SELECTED CHARACTERIZATION ISSUES

RICHARD R. ORSINGER, *San Antonio*
Orsinger, Nelson, Downing & Anderson, LLP

State Bar of Texas
24TH ANNUAL
NEW FRONTIERS IN MARITAL PROPERTY LAW
October 24-25, 2019
Savannah, GA

CHAPTER 2.5

SELECTED CHARACTERIZATION ISSUES:

1. Advance, Current, and Deferred Compensation
2. Formation, Reorganization, and Sale of Entities
3. Contributions to and Distributions from Entities
4. Retained Earnings
5. Partnership Capital Accounts

Richard R. Orsinger
richard@ondafamilylaw.com
http://www.orsinger.com

New Frontiers in Marital Property Law
October 24-25, 2019
The DeSoto Hotel
Savannah, GA

Table of Contents

SELECTED CHARACTERIZATION ISSUES

by

Richard R. Orsinger
Board Certified in Family Law
& Civil Appellate Law by the
Texas Board of Legal Specialization

I. INTRODUCTION. Texas law is not fully developed on how to characterize compensation for services rendered by a spouse. And there is only spotty guidance in appellate case law about how business entities mesh with marital property law. The case law and statutory framework for dealing with compensation and business entities is incomplete, so advanced practitioners may sometimes have to rely on well-informed judgment instead of "following the law" in handling these kinds of cases.

II. DEFINING COMPENSATION. As used in this Article, "compensation" means earnings from employment.

A. DEFINITIONS. One perspective on compensation is the term "personal service income."

1. Personal Service Income. Personal service income is described in IRS Publication 570 (3-6-2019) in this way:

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

<https://www.irs.gov/publications/p570#en_US_2018_publink1000221205>.

2. Earned Income. The IRS has another concept that applies to owners of sole proprietorships and partnerships, called "earned income." Earned income consists of "net earnings from self-employment" which is "your gross income from your trade or business (provided your personal services are a material income-producing factor) minus allowable business deductions." <https://www.irs.gov/publications/p560#en_US_2018_publink10008810>. Earned income is probably synonymous with the second sentence in the definition of personal service income given above. Be that as it may, in this Article "compensation" includes both personal service income and earned income.

3. Wages, Salary and Bonuses. Current income for services rendered by an employee is normally paid as wages, salary, tips, and bonuses. The employer is supposed to issue a Form W-2, setting out the income and the employee is supposed to report such income on Line 7 of the IRS Form 1040 Personal Tax Return (for 2018 & 2019, it is line 1). Under Texas law, such income earned during marriage is community property.

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

III. CHARACTERIZING COMPENSATION. Compensation can be paid in advance, current, or deferred. Compensation is paid in advance if it is paid before the work is done. Current compensation is paid at the end of a pay-period, with no delay. Compensation is deferred if payment for work done is delayed past the end of the pay period. When compensation is paid in advance or is deferred, marital property disputes can arise. This Article suggests that there are three approaches to characterizing advance or delayed compensation: (i) the inception-of-title approach (with or without offsetting reimbursement); (ii) the time-allocation approach; and (iii) the valuation-on-date-of-divorce approach. The three approaches could be called the *Boden*, *Taggart*, and the *Berry* approaches, based on the 1-2is not mentioned in the statue, so the proper characterization of those forms of compensation is a matter of common law or common sense. It should be noted that several other states have charged their trial courts with the duty to evaluate whether deferred compensation (i.e., stock options and restricted stock) was awarded for past services or future services. (The same approach could be taken to advance compensation.) This effort to determine the employer's intent is different from Texas' approach to the problem of characterizing advance and deferred compensation.

A. HOW IS COMPENSATION THAT IS PAID IN ADVANCE CHARACTERIZED? Sometimes an agreement provides that compensation for work will be paid in advance. If performance will take an extended period of time, and a divorce occurs, an issue arises as to the character of funds received during marriage for work to be done after the divorce. Sometimes an employee is paid a "signing bonus" for agreeing to come to work. This happens in the world of high finance, computer science, and professional athletes. If the signing bonus is received during marriage, but is contingent upon continued employment after the divorce, is the signing bonus entirely community property or entirely separate property or is it to be pro-rated between community and separate property according to the number of months of employment during marriage vs. the number of months after divorce? In *Loaiza v. Loaiza*, 130 S.W.3d 894 (Tex. App.--Fort Worth 2004, no pet.), the spouse-athlete received such a signing bonus about a year before divorce. Unfortunately for us, no contention was raised that the signing bonus should be prorated between separate and community property.

An article by two Texas lawyers from the Journal of the American Academy of Matrimonial Lawyers presented this analysis of the issue:

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

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

Katherine A. Kinser & R. Scott Downing, *Family Law Issues That Impact the Professional Athlete*, 15 J. AM. ACAD. MATRIM. LAW. 337, 345-47 (1998) <http://nc.aaml.org/sites/default/files/family%20law%20issues%20vol%2015-2.pdf>. The authors note possible complications if the bonus can be forfeited at a later time. *Id.* at 347.

Alaska – In *Lewis v. Lewis*, 785 P.2d 550, 555-56 (Alaska 1990), the Supreme Court of Alaska rejected a wife's claim that the husband's employment agreement gave the marital estate an interest in his post-divorce earnings. The court wrote: "Jeanne cites no authority from this or any other jurisdiction which recognizes employment contracts as marital property subject to division upon divorce. While it is possible that an employment contract may have a deferred earning component which should be recognized as marital property, there is no indication that Steve's contract contained such a feature. We conclude that the trial court did not abuse its discretion on this issue and therefore affirm the trial court's determination."

California – In *Finby v. Finby*, 222 Cal.App.4th 977, 166 Cal. Rptr.3d 305 (Cal. App. 2013), a front-end signing bonus was paid to a wife who was a money manager, in the form of a $2.8 million loan that did not have to be repaid if she remained with her new employer for 112 months. *Id.* at 980. The note was forgiven at the rate of $27,687.54 per month, which amount was treated as taxable income. If the wife left employment, the balance of the loan came due. If her profitability declined, the monthly bonus credit could be reduced. The appellate court held that the bonus represented compensation for wife's book of business that she built up during marriage, and was entirely community property. *Id* at 988-89.

Colorado – In *In re Marriage of Anderson*, 811 P.2d 419, 420 (Colo. App.1990), the court considered an NBA contract with the Portland Trailblazers, providing for employment over a three-year period with three annual payments totaling $1.5 million. "[T]he contract guaranteed payment: (1) if he died; (2) if he sustained injury during an NBA game or an official practice session; (3) if he had a mental breakdown or disability; (4) if he was terminated for lack of skill; or (5) if he were traded or waived by the team. Payment was not guaranteed if he sustained a physical disability from an injury unrelated to an NBA game or practice, or if he failed to pass a physical exam at the beginning of each season." *Id.* at 420. The appellate court rejected the wife's claim that the entire contract was marital property. Instead it held that the payment for the first season, which had already been paid, was cash on hand and therefore marital property. The payments for the second and third season were held to be non-marital property. *Id.* at 420. In *In re Marriage of Sewell*, 817 P.2d 594, 596 (Colo. App. 1991), the Court of Appeals characterized its holding in *Anderson* as being "that compensation which is either received or fully earned during a marriage is marital property subject to equitable distribution." *Id.* at 596. It went on to reverse the trial court's division of earnings under an NFL contract and remand in light of the holding in *Anderson*. There is little analysis in the case, but it is possible to tell that the trial court awarded wife an interest in husband's entire 1989-90 season, including a bonus for post-season games, and the court of appeals reversed the award of earnings attributable to the last regular season game, which was played four days after the divorce, and post-season games.

Florida – In *Reiss v. Reiss*, 654 So.2d 268 (Fla. App. 1995), a signing bonus paid to the husband after the marital property cut-off-date was held to be marital property. The dissent argued that the evidence showed that the bonus was not a replacement of benefits earned during the prior employment. To the extent that the bonus was for the husband's book of business, the dissent said that it was personal goodwill that was not marital property.

Michigan – In *Skelly v. Skelly*, 286 Mich. App. 578, 780 N.W.2d 368 (Mich. App. 2009), the appellate court held that a retention bonus was not marital property, despite the fact that two installments of that bonus had been advanced to the spouse as a loan that had to be paid back if he left the company before a certain date that was after the divorce. (The appellate court also reversed the trial court for awarding "future bonuses" to the non-employee spouse.)

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

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

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

Of interest is *Smith v. Smith*, No. CA99-279, 199 WL 1096122 (Ark. App. Dec. 1. 1999), which held that a spouse's unused accrued vacation time would, if taken in the form of cash, be martial property.

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

1. Tax-Sheltered Accounts. A tax-sheltered account is not necessarily deferred compensation. For example, an IRA and a 401(k) Plan are tax-sheltered, but they are not deferred retirement plans. They are simply money owned by the individual but held in an account where income tax is deferred until the money is withdrawn from the account. Accordingly, the marital property character of assets in the account are governed by the same rules as other bank and savings accounts or brokerage accounts. (An interesting case is *Brown v. Brown*, 236 S.W.3d 343 (Tex. App.–Houston [1st Dist.] 2007, no pet.), where the divorce decree awarded wife the "401(k) plan in the amount of $136,000"; but the account actually contained approximately $ 177,000; on appeal from a post-divorce suit to divide undivided property, the appellate court held that the decree was ambiguous and subject to interpretation by the trial court).

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

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

a. *Taggart* Time-Allocation. Under *Taggart v. Taggart*, 552 S.W.2d 422 (Tex. 1977), defined benefit pension plan benefits are characterized based on pure time-allocation alone. The community property interest in each pension payment is a fraction, in which the number of months that the pension benefit accrued during marriage is divided by the total number of months the pension benefit accrued overall. However, when the spouse will continue to accrue more pension benefit after divorce, it is necessary to do a "*Berry* valuation", which requires a different denominator for the fraction. See Section III.C.3.b below.

CAUTION: Many old cases, including *Taggart*, say that the denominator of the fraction is the total number of months worked. That is correct when pension benefits accrued over an employee's entire period of employment, like military retirement. That is not the correct approach for most private plans, which vest by a certain ate (like ten years) even if employment continues. The denominator should cover the period of time when an employee is accruing a benefit. That may be shorter than the period of employment.

In *Van Den Berg v. Van Den Berg*, 49 So. 3d 283, 285 (Fla. App. 2010), approved the use of a *Taggart*-like formula which the court called the "coverture fraction." The court also wrote that "if determining the present value is too speculative, a trial court should make an award of a portion of future payments when and if received."

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

See Trant v. Trant, 545 So. 428 (Fla. App. 1989), identified two types of division: "immediate offset" by awarding the pension to one spouse and offsetting property to the other; and the "deferred distribution method," where the court determines what the retirement benefit would be if the spouse retired on the date of divorce without an early retirement penalty, and then multiplies that dollar amount time the non-employee spouse's ownership percentage, thus fixing a dollar figure to be awarded out of each future payment.

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

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

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

Other states have articulated different approaches.

Arkansas – In *Richardson v. Richardson*, 280 Ark. 498, 659 S.W.2d 510 (1983), the Supreme Court of Arkansas without analysis held that stock options obtained during marriage are marital property that can be divided upon divorce. The appellate court affirmed the trial court’s valuing the options at market price minus strike price, and awarding the other spouse half of that figure. Two Justices dissented on this point. In *Nauman v. Nauman*, 2018 Ark. App. 114, 542 S.W.3d 212 (Ark. App. 2018), the appellate court held that the portion of nonvested stock options attributable to work performed during marriage were marital property, notwithstanding the fact that they were subject to the employer's ability to amend, modify, defer, claw back, or terminate the options, and notwithstanding the fact that, as to some options, the husband had to continue to work at the company after divorce. The appellate court noted that the options were payable to the husband’s estate upon death, and payable to him upon disability. *Id*. at 223. The trial court awarded the options as follows: wife to receive 80% of the first tranche exercisable during marriage 40% of the second tranche, execisable the year after the divorce; and zero % of the third tranche, exercisable two years after the divorce. The appellate court affirmed, but neither court explained how the split was determined.

California – In *In re Marriage of Hug*, 154 Cal. App.3d 780, 201 Cal. Rptr. 676 (1984), the court recognized that stock options can be characterized as compensation for past, present or future services, depending on the circumstances involved in the grant of the particular option. The court adopted a time rule for apportioning unvested stock options between community and separate property. The community property portion was determined by "a fraction in which the numerator is the period in months between the commencement of ... employment ... and the date of separation of the parties, and the denominator is the period in months between commencement of the employment and the date when each option is first exercisable, multiplied by the number of shares which can be purchased on the date the option is first exercisable." *Id.* at 782. The remaining options are the separate property of the employee spouse. *Id.* at 782-83.

Colorado – In *In re Marriage of Miller,* 915 P.2d 1314 (Colo. 1996), the Supreme Court of Colorado considered both unvested stock options and restricted stock. The options vested in tranches on the first, second, third and fourth anniversaries of the grant. The options were forfeited upon termination of employment other than for age or permanent disability, or at the end of 10 years, whichever occurs first. They could also terminate upon death. The restricted stock became free of restriction and freely sellable at the end of five years. The trial court found that both the options and the restricted stock were granted as consideration of both past and future services, and applied a marital fraction (the period of vesting during marriage divided by the entire vesting period). The Supreme Court held that the options were potentially marital property because they were not a mere expectancy since they were *not conditional* (i.e., the employer could not repudiate the options, even though vesting required both the passage of time and continuing employment). The options were marital or non-marital depending on whether the option was "granted in consideration of past services ... or granted in consideration of future services." The Supreme Court remanded the case to the trial court "to determine, with respect to each option, what portion was granted in consideration of past services and what portion was granted in consideration of future services. Upon making that determination, the trial court should then determine an appropriate means of evaluating those portions of the stock options that reflect compensation for future services. The portions of the stock options granted in consideration of past services may, as we have indicated, constitute marital property in their entirety." The Supreme Court thus recognized that different awards might have different reasons, and rejected rigidly applying a marriage fraction to all options unvested at the time of divorce. The Supreme Court held that all of the restricted stock was marital property because the award was unconditional, and the stock was received during marriage and husband started receiving dividends on the stock. The Court revisited the question in *In re Balanson*, 25 P.3d 28, 32 (Colo. 2001), The Court explained that vesting was not the test for marital property. The Court said: "In determining whether one has an enforceable right to employee stock options, a court must look to the terms of the contract granting such options. If an employee has a presently enforceable right under the contract, regardless of whether the options are presently exercisable, such a right constitutes a property interest rather than a mere expectancy." *Id* at 39. The Court goes on to explain:

> For example, if the contract granting the options indicates that they were granted in exchange for present or past services, in the situation for instance, where an employer offers stock options as a form of incentive compensation for joining a company, the employee, by having accepted employment, has earned a contractually enforceable right to those options when granted, even if the options are not yet exercisable.[4] *See Miller*, 915 P.2d at 1318–19. On the other hand, if the options were granted in consideration for future services, the employee "does not have enforceable rights under the option agreement until such time as the future services have been performed." Id. at 1318.

Id. at 39-40. The Court's distinction between vesting and performing services sufficient to earn a contractual right is elusive, if the options require continued employment until the vesting date, so that vesting and performing services that give rise to a contractual right are the same thing. *Balanson* had the effect of overturning *Marriage of Huston*, 967 P.2d 181 (Colo. App. 1998), which held that nonvested options were not marital property.

Connecticut -- In *Bornemann v. Bornemann*, 245 Conn. 508, 752 A.2d 978, 985-86 n. 4 (1998), the Connecticut Supreme Court held that unvested stock options granted during marriage are martial property to be divided upon divorce. The Opinion lists in note 4 on pp. 985-86 many other jurisdiction so holding. *Hopfer v. Hopfer*, 757 A.2d. 673, 677 (Conn. App. 2001), held that stock options granted entirely as an incentive for future services were not marital property.

Illinois – In *In re Marriage of Frederick*, 218 Ill.App.3d 533, 540-42, 161 Ill. Dec. 254, 578 N.E.2d 612 (1991), the court held that unvested stock options partially earned during marriage were marital property and could be divided according to the marital fraction, if, as, and when received. In *In re Marriage of Moody*, 119 Ill. App.3d 1043, 1048, 75 Ill. Dec. 581, 457 N.E.2d 1023 (1983), the court held that unvested employee stock options that were subject to various contingencies including continue employment could not be valued based on the NYSE stock value on the date of divorce. The case was remanded for the court to retain jurisdiction to divide the options when they were exercised.. *See Marriage of Little*, 25 N.E.3d 685 (Ill. App. 2014), where an allegation that a company was created during marriage with marital assets and efforts by the wife, who was to receive a 40% interest in the company after the divorce, stated a claim for marital property that would sustain a petition to vacate a marital settlement agreement.

Indiana – In *Hann v. Hann*, 655 N.E.2d 566 (Ind. App. 1995), the court wrote:

> Daniel's 1993 Stock Option is not a presently vested property interest subject to distribution as a divisible marital asset. Daniel was granted the stock options as a benefit of his employment with Biomet, and any future value to be realized by the exercise of these options (when and if they become exercisable) is wholly contingent upon Daniel's continued employment with Biomet. If Daniel terminates his employment with Biomet prior to the date the stock options become exercisable, he has no right under the Stock Option Plan to exercise that option. As such, the stock options not exercisable as of the date of separation, and which will become exercisable at a particular date in the future conditioned upon Daniel's continued employment, are not subject to division as marital property.

Maryland – In *Green v Green*, 64 Md App 122, 494 A.2d 721 (Md. App. 1997), the appellate court held that stock options awarded during marriage were marital property divisible upon divorce. The appellate court said that, although the options were not marketable, they nonetheless had value. Options represent the right to choose whether or not to purchase shares on certain dates at specified prices. But the court could not compel the employed spouse to exercise options, "since to do so would in effect deprive him of the essence of his property interest; i.e., the right to make a choice regarding the exercise of the options." The appellate court blessed the if, as, and when approach.

Michigan–In *Byington v. Byington*, 224 Mich. App. 103, 568 N.W.2d 141 (1997), a compensation package including bonus, incentives, and "phantom stock" plan, earned after dissolution action was filed but before divorce was final, was marital property. The court held that assets earned by a spouse during marriage are marital property, "whether the assets are received during the existence of the marriage or after the judgment of divorce. *Id.* at 568 N.W.2d 141. In *Skelly v. Skelly*, 286 Mich. App. 578, 780 N.W.2d 368 (Mich. App. 2009), the appellate court held that a retention bonus was not marital property, despite the fact that two installments of that bonus had been advanced to the spouse as a loan that had to be paid back if he left the company before a certain date that post-dated the divorce. The appellate court also reversed the trial court for awarding "future bonuses" to the non-employee spouse. *See Finby v. Finby*, 222 Cal. App.4th 977, 166 Cal. Rptr.3d 305 (2013), in which a front-end bonus was paid as a loan to the employee.

Minnesota – In *Salstrom v. Salstrom*, 404 N.W.2d 848 (Minn. App. 1987), the court held that a "time rule" like the one used in *Hug v. Hug* should be "as a starting point for its determination. Modifications of the rule may be warranted, especially because in Minnesota property is marital until the date of dissolution while in California property is considered community only until the parties separate.... *Hug* also stresses that the time rule is not inflexible and can be modified depending upon the particular facts of the case, including the different purposes to be served by the stock options."

New Jersey – In *Pascale v. Pascale*, 140 N.J. 583, 660 A.2d 485 (1995), the court said "stock options awarded after the marriage has terminated but obtained as a result of efforts expended during the marriage should be subject to equitable distribution." The lower courts held that half of the options granted upon the wife's promotion shortly after marital separation were attributable to past labors and half to future labors, the first being marital and the second being non-marital property. However, "the trial court made a credible finding after listening to many days of testimony that that promotion came about as a result of the excellent service that she had provided to the company during her marriage." For this reason, all the options in question were a reward for work done during marriage, and thus were marital property.

New Mexico – In *Garcia v Mayer*, 122 N.M. 57, 920 P.2d 522, 525-26 (N.M. App. 1996), the appellate court considered stock options that vested the day after divorce, as a result of the company unexpectedly signing a merger agreement. The appellate court held that "the community had an interest in the unvested options to the extent that the ultimate vested rights were earned by Husband's labor during marriage." The court went on:

> There is no a priori reason to treat all options the same. The purpose of awarding options to employees may differ from company to company and may even change from time to time within a single company. "[N]o single characterization can be given to employee stock options. Whether they can be characterized as compensation for future services, for past services, or for both, depends upon the circumstances involved in the grant of the employee stock option." *Hug*, 201 Cal. Rptr. at 681. Consequently, "[N]o single rule or formula is applicable to every dissolution case involving employee stock options. Trial courts should be vested with broad discretion to fashion approaches which will achieve the most equitable results under the facts of each case." *Id.* at 685.

The case presents the unusual question of what you do with a time allocation when the denominator turns out to be much shorter than the option agreement or plan assumes.

New York – In *DeJesus v. DeJesus*, 90 N.Y.2d 643, 687 N.E.2d 1319, 665 N.Y.S.2d 36 (1997), New York's highest court considered restricted stock and stock options. The court decided to adopt the approach articulated in the Colorado case of *In re Marriage of Miller*, described above. In the present case, there was no evidence about why the options or restricted stock were granted, so the case was remanded to determine the motive. The court then explained:

> The Trial Judge thus must first determine, based on competent evidence, whether and to what extent the stock plans were granted as compensation for the employee's past services or as incentive for the employee's future services. We recognize, as have other courts, that any list of pertinent considerations could only be illustrative and not exhaustive (*see*, *e.g.*, *In re Marriage of Miller*, 915 P2d 1314, 1319, n. 9, supra). However, relevant factors would include whether the stock plans are offered as a bonus or as an alternative to fixed salary, whether the value or quantity of the employee's shares is tied to future performance and whether the plan is being used to attract key personnel from other companies.
>
> To portions of the stock plans found to be compensation for past services, a time rule should be applied to factor out any value which may be traceable to the period before the marriage, where the numerator is the time from the later of the beginning of the titled spouse's employment with the issuing company, or the beginning of the marriage, until the date of the grant, and the denominator is the time from the beginning of the titled spouse's employment until the date of the grant. To portions found to be granted as incentive, a second time rule should be applied to determine the marital share, that is, accretions from the time of the grant until the matrimonial action was commenced, and any further accumulations attributable to the contributions of the nontitled spouse. Here, the numerator is the period of time from the date of the grant until the end of the marriage, which is the earlier of the date of the separation agreement or the commencement of the matrimonial action and the denominator.

North Carolina – In *Hall v. Hall*, 88 N.C. App. 297, 363 S.E.2d 189 (1987), the appellate court held that vested stock options were divisible, but unvested stock options were not.

Oklahoma – In *Ettinger v. Ettinger*, 637 P.2d 63 (Okla. 1981), the divorce decree awarded to wife a "one-half interest in all stock options that defendant (Appellee) now has or may have ...." The Supreme Court of Oklahoma held that the award of stock options that were not in existence at the time of divorce was erroneous. In *Duty v. Duty*, 162 P.3d 939 (Okl. App. 2007), the appellate court held that unvested options granted to a spouse during marriage are marital property.

Pennsylvania – In *MacAleer v. MacAleer*, 725 A.2d 829, 833 (Pa. Super. Ct. 2001), the court rejected a "per se" rule based on either the date the options were granted or the date they vested, and elected instead to characterize options based on when they are "earned." This requires a case-specific analysis of whether the options were compensation for past services or incentives for future services. *Id*. at 833. The court said:

> "Continued employment is merely a contingency to be met before the right to exercise any such option matures." *Id*. at 833.

South Carolina – In *Shorb v. Shorb*, 643 S.E.2d 124, 128 (S.C. App. 2007), the court said: "Most jurisdictions determine the nature of stock options by whether the options are compensation for past services or are incentive for future services." The Court ignored vesting and ruled that options are marital property if granted during marriage.

Washington – In *In re Marriage of Short*, 125 Wash. 2d 865, 890 P.2d 12 (1995), the Washington Supreme Court held that Microsoft stock options received during marriage that were vested when granted were community property. Options granted during marriage for services during marriage are community property, regardless of when they vest. Unvested options that are granted partly for services during marriage and partly for services after divorce are to be time-allocated. However, the time allocation is to be applied only to the first tranche of options to vest after the divorce. All options that subsequently vest are separate property.

West Virginia – In *Kapfer v. Kapfer*, 187 W. Va. 396, 419 S.E.2d 464, 468 (1992), the court held that employee stock options received during marriage were community property even thought they were subject to forfeiture upon termination of employment and the value was dependent on market price. Additionally, the appellate court reversed the trial court for allowing the husband to select which stock he would keep and which stock would go to the wife. The appellate court said that the trial court should determine the tax basis and tax consequences of the division.

Wisconsin – In *Chen v. Chen*, 416 N.W.2d 661 (Wisc. App. 1987), the appellate court approved the use of the "time-rule" formula suggested in *Hug v. Hug*, but left the trial court with discretion whether or not to apply the formula in a particular case. Thus the trial court's decision to divide all vested and unvested stock options was affirmed. In *Wikel v. Wikel*, 168 Wis.2d 278, 483 N.W.2d 292 (Wisc. App. 1992), the appellate court affirmed, without analysis, the trial court's ruling that only shares that had vested by the first day of trial were divisible marital property.

Additional reading – David S. Rosettenstein, Professor of Law, Quinnipiac University School of Law, *Options on Divorce: Taxation, Compensation Accountability, and the Need to Look For Holistic Solutions*, 37 FAMILY LAW QUARTERLY 203 (2003); David S. Rosettenstein, *Exploring the Use of the Time Rule in the Distribution of Stock Options on Divorce*, 35 FAMILY LAW QUARTERLY 263 (2001); Joseph W. McKnight, Professor of Law, Southern Methodist University, *Defining Property Subject to Division at Divorce*, 23 FAMILY LAW QUARTERLY 193 (1989-90).

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

Hypothetical:

<u>The Plans</u>–Husband received two option grants on January 1 of Year 1. Option Plan No. 1 gives husband an option right to acquire 300 shares of the company's stock. But the husband must be employed at the company for 3 years after the grant date, in order for the options to vest, and they all vest on the last day. Option Plan No. 2 gives husband an option right to acquire 300 shares of the company's stock, with the option for the first 100 shares vesting at the end of one year, the option for another 100 shares vesting at the end of two years, and the option for the last 100 shares vesting at the end of three years.

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

<u>The Calculation</u>

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

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

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

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

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

Compare with Marriage of Steffan, 423 N.W.2d 729 (Minn. App. 1988) (bonus expected to be received five months after divorce was marital property).

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

b. Discretionary Bonuses. Some employers compensate employees through a bonus. In many (if not most) instances, the declaration of a bonus is discretionary with employer. *See Lewis v. Vitol*, No. 01-05-00367-CV (Tex. App.--Houston [1st Dist.] June 28, 2006, no pet.) (memo op.) (thus bonus was discretionary and employee could not sue employer for not paying bonus). The issue of whether a discretionary annual bonus, paid pursuant to a written or established bonus plan, but actually declared after divorce, could contain a component of community property if the bonus was awarded for work done during the year of divorce, arose in *Loya v. Loya*, 473 S.W.3d 362 (Tex. App.--Houston [14th Dist.] 2015), *rev'd on other grounds*, 526 S.W.3d 448 (Tex.). In *Loya*, the Fourteenth Court of Appeals reversed a summary judgment dismissing an ex-wife's post-divorce suit claiming a community property interest in the bonus, saying that the ex-wife was entitled to a trial in which to prove whether any of the bonus paid to the ex-husband after the divorce constituted community property compensation for work done during marriage. *Loya*, 473 S.W.3d at 369. The court relied upon its earlier decision in *Sprague v. Sprague*, 363 S.W.3d 788, 801-02 (Tex. App.--Houston [14th Dist.] 2012, pet. denied), where the court had ruled that a bonus awarded during a marriage for work performed at least partially before the marriage could be established as a spouse's separate property. In the *Loya* appeal to the Supreme Court, the parties briefed and argued whether a bonus declared and paid after divorce could be community property to the extent it compensated work done during marriage. However, the Supreme Court's Opinion avoided the question, by ruling that the bonus had been partitioned to the husband in the MSA under a clause setting aside to each spouse "future earnings." So the law now stands that the Fourteenth Court of Appeals ruled that a post-divorce bonus can be community property, but that opinion was reversed on other grounds. The Supreme Court briefing in the *Loya* case is available on-line for anyone wishing to raise the issue in another case. http://www.search.txcourts.gov/Case.aspx?cn=15-0763&coa=cossup. A video of the oral argument is at http://www.texasbarcle.com/CLE/SCPlayer.asp?sCaseNo=15-0763. Other states have addressed the issue:

Arkansas – In *Wilson v. Wilson*, 294 Ark. 194, 741 S.W.2d 640 (1987), the Arkansas Supreme Court held that a bonus awarded five days after divorce was marital property, because the husband was entitled to the bonus under a set formula and the bonus was an award for services in the past. In *Schumacher v. Schumacher*, 986 S.W.2d 883 (Ark. App. 1999), the court held that a bonus for work done during the marriage to be paid after divorce was divisible, even though the amount of the bonus had not been determined at the time of divorce.

Alaska – In *Lewis v. Lewis*, 785 P.2d 550 , 555-56 (Alaska 1990), the Alaska Supreme Court held that stock to be given to employee spouse after the employer had 18 consecutive profitable months was marital property, even though the shares had not been issued by the time of divorce. The court analogized to an nonvested pension. The court rejected the husband's claim that the award related to his professional education and experience, saying "there is a *bright line* demarcation that all property acquired during marriage is marital property. This relieves the court of the complex task of analyzing the multitude of events and experiences which could be said to contribute to earnings received during the marriage. This is not to say that earnings accrued before marriage, but paid during marriage should be counted as marital property. That situation, however, is not present here."

California – In *Finby v. Finby*, 222 Cal. App.4th 977, 166 Cal. Rptr.3d 305 (2013), the appellate court determined that a bonus is partially community property if it is awarded during marriage even if paid after the date of separation (California cuts off the community estate upon separation). In this instance, "the contractual right to receive each bonus and at least some of the effort necessary to qualify for them occurred before the couple separated." *Id.* at 990.

Colorado – In *In re Marriage of Huston*, 967 P.2d 181 (Colo. Ct. App. 1998), the court held that a bonus earned during the marriage was marital property, even though the amount of the bonus had not been determined by the time of divorce.

Florida – In *Burns v. Burns*, 687 So. 2d 933 (Fla. 2d Dist. Ct. App. 1997), the court held that a bonus for past efforts received after date of classification was marital property. In *Reiss v. Reiss*, 654 So. 2d 268 (Fla. 1st Dist. Ct. App. 1995), the court held that an employment bonus received after marital property cut-off-date was compensation for marital efforts, and thus marital property.

Illinois – In *Marriage of Peters*, 326 Ill. App.3d 364, 760 N.E.2d 586 (Ill. App. 2001), the appellate court held that a bonus with a 10-year vesting period, about half of which was worked during marriage, had a component of marital property. The appellate court remanded the case for the trial court to "reserve jurisdiction" to divide the bonus if and when it was paid out. In *Marriage of Wendt*, 374 Ill. Dec. 300, 996 N.E.2d 439 (Ill. App. 2013), the appellate court said that a discretionary bonus not awarded by the time of divorce was not marital property. The appellate court noted that the husband had no employment agreement, and was an employee at will. Additionally, the bonus was discretionary, and was based on factors some of which were related to his performance and some not. The bonus would not be determined until five months after divorce.

Michigan – In *Byington v. Byington*, 224 Mich. App. 103, 568 N.W.2d 141 (1997), the court held that a compensation package contracted for during marriage was marital property, even though it contained bonuses and incentives that would be triggered only upon specified future events.

Mississippi – In *Pittman v. Pittman,* 791 So. 2d 857 (Miss. Ct. App. 2001), where the husband received a 5% interest in business for working in business without pay during the year in which the date of classification occurred, the 5% interest was marital property to extent that work was by the husband was performed before date of classification.

Nebraska – In *Myhra v. Myhra*, 16 Neb. App. 920, 756 N.W.2d 528 (Neb. App. 2008), the wife rested her case in the divorce trial, but nine months later moved to reopen the evidence upon discovery of an undisclosed bonus. The trial court allowed her to reopen, which meant that the bonus occurred before the trial ended. The appellate court held that a merger bonus that vested before the conclusion of the divorce trial was divisible marital property.

New York – In *Hartog v. Hartog*, 85 N.Y.2d 36, 647 N.E.2d 749, 623 N.Y.S.2d 537 (1995), New York's highest court held that a bonus received during marriage but after separation was marital property.

Ohio – In *Kaechele v. Kaechele*, 35 Ohio St. 3d 93 (Ohio 1988), the Supreme Court of Ohio considered a complaint that a bonus was improperly excluded from consideration in dividing property and setting alimony. The bonus was a fixed amount to be paid in six annual installments over a period of six years, and was contingent on continued employment. The case was remanded for the trial court to say whether it was or was not reserving jurisdiction to consider dividing the bonus when it was paid.

South Carolina – In *Lineberger v. Lineberger*, 303 S.C. 248, 399 S.E.2d 786 (Ct. App. 1990), the court rejected the claim that a bonus received after separation was separate property, where the bonus was based on performance during the marriage. The court drew an analogy to the case law on pensions.

Virginia – In *Joynes v. Payne*, 36 Va. App. 401, 551 S.E.2d 10 (Va. App. 2001), the court held that a bonus received for work done during marriage was marital property, even thought the husband had to work one month past the cut-off date of separation in order to receive the bonus.

c. Delayed Payments Based on Performance. Texas Family Code Section 3.007(d) applies only to stock options and restricted stock. A number of highly-compensated employees are given deferred compensation that is dependent on economic performance of the business but is not in the form of options or restricted stock. These include performance-related bonuses, performance units, stock appreciation rights, and phantom stock, to name a few. Some publicly-traded corporations peg the benefit to the increase in price of the company's stock. Performance units might be measured against a benchmark that involves profitability, or might be measured against the performance of competing companies in the same industry. Generally they all require that the employee continue to be employed by the company up to the time the benefit matures or vests. Sometimes you can say that the individual's performance influenced the outcome, but in some organizations there may be too many employees to tie the outcome to the spouse's individual labors, or the spouse may not be high up enough on the executive ladder to claim credit for how the company performs.

d. Is a *Berry* Valuation Appropriate? The values of stock options and restricted stock and phantom stock and stock appreciation rights are derivative of the underlying value of the company's stock. If the court wants to value unvested share-price-related benefits, as of the date of divorce, you cannot use the current market price because the options on restricted stock cannot be liquidated. If you want to use the date when the options are exercisable or the restricted stock can be sold or the units converted to cash, who can predict the value of a company's stock 1 year, or 2 years, or 3 years in the future? Should you use the Black-Scholes Method (designed for short-term European options traded on an open market), or the binomial or "lattice" binomial method, or should you gut open a goose and read the entrails? The problem is even worse for performance awards that are based on meeting profitability targets, etc.

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

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

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

property interest will be extinguished. Any post-divorce increases or decreases in the value of these stock options that are not attributable to Randall's post-divorce work will not be his separate property. Ginger will be entitled to 50% of the increases, and the contingent value of her interest will be reduced by any decreases. Ginger will not be entitled to any post-divorce increases in the value of these stock options that are attributable to Randall's post-divorce work for the company because these post-divorce increases will be his separate property. However, the divorce decree does not contain any language purporting to give Ginger an interest in these latter post-divorce increases. Therefore, the trial court's division of the contingent value of the stock options was not an abuse of discretion. We overrule point nine.

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

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

For courts wondering where to go on this issue: a time-allocation approach, whether under Section 3.007(d) or otherwise, although arbitrary and crude, leads to a simple answer that approximates rough justice at a low cost.

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

1. Bonus. The problem of the post-divorce bonus is discussed in Section III.C.5.a above.

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

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

In *Chambers v. Chambers*, 840 P.2d 841, 844-45 (Utah App. 1992), the court held that future income under a professional basketball employment agreement with the Phoenix Suns was not marital property to be divided in a divorce. The court wrote: "Mr. Chambers's future income will be derived from his playing basketball during the term of his contract, rather than from some past effort or a product produced during the marriage. Furthermore, his right to the benefit of that salary will accrue at that time, and did not accrue during the course of the marriage. This is especially true in light of the fact that the contract payments will only be made provided that Mr. Chambers does not suffer injury, illness, disability or death as a result of participation or involvement in any one of a number of off-court activities. Thus, the trial court correctly determined that Mr. Chambers's future contract payments were post-marital income and not marital property rights subject to division."

In *Marriage of Johnson*, 576 P.2d 188, 190 (Colo. App. 1978), the appellate court held that husband's real estate broker commissions on two contracts of sale outstanding at the time of divorce were marital property to be divided in the divorce. The reason was that "husband's rights to the commissions arose prior to the date of the hearing ...."

A case of interest in this area with little guiding authority is *Gastineau v. Gastineau*, 151 Misc.2d 813 (New York Sup. Ct. 191), where the husband (the once famous Mark Gastineau), who was leading the National Football League in quarterback sacks, walked away from his contract with the New York Jets, he said because of concern that his girlfriend (actress Brigitte Nielsen) was diagnosed with uterine cancer. Under his NFL contract, Gastineau was to be paid $48,437 per game. He played six games in the 1988 seasons, and failed to show for the remaining ten games. The divorce court calculated the loss to the marital estate of $484,437, which it netted downward for tax at a 33% rate. The sum was included in the marital estate which was awarded 1/3 to the husband, 2/3 to the wife.

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

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

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

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

Austin v. Austin, 619 S.W.2d 290, 291-92 (Tex. Civ. App.--Austin 1981, no writ): '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." This case focuses on the part of *Nail* that described goodwill as not possessing value or constituting an asset separate and apart from the individual. Another part of the *Nail* rationale was that personal goodwill has value dependent on the continuation of existing circumstances. One existing circumstance that affects the value of personal goodwill to a great degree is *the spouse's continuing to work*. Compensation for work done after the divorce is separate property. So an alternative approach in the *Austin* case would be to determine whether the goodwill included in the purchase price was enterprise goodwill or personal goodwill. If enterprise goodwill, then the price paid for goodwill would be community property (where the business is community property; if the business were separate property, the price paid for enterprise goodwill would be separate property). If in *Austin* the price paid for goodwill included personal goodwill (such as through the continued use of the seller's name or image, or through a contractual requirement to remain with the business or assist in generating referrals, etc.), that personal goodwill would need to be allocated to the portion related to the fruits of personal goodwill during marriage and the portion related to the fruits of personal goodwill after divorce. Remember the Supreme Court in *Nail* said: "We are not concerned with goodwill as an asset incident to the sale of a professional practice...."

4. Book of Business. Some non-Texas cases have considered whether a spouse's "book of business," or payments received for a book of business, are marital property. In *Finby v. Finby*, 222 Cal. App.4th 977, 166 Cal. Rptr.3d 305 (Cal. App. 2013), a front-end signing bonus was paid by a brokerage company to the wife who was coming to the new brokerage company, and hopefully bringing along her established clients. The appellate court held that the bonus represented compensation for wife's book of business that she had built up during marriage, and was entirely community property. *Id*. at 988-89. In *Reiss v. Reiss*, 654 So.2d 268 (Fla. App. 1995), a signing bonus paid to the husband after the marital property cut-off-date was held to be marital property. The dissent said that the bonus was not a replacement of benefits earned during the prior employment, but was instead compensation for the husband's book of business. The dissent said that the book of business was the husband's personal goodwill, and not marital property. In *Hughes v. Hughes*, 311 N.J. Super. 15, 709 A.2d 261 (App. Div. 1998), wife contended that a "shopping center catalogue" was a significant asset of a martial corporation, worth in excess of $100,000. She testified that husband said it cost $100,000 to develop. The appellate court believed that its independent worth was negligible. The appellate court said: " It required constant updating and was merely a compendium of outstanding available property. It was one vehicle that permitted plaintiff to earn his substantial income from the business. The business, however, did not necessarily have any great intrinsic value. It was more of a personal service corporation whose value was dependent on plaintiff's services which generated the firm's income."

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

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

Id. at 279.

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

In *Harris v. Harris*, 765 S.W.2d 798, 803 (Tex. App.--Houston [14th Dist.] 1989, writ denied), the court pointed out that the contingent fee contract in question belonged to the law firm, not the individual lawyers. This fact is overlooked by most appellate courts that have addressed the question.

Arizona – In *Garrett v. Garrett*, 140 Ariz. 564, 683 P.2d 1166 (Ariz. App. 1983), the appellate court considered "whether the rights flowing from an attorney-husband's contingent fee contracts entered into during marriage but which were not fully performed at the time of dissolution are community or separate property." The analysis in the case is good, and the case is recommended reading. Neither contingent-fee case had settled by the time of divorce. The appellate court rejected the idea that the interest in a contingent fee contract is classified as separate or community depending on when the contract was signed. *Id*. at 568 n. 3. Instead the court said to use a time-allocation based on hours spent during, as opposed to before and after, marriage. *Id.* at 569. Upon reconsideration, the court backed away from a purely hourly assessment and said: "in evaluating the community interest in a contingent fee contract, the trial court may consider the following factors: the amount of time expended before and after the dissolution, how that time was expended, the settlement history of the case, and any other relevant factor as may bear on the equitable division of this community asset." *Id.* at 570-71.

Arkansas – In *Meeks v. Meeks*, 290 Ark. 563, 721 S.W.2d 653 (1986), the Supreme Court of Arkansas held that a lawyer's accounts receivable and work-in-progress are marital property. In *McDermott v. McDermott*, 336 Ark. 557, 986 S.W.2d 843, 847 (1999), the Supreme Court held that contingent fee agreements entered into during marriage are marital property, because they established an enforceable right that is a property right.

Colorado – In *Marriage of Bayer*, 687 P.2d 537, 539 (Colo. App. 1984), the appellate court held that the receivables of the husband, who was an attorney, were marital property. The court noted that the receivables were for services already rendered. The court also noted that under the husband's law firm's partnership agreement, upon his retirement or death he would receive 90% of his outstanding receivables. The appellate court affirmed the trial court's reducing the value of the receivables by the 10% in the partnership agreement, plus another 10% for uncollectability. In *Marriage of Vogt*, 773 P.2d 631 (Colo. App. 1989), the appellate court ruled that two contingent fees of husband's law firm were marital property. One case was settled before the divorce, so that the fee was "vested and matured during the time of the marriage although it was not collected." *Id.* at 632. The other was a favorable judgment that was on appeal. The trial court acknowledged that the judgment could be reversed and additional work might be required. The appellate court cited case law that deferred compensation earned during marriage was marital property. It also cited the Arizona case of *Garrett v. Garrett*, *supra*, saying that an attorney's contingent fees are not a mere expectancy, but instead are valuable contract rights that are marital property if acquired during marriage. The husband complained at the ignoring of his post-divorce labor. The appellate court said that the settled case gave rise to a receivable, so it was treated as a marital asset. As to the judgment on appeal, the court held that the award of an interest to the wife should be limited to the portion of the fee attributable to work done during marriage. *Id.* at 632-33. Both courts ignored the fact that the contracts were with a law firm. The appellate court did note, however, that in the event of husband's death, his estate would received his interest in the fees. *Id.* at 632.

Florida – In *Brock v. Brock*, 690 So. 2d 737 (Fla. 5th Dist. Ct. App. 1997), the court held that a legal fee earned during marriage and paid after separation but prior to divorce was marital property.

Illinois – In *Marriage of Zells*, 143 Ill.2d 251, 157 Ill. Dec. 480, 572 N.E.2d 944 (Ill. 1991), the Supreme Court of Illinois held that a lawyer's contingent fee contracts are not marital assets subject to division. The Supreme Court agreed with the intermediate appellate court's analysis:

> "First, the nature of a contingent fee contract indicates that an attorney has neither the right to receive the fee until the case is disposed of, nor any assurance that he ever will receive the fee. Second, the amount of the contingent fee depends on the amount of the award or settlement in the case; therefore its ultimate value, if any, remains highly speculative during the pendency of the case. * * * Third, the worth of a contingent fee to an attorney, if any, remains intangible until the firm receives cash or other consideration for the services rendered." 197 Ill.App.3d at 237, 143 Ill. Dec. 354, 554 N.E.2d 289.

To that the Court added "the impermissible ethical conflict posed by a court-ordered division of contingent fees." *Id*. at 945.

5. Insurance Renewal Commissions. Insurance agents are typically compensated based on a percentage of the premiums the insurance company receives from the agent's sale of insurance policies. The percentage applies not only to initial premiums, but also premiums generated by the renewal of existing policies. In *Cunningham v. Cunningham*, 183

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

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

> On provisions of Vibrock's contracts with Fidelity Union Life Insurance Company: After the portion thereof which set forth the Agent's entitlement (Vibrock's) on "first year commissions on premiums"; the same for "second year commissions"; and the same for "subsequent years" was a provision as follows: "Agent agrees that for so long as this contract shall remain in force and effect, he will not enter the service of any other insurance company . . .."
>
> Further contractual provisions: "No renewal commission shall be payable on the business produced during any contract year not fully completed by the Agent while in the service of the Company. . . . Renewal commissions are paid in recognition of continuous full time service and as compensation for services rendered in keeping the business in force." Further, "If for any reason this contract should be terminated within three (3) years, no renewal commissions shall be paid to the Agent thereafter."

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

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

Id. at 778.

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

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

> opinion of the court of civil appeals which suggests that these renewal commissions are not community property. *See Cearley v. Cearley,* 544 S.W.2d 661 (Tex.1976).

Vibrock v. Vibrock, 561 S.W.2d 776, 776-77 (Tex. 1977). Each insurance agent's agency/employment agreement is different, and current practices have changed since 1977, so the applicability of *Vibrock* must be assessed in each new case.

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

7. Royalty Interests on Intellectual Property. In *Alsenz v. Alsenz*, 101 S.W.3d 648 (Tex. App.–Houston [1st Dist. 2003, pet. denied), the appellate court wrote: "No Texas case has addressed when inception of title to patent rights occurs. Arguably, inception may occur at any of three times: (1) when the concept is sufficiently developed to generate a plan to build the invention; (2) when the invention is actually built; or (3) on the effective date of the patent.... However, this is not a question that this Court need decide today. All three of these steps occurred before Richard's marriage to Sue. Thus, inception of title to Richard's patents clearly occurred before marriage and the inventions are Richard's separate property." *Id.* at 652. (Citation omitted.) The court went on to state the following review of out-of-state case law:

> It is unquestionable that, had these patents been taken out during the marriage, the patents and the income they generated would be community property. In this, we would join other jurisdictions in which the courts treat the income from intellectual property created during marriage as marital or community property. *See, e.g., In re Monslow*, 259 Kan. 412, 912 P.2d 735, 747 (1996) ("Video on Demand" concept created during marriage is marital property); *accord Rodrigue v. Rodrigue*, 218 F.3d 432, 443 (5th Cir. 2000) (wife entitled to half interest in net benefits resulting from copyrighted works created during marriage); *In re Perkel*, 963 S.W.2d 445, 451 (Mo. Ct. App. 1998) (computer software written by husband is marital property); *Curtis v. Curtis*, 208 Cal. App.3d 387, 256 Cal. Rptr. 76, 78 (1989) (future residuals from performances during marriage are community property); *In re Worth*, 195 Cal. App.3d 768, 241 Cal. Rptr. 135, 137 (1987) (artistic work created during marriage is community property).
>
> Although we recognize that the foregoing cases deal with intellectual property created during marriage, we note that two courts have awarded a spouse an interest in the revenue stream generated by intellectual property the other spouse created before marriage when the spouse contributed to the success of the resulting product. *See Teller v. Teller*, 99 Hawai'i 101, 53 P.3d 240, 254 (2002) (rights to trade secrets vested before marriage but revenue stream awarded to both spouses); *McDougal v. McDougal*, 451 Mich. 80, 545 N.W.2d 357, 358 (1996) (although patents issued before marriage, both spouses awarded income generated from patents). We are

> persuaded that this is the correct approach to take here, regardless of whether the spouse makes a contribution to the generation of an income stream. We go farther in holding that a spouse is entitled to an interest during marriage in the revenue stream from intellectual property that was created by the other spouse before marriage.

Id. 653-54. The court concluded, at p. 654:

> We hold that the income stream generated during the marriage from Richard's inventions patented before the marriage was a "revenue" and a "fruit" of his separate property; therefore, we hold that it was community property. The trial court did not err in so finding.

Fifth Circuit Deciding Under Louisiana Law -- In *Rodrigue v. Rodrigue*, 218 F. 3d 432, 442-43 (5th Cir. 2000), the Fifth Circuit Court of Appeals ruled that an interest in the income from a copyright can be community property, even though Federal law gave the author-spouse the exclusive right to manage and control the copyright. *Id.* 441. The appellate court remanded the case with instructions. The wording is worth reading closely:

> Specifically, we instruct the district court to determine on remand which copyrights are subject to the rules of community property law that we announce today, either directly as works created during the existence of the community of acquets and gains or derivatively as works created after the termination of the community but based on pre-divorce works.[52] Even though the parties briefed the issue of derivative works in the instant appeal, the district court has not yet ruled on it so that issue is not ripe for our consideration and disposition. In holding that George alone is the owner of all copyrights in the artistic works, the district court denied Veronica's cross-motion for a summary judgment declaring her economic interests in the copyrights, including determination of which post-divorce works were derivative of the artwork created during the marriage. That ruling, however, was not certified to be a final judgment ready for appeal under Rule 54(b). As we now hold that Veronica does have economic rights with respect to the copyrights at issue, the district court must determine on remand which works are derivative as well.
>
> We further instruct the district court, following such determinations, to enter judgment recognizing Veronica's entitlement to an undivided one-half interest in the net economic benefits generated by or resulting from copyrighted works created by George during the existence of the community and from any derivatives thereof. Such judgment also must recognize George's continued entitlement to the exclusive control and management of the five rights in such intellectual property specified in § 106, albeit subject to any duty that he might ultimately be held to owe Veronica to "manage prudently" all such copyrights and derivatives thereof under his control.

California – In *Worth v. Worth*, 195 Cal. App.3d 768, 774, 241 Cal. Rptr. 135, (Cal. App. 1st Dist. 1987), the appellate court held that copyrights arising from the authorship of books during marriage were community property, as were the future royalties from those works. A law review note was written about the *Worth* decision, Carla M. Roberts, *Worth of Rejection: Copyright as Community Property*, 100 YALE L. J. 1053 (1991). In *Enovsys LLC v. Nextel Communications, Inc.*, 614 F. 3d 1333, 1342 (Federal Cir. 2010), the Federal Circuit Court of Appeals had to determine whether under California law there was a community property interest in two patents, in connection with patent litigation. The court wrote: "Sprint Nextel is correct that under California law, all property acquired by a married person during marriage is presumed to be community property.... This presumption applies here, because Fomukong filed the applications for the '159 and '461 patents while he was married to Whitfield....; *see also In re Marriage of Worth*, 195 Cal. App.3d 768, 773, 241 Cal. Rptr. 135 (Cal. Ct. App. 1987). Prior to the divorce, the patents were thus presumptively community property in which Whitfield had an undivided half-interest." [Some citations omitted.]

Hawai'i – In *Berry v. Berry*, 127 Hawai'i 243, 277 P.3d 968 (Hawai'i 2012), the Supreme Court of Hawaii criticized *Worth*'s view that "the copyright is automatically transferred to both spouses by operation of the California law of community property." *Id.* 986. It adopted instead the approach in *Rodrigue*, that community property law was preempted by Federal law only as to "the scope of the exclusive rights under 17 U.S.C. § 106 (rights to reproduce, adapt, distribute, perform, and display copyrighted works)." *Id.* at 987, quoting *Rodrigue* at 218 F.3d at 439. In *Teller v. Teller*, 99 Hawai`i 101, P. 3d 240 (Hawai'i 2002), the Supreme Court of Hawaii ruled that a trade secret is a presently existing intangible property right, which carries with it the right to sue for misappropriation, and that a trade secret can be marital property.

The court goes on to discuss when an intellectual property right becomes property. The court said that "[u]nder federal statute, the right in a patent accrues at the time the patent is issued." *Id* at 250. The court interchangeably used the terms "vesting" and "arising." In conclusion, the court held:

> Pre-maritally, Howard solely owned the rights to his trade secrets. Those property rights vested at various times but before the 1976 marriage. After the marriage, Howard applied for and was issued two separate patents. Those patent rights, therefore, vested after marriage and are properly part of the marital estate. Howard argues that the trial court erred when it "found no competent evidence was offered by Scott or Dr. Sullivan[.]" According to Howard's expert, "every aspect of Howard's weather radio was governed by pre-marital trade secrets." This is simply not so. Had Howard never been issued a patent, his argument may have been more persuasive. The patent alters the nature of the property right. It is no longer protected solely by the conduct of the holder. Once the patent has been issued the full force of the laws of the United States act to protect the property. In dividing this property, it was incumbent upon the family court to value all of the assets, in both their pre-marital and marital forms.

Id. at 254. ***Under this reasoning, a separate property trade secret becomes a community property patent right, by virtue of the patent being issued during marriage.***

Utah – In *Dunn v. Dunn*, 802 P.2d 1314 (Utah App. 1990), the husband designed surgical instruments for the implantation of artificial knees, then entered into fixed royalty payments in exchange for a license to use and sell the instrument. (There is no mention of a patent.) The royalty agreement did not require the husband to perform any services. The husband also licensed a hip-replacement, but was required to consult, present workshops, and perform other personal services for the licensee. The wife claimed the knee replacement royalty payments were marital property; she made no claim to the hip-replacement royalty payments. *Id* at 1317. The appellate court ruled that the trial court should consider the knee-replacement royalties as marital property, but should deduct the value of 14 days per year of the husband's time spent traveling in relation to the knee-replacement agreement.

Articles – J. Wesley Cochran, *It Takes Two to Tango!: Problems with Community Property Ownership of Copyrights and Patents in Texas*, 58 BAYLOR L. REV. 407 (2006); Kristen Prout, *Intellectual Property Distribution in Divorce Settlements*, 18 QUINNIPIAC PROB. L.J. 160 (2004-2005); Garth R. Backe, *Community Property and the Copyright Act: Rodrigue's Recognition of a Community Interest in Economic Benefits*, 61 LA. L. REV. 655 (2000-2001); Dane S. Ciolino, *Why Copyrights are Not Community Property*, 60 LA. L. REV. 127 (1999-2000); Brett R. Turner, *Division of Intellectual Property Interests Upon Divorce*, 12 No. 2 DIVORCE LITIG. 17 (2000); s*ee also* Sally Brown Richardson, *Classifying Virtual Property in Community Property Regimes: Are My Facebook Friends Considered Earnings, Profits, Increases in Value, or Goodwill*, 85 TUL. L. REV. 717 (2010-2011)

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

E. EARLY TERMINATION PAYMENTS. In *Whorrall v. Whorrall*, 692 S.W.2d 32, 38 (Tex. App.--Austin 1985, writ. dism'd), the appellate court held that a payment received during marriage as an inducement for the employee to retire early was entirely community property, and not subject to time allocation like a pension. The court did not cite to any precedent regarding early retirement payments. In *Henry v. Henry*, 48 S.W.3d 468 (Tex. App.--Houston [14th Dist.] 2001, no pet.), the court considered a "commuted retirement" and a "severance package." The husband had worked at the company for nine years prior to marriage, and five years during marriage. The company downsized and paid husband the "commuted value" of his pension. Husband deposited the funds, and the trial court applied a "*Berry* formula" to the funds, and was affirmed. The trial court also applied a "*Berry* formula" to the severance paid to the husband, but was reversed. The appellate court noted that the severance payment was entirely community property because it included eleven months' salary, and husband had to release all claims, and had no earmarks of a benefit that accrued over time, like a pension.

In *Russell v. Russell*, No. 325405, 2016 WL 1688907 (Mich. App. April 26, 2016), the wife's company merged and she lost her job, but she received severance pay equal to five months' wages and the monetary value of her accrued time off. The trial court found all payments to be marital property, even though the five months' wages at least conceptually included post-divorce months. The appellate court affirmed, noting that the wife also signed a release of claims against her employer.

In *Warner v. Warner*, 692 So. 2d 266 (Fla. 5th Dist. Ct. App. 1997), after the divorce was filed the husband received a payment from his former employer in settlement of all disputes and to compensate husband for his "past creative efforts." Although the payment was received after the divorce was filed (which cut off marital property), the payment was nonetheless marital property.

IV. FORMATION, ACQUISITION, AND REORGANIZATION OF ENTITIES.

A. FORMATION. The character of the spouse's interest in a business formed during marriage is determined by the character of the capital contributed by the spouse in exchange for his/her interest. *Hunt v. Hunt*, 952 S.W.2d 564, 567 (Tex. App.--Eastland 1997, no pet.) ("[w]hen a corporation is funded with separate property, the corporation is separate property"). Separate property capitalization of a business incorporated during marriage was established in *Holloway v. Holloway*, 671 S.W.2d 51, 56-57 (Tex. App.–Dallas 1983, writ dism'd).

1. The Organizer is Not the Owner. The fact that a spouse is the organizer of a corporation or LLC does not mean that s/he is an owner. Ownership derives from the contribution of labor or capital in exchange for an ownership interest. Contributing community labor, or cash, or credit begets community ownership. Contributing separate labor, cash, or credit capital begets separate ownership.

2. Distinguish Ownership Interest From Ownership Percentage. It should be noted that, as partners acquire partnership interests from the partnership, or have the partnership redeem their ownership interest, the remaining partners' percentage of ownership interest in the partnership will rise or fall. This does not indicate that the other partners are acquiring or losing an interest is the partnership. They have the same partnership interest, although the percentage of ownership may change. Persons who buy another partner's interest in the partnership are effecting a purchase, as distinguished from making a capital contribution. In such a transaction, the other partners' percentage of total partnership ownership interests does not change.

3. Initial Capital of $1,000. Up until September 1, 2003, TBCA art. 3.05(A) required that a corporation receive $1,000 in capital before commencing business. This resulted in lawyers routinely providing for the initial owners to convey $1,000 in cash to the company at start-up, even if the "real" capitalization was to follow later. Often a $1,000 check was not written, but the phantom $1,000 contribution was recited in the organizational paperwork, accounting records, and tax returns as if it had been paid. One thousand dollars was hardly ever enough capital to actually start a business, so that something more, often intangible assets, were usually at least tacitly contributed as capital. The $1,000 minimum capital requirement was eliminated by the repeal of TBCA art. 3.05(A) effective September 1, 2003, but old habits die hard (or "old forms never die, they just fade away") and the recital of $1,000 as initial capital is still found after that date. If the initial capital contribution was made using a check drawn on an account containing commingled separate and community property funds, sometimes the character of the ownership interest will depend on the tracing done in the account, which in turn may depend on tracing other accounts.

4. Other Capital Contributions. Corporations can receive contributions from shareholders at the time of start-up, or later. Because the character of an asset is determined at the time the property is acquired (or upon inception of title of if that occurs earlier), making subsequent capital contributions to a corporation will not change the character of the ownership interest, unless additional ownership interests are acquired. *See Harris v. Harris*, 765 S.W.2d 798, 803-4 (Tex. App.--Houston [14th Dist.] 1989, writ denied) (where no additional interest was acquired during marriage, changes in partnership "units" were mutations and constituted separate property). However, where the initial capitalization is designed to be paid in installments or at intervals, all installments may constitute the initial capitalization. If the arrangement occurred during marriage, community credit could introduce a community interest related to the deferred capital contributions.

5. Formation of a Partnership. Some persons have espoused the view that a partnership formed by a spouse during marriage is always community property because the partnership interest arises upon the handshake before any capital is contributed. That argument defies the doctrine of mutation, and is contra to *Higley*, *Horlock*, and *York* cited above.

6. Incorporating a Sole Proprietorship. When the operator of a sole proprietorship incorporates the going business during marriage, the assets of the sole proprietorship constitute the capital contributed to the corporation in exchange for its shares. Since all such assets are presumptively community property, it is necessary to trace the character of all of the assets that are contributed to the corporation. Even though all the assets of an unincorporated business may have been separate property on the day of marriage, profits from the unincorporated business are usually reinvested in inventory, equipment, and money, so that the assets of the business will slowly become community property overtime. 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 v. Allen*, 704 S.W.2d 600, 603-04 (Tex. App.–Fort Worth 1986, no writ); and *Hunt v. Hunt*, 952 S.W.2d 564 (Tex. App.--Eastland 1997, no writ).

B. ACQUISITION. An interest in a business acquired during marriage is governed by the doctrine of mutations. *See In re Marriage of Higley*, 575 S.W.2d 432 (Tex. Civ. App.--Amarillo 1978, no writ) (partnership interest acquired prior to marriage was separate property); *Horlock v. Horlock*, 593 S.W.2d 743 (Tex. Civ. App.--Houston [1st Dist.] 1980, writ ref'd n.r.e.) (limited partnership interest acquired by husband after divorce was his separate property); *York v. York*, 678 S.W.2d 110 (Tex. App.--El Paso 1984, writ ref'd n.r.e.) (partnership interest acquired during marriage was community property).

C. REORGANIZATION. Prior to 1997, in order to change from a corporation to a partnership in Texas it was necessary to find or create at least two partners (or for a limited partnership to find or create at least one general partner and one limited partner), then merge the corporation into the partnership or convey some or all of the corporate assets into the limited partnership. See Byron F. Egan, *Choice of Entity Tree After Margin Tax and Texas Business Organizations Code*, 42 TEX. J. OF BUS. LAW 71, 112 (Spring 2007) [available on Westlaw at 42 TXJBL 71]. Using this approach, at some point in time there might be two or three entities where before there was just one.

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

On the other hand, if a separate property business distributes earnings and profits to a married spouse who then invests in a new business entity, conventional marital property law suggests that the new business is community property. Where a transaction that looks like a distribution and investment is really a form of mutation can be a point of contention. The language in *Lifshutz v. Lifshutz*, 199 S.W.2d 9 (Tex. App.–San Antonio 2006, no pet.) ("*Lifshutz II*"), is an example of a business reorganization that was treated as separate transactions, resulting in a community interest. In *Lifshutz II*, a separate property partnership conveyed its interest in a corporate subsidiary to a separate property corporation in a tax-free business reorganization. *Id.* at 24-28. The trial court found this transfer to be "non-liquidating community distribution" from the partnership, and held the stock of the subsidiary to be community property of the husband. *Id.* at 24. Applying *Lifshutz II* to a reorganization, in which a limited partnership is created and the corporation conveys assets into the limited partnership, could result in a later claim that separate property wealth was inadvertently transformed into community property wealth in the process.

In *Harris v. Harris*, 765 S.W.2d 798, 803-4 (Tex. App.--Houston [14th Dist.] 1989, writ denied), the husband entered into a law partnership prior to marriage. During marriage, a second partnership agreement was signed among some of the partners, that clarified and defined each partner's proportionate share of a contingent fee belonging to the partnership. The jury found that the husband's rights under the second agreement were his separate property, and the appellate court affirmed.

V. SELLING AN OWNERSHIP INTEREST.

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

B. GOODWILL THAT IS SOLD. In *Nail v. Nail*, the Supreme Court said: "We are not concerned with goodwill as an asset incident to the sale of a professional practice." In *Austin v. Austin*, 619 S.W.2d 290, 291-92 (Tex. Civ. App.--Austin 1981, no writ), the court considered goodwill assigned in an agreement to purchase an accounting practice to be divisible on divorce. The court wrote: "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…. 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."

C. POST-SALE EMPLOYMENT AND CONSULTING AGREEMENTS. It is not uncommon, in the purchase of a business, for the buyer and seller to agree for the seller to remain employed by the business for a period of time after the purchase/sale. This facilitates the transfer of both enterprise and personal goodwill, and makes for a smoother transition to new ownership with customers, suppliers, and employees. Sometimes the seller agrees to a consulting agreement as an alternative to an employment agreement. Because money paid to buy a business must be capitalized over time, whereas compensation paid to an employee or consultant is deductible to the business as an expense when paid, buyers have a tax motive to move part of the purchase price into an employment or consulting agreement. In any sale of a closely-held business, the terms of the sale and any related payments or agreements should be scrutinized to see if purchase price contains a component of personal goodwill that is protected by a symbolic continuation of the seller's association with the business and thus may be considered to be separate property.

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

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

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

When a business is sold, they buyer wants to get the seller's covenant not to compete, since it protects the buyer's investment in the business, assuring the buyer that the seller will not use his/her personal goodwill to lure away suppliers, customers, or employees to the seller's new business. Some have argued that the covenant not to compete represents the embodiment of the seller's personal goodwill, and as such all payments attributable to the covenant not to compete are separate property, whether received before or after divorce.

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

E. TRANSFER RESTRICTIONS AND BUY-SELL AGREEMENTS. Except for the requirement that business in licensed professions can be owned only by licensed professionals, TBOC §§ 301.006-008, Texas corporate law imposes no restrictions on the transfer of shares from a shareholder to his/her spouse in a divorce. The transfer of a partnership interest to a partner's spouse in a divorce is restricted by TBOC § 152.406 to a transferee's interest. The subject is not mentioned in the LLC provisions of the TBOC. The TBOC prohibits unlicensed individuals from being an owner of an entity that is engaged in a licensed profession (medical, legal), which effectively bars an assignment of an ownership interest in the entity to an unlicensed spouse. TBOC ch. 301. Apart from these statutory transfer restrictions, business entities are free, in organizational documents, to restrict the transfer of ownership interests as a condition to ownership, or it can be done by agreement of the owners. *Ritchie v. Ritchie*, 443 S.W.2d 856, 871 (Tex. 2014) ("Shareholders of closely-held corporations may address such problems by entering into shareholder agreements that contain a buy-sell, first refusal, or redemption provisions that reflect their mutual expectations and agreements").

Buy-sell agreements are terms in an entity's organizational paperwork, or in agreements between owners, that give the other owners or the company itself the right to purchase an owner's ownership interest under certain circumstances. The triggering events are usually leaving employment, death, disability, or the award of an ownership interest to the non-owning spouse in a divorce.

1. Texas Divorce Cases. In *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192, 201-202 (Tex. Civ. App.--Houston [1 Dist.] 1975, no writ), the court wrote: "A provision which restricts a stockholder's right to sell or transfer his stock, particularly one which affords a prior right of purchase to the corporation or to another stockholder, is not looked upon with favor in the law and is strictly construed.... It has generally been held that such a restriction is inapplicable to a transfer occurring as a result of an involuntary sale or by operation of law unless by specific provision in the restriction it is made applicable...." (Citations omitted).

In *Finn v. Finn*, 658 S.W.2d 735, 742, 749-750 (Tex. App.--Dallas 1983, writ ref'd n.r.e.) (en banc), the court wrote: "The lack of any legal right of the husband to realize the value of the firm's goodwill is a decisive factor.... [W]e hold that the trial court properly instructed the jury not to consider the law firm's accrued goodwill or future earning capacity when placing a value on the community interest in the husband's law practice." [Footnote omitted.] Justice Stewart wrote a Concurring Opinion saying: "The partnership agreement does not control the value of the individual partnership interests. The asset being divided is the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights.... The value of the husband's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill, if any. Goodwill is property and, although intangible, it is an integral part of a business, the same as its physical assets."

In *Keith v. Keith*, 763 S.W.2d 950, 953 (Tex. App.--Fort Worth 1989, no writ), the court wrote: "The partnership agreement entered into between Charles and Ty provided a method for determining the value of the business in the event it was terminated due to the withdrawal, other act, or death of one of the partners. The trial court did not use the method provided in determining the value of the partnership. Since the partnership is not being terminated, we do not find this provision of the agreement has any applicability to the matter before the trial court. Accordingly, the trial court did not err in failing to use the formula."

In *R.V.K. v. L.L.K.*, 103 S.W.3d 612 (Tex. App.--San Antonio 2003, no pet.) (3-2-1), the Plurality Opinion said: "Contrary to R.V.K.'s argument, the divorce proceeding has not triggered the buy/sell agreements. There has not been an "operative event"--an attempted sale, transfer, gift, mortgage, or pledge of stock without the corporations' consent; termination of R.V.K.'s employment; or termination of his marriage by death or divorce in a manner that dictates that R.V.K. will not succeed to L.L.K.'s community interest in the Medical Practice Group and the Medical Equipment Business stock...." Two Justices dissented, writing: " I believe this court should answer the question presented at trial and on appeal: should the *Finn* decision or the *Keith* decision be followed when determining the value of a professional practice upon divorce? I agree with Annette Stewart's concurring opinion in *Finn* and the court in *Keith*, and would 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 agreements and consideration of commercial goodwill." The Chief Justice concurred in the result, but wrote: "I concur in the majority's conclusion that the trial court erred in failing to properly derive a fair market value for R.V.K.'s ownership interest, but I agree with the dissent that we should address whether *Finn* or *Keith* should be followed in determining whether goodwill should be included in valuing a professional practice. I also agree with the dissent that we should follow the holding in *Keith* and the reasoning in Justice Stewart's concurring opinion in Finn."

In *Von Hohn v. Von Hohn*, 260 S.W.3d 631 (Tex. App.--Tyler 2008, no pet.), the court wrote: "Based on these facts, we agree with the concurrence in *Finn* that the Nix Law Firm partnership agreement does not control the value of the individual partnership interests in the event of a divorce. *See Finn*, 658 S.W.2d at 749. The Nix Law Firm was an ongoing partnership as of the time of divorce, Edward had not died nor had he withdrawn from the partnership, and, thus, none of the triggering events specified in the partnership agreement had occurred. *See R.V.K.*, 103 S.W.3d at 623; *Keith*, 763 S.W.2d at 953. Consequently, the formula in the partnership agreement was not determinative of the value of Edward's interest in the Nix Law Firm. *See Keith*, 763 S.W.2d at 953. Therefore, the trial court did not err when it determined that the proper measure of the value of the community interest in the Nix Law Firm could include methods other than those set forth in the partnership agreement."

In *Mandell v. Mandell*, 310 S.W.3d 531, 537 (Tex. App.–Fort Worth 2010, pet. denied), the court wrote: "A straight fair market value is not an appropriate valuation method, however, when a community estate owns shares in a closely held corporation and, by agreement, any sale of the shares of stock is restricted to the corporation or other stockholders. See *Beavers v. Beavers*, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ). When the sale of stock is restricted by a requirement that the shares be offered first to the corporation or to other shareholders, then essentially the fair market value of the stock is zero. *See id.* [FN5] In this situation, the parties may show the actual value of the property interest to the owner. See *R.V.K.*, 103 S.W.3d at 618. Such evidence might include the value of being able, by virtue of ownership of the closely held stock, to drive a new automobile, to have health insurance paid for by the company, to have a company-financed life insurance policy, to belong to a country club at company expense, and other similar financial benefits."

2. Other States.

California – In *Aufmuth v. Aufmuth*, 89 Cal. App.3d, 446 (Cal. App. 1979), held that a stock purchase agreement providing a formula for the sale of corporate shares was binding in a divorce. The formula considered receivables but excluded goodwill. However, rather than announcing a universal rule, the court noted that the husband was a 31-year old attorney, licensed for seven years, and a member of the firm for five years. The court wrote: "the trial court could reasonably conclude that he had not contributed in any substantial way to whatever goodwill the firm might possess. These factors support the court's determination that goodwill was not to be considered in evaluating his interest in the firm." So the court did not say that buy-sell restriction are per se binding.

Colorado – In *Marriage of Bayer*, 687 P.2d 537, 539 (Colo. App. 1984), the appellate court held that the receivables of the husband, who was an attorney, were marital property. The court noted that the receivables were for services already rendered. The court also noted that under the husband's law firm's partnership agreement, upon his retirement or death he would receive 90% of his outstanding receivables. The appellate court also affirmed the trial court's reducing the value of the receivables by the 10% in the partnership agreement, plus another 10% for uncollectability. The fact that the receivables belonged to the partnership and not the spouse was not factored into the analysis, apart from the 10% reduction.

3. Conceptual Choices. In answering the legal policy question of what to do about transfer restrictions in determining value for purposes of divorce, the choices fall into four categories:

(i) assume the restrictive provision is triggered at the time of divorce;
(ii) assume the restrictive restriction is not triggered at the time of divorce;
(iii) determine from the evidence whether and when the restrictive provision will trigger; and
(iv) give trial courts the discretion to use a valuation approach that permits a just and right property division.

The Plurality Opinion in *Finn* tacitly assumed that the withdrawal provision applied at the time of divorce, as did the Opinion in *Mandell*. The Opinion in *Earthman*, the Concurring Opinion in *Finn*, the opinion in *Keith*, all three Opinions in *R.V.K.*, and the Opinion in *Von Hohn*, all said that the transfer provision did not trigger and thus did not control the divorce value. Intellectually we must be ask whether the definition of fair market value, which assumes a hypothetical sale by an imaginary seller to an imaginary buyer, forces us to assume that there is an imaginary trigger of the buy-sell clause that hypothetically results from the hypothetical sale.

VI. CONTRIBUTIONS TO ENTITIES. When a business-owner puts money or assets into the business entity, it could be a purchase (if ownership increases), or a loan (if a promissory note is signed, or "accounts payable to owners" is credited on the books), or it could be a capital contribution that increases the owner's equity or the partner's capital account while not increasing the ownership percentage.

A. REIMBURSEMENT. An issue arises when a spouse transfers community money to a separate property business. If the transaction is not a loan, it gives rise to a claim for reimbursement. In *Horlock v. Horlock*, 533 S.W.2d 52, 60 (Tex. Civ. App. --Houston [14th Dist.] 1975, writ dism'd w.o.j.), the appellate court held that the community estate was entitled to reimbursement for community funds contributed to a separate property corporation. In *Jacobs v. Jacobs*, 669 S.W.2d 759 (Tex. App.--Houston [14th Dist.]1984, *aff'd in part, rev. in part*, 687 S.W.2d 731 (Tex. 1985), the appellate court affirmed an award of reimbursement for contributions to separate property partnerships using community funds. However, the court announced no law and merely concluded that no abuse of discretion had been shown. In *Halamka v. Halamka*, 799 S.W.2d 351, 354-55 (Tex. App.--Texarkana 1990, no writ),where there was inadequate evidence of the amount of community funds invested in husband's separate property business, the trial court awarded wife 60% of the community estate, in lieu of a specific reimbursement award, and the decision was upheld on appeal.

B. INCREASE IN PARTNER'S CAPITAL ACCOUNT. A partner's capital account is discussed in Section IX below. If community property is contributed to a partnership, does the other spouse have a choice between a reimbursement claim versus a claim to part of the capital account? Does a capital account have a character as separate, community, or mixed? What are the advantages or disadvantages of claiming reimbursement, loan, or ownership of a capital account?

VII. DISTRIBUTIONS FROM ENTITIES.

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

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

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

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

> Nondividend Distributions
>
> If a corporation has neither accumulated nor current E&P ["earnings and profits"], a distribution to its shareholders (as shareholders) will not be a ""dividend" includable in their gross income under IRC § 61(a)(7). This assumes that the distribution itself (e.g., of appreciated property) will not trigger gain that will generate current E&P. As specified in IRC § 311(b), the distribution of appreciated property will cause gain recognition of that appreciation to the corporation, and that gain (after applicable income tax) is includable in E&P. This treatment results because of the repeal of the General Utilities doctrine in the Tax Reform Act of 1986. Of

course, the risk of increasing E&P does not exist if cash (at least in the form of U.S., not foreign, money) is being distributed. Furthermore, if gain is realized on a property distribution, E&P may still not result if the gain would be absorbed by, and be less than the net operating loss accumulated for, that year.

> Under IRC § 301(c)(2), a nondividend distribution is applied against, and reduces the adjusted basis of, the shareholder's stock. If the distribution is greater than the adjusted basis of the stock, the excess is subject to IRC § 301(c)(3) and will be treated as gain from the sale or exchange of property (and, therefore, capital gain, assuming the stock is a capital asset).
>
> Of course, to have nondividend treatment, the absence of E&P must be demonstrated by the recipient or the payor.

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

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

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

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

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

> In 2014, based on reasonable assumptions by Mattel, 80% of the distribution is a non-dividend distribution

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

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

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

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

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

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

1. Distributions of Profits are Community Property. Under the community property presumption, all property possessed by a spouse during or on dissolution of marriage is presumed to be community property, and the party claiming separate property has the burden of proof on clear and convincing evidence. Tex. Fam. Code § 3.003. One possible rule for distributions from entities would be that there is no path to proving that the distributions are separate property, so all such distributions fall into the community estate. Considering the three leading cases in the area of distributions from entities, this "all community property" approach was not suggested in *Marshall v. Marshall*, 735 S.W.2d 587 (Tex.

App.–Dallas 1987, writ ref'd n.r.e.), nor was it suggested in *Lifshutz v. Lifshutz*, 199 S.W.2d 9 (Tex. App.–San Antonio 2006, no pet.) ("Lifshutz II"), and it was rejected in *Legrand-Brock v. Brock*, 246 S.W.3d 318 (Tex. App.–Beaumont 2008, pet. denied) ("*Brock II*").

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

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

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

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

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

Harris did not say that distributions of capital from a separate property partnership are community property.

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

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

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

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

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

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

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

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

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

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

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

(6) (A) “Distribution” means a transfer of property, including cash, or issuance of debt, by a corporation to its shareholders in the form of:

(i) a dividend on any class or series of its outstanding shares;
(ii) a purchase or redemption, directly or indirectly, of any of its own shares; or
(iii) a payment by the corporation in liquidation of all or a portion of its assets.

(B) The term does not include:

(i) a split-up or division of the issued shares of a class of a corporation into a larger number of shares within the same class that does not increase the stated capital of the corporation; or
(ii) a transfer of the corporation’s own shares or rights to acquire its own shares.

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

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

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

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

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

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

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

---

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

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

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

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

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

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

<u>The *Barrington* Case.</u>

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

> Plaintiff had on hand $4,254.29 worth of new and used tires at the time of his marriage as his separate property and in his business he sold new and used tires and serviced tires. As he sold these tires and serviced tires in his business he deposited the proceeds in his one bank account and he would use the money he received in his business to buy new stock. His stock turned over about five times during his coverture with defendant. On February 28, 1955, a few days before the divorce suit, his stock of merchandise of new and used tires on hand was of the value of $2,700, which was a decrease of $1,554.29 from his original stock. He also sold some of his old equipment and bought new equipment which was necessary in his business of remolding and recapping tires-however, he kept accurate records of all of these transactions as hereinafter more fully shown. During the marriage he sold two re-tread molds (which was his original separate property) for $1,050 which money was placed in his business bank account. During the marriage he bought a new re-tread mold, paid $160 down on it from the bank deposit and paid a few (8 or 9) monthly payments of $68 per month from his business bank account and owed a balance on it at the time of the dissolution of the marriage. During the marriage he also bought a tire changer for $189, paying for same out of the business bank account check, also paid $75 out of said account on a cement spray machine, with an indebtedness still due against it at the time of the divorce, bought an air compressor on credit and made a few payments on it out of the business bank account as shown

> by the accountant's statement, and with an indebtedness still due against it at the time of the divorce, and also paid $350 out of said business account for a matrice. Mr. Barrington caused to be kept a complete and correct set of books with reference to such business by T. C. Wilson, Tax Service and Accounting Office, certified public accountants in Jacksonville, Texas. This office prepared inventory of this business in March 1954, five days after the marriage and another inventory as of February 28, 1955, the closing month immediately preceding the trial of March 5, 1955. The accountants also prepared a profit and loss statement in detail covering from March 1, 1954, through *304 March 1, 1955, and also prepared a net worth statement of Elray Barrington during a like period of time. All of these inventories, profit and loss statement and net worth statement, were introduced in evidence. The operation of the business of the Barrington Tire Shop and the income and disbursement of its earnings was at no time invested, mixed or mingled with income or monies derived from any other source as only one bank account was maintained.
>
> *   *   *
>
> Unquestionably the real estate and the original tools, appliances, office furniture, and certain other original property of the Barrington Tire Shop owned by Mr. Barrington prior to his marriage and still on hand at the dissolution of the marriage had in no way changed their form and were and still remained the unquestioned separate property of Mr. Barrington.
>
> It is our further view that the other remaining property of the Barrington Tire *305 Shop, consisting of the new re-tread mold, tire changer, cement spray machine, air compressor and matrice purchased out of the bank account of Barrington Tire Shop during the marriage (which was subject to various indebtedness as shown by the record) and other property on hand in the Tire Shop including the $2,700 worth of stock of new and used tires on hand in Barrington Tire Shop at the dissolution of the marriage, under the undisputed facts in this case, and under the authorities cited in the Farrow and Sibley cases, supra, were in law the separate property of appellee, Elray Barrington.

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

Treas. Reg. § 1.316-2(a) provides:

> § 1.316-2 Sources of distribution in general.
>
> (a) For the purpose of income taxation every distribution made by a corporation is made out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits. In determining the source of a distribution, consideration should be given first, to the earnings and profits of the taxable year; second, to the earnings and profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings and profits of that year; third, to the earnings and profits accumulated before March 1, 1913, only after all the earnings and profits of the taxable year and all the earnings and profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings and profits only after the earnings and profits have been distributed.
>
> (b) If the earnings and profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings and profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. See § 1.316-1. If the distributions made during the taxable year consist only

of money and exceed the earnings and profits of such year, then that proportion of each distribution which the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year. The portion of each such distribution which is not regarded as out of earnings and profits of the taxable year shall be considered a taxable dividend to the extent of the earnings and profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings and profits accumulated since February 28, 1913, and the actual earnings and profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made.

(c) The provisions of the section may be illustrated by the following example:

Example.

At the beginning of the calendar year 1955, Corporation M had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1955 amounted to $30,000. During the year it made quarterly cash distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and before the taxable year, as follows:

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

(d) * * *

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

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

A. *Tax Treatment of Corporate Distributions*

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

1. Earnings and profits of the taxable year;
2. Earnings and profits accumulated since February 28, 1913;
3. Earnings and profits accumulated before March 1, 1913;
4. Sources other than earnings and profits.

Each of these sources is chargeable only to the extent that a distribution exceeds the source mentioned in the preceding class or classes. Thus, if the corporation has current year's earnings and profits (irrespective of a deficit in accumulated earnings and profits) or accumulated earnings and profits since February 28, 1913 (irrespective of a lack of earnings and profits in the current year), a distribution is taxable to the shareholder as a dividend.

The source of the distribution is determined by specific statutory rules not affected by statements or designations as to the source made by corporate directors or by entries upon the corporation's books. A corporation cannot control the taxability of distributions by designating them to be from some specific fund such as accumulated earnings prior to February 28, 1913, or paid-in surplus. There is a conclusive presumption that all such distributions are made from the most recent earnings and profits.

A dividend declared by a corporation which does not have current earnings and profits or accumulated earnings and profits after February 28, 1913 will be treated as a return of capital and therefore tax exempt until it exceeds the stockholder's tax basis for his stock. Any amount received in excess of the stockholder's tax basis is given capital gain treatment. [Footnotes omitted.]

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

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

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

§ 153.208. Sharing of Distributions

(a) A distribution of cash or another asset of a limited partnership shall be made to a partner in the manner provided by a written partnership agreement.

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

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

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

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

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

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

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

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

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

VIII. RETAINED EARNINGS. *Martinez* 761 So.2d 433 (Fla. 3d Dist. 2000).

A. RETAINED EARNINGS BELONG TO THE BUSINESS. In *Thomas v. Thomas*, 738 S.W.2d 382 (Tex. App.-— Houston [1st Dist.] 1987, writ denied), the husband owned a separate property interest in a Sub S corporation that generated tax liability that was paid for using community property funds. Some but not all of the corporation's earnings were distributed to the husband. the retained earnings amounted to $146,000. The divorce decree ordered the husband to pay half of his future distributions from the company until husband had paid wife $76,000 (half the retained earnings). The appellate court reversed, saying that the retained earnings of an S Corporation are not community property.

B. TAXATION OF RETAINED EARNINGS IN PASS-THROUGH ENTITIES. The management of an S Corporation, partnership, or LLC taxed as a partnership, can retain earnings without distributing them, even though the income on those earnings must be reported on the owners' personal tax returns. *See Cleaver v. Cleaver*, 935 S.W.2d 491, 495 (Tex. App.–Tyler 1996, writ denied); *Thomas v. Thomas*, 738 S.W.2d 342 (Tex. App.–Houston [1st Dist.] 1987, writ denied (involving an S Corporation). This can create a tax liability for the partners or owners on income they did not actually receive in the form of distributions.

C. REIMBURSEMENT FOR PAYING TAXES ON SEPARATE PROPERTY PHANTOM INCOME. Many past theoretical discussions about the community estate's recourse when community funds were used to pay tax liability on income retained inside a separate property pass-through entity, were brought to a point by *Dyer v. Dyer*, No. 03-16-00753-CV, at *4-5 (Tex. App.--Austin June 15, 2018, no pet.) (mem. op.), in which the appellate court held that there is no claim for reimbursement when community funds are used to pay income tax on retained earnings because the pass-through tax is a community liability, and reimbursement cannot be claimed for using community funds to pay a community debt. This decision deserves much discussion, because in adhering to the letter and logic of the law the court may have overlooked the equitable principle underlying marital property reimbursement, which is unjust enrichment.

D. SUING FOR WITHHOLDING DISTRIBUTIONS. In *Dyer*, the court of appeals pointed out that the jury was not asked whether the husband wrongfully retained earnings or was under-compensated. Instead, the jury was asked how much community was expended to benefit the husband's separate property in connection with paying income taxes on husband's separate property companies. *Id.* at *4. The appellate court thus intimates that there might be a claim for wrongfully retaining earnings. Such a claim would probably be in the nature of actual or constructive fraud on the community.

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

A. WHAT IS A PARTNER'S CAPITAL ACCOUNT?

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

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

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

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

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

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

Sec. 152.202. Credits of and Charges to Partner.

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

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

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

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

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

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

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

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

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

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

Sec. 153.206. ALLOCATION OF PROFITS AND LOSSES.

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

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

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

(2) if the allocation of profits and losses is not provided for in partnership records of the kind described

by Section 153.551(a), in proportion to capital accounts.

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