 S.W.2d 540, 543 (Tex. 1973); *Jackson v. Jackson*, 524 S.W.2d 308, 311 (Tex. Civ. App.–Austin 1975, no writ).

[22] State Bar of Texas Pattern Jury Charges-Family PJC 202.4 (2002). To overcome the presumption of community, the party asserting separate property must trace and clearly identify the property which (s)he claims to be separate. *McKinley v. McKinley*, 496 S.W.2d 540, 543 (Tex. 1973); *Tarver v. Tarver*, 394 S.W.2d 780, 783 (Tex. 1965). The court in *Faram v. Gervitz-Faram*, 895 S.W.2d 839, 842 (Tex. App.–Fort Worth 1995, no writ), described tracing in the following way:

> [T]he party claiming separate property must trace and identify the property claimed as separate property by clear and convincing evidence. Tracing involves establishing the separate origin of the property through evidence showing the time and means by which the spouse originally obtained possession of the property. *Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex. App.–Dallas 1985, no writ). Separate property will retain its character through a series of exchanges so long as the party asserting separate ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to property that, because of its time and manner of acquisition, is separate in character. *Cockerham v. Cockerham*, 527 S.W.2d 162, 167 (Tex. 1975).

See Celso v. Celso, 864 S.W.2d 652, 654 (Tex. App.–Tyler 1993, no writ) (trial court reversed for failing to find that Husband successfully traced CD funds into purchase of house); *Scott v. Scott*, 805 S.W.2d 835 (Tex. App.–Waco 1991, writ denied).

[23] *Celso v. Celso*, 864 S.W.2d 652, 654 (Tex. App.–Tyler 1993, no writ). The Court wrote:

> Separate property will retain its character through a series of exchanges so long as the party asserting separate ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to property that, because of its time and manner of acquisition, is separate in character.

See also Martin v. Martin, 759 S.W.2d 463, 466 (Tex. App.–Houston [1st Dist.] 1988, no writ) (of three lots, two were separate and one community; the lots were sold for a unified price; absent proof of the sales price for each lot, all proceeds were deemed to be community property; tracing failed).

[24] *Eggemeyer v. Eggemeyer*, 554 S.W.2d 137 (Tex. 1977).

[25] Sampson & Tindall, Family Code Annotated §3.02 cmt. (2004) at 25.

[26] *Cockerham v. Cockerham*, 527 S.W.2d 162, 171 (Tex. 1975); *Anderson v. Royce*, 624 S.W.2d 621, 623 (Tex. Civ. App.–Houston [14th Dist.] 1981, writ ref'd n.r.e.).

[27] *Glover v. Henry*, 749 S.W.2d 502, 503 (Tex. App.–Eastland 1988, no writ).

[28] *Cockerham v. Cockerham*, 527 S.W.2d 162, 171 (Tex. 1975).

[29] *Kahn v. Kahn*, 94 Tex. 114, 58 S.W. 825, 826 (1900); *Kyles v. Kyles*, 832 S.W.2d 194, 196 (Tex. App.–Beaumont 1992, no writ).

[30] *Kahn v. Kahn*, 94 Tex. 114, 58 S.W. 825, 826 (1900); *Henry S. Miller Co. v. Evans*, 452 S.W.2d 426, 431 (Tex. 1970).

[31] *Kahn v. Kahn*, 94 Tex. 114, 58 S.W. 825, 826 (1900).

[32] *Pemelton v. Pemelton*, 809 S.W.2d 642, 646 (Tex. App.–Corpus Christi 1991), *rev'd on other grounds sub nom. Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992).

[33] *In re Marriage of Thurmond*, 888 S.W.2d 269, 273 (Tex. App.–Amarillo 1994, no writ), *citing Cockerham v. Cockerham*, 527 S.W.2d 162, 168 (Tex. 1975); *see Graham v. Graham*, 836 S.W.2d 308, 310 (Tex. App.–Tyler 1992, no writ) (recognizing rule but holding it was not applicable); *Peterson v. Peterson*, 595 S.W.2d 889, 892-93 (Tex. Civ. App.–Austin 1980, writ dism'd) (presumption overcome by Husband's testimony that no gift was intended). In *Whorrall v. Whorrall*, 691 S.W.2d 32, 35 (Tex. App.–Austin 1985, writ dism'd), wife's testimony that she did not intend a gift was sufficient to support the trial court's finding of separate property.

[34] Tex. Const. art XVI, § 15, Tex. Fam. Code§ 3.005.

[35] *Horlock v. Horlock*, 533 S.W.2d 52, 59 (Tex. Civ. App.–Houston [14th Dist.] 1976, writ dism'd); *accord, Harris v. Ventura*, 582 S.W.2d 853, 855-56 (Tex. Civ. App.–Beaumont 1979, no writ).

[36] *Celso v. Celso*, 864 S.W.2d 652, 655 (Tex. App.–Tyler 1993, no writ) ("The mere fact that the proceeds of the sale were placed in a joint account does not change the characterization of the separate property assets. The spouse that makes a deposit to a joint bank account of his or her separate property does not make a gift to the other spouse."); *see also Higgins v. Higgins*, 458 S.W.2d 498, 500 (Tex. Civ. App.–Eastland 1970, no writ).

[37] A "fixture" is something that is personal but has been annexed to the realty so as to become part of it. *Fenlon v. Jaffe*, 553 S.W.2d 422, 428 (Tex. Civ. App.–Tyler 1977, writ ref'd n.r.e.). The three-pronged test for fixtures is: (i) has there been a real or constructive annexation of the personalty to the realty; (ii) was there a fitness or adaptation of the item to the uses or purposes of the realty; (iii) was it the intention of the party annexing the personalty that it would become a permanent accession to the realty? *O'Neill v. Quiltes*, 111 Tex. 345, 234 S.W. 528, 529 (1921). Intention is controlling; the first two prongs are primarily evidentiary. *Capital Aggregates, Inc. v. Walker*, 488 S.W.2d 830, 834 (Tex. Civ. App.–Austin 1969, writ ref'd n.r.e.).

[38] *Missouri Pacific Ry. Co. v. Cullers*, 81 Tex. 382, 17 S.W. 19, 22 (1891).

[39] *Lindsay v. Clayman*, 254 S.W.2d 777 (Tex. 1952).

[40] *Keller v. Keller*, 141 S.W2d 308, 310-11 (Tex. 1940), *Moore v. Moore*, 192 S.W.2d 929, 930 (Tex. App.–Fort Worth 1946, no writ), respectively.

[41] *Cunningham v. Cunningham*, 183 S.W.2d 985, 986 (Tex. App.–Dallas 1944, no writ).

[42] *Dessommes v. Dessommes*, 543 S.W.2d 165 (Tex. Civ. App.–Texarkana 1976, writ ref'd n.r.e.); *Moore v. Moore*, 192 S.W.2d 929 (Tex. Civ. App.–Fort Worth 1946, no writ).

[43] *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972).

[44] *Geesbreght v. Geebreght*, 570 S.W.2d 427, 436 (Tex. App.–Fort Worth 1978, writ dism'd).

[45] *See Snider v. Snider*, 613 S.W.2d 8, 11 (Tex. Civ. App.–El Paso 1981, no writ) ("Prior to the actual declaration of a dividend, all the accumulation of surplus in the corporation merely enhanced the value of the shares held by Husband as his separate property and the community had no claim thereto.").

[46] *Parker v. Parker*, 897 S.W.2d 918, 928 (Tex. App.–Fort Worth 1995, writ denied), *overruled on other grounds by Formosa Plastics Corp. USA v. Presidio Eng'rs and Contractors, Inc.*, 960 S.W.2d 41 (Tex. 1998) (where corporation found to be alter ego of Husband, corporate assets could become part of community estate; assets owned by corporation at time of marriage were Husband's separate property, but assets acquired by the corporation during marriage were community property, absent tracing).

[47] *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984).

[48] Tex. Rev. Civ. Stat. Ann. art. 6132b-art. 4.01, 5.02(a), 5.03(a)(4); Tex. Bus. Orgs. Code §§ 152.203, 154.001, 152.402(3).

[49] *Id*.

[50] *Id.*

[51] *Marshall v. Marshall*, 735 S.W.2d 587 (Civ. App.–Dallas, 1987, writ ref'd n.r.e.).

[52] *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App.–Fort Worth 1967, writ dism'd); *In re Marriage of Burns*, 573 S.W.2d 555 (Tex. Civ. App.–Texarkana 1978, writ dism'd); *Currie v. Currie*, 518 S.W.2d 386 (Tex. Civ. App.–San Antonio 1974, writ dism'd); *Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. App.–Corpus Christi 1997, no pet.).

[53] *Mercantile National Bank at Dallas v. Wilson*, 279 S.W.2d 650 (Tex. Civ. App.–Dallas 1955, writ ref'd n.r.e.).

[54] *See, on the one hand, In re Marriage of Burns*, 573 S.W.2d 555, 557 (Tex. Civ. App.–Texarkana 1978, writ dism'd); *see also Lemke v. Lemke*, 929 S.W.2d 662, 664 (Tex. App.–Fort Worth 1996, writ denied); *Lipsey v. Lipsey*, 983 S.W.2d 345, 351 (Tex. App.–Fort Worth 1998, no pet.). *See, on the other hand, McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd); *Sullivan v. Skinner*, 66 S.W. 680 (Tex. Civ. App. 1902, writ ref'd); *Hutchinson v. Mitchell*, 39 Tex. 488 (1873); *Shepflin v. Small*, 23 S.W. 432 (Tex. Civ. App.–El Paso 1893, no writ); *In re Marriage of Thurmond*, 888 S.W.2d 269, 272-75 (Tex. App.–Amarillo 1994, no writ); *Wilmington Trust Co. v. United States*, 83-2 USTC (1983); *Taylor v. Taylor*, 680 S.W.2d 645, 649 (Tex. App.–Beaumont 1984, writ ref'd n.r.e.).

[55] For a good discussion of preemption, *see Ex parte Hovermale*, 636 S.W.2d 828, 837 (Tex. App.–San Antonio 1982, orig. proceeding) (Cadena, C.J., dissenting); *see also Ridgway v. Ridgway*, 454 U.S. 46, 102 S.Ct. 49, 70 L.Ed.2d 39 (1981) (provisions of the Serviceman's Group Life Insurance Act of 1965, giving an insured service member the right to freely designate and alter the beneficiaries named under the contract, prevail over and displace a constructive trust for the benefit of the service member's children imposed upon the policy proceeds by a state court divorce decree); *McCarty v. McCarty*, 453 U.S. 210, 101 S.Ct. 2728, 69 L.Ed.2d 589 (1981) (federal law preempted power of state court to divide military retirement benefits in a divorce); *Hisquierdo v. Hisquierdo*, 439 U.S. 572, 99 S.Ct. 802, 59 L.Ed.2d 1 (1979) (federal law preempted power of state court to divide railroad retirement benefits on divorce); *Yiatchos v. Yiatchos*, 376 U.S. 306, 84 S.Ct. 742, 11 L.Ed.2d 724 (1964); *Free v. Bland*, 369 U.S. 663, 82 S.Ct. 1089, 8 L.Ed.2d 180 (1962) (saving bond survivorship provisions in treasury regulations preempted inconsistent Texas community property law); *Wissner v. Wissner*, 338 U.S. 655, 70 S.Ct. 398, 94 L.Ed. 424 (1950) (National Service Life Policy benefits are the sole property of the beneficiary, and are not community property); *McCune v. Essig*, 199 U.S. 382, 26 S.Ct. 78, 50 L.Ed. 237 (1905) (veteran's right, under federal statute, to designate beneficiary of life insurance could not be controlled by state court); *Ex parte Burson*, 615 S.W.2d 192 (Tex. 1981) (Veterans Administration disability payments are not property and cannot be divided upon divorce); *Eichelberger v. Eichelberger*, 582 S.W.2d 395 (Tex. 1979) (railroad retirement preempted); *Perez v. Perez*, 587 S.W.2d 671 (Tex. 1979) (military adjustment benefits held to be separate property due to gratuitous nature under federal statute); *United States v. Stelter*, 567 S.W.2d 797 (Tex. 1978) (ex-Wife could not garnish ex-Husband's retirement pay, under federal statute); *Valdez v. Ramirez*, 574 S.W.2d 748 (Tex. 1978) (joint survivor annuity permitted by Civil Service Retirement Act preempted contrary state law); *Ex parte Johnson*, 591 S.W.2d 453 (Tex. 1979) (federal statute precluded division of V.A. disability benefits upon divorce); *Arrambide v. Arrambide*, 601 S.W.2d 197 (Tex. Civ. App.–El Paso 1980, no writ) (federal law prohibits division of Veterans Administration disability payments upon divorce whew).

[56] Tex. Fam. Code § 3.007(a).

[57] Tex. Fam. Code § 3.007(b).

[58] Tex. Fam. Code § 3.007(c).

[59] Tex. Fam. Code § 3.007(d).

[60] Tex. Fam. Code § 3.008.

[61] Tex. Fam. Code §§ 4.003(a), 4.102, 4.103.

[62] Tex. Fam. Code §§ 4.003(a)(8), (b), 4.102, 4.103