COMPENSATION, RETURN ON CAPITAL AND RETURN OF CAPITAL

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I. INTRODUCTION. Texas law is inconsistent in the way it treats different kinds of compensation for services rendered. And surprisingly, there are many areas where the proper way to characterize compensation is uncertain. Where a spouse is both an owner and an employee of a business, there can be difficulties discerning whether money or assets received from the business are compensation, or a return *on* invested capital, or a return *of* invested capital. This can create problems when valuing the business. If the ownership interest in the business is separate property, issues arise whether distributions from the business are compensation (i.e., community property), or return *on* capital (i.e., community property), or return *of* capital (i.e., separate property). This paper explores some of these issues.

II. COMPENSATION. As used in this Article, "compensation" means earnings from employment. One perspective on compensation is the term "personal service income." Personal service income is described in IRS Publication 570 (2011) in this way:

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

<http://www.irs.gov/publications/p570/ch02.html#en_US_2011_publink1000221205>. The IRS has another concept that applies to owners of sole proprietorships and partnerships, called "earned income." Earned income consists of "net earnings from self-employment" which is "your gross income from your trade or business (provided your personal services are a material income-producing factor) minus allowable business deductions." <http://www.irs.gov/publications/p560/ch01.html>. Earned income is probably synonymous with the second sentence in the definition of personal service income given above. Be that as it may, in this Article "compensation" includes both personal service income and earned income.

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

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

B. DEFERRED COMPENSATION. The IRS defines "deferred compensation" as compensation that is earned in one tax year but is paid in another tax year. Under Texas marital property law, deferred compensation is compensation for labor that is not paid until some time after the services are rendered. Exactly how long a delay is required before the compensation is deferred is subjective. Deferred compensation could be deferred a few months, or until the next calendar year, or until retirement. And deferred compensation can be dependent upon, or contingent upon, subsequent events.

C. FRINGE BENEFITS. "Fringe benefits" are a form of compensation, but most employers treat them differently from wages, salary, and bonuses. Some owner-employees cause the business to provide fringe benefits without reporting them as income for tax purposes. Fringe benefits are addressed in the IRS publication *Executive Compensation - Fringe Benefits Audit Techniques Guide* (02-2005).<http://www.irs.gov/Businesses/Corporations/Executive-Compensation---Fringe-Benefits-Audit-Techniques-Guide-(02-2005)>. The IRS considers fringe benefits to be taxable income. Examples given in the Audit Techniques Guide of fringe benefits include:

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

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

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 compensation received just after marriage or just after divorce? The easy answer is to say that compensation received during marriage is community property, regardless of when the work was done that gave rise to the compensation. And that compensation received after the divorce is separate property, even if the work that gave rise to the compensation was done during marriage. However, an argument can be raised that such compensation should be attributed to the period of time when the work was done. This is the approach taken by the Supreme Court in *Keller v. Keller*, 141 S.W.2d 308 (Tex. Comm'n App. 1940, opinion adopted), where the Supreme Court held that salary earned during marriage was community property, even though it was not paid until after the divorce. It seemed important to the Court's decision that the salary was reported as income on the husband's tax return during marriage, even though the salary was not actually paid until after the divorce. *Id.* at 311. 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 current compensation paid after divorce for work done prior to divorce.

Where the marriage or divorce occurs during a pay period, it raises the question of whether there should be an allocation of a paycheck or bonus between separate and community portions based on some allocation method, like time allocation. That policy of allocation has been applied in the context of deferred compensation (i.e., pension plans and employee stock option and restricted stock plans). Should the same principle be applied to characterizing current compensation?

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

1. Defined Contribution Plans. Defined contribution plans are considered to be a form of deferred compensation. Under existing case law, defined contribution plans are characterized just like other financial accounts. The contents of the plan account are

presumed to be community property. Tex. Fam. Code § 3.003(a). The burden to prove separate property is by clear and convincing evidence. Tex. Fam. Code § 3.003(b). Where the beginning balance of the account is known, the court subtracts the value in the account on the date of marriage from the value of the account on the date of divorce, and the difference is presumed to be community property, as having been earned or contributed during marriage. *See* e.g., *Iglinsky v. Iglinsky,* 735 S.W.2d 536, 538 (Tex. App.--Tyler 1987, no writ). Tex. Fam. Code § 3.007(c) permits a spouse to trace commingled assets in a defined contribution plan account, just like any other financial account. Defined contribution plans are usually not deferred in the sense that the contributions are delayed. They are "deferred" in the sense that the deposits and income inside a defined contribution plan are held in trust for the benefit of the employee, and are not taxed until they are withdrawn from trust; so they are "tax deferred." Because they are not really deferred and they are treated like regular financial accounts, defined contribution plans will not be further discussed in this Article.

2. Defined Benefit Plans. In *Baw v. Baw*, 949 S.W.2d 764, 768 n. 3 (Tex. App.--Dallas 1997, no writ), the court said that "[a] 'defined-benefit' plan promises employees a monthly benefit beginning at retirement. A 'defined-benefit' plan calculates benefits by plan-specific factors, such as years of service, age, and salary. *An Interdisciplinary Analysis of the Division of Pension Benefits in Divorce and Post–Judgment Partition Actions*, 37 BAYLOR L. REV. at 115."). 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. The amount of each payment is the same (subject to a cost-of-living adjustment), and is determined according to the retirement plan's formula. The formula is usually the product of multiplying the number of months of total employment, times a set number (like 1, or 1.5, or 2, etc.), times average final compensation (as defined in the plan).

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

Defined benefit pensions used to be covered by TFC § 3.007, but that statutory provision has been repealed.

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

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

S.W.2d 262, 263-64 (Tex. App.--San Antonio 1998, no pet.); *Limbaugh v. Limbaugh*, 71 S.W.3d 1, 16 (Tex. App--Waco 2002, no pet.); *Stavinoha v. Stavinoha*, 126 S.W.3d 604, 616 (Tex. App.--Houston [14th Dist.] 2004, no pet.); *Prague v. Prague*, 190 S.W.3d 31, 39 (Tex. App.--Dallas 2005, pet. denied); *In re Marriage of Jordan*, 264 S.W.3d 850, 854 (Tex. App.--Waco 2008, no pet.).

c. Qualified vs. Non-Qualified Plans. The distinction between qualified and non-qualified retirement plans does not affect characterization. A retirement plan is "qualified" when it meets the requirements of the Internal Revenue Code that allows 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. Both defined contribution plans and defined benefit plans can be qualified. 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. The most delicate 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's claim must be as a general creditor of the company.

3. Options/Restricted Stock. Initially, Texas courts characterized employee stock options using the inception of title rule. *See Boyd v. Boyd*, 67 S.W.3d 398, 410 (Tex. App.--Fort Worth 2002, no pet.) (recognizing that the ability to sell the options was limited); *Charriere v. Charriere*, 7 S.W.3d 217, 220 (Tex. App.--Dallas 1999, no pet.) (holding that the community nature of 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 the statute, these 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 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 for the benefit 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 spouse owning the deferred compensation claim 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 can calculate what an option or restricted stock will be worth in a year or two. And how would you discount for the risk of non-vesting?

a. Cliff Vesting vs. Vesting in Tranches. The proper application of Section 3.007(d) 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:

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

The Marriage–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.

The Calculation

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

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

4. Other Deferred Compensation. The characterization of pensions is controlled by common law principles stated in the *Taggart*/*Berry* line of cases. Employee stock options and restricted stock are governed by Section 3.007(c). Other forms of deferred compensation include delayed bonuses, phantom stock, performance units, stock appreciation rights, incentive payments, etc. They do not fall under either approach. How are other forms of deferred compensation handled? Do we (i) time-allocate according to the total accrual period (*Taggart*)? Do we (ii) time allocate up to the date of divorce and multiply times the value on the date of divorce (*Berry*)? Or do we do a third thing, which is what the case law did with options before Section 3.007 was adopted, and that is to (iii) apply the inception of title rule (i.e., phantom shares, or PUs, or SARs granted before marriage are 100% separate, and those that are granted during marriage are 100% community, even if post-divorce employment is required for vesting). If we go the inception of title route, is there a *Jensen*-like reimbursement claim for enhancement in value of separate property benefits due to work done during marriage, or for the enhancement of community property benefits due to work done after divorce? If there is reimbursement, is it measured by the amount of enhancement or by the value of the services contributed to increase the value of the benefit? If there is some enhancement measure, what if the value of the benefits drops after divorce, due to stock price going down, or performance targets not being met, etc.?

a. Bonuses. Bonuses can be deferred compensation if their payment is delayed. Some companies have bonus plans that say bonuses accrue over time. Most bonuses are paid after the fact for work done before the bonus is declared and paid. *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 yet unpaid at the time of mediation was still community property that needed to be disclosed to the other spouse. The Court explained:

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

> [A] Yes, I could have. I had been paid the sixty and I knew the two thirty was coming. I just didn't know when, so—
> ....
> [Q] You knew that at the time of mediation?
>
> [A] Right.
>
> [Q] And you knew the specific dollar amount at the time of the mediation?
>
> [A] Yeah. I was pretty clear on the dollar amount, yes.

Should the bonus be determined by the employee's marital status on date the bonus is declared or received, or should it be characterized based on the time period over which it was earned? Also, in some instances bonuses are paid before the work is done. See Section II.G below.

b. Delayed Payments Based on Performance. A number of highly-compensated employees are given deferred compensation that is dependent on economic performance of the business. These include 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 corporations 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.

c. Is a *Berry* Valuation Even Possible, at the Time of Divorce? 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. When the court wants to value non-vested benefits not governed by *Taggart/Berry* or Section 3.007, as of the date of divorce, who can predict the value of a company's stock 1 year, or 2 years, or 3 years in the future? Do you use Black-Scholes (designed for short term European options traded on an open market), or the binomial or "lattice" binomial method, or by gutting a goose and reading the entrails? The same problem exists for performance awards that are based on meeting profitability targets, etc.

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

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

> Randall also contends that the trial court should have valued the stock options as of the date of divorce rather than giving Ginger the benefit of the value of the options attributable to his post-divorce employment. Thus, Randall lodges the same complaint regarding the stock options as he did concerning the retirement benefits: Ginger was not entitled to 50% of the future increases in the value of the stock options.
>
> Randall's company was privately held, not publicly traded. If Randall left his employment before he was 100% vested in his stock options, he could sell the options to the company for the price he paid for them. But Randall's ability to exercise his stock options for a profit was contingent upon his employer becoming a publicly traded company or being wholly or partially acquired by a third party. In either of these circumstances, Randall would have the opportunity to sell his stock options for the price the company received for its shares.
>
> Randall's stock options vested at the rate of 1% per year from 1998 through 2006, after which they became entirely vested. However, if Randall's company went public or was substantially acquired by a third party, vesting was accelerated to 20% per year. If there was a total sale of the company,

Randall would be treated as if he were 100% vested.

The trial court determined that Randall's fair value stock options had a contingent value at divorce of $5,628,776. This value was determined by using a formula that did not take into account Randall's post-divorce work for his company or the company's future productivity. The formula was fixed at the time of the divorce.

The contingent value of the stock options could not be realized, however, until between 2002 and 2004, during which time a third-party corporation had the option to acquire all of the remaining stock in Randall's company. If Randall was not employed by the company at that time, he would not make any more profit on his fair value stock options because he would no longer be a company stockholder. In addition, even if his employment continued after divorce, Randall would not make any more profit on the stock options if the sale did not occur or if his company's stock did not become publicly traded after 2004.

To date, no Texas court has considered how to determine the community property value of stock options at divorce. The cases have only addressed whether stock options are community property. See *Kline*, 17 S.W.3d at 446; *Bodin*, 955 S.W.2d at 381; *Demler*, 836 S.W.2d at 699; *see also Charriere*, 7 S.W.3d at 220 n. 6 (holding that stock options that could be purchased but not sold without company consent during marriage were community property, even though value of options was dependent upon employee spouse's post-divorce employment). The factors presented here cause us to conclude that the contingent value of the stock options was community property. The method for calculating this contingent value was fixed at divorce, and the minimum price for the stock options was also fixed. Randall would either be able to exercise the stock options in the future for their contingent value (if he was employed and the stock sale took place or the company went public), or he would only be able to recover what he paid for them. Further, the contingent value of the options was not dependent on Randall's post-divorce work for his company, even though he had to be employed to receive it.

The trial court awarded Ginger one half of the contingent value of the stock options as her 50% share of the community estate. If Randall is no longer employed when the stock options are sold, Ginger's contingent community property interest will be extinguished. Any post-divorce increases or decreases in the value of these stock options that are not attributable to Randall's post-divorce work will not be his separate property. Ginger will be entitled to 50% of the increases, and the contingent value of her interest will be reduced by any decreases. Ginger will not be entitled to any post-divorce increases in the value of these stock options that are attributable to Randall's post-divorce work for the company because these post-divorce increases will be his separate property. However, the divorce decree does not contain any language purporting to give Ginger an interest in these latter post-divorce increases. Therefore, the trial court's division of the contingent value of the stock options was not an abuse of discretion. We overrule point nine.

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

Similar questions can be asked about a *Jensen*-like 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 what value will be added by post-divorce labors, when it is essentially impossible to value stock in advance of some future date.

F. POST-DIVORCE INCOME FROM PRE-DIVORCE WORK. Complications can arise with future income that compensates for work done before divorce. As noted in *Murray*: “It is well settled that a person's earnings after divorce are separate property and therefore not subject to division.” *Murray v. Murray*, 276 S.W.3d 138 , 147 (Tex. App.--Fort Worth 2008, no

pet.). That is more easily said than applied.

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

In *Loaiza v. Loaiza*, 130 S.W.3d 894 (Tex. App.--Fort Worth 2004, no pet.), the court of appeals considered a major league 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.

2. 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.*

3. 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 future money received as referral fees on cases the lawyer 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.*

4. 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).

5. Residual Income. Residual income is 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 that were in place, but not from members or brokers added after the date of divorce. *Id.* The members and brokers are called the "downline." The Court said: "Whereas, the monthly income from the downline in existence at the time of divorce is already earned, the income resulting from new members and brokers being added after divorce is not." *Id.* at 147. Note that the Court said the income from the existing downline was "already earned," even though the future membership fees were not yet due or received. Importantly, the appellate court was not influenced by the fact that the former husband had to recruit one new member or broker each month in order to receive the income from the downline. Even though the future income had not yet been *received*, it had already been *earned*. *Id.* at 147. The former husband did get 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.

6. Disability Payments. The case of *Simmons v. Simmons*, 568 S.W.2d 169, 170 (Tex. Civ. App.–Dallas 1978, pet. dism'd), held that long-term monthly disability benefits provided by an employer and payable to a former husband after divorce are community property, because the right to the payments was part of the husband's compensation for services during marriage. That law has been 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. However, the original argument remains in other domains, that contractual rights arising from employment during marriage are community property. This is sort of an inception of title approach.

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

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

> The argument that a signing bonus actually constitutes future income is based on equitable considerations. The court then must be persuaded to recognize the realities of the NFL salary cap. In other words, the argument is one of substance over form.
>
> First, it must be conceded that a court is likely to consider a signing bonus that has already been received by the parties a vested marital property right. A Texas court has defined the word "vested" as "a fixed right of present or future enjoyment." [FN23] Therefore, although the court is going to

view the signing bonus as a vested asset, it is up to the advocate to show the court that this should be characterized as future income. In the case of a retirement benefit, courts often look to see if the benefit was earned during the course of the marriage to determine if it is divisible. [FN24] The court must be shown that the signing bonus was not earned during the marriage. Although the signing bonus actually may be received during the marriage, it may be in exchange for the athlete agreeing to take less salary in the future. The NFL's own salary cap policy takes this into consideration and distributes the signing bonus salary cap impact over the lifetime of the contract.

This kind of reasoning might appeal to a court. Ask the court to consider applying the effect of the signing bonus the same way it is calculated by the NFL. If this argument were successful, only a portion of the signing bonus would be divisible marital property. The remainder of the signing bonus would be allocated over the remaining years of the contract as future income, just as the base salary is allocated.

Acceptance of a signing bonus in return for accepting a lower base salary during the early years of the contract can be compared to a corporation offering employees a lump sum payment to retire early. Often a company will offer a highly compensated employee some type of subsidy to induce the employee to take an earlier retirement. This is not a mere altruistic gesture by the company, but an attempt to induce a highly compensated employee to retire early, so a less costly employee can replace him or the position can be eliminated altogether.

Similarly, NFL teams do not pay players large signing bonuses because they want to reward the player for signing the contract. They pay a signing bonus to maneuver around the NFL salary cap and free up more money to sign other skilled players, thereby making the team more competitive. The player has to forgo the right to earn more money under the base salary because he accepted the signing bonus. Texas case law supports the position that a payment to induce an employee to retire early is not a benefit which is earned or accrued during the employee's tenure, but is merely an incentive to get the employee to retire early, thereby benefitting the company financially. [FN25] The court may be persuaded to view a signing bonus the same way. The player is giving something up in the future to get the bonus. The court needs to understand that the signing bonus was not to reward past or current services, but actually to compensate the athlete for future services.

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

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

H. COMPENSATION IN CONNECTION WITH SELLING THE BUSINESS. In some business sales, the buyer pays not only a purchase price, but also agrees to pay the selling owner to continue to work for, or consult with, the business. If such payments exceed the value of services to be rendered, they might be disguised sales proceeds to the extent of the excess. Covenants not to compete are discussed in Section III.E.3 below.

III. RETURN ON CAPITAL/RETURN OF CAPITAL.

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

In *Carter v. Carter*, 736 S.W.2d 775 (Tex. App.--Houston [14th Dist.] 1987, no writ), the parties married on December 7, 1974. Husband testified that in 1970 he received 159 shares of stock in MPI, a family-owned business, as a gift from his father. He corroborated this testimony by showing dividends reflected on his 1974 tax returns, coupled with his testimony that MPI declared dividends at the end of the year and paid them in the following year. In 1976, MPI was acquired by Stauffer Chemical Company, and

husband received 4,645 shares of Stauffer in exchange for his MPI stock. In 1979, Stauffer had a 2-for-1 split, raising husband's shares to 9,290 in number. In 1981, husband sold 1,156 plus 1,000 shares of Stauffer, and expended the proceeds. Husband acquired 166 shares of Stauffer stock as a Christmas gift from his father in 1981 which he later sold, and participated in six short sales in 1982 and 1983. The trial and appellate courts held that the stock was proven to be husband's separate property.

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

B. CASH DIVIDENDS. 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).

C. STOCK DIVIDENDS. Stock dividends deriving from separate property stock are separate property. *See Duncan v. U.S.*, 247 F.2d 845, 855 (5th Cir. 1957). Stock dividends arising from community property stock are community.

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.). What about distributions of capital? See Section III.G.b below.

E. SELLING AN OWNERSHIP INTEREST.

1. Character of Sales Proceeds. The proceeds from selling a business have the same character as the ownership interest. This is an application of the law of mutations.

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

3. 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, being a contract right arising during marriage, and payments received under the agreement could be characterized as 100% community. On the other hand, an argument can be made that the payments represent foregone wages, and that foregone wages after divorce are separate property.

Another potential concern can arise with a covenant not to compete that extends past the date of divorce. When a business is sold, they buyer wants to get the seller"s covenant not to compete, since it protects the buyer's investment in the business, assuring the buyer that the seller will not try to lure away suppliers, customers, or employees. Some have argued that the covenant not to compete represents the embodiment of the seller's personal goodwill, and as such all payments attributable to the covenant not to compete are separate property under *Nail v. Nail*, neither 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.

F. PARTIAL AND TOTAL LIQUIDATIONS. Controversy exists about the extent to which distributions made from separate property entities to a married spouse are separate or community property.

1. Distributions of Profits. All would probably agree that distributions of profits to a married owner are community property, absent a partition and exchange agreement or a spousal income agreement. The trouble starts when the distributions might be distributions of capital and not profits.

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.).

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

3. Partial Liquidation. A controversy surrounds partial distributions from a separate property business, as to whether the are, separate property.

In *Legrand-Brock v. Brock*, 246 S.W.3d 318 (Tex. App.--Beaumont 2008, pet. denied) ("*Brock* II"), the court said:

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

Brock II, at 323. 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.

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. For federal income tax purposes, every distribution of a corporation to its shareholders is deemed to be made out of earnings and profits, to the extent there are any. See Treas. Reg. § 1.316-2(a). The 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.

Marshall v. Marshall, 735 S.W.2d 587 (Tex. App.–Dallas 1987, writ ref'd n.r.e.), is frequently cited in support of the view that all distributions from a partnership during marriage are community property. In *Marshall*, the husband owned an interest in a partnership at the time of marriage. The partnership owned mineral leases 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. *Marshall* clearly states that distributions of current income or profits are community property. However, the opinion does not expressly say that all distributions from a partnership are community property. *Marshall* establishes that separate property capital, once contributed to the partnership, loses its character as separate property, so that distributions cannot be mutations of the separate property contribution. The significance of *Marshall* to a great degree depends on whether you read some of the statements in the Court's Opinion as broad principles of law, or whether you read them as conclusions drawn from the facts in the particular case (in particular, the language of the partnership agreement and the fact that all distributions were from current income).

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.

G. TEX. BUS. ORG. CODE § 153.208. It is clear that the Texas Legislature believes that partial distributions from a limited partnership can be a return of capital, because Section 153.208 of the Business Organization Code specifically covers them. 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.

Chapter 153 applies to limited partnerships, not

corporations, general partnerships, or limited liability companies.