WHOSE MONEY IS IT?
THE CHARACTERIZATION OF PARTNERSHIP DISTRIBUTIONS

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By Jim Wingate[1]

I. INTRODUCTION.

The numbers are surprising: over 147,000 active limited partnerships registered in Texas, an additional 11,000 foreign limited partnerships registered in Texas, over 4,000 limited liability partnerships and an indeterminate number of general partnerships.[1] Even more surprising, there have only been two courts of appeals cases that have considered the character (separate, community or mixed) of distributions from partnerships. The first case is *Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.—Dallas 1987, writ ref'd n.r.e). The second, decided almost twenty years later, is *Lifshutz v. Lifshutz*, 199 S.W.3d 9 (Tex. App.—San Antonio 2006, pet. denied).[2] In spite of the fact that neither case actually involves a distribution of capital by a partnership, both are cited as standing for the proposition that capital contributions cannot be traced through a partnership's capital account.

Both *Marshall* and *Lifshutz*, although reaching the correct result, were wrongly reasoned. The courts of appeals in both cases state that separate property assets contributed to a partnership do not retain their separate property character in the hands of the partnership. Although this is correct, it is not dispositive in determining the character (separate, community or mixed) of a distribution from a partnership. This article will discuss tracing principles, partnership capital accounts, profits and distributions, and will summarize and analyze both *Marshall* and *Lifshutz*. Because a different analysis applies to the characterization of amounts received as a result of redemptions and liquidations of partnerships, a brief discussion of that issue is also included.

II. PRINCIPLES OF TRACING AND MUTATION IN FORM.

Most Texas attorneys are familiar with the basic tenants of Texas' community property system, and most Texas family law attorneys can recite them from memory. For the sake of completeness and for a frame of reference, I repeat them here:

No. 1: Community property is all property acquired during the marriage other than separate property.[3]

No. 2: All property of the marriage is presumed to be community property.[4]

No. 3: Separate property is (a) property owned or claimed by a spouse before marriage, (b) property acquired by a spouse during the marriage by gift, devise or descent, and (c) any recovery for personal injuries sustained by a spouse during marriage, except for recoveries for loss of earning capacity during the marriage.[5]

No. 4: Clear and convincing evidence is required to establish separate property.[6]

Courts also recognize that property may be of mixed character, i.e., part separate and part community, based upon the relative amounts of separate and community property used to acquire the property.[7]

Frequently, the establishment of separate property involves some form of tracing of assets. By definition, tracing involves demonstrating the separate origin of the property by showing that it derived from property that was the separate property of a spouse.[8] For example, when shares of stock that are the husband's separate property are sold and the proceeds reinvested in other shares, then the new shares are considered a mutation in form of the original shares provided the husband can show by clear and convincing evidence that the proceeds from the sale of the old shares were used to purchase the new.[9] As far back as 1851, only five years after statehood, the Texas Supreme Court applied the community presumption and the interrelated concepts of tracing and mutation in form.[10] Mutations in form typically involve some form of cash held in a financial account at some point in the tracing trail.[11]

Harris v. Ventura, 582 S.W.2d 853 (Tex. Civ. App.—Beaumont 1979, no writ), contains an excellent description of the tracing of assets through mutations in form. In *Harris*, the deceased, George Ventura ("George"), owned real property and also held inherited funds, all of which was his separate property. George deposited his inherited monies into a bank account, and he sold the real property and deposited the proceeds into that same account. George also deposited other monies, whose origin was not identified by the court of appeals but that were of a separate character, into that same account. The account earned community interest, and George wrote checks drawn on the account. The husband's estate

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hired an expert, who prepared tracing schedules of the activity in the account. The expert prepared exhibits showing the activity in the account, characterizing each deposit and withdrawal as separate, community or mixed. The tracing was facilitated by use of the community-out-first presumption, which presumes that all withdrawals are made first from community funds.[12] By tracing funds as a mutation in form of antecedent assets, the estate's expert was able to trace separate property into a bank account, and then trace and characterize the activity in that account. The tracing expert was ultimately able to demonstrate that the account held $3,657.88 of the deceased's separate property.

When tracing funds held in an account, attorneys and experts treat the process as tracing actual dollars held in an account for a spouse, but everyone realizes this is not actually the case. As we all know too well during these times of accelerating banks failures (one hundred fifteen FDIC insured banks as of October 30, 2009 as compared to twenty-six in 2008, and only three in 2007), no actual dollars are segregated at the bank and identified as belonging to the account holder.[13] What each depositor actually holds are rights under the deposit contract that he or she signed with the bank, and the bank is required to return the customer's funds according to the terms of the deposit agreement.[14] Title to the deposited funds rests in the bank, and the relationship between the bank and its depositor is that of debtor (the bank) and creditor (the depositor).[15] The bank is required under the contract to pay out funds on deposit according to the directions of the depositor.[16] This is why banks use the phrase "credit your account." In accounting terms, a "credit to your account" represents a liability of the bank to repay you your funds.

III. PARTNERSHIP FORMATION, CAPITAL, PROFITS, AND DISTRIBUTIONS.

Effective January 1, 2010, the present Texas statutes governing partnerships, as well as all other entities, will be replaced by the provisions of the Texas Business Organizations Code (the "TBOC").[17] Because it will soon apply to all partnerships, this discussion is based upon the partnership provisions contained in the TBOC. It should be noted, though, that the TBOC is basically a recodification of existing statutes.[18]

The term "partnership" is defined in the TBOC as any entity that is governed under Title 4 of the TBOC.[19] Title 4 governs general partnerships (Chapter 152, §152.001 through §152.914), limited partnerships (Chapter 153, §153.001 through §153.555) and limited liability partnerships (Chapter 153, Subchapter H, § 153.351 through §153.353.). Also, the statutes contained in Title 4, Chapters 151 and 154 supplement the general partnership provisions of Chapter 152 and the limited partnership provisions of Chapter 153, unless specifically provided for otherwise.[20] Because limited liability partnerships are a special form of either a general or limited partnership, there is no need for purposes of this discussion to separately discuss limited liability partnerships.[21] Those provisions of the TBOC that are applicable to general partnerships can be cited as "Texas General Partnership Law" ("TGPL"), and the provisions applicable to limited partnerships can be cited as "Texas Limited Partnership Law" ("TLPL").[22]

There are different requirements for the formation of general and limited partnerships. To form a general partnership, all that is required is for two or more persons to engage in a business for profit as owners, regardless of whether they intended to create a partnership.[23] Thus, there is no requirement for a written partnership agreement, and the TGPL lists five factors that indicate whether a partnership has been created.[24] Not surprisingly, such informality in the formation process has led to lawsuits over the existence or nonexistence of general partnerships.[25] If a matter is not dealt with in the partnership agreement of a general partnership, the provisions of the TGPL govern such matters.[26] In contrast to a general partnership, a limited partnership is formed only after the partners enter into a partnership agreement and file a certificate of formation with the Texas Secretary of State.[27] The term "partnership agreement" includes both written and oral agreements.[28]

Usually, limited and general partners contribute capital upon formation of the partnership, and possibly at other times during the life of the partnership. The TBOC broadly defines contributions to include any tangible or intangible benefit transferred to an entity, including cash, services rendered, a contract for services to be rendered, promissory notes, securities, etc.[29] Limited partnerships are required to maintain a statement of the agreed value for any noncash contribution, but there is no similar requirement for general partnerships.[30] Partnership capital contributions, for both general and limited partnerships, are generally recorded at the fair market value of the capital contributed.[31]

The accounting records of any partnership (or at least those partnerships in which the participants intended for there to be a partnership) will include a capital account for each partner. Each partner's capital account is used to maintain a running total for the value of all capital contributed by the partner, the profits and losses allocated to that partner and all distributions to the partner. For purposes of the partnership provisions of the TBOC, "capital account" is defined as a calculation: an amount calculated by adding a partner's cash contributions to the partnership, the agreed value of non-cash assets contributed, plus the partner's share of profits, and then subtracting distributions to the partner as well as the partner's share of losses.[32]

The TGPL and the TLPL differ with respect to the allocation of profits. For limited partnerships, if the partnership agreement is silent as to the allocation of profits, they are allocated to the partners based upon their respective capital contributions.[33] For general partnerships, however, each partner is entitled to an equal share of partnership profits and losses unless the partnership agreement provides otherwise.[34]

TLPL provides that distributions of cash or other assets to a partner shall be made by a limited partnership "in the manner provided by a written partnership agreement," and to the extent and in accordance with the schedule provided for in that agreement.[35] The TLPL also provides that a distribution from a limited partnership that is a return of capital is to be made on the basis of the agreed value of the original contribution of the capital (unless the partnership agreement provides otherwise).[36] With respect to distributions of profits, TLPL provides that profits are to be distributed in proportion to the allocation of profits as determined under the limited partnership agreement, or distributed as specified in TLPL if there is no agreement.[37] TGPL is silent regarding distributions from general partnerships except to require that each partner be charged with cash and the value of any non-cash assets distributed to the partner.[38]

Partnership agreements can become quite complex with respect to the sharing of revenue and expenses between partners, and this is especially true in partnerships involved in the development and production of oil and gas leases. For example, various costs can be allocated disproportionately between partners, and allocation of revenues to the partners can depend upon whether development costs have been recovered.[39] Similarly, real estate development partnerships can also be complex, with preferred returns and carried interests.

There is no requirement in either TGPL or TLPL that profits be distributed before capital is distributed. The order of distributions is controlled by the partnership agreement. However, in the absence of a provision in a limited partnership agreement specifying the order of distributions, profits are distributed before capital.[40] An example of the various possibilities for the order of distributions can be found in Sally Schreiber's State Bar of Texas CLE article entitled *Partnership (General, Limited and LLP) Formation and Opt-In Decisions*.[41] In her example limited partnership agreement, distributions are made first to limited partners to satisfy a preferred return requirement, then to all partners to the extent of unreturned capital contributions and finally to all partners in accordance with their profit sharing ratios.

IV. SUMMARY OF MARSHALL AND LIFSHUTZ.

In *Marshall*, the parties had remarried each other only five months after their earlier divorce. Then just fifteen months after their remarriage, both parties filed for divorce on the same day. The husband, Woody, was a partner in an oil and gas partnership, and he had acquired his interest in the partnership before his second marriage to Arlene. Woody received approximately $542,000.00 from the partnership during the short marriage. Of that amount, approximately $22,000.00 was received as wages, and the balance was received by him as partnership distributions. The partnership agreement provided that all distributions to the partners were to be from the profits of the partnership.

Woody's position was that the partnership distributions were received by him as a return of his separate property partnership capital. He reasoned that the distributions to him were mutations in form of his separate property because they were derived from sales of oil and gas sold from leases that were all acquired by the partnership prior to his marriage. Thus, he argued, they were received by him as a return of capital and not as income. Woody appeared to be relying on the legal principle that separate property, if properly traced through mutations in form, remained separate property. Arlene understandably took the opposite view—that all partnership distributions to Woody were community property because they were either wages or distributions of partnership profits.

In support of his position that the partnership distributions received by him were his separate property, Woody cited the Texas Supreme Court's decision in *Norris v. Vaughn*, 260 S.W.2d 676 (1953). In that case, the Supreme Court concluded that distributions from an oil and gas partnership were received by the husband as his separate property.[42] The Supreme Court's characterization in *Norris* was based on the aggregate theory of partnership law in force at that time. Under the aggregate theory, a partnership is treated as an aggregate of its individual partners, and the assets are considered held by the individual partners, not the partnership. However, the Dallas Court of Appeals found that *Norris* was no longer relevant because Texas had adopted the entity theory of partnerships subsequent to that decision when the Texas legislature passed the Uniform Partnership Act in 1961.

Under the entity theory, the partnership is the owner of all partnership assets, and the partners simply hold an interest in the partnership itself. It is only this interest that can be characterized as either separate or community property, and not the assets of the partnership. The Dallas Court of Appeals therefore held that profits distributed to a partner are community property "regardless of whether the partner's interest in the partnership is separate or community in nature." The court of appeals noted that (i) "all monies disbursed by the partnership were from current income," and that (ii) the partnership agreement specifically provided that amounts distributed to a partner in excess of salary are to be charged against the partner's share of profits. The court of appeals then stated that "[u]nder these facts, we hold that all of the partnership distributions that Woody received were either salary under the partnership agreement or distributions of profits of the partnership."

The Dallas Court of Appeals in *Marshall* also engaged in an analysis regarding the tracing of assets through a partnership's capital accounts, and concluded that a distribution from a partner's capital account can never be characterized as a mutation in form of a partner's separate property contribution to the partnership. The court of appeals' reasoning was that if a partner could trace through his capital account, this would imply that the partners retained an ownership interest in the assets contributed to the partnership. The court of appeals noted that the Texas Supreme Court had already determined in *McKnight v. McKnight,* 543 S.W.2d 863 (Tex. 1976), that "the only partnership-related property a trial court can award upon dissolution of a partner's marriage is the partnership interest." It then concluded that since partnership assets were the property of the partnership and not of the partner, it was impossible to trace a capital contribution so as to determine that a later distribution from a capital account was a mutation in form of the original capital contribution.

Lifshutz, which is the only other case in which a Texas court of appeals has considered the issue of the characterization of partnership distributions, involved some unusual facts. The parties, James and Kymberly, were married in 1990. James was a partner in Liberty Properties Partnership ("Liberty Partnership"), and in 1990 Liberty Partnership acquired one-third of the stock of Berlee Lumber Company ("Berlee Lumber") from James's father. The record is silent as to whether the stock was purchased by Liberty Partnership or was contributed as capital by James's father. Pursuant to a plan of reorganization, Liberty Partnership transferred the Berlee Lumber stock to Liberty Financial Corporation ("Liberty Corporation") in 1996. The trial court found that, to the extent of his relative ownership interest in the partnership, there was a constructive distribution of the Berlee Lumber stock to James by Liberty Partnership followed by a contribution of the stock by James to Liberty Corporation.

James made two arguments to the Court: first that under *Thomas v. Thomas*, 738 S.W.2d 342 (Tex. App.—Houston [1st Dist.] 1987, writ denied), "corporate earnings remained corporate property until distributed and, therefore, were not divisible on divorce"; and, second, that the distribution of the Berlee Lumber stock constituted an asset distribution and not a profits distribution. The San Antonio Court of Appeals summarily disposed of James's first argument by noting that the present case was one in which assets were distributed, not one in which assets were retained.

James's second argument, that his case involved a distribution of assets instead of profits, apparently was made in order to circumvent the holding in *Marshall* that profits distributed by a partnership constituted community property upon receipt. The San Antonio Court of Appeals applied the logic of *Marshall* in spite of James's attempt to reframe the issue. The court of appeals quoted with approval the Dallas Court of Appeals' statements in *Marshall* that "[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." Like the Dallas Court of Appeals, the San Antonio Court of Appeals also cited cases holding that a partner has no interest in the assets of the partnership. The San Antonio Court of Appeals then held that distributions from a partnership are characterized as community property because partnership property does not retain a separate character, "regardless of whether the distribution is of income or an asset."

V. ANALYSIS OF MARSHALL AND LIFSHUTZ.

The Dallas Court of Appeals in *Marshall* based its decision on the terms of the partnership agreement, which specifically provided that all partnership distributions were to be made from the profits of the partnership. The trial court had previously found that partnership income each year exceeded the dollar amount of the distributions to the partners. The methodology applied by the court of appeals in its analysis was consistent with the numerous cases that have held that the agreement of the parties as contained in the partnership agreement is controlling. Thus in *Park Cities Corp. v. Byrd*, 534 S.W.2d 668, 672 (Tex. 1976), the Texas Supreme Court found that the agreement of the parties was controlling in reaching a decision as to whether a partner had to restore a negative capital account balance upon the dissolution of a partnership. Moreover, the Texas Supreme Court also held in *Park Cities Corp*. that a partnership agreement constitutes a contract between the partners.[43]

However, going beyond the terms of the partnership agreement, the court of appeals in *Marshall* also stated:

> [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. 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.

These statements of the Dallas Court of Appeals are *obiter dicta*. *Dicta* is defined as those "words of an opinion entirely unnecessary for the decision of the case …. Such are not binding as precedent."[44] The court of appeals' statements regarding tracing through a capital account are not necessary for the decision in *Marshall* because the court's opinion in *Marshall* was based on the finding of the trial court that the distributions Woody received from the partnership were comprised of salary and distributions of partnership income. As such, they were not distributions of capital, but rather of profits and wages, and were received by Woody as community property. Since the distributions in *Marshall* consisted of wages and partnership income, the court of appeals did not have before it the issue of the character of a distribution to a partner of previously contributed capital.

In *Lifshutz*, the husband, James, was also attempting to trace assets "through" a partnership, and both the facts and James's legal arguments were somewhat unusual. The district court had found that the Berlee Lumber stock was distributed to James as a "non-liquidating community distribution," and then recontributed by James to Liberty Corporation, his separate property company. Therefore, the community was due reimbursement for the value of the community stock that was contributed to Liberty Corporation. Evidently, the district court was uncertain as to whether the stock represented a distribution of income or of capital, and side-stepped this issue by simply calling it a "nonliquidating community distribution."

The San Antonio Court of Appeals' opinion is silent regarding one important matter: the record is totally devoid of any discussion of the terms of the partnership agreement of Liberty Partnership, and of what, if any, provisions that it contained regarding partnership distributions. Were all distributions to come from profits, as in *Marshall*, or did the agreement permit contributed capital to be repaid to the partners prior to liquidation? Were there any partnership provisions specifying the priority of distributions, i.e., profits first, then capital or vice versa?

There is also nothing in the record indicating how the Berlee Lumber shares were acquired by Liberty Partnership, only that they were acquired by the partnership from James's father. Were the shares purchased from James's father, or instead did James's father convey them to the partnership as a contribution to capital? Regardless, there was nothing to indicate that James held any interest in the stock before its transfer to Liberty Partnership.

Lifshutz did not have to be decided on the basis that a partner cannot trace his capital contribution through a partnership. There is nothing in the record to show that the Berlee Lumber stock distributed to James was a return of capital, and James did not even put forth an argument that it was a return of capital. James simply asserted that the stock was "an asset distribution and not a profit distribution." The record shows that the stock was conveyed to Liberty Partnership by his father, so James did not contribute the stock to the partnership. Additionally, no evidence was brought forward at trial to show that, under the terms of the partnership agreement, the distribution of the Berlee Lumber stock was a return of invested capital. The mere fact that a distribution was in the form of a non-cash asset is not determinative of its classification as a distribution of profits or a distribution of invested capital. Profits can be held by a partnership in the form of a non-cash asset, and there was nothing in the record in *Lifshutz* to evidence that the deemed distribution of stock to James was a return of capital. James therefore had not established any basis whatsoever for arguing that this was a return of his separate property investment.[45]

James was essentially arguing that his distribution could not be a distribution of profits because it was a distribution of a non-cash asset instead of cash. This presupposes that profits can only be distributed in the form of cash. This is not the case. As decided by the Texas Supreme Court in a 2009 case dealing with the issue of whether a general partnership existed, profits are simply the excess of revenue over expenditures**.**[46] This is a mathematical calculation, and there is not necessarily a one-to-one correlation between cash and profits. Thus, a distribution of either a cash or non-cash asset could be either a distribution of capital or of profits. Cash generated from operations is frequently used to purchase assets, and it is possible for such assets to be distributed to the partners, as may have been the case in *Lifshutz*. Whether such in-kind distribution is a distribution of capital or of profits will be determined by the partnership agreement, and, in the absence of provisions in the partnership agreement, then by TGPL and TLPL, as appropriate.[47]

Unfortunately, the San Antonio Court of Appeals based its decision upon the dicta in *Marshall* that, because the partnership, and not the partners, is the owner of any assets contributed to it, then a distribution of capital cannot be traced as a mutation in form of the original contribution. The court of appeals appears to be confusing the tracing of the ownership of individual assets with the tracing of investments made in entities. When a partner contributes capital to a partnership, whether in the form of cash or other assets, there is no denying that the assets become the property of the partnership.[48] However, notwithstanding the fact that the partners do not own the assets of the partnership, the partners do hold an investment in the partnership that is represented by the value of their capital contributions, regardless of whether that contribution is of cash or of a non-cash asset, and those capital investments are to be repaid according to the terms of the partnership agreement. If and when the partnership repays the capital to the partners according to the terms of the partnership agreement, the funds received in repayment have the same character as the original capital that was contributed. It is the character of the investment that determines the character of the capital contribution that is repaid, and this has nothing whatsoever to do with ownership of partnership assets or with how the partnership may have invested that capital.

The relationship of the partners to the partnership with respect to their capital accounts is similar to that of a bank's depositors to a bank. Both the partners and the depositors expect to be repaid their monies, and one court of appeals, perhaps overstating the case, has even held that a partner's positive capital account balance is a debt owed by the partnership to the partner.[49] The cash held by a financial institution is neither separate cash nor community cash, but rather is the bank's cash, some part of which is subject to the claims of the depositors. Nevertheless, we speak of tracing cash held in an account, when it is actually the institution's obligation to repay its depositors according to the terms of the deposit agreement that is being traced. In like manner, a partnership's obligation to repay the capital it holds according to the terms of its contract with the partners can be traced. Cash withdrawn from a bank account is not literally the same cash that was deposited. A tracing expert acts like it is when he or she traces the cash, but this is simply an intellectual construct. There is no reason for the tracing of capital invested in a partnership to fail because the assets held by a partnership are not owned by the partners. The assets of the partnership play no role in the tracing of the capital invested by the partners. When characterizing a distribution of capital from a partnership, the capital returned to the partner will have the same character as the capital contributed, just as cash withdrawn from a bank account will have the same character as the funds initially deposited.

VI. PARTNERSHIP REDEMPTIONS AND LIQUIDATIONS.

The principal of mutation in form applies to more than just distributions from partnerships—it also applies, although in a somewhat different manner, to both redemptions of a partner's interest and to liquidations of partnerships. The treatment of amounts received in redemption of a partner's interest was considered by the Houston Court of Appeals in a 1988 case, *Harris v. Harris*, 765 S.W.2d 798, 803 (Tex. App.—Houston [14th Dist.] 1988, writ denied). In *Harris*, a partner in the law firm of Andrews and Kurth received monthly installments from the partnership as a buy-out, i.e., redemption, of his interest in that partnership, and the total value of the redemption payments was estimated as being $500,000.00.[50]

The husband had acquired his partnership interest prior to his marriage. During the marriage, the partners executed a new agreement that changed the terms of redemption for any withdrawing partner. The wife argued that since the new agreement changed the amount that her husband would receive upon leaving the firm, the partnership interest redeemed was different from the partnership interest held by her husband at the time of their marriage. The court of appeals cited the Texas Supreme Court's holding in *Norris* that property remains separate even when it undergoes "any number of mutations and changes in form," and upheld the jury's characterization of redemption payments as the husband's separate property. In its analysis, the court of appeals analogized a partnership interest to an interest in stock, holding that the interest the husband held prior to marriage was the same interest that he held upon withdrawing from the firm, and any increase in value attributable to the new agreement was analogous to stock splits and other increases in the value of stock. The redemption payments received by the husband were therefore a mutation in form of his partnership interest.

Although there do not appear to be any cases directly on point regarding the characterization of a liquidating distribution from a partnership, the

Beaumont Court of Appeals has recently considered the character of payments received in complete liquidation of a corporation. In *Legrand-Brock v. Brock*, 246 S.W.3d 318, 322 (Tex. App.—Beaumont 2008, pet. denied), a corporation distributed its assets to the shareholders "in complete cancellation or redemption of all the shares" of the corporation. The husband was paid approximately $7 million cash in return for the cancellation of his shares, which were admittedly his separate property. The wife's expert attempted to characterize the liquidating distributions as "liquidating dividends," and argued that they should be characterized the same as dividends paid from on-going operations, that is to say, as income from separate property and therefore community property.

The Beaumont Court of Appeals concluded that the cash received by the husband was a mutation in form of the husband's cancelled stock, and was therefore his separate property. The court of appeals relied on two earlier decisions, one by the El Paso Court of Appeals in 1957 and another by the Texarkana Court of Appeals in 1956, both of which involved the distribution of assets to a shareholder in liquidation of his separate property interest.[51] Both of those courts concluded that assets distributed in liquidation of separate property stock were received as separate property.[52] The Beaumont Court of Appeals also supported its opinion by citing to the holding in *Harris* that a partner receives redemption payments as a mutation in form of his investment, and "the character of property is not altered by the sale, substitution or exchange of the property …." The Beaumont Court of Appeals obviously believes that a liquidating distribution of a corporation is similar to a redemption payment by a partnership.

How is it that retained earnings that are distributed as dividends with respect to separate property stock are characterized as community property, while retained earnings that are received in liquidation of separate property shares are characterized as separate property? The answer can be found in the distinction that the court of appeals drew between retained earnings paid as dividends and those paid as liquidating distributions. Since the payment in *LeGrand-Brock* was a liquidating distribution, the Beaumont Court of Appeals viewed the transaction between the husband and the corporation as an exchange of his separate property stock for cash received from the corporation. The cash was therefore a mutation in form of the shares, and retained the character of the shares. In its analysis, the court of appeals held that the fact that the liquidating distribution was paid from corporate earnings was not relevant to the characterization of the distribution because the earnings of a corporation belong to the corporation until a dividend is declared. The court of appeals also noted that federal case law also distinguishes between dividends and liquidating distributions.[53]

The Beaumont Court of Appeals' analysis is consistent with the manner in which dividends received by a spouse are characterized. In characterizing a dividend, earnings are not traced to determine which earnings were accumulated prior to marriage and which were accumulated during marriage. Thus, dividends received during marriage are considered community property regardless of the fact that the earnings from which they are paid were accumulated prior to marriage; and, similarly, the community has no claim to undistributed earnings held by a corporation at the time of divorce. Absent a marital property agreement, the only factor controlling the characterization of a dividend as community property is simply whether the dividend was paid during the marriage. The analysis of the court of appeals is consistent with this methodology—accumulated earnings belong to the corporation, and are community property only if and when a dividend is declared. The community has no claim to these assets, and receipt of a liquidating distribution is therefore distinguishable from the receipt of a dividend even though both are paid from accumulated earnings.

Likewise, a liquidating distribution to a partner should also be treated as a mutation in form of the partnership interest. This is consistent with both the treatment of corporate liquidations as determined by the court of appeals in *LeGrand-Brock* and with the characterization of partnership redemption payments in *Harris*. As with the retained earnings of a corporation, the accumulated earnings of a partnership are partnership assets and cannot be characterized as either community assets or separate assets. If payments are made in liquidation of a partnership, they should be characterized as a mutation in form of the partnership interest surrendered in exchange for the payment. All assets received in liquidation, including the previously undistributed earnings, would be received by the partner as his or her separate property. Conversely, if a partnership distribution is not made in liquidation, then the partnership agreement should be examined to determine whether the distribution is from income or from capital. This treatment creates a dichotomy between the treatment of earnings distributed during the ordinary course of business versus those distributed in liquidation or redemption, but it is consistent with the treatment of funds received in exchange for an interest in an entity as a mutation in form of the interest formerly held in the entity.

Consistency in the application of the law requires that assets received in liquidation of a partnership be treated the same as those received in liquidation of a corporation. Both are entities formed under the applicable laws of Texas, and both have a separate existence from their owners. Additionally, the basis for the Beaumont Court of Appeals' holding in *LeGrand-Brock* was that liquidating distributions are distinguishable from dividends because the community has no claim to the accumulated earnings of a corporation until they are distributed as either a dividend or a liquidating distribution. This applies equally to a partnership. As described above, partnership assets belong to the partnership until distributed to the partners. As with corporate distributions, the character of partnership distributions should be determined by the nature of the distributions, and liquidating distributions should have the character of the partnership interest surrendered.[54]

VII. EXAMPLE.

A hypothetical example, based loosely on facts from an actual case, might be instructive. In 1999, a real estate promoter in Houston held an option to purchase ten acres of undeveloped land on South Padre Island for $100,000.00. He found a group of investors who were willing to purchase the land at that price, and give him a 10% carried interest. The investors agreed with the promoter to form a limited partnership to purchase the land. Because of the carried interest, the developer did not contribute any capital for the purchase of the land, but, along with the investing partners, was assessed capital calls from time to time by the partnership to cover his pro rata share of the carrying costs of the land (taxes, insurance, upkeep, etc.). The limited partnership agreement provided that the first distributions from the partnership would be paid to the investors as a return of their initial $100,000.00 investment, then capital contributed for carrying costs would be repaid, and finally profits, if any, would be distributed pro rata, 90% to the investors and 10% to the promoter. The agreement also provided that the partnership would terminate upon the disposition of all the land.

The land was sold in two parcels, five acres in 2005 and five acres in 2009. The carrying costs of the land up through the point of the first sale were $40,000.00, and there were $50,000.00 of additional carrying costs through the date of the second sale. The net proceeds from the sale of the first parcel in 2005 were $200,000.00, and the net proceeds from the second parcel in 2009 were $400,000.00. The only distributions from the partnership were in 2005 and 2009, at the time of the sale of each parcel. The entire net proceeds were distributed on each occasion, but the 2009 distribution was handled as a liquidating distribution.

Based upon the partnership agreement, the first $140,000.00 distributed to the partners in 2005 represented a return of both the investing partners' $100,000.00 initial capital investment and all partners' subsequent $40,000.00 contributed as capital to pay the carrying costs of the land. The remainder of the 2005 distribution, $60,000.00, represented a distribution of profits, and was allocated 90% to the investors and 10% to the promoter. By the time of the 2009 liquidating distribution, the only unreturned capital was the carrying costs incurred between the sale in 2005 and the sale in 2009 ($50,000.00). The balance, $350,000.00, came from profits.

The characterization of the first distribution is handled differently than the characterization of the second based upon the fact that the second distribution is a liquidating distribution. To the extent that the first distribution is a repayment of the partners' contributed capital, it has the character of the capital that was contributed. Thus, $140,000.00 would have the character of the capital that was contributed, and $60,000.00 would be characterized as community property because it represented a distribution of profits, which, absent a binding agreement between spouses, is always characterized as community property. The second distribution, which was a liquidating distribution, would be treated as a mutation in form of the partnership interest that was given up. Therefore, all of the second distribution would have the character of the original investment in the partnership, which, based upon both *LeGrand-Brock* and *Harris v. Harris*, would be separate if the investment for a given partner were separate and community if that investment were community.

VIII. CONCLUSION.

Characterizing distributions made to a partner is not unlike characterizing the withdrawal of funds from a bank account. Just as a depositor holds rights under his or her deposit contract that specifies what is held in the account as interest and what is held as deposits, a partner is a party to the partnership agreement that distinguishes between contributed capital and profits. In neither case is it necessary to characterize and trace the assets held within the entity, regardless of whether it is a bank or a partnership, in order to establish the character of amounts repaid to the investor or depositor. The fact that funds withdrawn from a bank account are not the same physical dollars that were deposited into that account does not prevent the tracing of funds credited to an account. Likewise, the fact that dollars or assets invested in a partnership are not the same dollars or assets distributed to a partner does not prevent the tracing of the capital distributed back to the original investment, so that the capital distributed has the same character as the capital originally invested.

The courts of appeals in both *Marshall* and *Lifshutz* concluded, based upon the legal premise that partnership assets are owned by the partnership and not the partners, that a distribution of capital to a partner cannot be traced as a mutation in form of the original capital investment. This shows a misunderstanding of the manner of tracing the mutations in forms for investments in entities. Under the former aggregate theory of partnerships, tracing of individual assets held within the partnership would have been required because the partners were viewed as owners of those assets. Under the existing entity theory of partnerships, such tracing within a partnership not only cannot be done, but is not required to be done in order to establish the character of a distribution of capital because the partner simply holds an investment in the partnership, and not in the underlying assets.

There is no need to trace "through" a partnership in order to characterize a return of invested capital as the separate property of a spouse. In both *Marshall* and *Lifshutz*, both husbands were attempting to prove separate property claims by tracking individual assets from the point in time at which they were conveyed to the partnership to the point at which they were later distributed to the husbands. For the reasons discussed above, these arguments were flawed. In rejecting the husbands' logic, however, both courts of appeals appear to have accepted the husbands' premise that the tracing of a separate property capital contribution by a partner would have to involve the tracing of assets from the point in time at which they were contributed to a partnership to a later point in time at which these same assets were distributed back to the partner. It is simply a false premise that you have to trace individual assets held within a partnership in order to trace the capital invested in the partnership.

In conclusion, capital contributed to a partnership can be traced like any other investment, and does not fail simply because partnership assets cannot be characterized as either community or separate property assets. The characterization attaches to the investment made, not to the assets held by the partnership. The provisions of the partnership agreement then determine whether any given distribution is a return of invested capital or a distribution of profits. To the extent that it is a return of invested capital, it will have the character of the original investment. Redemptions and liquidations are, however, an exception to this treatment, and, in those instances, the entire distribution will have the character of the investment made.

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[1] E-mail dated August 18, 2009, from Lorna Wassdorf, Director, Business & Public Filings, Texas Secretary of State to Jim Wingate. No count of active general partnerships is available because there is no requirement for general partnerships to file with the Secretary of State. Both general and limited partnerships can register as limited liability partnerships, but no information is maintained by the Texas Secretary of State's office identifying those limited liability partnerships that are also registered as limited partnerships. *Id*.

[2] The Houston Court of Appeals noted in *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex. App.—Houston [14th Dist.] 1988, writ denied), that the Dallas Court of Appeals in *Marshall* had held that distributions of income from a partnership were always community in nature. *Id*. However, the issue being considered in *Harris* was whether payments received by a former partner to redeem his interest in a partnership were community or separate. There was no analysis in *Harris* of the character of distributions from partnerships.

[3] *See* TEX. FAM. CODE § 3.002; *see also Bailey-Mason v. Mason*, 2008 --- S.W.3d --- (Tex. App.—Dallas 2008, pet. denied) WL 5158912, 4.

[4] *See* TEX. FAM. CODE § 3.003(a); *see also McKinley v. McKinley*, 496 S.W.2d 540 (Tex. 1973).

[5] *See* TEX. FAM. CODE § 3.001; *see also Wilson v. Wilson*, 44 S.W.3d 597, 601 (Tex. App.—Fort Worth 2001, no pet.)(denying husband's claim of separate property for property acquired during separation from wife).

[6] *See* TEX. FAM. CODE § 3.003(b); *see also Long v. Long*, 234 S.W.3d 34, 37 (Tex. App.—El Paso 2007, pet. denied)(requiring clear and convincing evidence to prove separate property).

[7] *See Gleich v. Bongio*, 99 S.W.2d 881, 883 (Tex. 1937) (when property is purchased partly with community funds and partly with separate funds a tenancy in common is created between the separate and community estates with each estate owning an interest in the proportion that it supplied the funds); *see also Cockerham v. Cockerham*, 527 S.W.2d 162, 168 (Tex. 1975)(citing Gleich).

[8] The "typical" definition of tracing used in case after case is that "[t]racing involves establishing the separate origin of the property through evidence showing the time and means by which the spouse originally obtained possession of the property." *See, e.g., Boyd v. Boyd*, 131 S.W.3d 605, 612 (Tex. App.—Fort Worth 2004, no pet.); *Granger v. Granger*, 236 S.W.3d 852, 856 (Tex. App.—Tyler 2007, pet. denied); *Mock v. Mock*, 216 S.W.3d 370, Tex. App.—Eastland 2006, pet. denied).

[9] *See, e.g. Norris v. Vaughan*, 260 S.W.2d 676 (Tex. 1953); *Legrand-Brock v.Brock*, 246 S.W.3d 318, 322 (Tex. App.—Beaumont 2008, pet. denied).

[10] *See, e.g., Love v. Robertson*, 7 Tex. 6 (Tex. 1851) ("The presumption that property purchased during the marriage was community property would certainly be very cogent, and would require to be repelled by clear and conclusive proof. But where it is established, as in this case, clearly and conclusively, that the property was purchased with the separate money of one of the parties, no reason is perceived why it should have a destination different from that of

property received in payment of a debt due the party, or why it should not remain in the one case as well as in the other, the separate property of the party with whose money it was purchased.") There is also a discussion in this case of the earlier Spanish law from which the concepts of community and separate property were taken.

[11] The most common exception to this would be mutations in the form of a business entity which obviously would not involve the tracing of cash. An example of this would be when a corporation undergoing a divisive reorganization drops assets into a new corporation and a shareholder of the previously existing corporation receives shares of the new corporation in exchange for his shares of the previously existing company.

[12] *See Hill v. Hill*, 971 S.W.2d 153, 158 (Tex. App.—Amarillo 1998, no writ); *Sibley v. Sibley*, 286 S.W.2d 657, 659 (Tex. Civ. App.—Dallas 1955, writ dism'd)

[13] *See* http://www.fdic.gov/bank/individual/failed/banklist.html.

[14] *See* TEX. FINANCE CODE § 95.004 (Vernon Supp. 2008).

[15] *See Mesquite State Bank v. Prof'l Inv. Corp.*, 488 S.W.2d 73, 75 (Tex. 1972).

[16] *Id.*; *see also Newsome vs. Charter Bank Colonial*, 940 S.W.2d 157, 166 (Tex. App.—Houston [14th Dist.] 1996, pet. denied).

[17] Although the TBOC was enacted in 2003, it contained transitional rules that applied to existing entities, and it is not until January 1, 2010 the TBOC will apply to all entities. *See* TEX. BUS. ORGS. CODE §§401.001 *et seq.*]

[18] *See* TEX. BUS. ORGS. CODE § 1.001.

[19] *See* TEX. BUS. ORGS. CODE § 1.002(67).

[20] *See* TEX. BUS. ORGS. CODE §§ 152.001(4), 152.003, 153.001 and 153.003(a).

[21] *See* TEX. BUS. ORGS. CODE § 153.351.

[22] *See* TBOC §§ 1.007 (f) and (g).

[23] *See* TGPL § 152.051(b).

[24] *See* TGPL §152.052 (a).

[25] *See, e.g.*, *Ingram v. Deere*, 288 S.W.3d886 (Tex. 2009).

[26] *See* TEX. BUS. ORGS. CODE § 152.002(a).

[27] *See* TBOC §§ 3.001(c) and 3.011.

[28] *See* TBOC § 151.001(5).

[29] *See* TBOC § 1.002(9).

[30] *See* TLPL §§ 153.551(5)(A) and (B).

[31] *See* Partnership Audit Technique Guide – Chapter 1 – Basic Principles (Rev. 3/2008), Internal Revenue Service, at http://www.irs.gov/businesses/partnerships/article/0,,id=134691,00.html.

[32] *See* TEX. BUS. ORGS. CODE § 151.001(1); *see also* TEX. BUS. ORGS. CODE § 152.202(a) and (b).

[33] *See* TEX. BUS. ORGS. CODE § 153.206(a) and (b).

[34] *See* TEX. BUS. ORGS. CODE §§ 152.002(a) and 152.202(c).

[35] *See* TEX. BUS. ORGS. CODE §§ 153.208(a) and 153.209.

[36] *See* TEX. BUS. ORGS. CODE § 153.208(b).

[37] *See* TEX. BUS. ORGS. CODE §§ 153.208(b) and 153.206.

[38] *See* TEX. BUS. ORGS. CODE § 152.202(b).

[39] *See, e.g., XCO Production Co. v. Jamison*, 194 S.W.3d 622, 625 -626 (Tex. App.—Houston [14th Dist.] 2006, pet. denied)

[40] *See* TEX. BUS. ORGS. CODE § 153.208(c).

[41] *See* Sally A. Schreiber, *Partnership (General, Limited and LLP) Formation and Opt-In Decisions* published in Chapter 4, Texas Business Organizations: Choice of Entity and Formation 2006, State Bar of Texas, San Antonio, May 26, 2006.

[42] *Id.* at 681.

[43] *Park Cities Corp.*, 534 S.W.2d at 672; *see also XCO Production Co*, 194 S.W.3d at 627-628 (general partnership agreement interpreted under the law of contracts); *Crossley v. Staley*, 988 S.W.2d 791, 798 (Tex. App.—Amarillo 1999, mandamus denied)(limited partnership agreement construed under the law of contracts)(citing *Park Cities Corp. v. Byrd*, 534 S.W.2d 668, 672 (Tex.1976)); *Parker County's Squaw Creek Downs, L.P. v. Watson*, 2009 WL 885941, 3 (Tex. App.—Fort Worth 2009, pet. denied and mandamus denied)(limited partnership agreement construed under the law of contracts).

[44] *State v. Skiles*, 938 S.W.2d 447, 456 (Tex. Crim. App. 1997) (Baird, J., concurring and dissenting) (quoting Blacks Law Dictionary, 6th Ed.); *see also Continental Cas. Ins. Co. v. Functional Restoration Associates*, 19 S.W.3d 393, 400 (Tex. 2000)(dictum is not binding as precedent).

[45] In his petition for review that was filed with the Texas Supreme Court, James pointed to the fact that the Berlee Lumber stock was acquired by Liberty Partnership prior to the parties' marriage as further evidence of its separate property character upon receipt by James. For the reasons discussed herein, the fact that assets are held by an entity prior to marriage is not determinative of their character upon distribution.

[46] *Ingram v. Deere*, 288 S.W.3d 886 (Tex. 2009).

[47] *See* TEX. BUS. ORGS. CODE § 152.002(a) (partnership agreement governs relations of partners and of partners to partnership, and if not provided for in partnership agreement, then TGPL or TLPL controls, as applicable); see also *XCO Production Co*, 194 S.W.3d at 628 (general partnership agreement is enforced according to its terms).

[48] *See* TEX. BUS. ORGS. CODE § 152.202(b)(partners do not have an ownership interest in partnership property). Although § 152.202 is found in the provisions governing general partnerships, it is also applicable to limited partnerships pursuant to TEX. BUS. ORGS. CODE § 153.003.

[49] *Farnsworth v. Deaver*, 147 S.W.3d 662, 664 (Tex. App.—Amarillo 2004, no pet.). Partners are equity investors, and have a right to repayment of their investment only to the extent allowed by the partnership agreement.

[50] *Harris*, 765 S.W.2d at 802-03. The court of appeals in *Harris* also considered the character of husband's interest in a Reserved Capital Agreement that governed the sharing of fees arising from a contingent fee agreement between the partners and the maternal heirs of Howard Hughes. The agreement had been entered into during the parties' marriage, and the jury had characterized the agreement as the husband's separate property. The husband's interest in the agreement was estimated as being worth millions of dollars. Noting that the agreement only clarified the rights of the respective partners in the contingent fee contract, the court of appeals sustained the jury's separate property characterization of the husband's interest. *Id*. at 804.

[51] *Fuhrman v. Fuhrman*, 302 S.W.2d 205 (Tex. Civ. App.—El Paso 1957, writ dism'd) and *Wells v. Hiskett*, 288 S.W.2d 257 (Tex. Civ. App.—Texarkana 1956, writ ref'd n.r.e.).

[52] *See Fuhrman*, 302 S.W.2d at 212; *Wells*, 288 S.W.2d at 265.

[53] *LeGrand-Brock*, 246 S.W.3d at 323 (citing to Title 26 U.S.C. § 331(a) and *Hellmich v. Hellman*, 276 U.S. 233, 235).

[54] *See Norris*, 260 S.W.2d at 679 ("… separate property remains separate property regardless of the fact that the separate property may undergo 'mutations and changes.'" (Quoting with approval from *Stephens v. Stephens*, 292 S.W. 290 (Tex. Civ. App.—Amarillo 1927, writ dism'd w. o. j,).