TROUBLING ISSUES OF CHARACTERIZATION, REIMBURSEMENT, VALUATION, AND DIVISION UPON DIVORCE

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CHAPTER 36

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Member, Supreme Court Advisory Committee on Rules of Civil Procedure (1994-2011); Chair, Subcommittee on Rules 16-165a
Member, Pattern Jury Charge Committee (Family Law), State Bar of Texas (1987-2000)
Supreme Court Liaison, Texas Judicial Committee on Information Technology (2001-2005)
Tx. Bd. of Legal Specialization, Civil Appellate Law Advisory Commission (Member and Civil Appellate Law Exam Committee (1990-2006; Chair 1991-1995); Family Law Advisory Commission (1987-1993)
Member, Supreme Court Task Force on Jury Charges (1992-93)
Member, Supreme Court Advisory Committee on Child Support and Visitation Guidelines (1989, 1991; Co-Chair 1992-93; Chair 1994-98)
Member, Board of Directors, Texas Legal Resource Center on Child Abuse & Neglect, Inc. (1991-93)
President, Texas Academy of Family Law Specialists (1990-91)
President, San Antonio Family Lawyers Association (1989-90)
Associate, American Board of Trial Advocates
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Director, San Antonio Bar Association (1997-1998)
Member, San Antonio, Dallas and Houston Bar Associations

Professional Activities and Honors:

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Listed as Texas' Top Family Lawyer, Texas Lawyer's *Go-To-Guide* (2007)
Listed as one of Texas' Top 100 Lawyers, and Top 50 Lawyers in South Texas, *Texas Monthly* Super Lawyers Survey(2003-2010)
Texas Academy of Family Law Specialists' *Sam Emison Award* (2003) for significant contributions to the practice of
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Association for Continuing Legal Excellence Best Program Award for *Enron: The Legal Issues* (2002)
State Bar of Texas *Presidential Citation* "for innovative leadership and relentless pursuit of excellence for continuing legal education" (June, 2001)
State Bar of Texas Family Law Section's *Dan R. Price Award* for outstanding contributions to family law (2001)
State Bar of Texas *Gene Cavin Award for Excellence in Continuing Legal Education* (1996)
State Bar of Texas *Certificate of Merit*, June 1995, June 1996, June 1997 & June 2004
Listed in the BEST LAWYERS IN AMERICA: Family Law (1987-2009); Appellate Law (2007-2009)

Continuing Legal Education and Administration:

Course Director, State Bar of Texas:
• Practice Before the Supreme Court of Texas Course

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- *Enron, The Legal Issues* (Co-director, March, 2002) [Won national ACLEA Award]
- Advanced Expert Witness Course (2001, 2002, 2003, 2004)
- 1999 Impact of the New Rules of Discovery
- 1998 Advanced Civil Appellate Practice Course
- 1991 Advanced Evidence and Discovery
- Computer Workshop at Advanced Family Law (1990-94) and Advanced Civil Trial (1990-91) courses
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Course Director, Texas Academy of Family Law Specialists First Annual Trial Institute, Las Vegas, Nevada (1987)

Books and Journal Articles:

—Editor-in-Chief of the State Bar of Texas' TEXAS SUPREME COURT PRACTICE MANUAL (2005)
---Chief Editor of the State Bar of Texas Family Law Section's EXPERT WITNESS MANUAL (Vols. II & III) (1999)
---Author of Vol. 6 of McDonald Texas Civil Practice, on Texas Civil Appellate Practice, published by Bancroft-Whitney Co. (1992) (900 + pages)
---*A Guide to Proceedings Under the Texas Parent Notification Statute and Rules,* SOUTH TEXAS LAW REVIEW (2000) (co-authored)
---*Obligations of the Trial Lawyer Under Texas Law Toward the Client Relating to an Appeal,* 41 SOUTH TEXAS LAW REVIEW 111 (1999)
---*Asserting Claims for Intentionally or Recklessly Causing Severe Emotional Distress, in Connection With a Divorce*, 25 ST. MARY'S L.J. 1253 (1994), republished in the AMERICAN JOURNAL OF FAMILY LAW (Fall 1994) and Texas Family Law Service *NewsAlert* (Oct. & Dec., 1994 and Feb., 1995)
---Chapter 21 on *Business Interests* in Bancroft-Whitney's TEXAS FAMILY LAW SERVICE (Speer's 6th ed.)
---*Characterization of Marital Property*, 39 BAY. L. REV. 909 (1988) (co-authored)
---*Fitting a Round Peg Into A Square Hole: Section 3.63, Texas Family Code, and the Marriage That Crosses States Lines*, 13 ST. MARY'S L.J. 477 (1982)

SELECTED CLE ARTICLES AND SPEECHES

State Bar of Texas' [SBOT] **Advanced Family Law Course**: Intra and Inter Family Transactions (1983); Handling the Appeal: Procedures and Pitfalls (1984); Methods and Tools of Discovery (1985); Characterization and Reimbursement (1986); Trusts and Family Law (1986); The Family Law Case in the Appellate Court (1987); Post-Divorce Division of Property (1988); Marital Agreements: Enforcement and Defense (1989); Marital Liabilities (1990); Rules of Procedure (1991); Valuation Overview (1992); Deposition Use in Trial: Cassette Tapes, Video, Audio, Reading and Editing (1993); The Great Debate: Dividing Goodwill on Divorce (1994); Characterization (1995); Ordinary Reimbursement and Creative Theories of Reimbursement (1996); Qualifying and Rejecting Expert Witnesses (1997); New Developments in Civil Procedure and Evidence (1998); The Expert Witness Manual (1999); Reimbursement in the 21st Century (2000); Personal Goodwill vs. Commercial Goodwill: A Case Study (2000); What Representing the Judge or Contributing to Her Campaign Can Mean to Your Client: Proposed New Disqualification and Recusal Rules (2001); Tax Workshop: The Fundamentals (2001); Blue Sky or Book Value? Complex Issues in Business Valuation (2001); Private Justice: Arbitration as an Alternative to the Courthouse (2002); International & Cross Border Issues (2002); Premarital and Marital Agreements: Representing the Non-Monied Spouse (2003); Those Other Texas Codes: Things the Family Lawyer Needs to Know About Codifications Outside the Family Code (2004); Pearls of Wisdom From Thirty Years of Practicing Family Law (2005); The Road Ahead: Long-Term Financial Planning in Connection With Divorce (2006); A New Approach to Distinguishing Enterprise Goodwill From Personal Goodwill (2007); The Law of Interpreting Contracts: How to Draft Contracts to Avoid or Win Litigation (2008); Effect of Choice of Entities: How Organizational Law, Accounting, and Tax Law for Entities Affect Marital Property Law (2008); Practicing Family Law in a Depressed Economy, Parts I & II (2009); Property Puzzles: 30 Characterization Rules, Explanations & Examples (2009)

SBOT's **Marriage Dissolution Course**: Property Problems Created by Crossing State Lines (1982); Child Snatching and Interfering with Possess'n: Remedies (1986); Family Law and the Family Business: Proprietorships, Partnerships and Corporations (1987); Appellate Practice (Family Law) (1990); Discovery in Custody and Property Cases (1991); Discovery (1993); Identifying and Dealing With Illegal, Unethical and Harassing Practices (1994); Gender Issues in the Everyday Practice of Family Law (1995); Dialogue on Common Evidence Problems (1995); Handling the Divorce Involving Trusts or Family Limited Partnerships (1998); The Expert Witness Manual (1999); Focus on Experts: Close-up Interviews on Procedure, Mental Health and Financial Experts (2000); Activities in the Trial Court During Appeal and After Remand (2002)

UT School of Law: Trusts in Texas Law: What Are the Community Rights in Separately Created Trusts? (1985); Partnerships and Family Law (1986); Proving Up Separate and Community Property Claims Through Tracing (1987); Appealing Non-Jury Cases in State Court (1991); The New (Proposed) Texas Rules of Appellate Procedure (1995); The Effective Motion for Rehearing (1996); Intellectual Property (1997); Preservation of Error Update (1997); TRAPs Under the New T.R.A.P. (1998); Judicial Perspectives on Appellate Practice (2000)

SBOT's **Advanced Evidence & Discovery Course**: Successful Mandamus Approaches in Discovery (1988); Mandamus (1989); Preservation of Privileges, Exemptions and Objections (1990); Business and Public Records (1993); Grab Bag: Evidence & Discovery (1993); Common Evidence Problems (1994); Managing Documents--The Technology (1996); Evidence Grab Bag (1997-1998); Making and Meeting Objections (1998 & 1999); Evidentiary Issues Surrounding Expert Witnesses (1999); Predicates and Objections (2000 & 2001); Building Blocks of Evidence (2002); Strategies in Making a Daubert Attack (2002); Predicates and Objections (2002); Building Blocks of Evidence (2003); Predicates & Objections (High Tech Emphasis) (2003)

SBOT's **Advanced Civil Appellate Practice Course**: Handling the Appeal from a Bench Trial in a Civil Case (1989); Appeal of Non-Jury Trials (1990); Successful Challenges to Legal/Factual Sufficiency (1991); In the Sup. Ct.: Reversing the Court of Appeals (1992); Brief Writing: Creatively Crafting for the Reader (1993); Interlocutory and Accelerated Appeals (1994); Non-Jury Appeals (1995); Technology and the Courtroom of the Future (1996); Are Non-Jury Trials Ever "Appealing"? (1998); Enforcing the Judgment, Including While on Appeal (1998); Judges vs. Juries: A Debate (2000); Appellate Squares (2000); Texas Supreme Court Trends (2002); New Appellate Rules and New Trial Rules (2003); *Supreme Court Trends* (2004); Recent Developments in the *Daubert* Swamp (2005); Hot Topics in Litigation: Restitution/Unjust Enrichment (2006); The Law of Interpreting Contracts (2007); Judicial Review of Arbitration Rulings: Problems and Possible Alternatives (2008)

Various CLE Providers: SBOT Advanced Civil Trial Course: Judgment Enforcement, Turnover and Contempt (1990-1991), Offering and Excluding Evidence (1995), New Appellate Rules (1997), The Communications Revolution: Portability, The Internet and the Practice of Law (1998), Daubert With Emphasis on Commercial Litigation, Damages, and the NonScientific Expert (2000), Rules/Legislation Preview (State Perspective) (2002); College of Advanced Judicial Studies: Evidentiary Issues (2001); El Paso Family Law Bar Ass'n: Foreign Law and Foreign Evidence (2001); American Institute of Certified Public Accounts: Admissibility of Lay and Expert Testimony; General Acceptance Versus Daubert (2002); Texas and Louisiana Associations of Defense Counsel: Use of Fact Witnesses, Lay Opinion, and Expert Testimony; When and How to Raise a Daubert Challenge (2002); SBOT In-House Counsel Course: Marital Property Rights in Corporate Benefits for High-Level Employees (2002); SBOT 19th Annual Litigation Update Institute: Distinguishing Fact Testimony, Lay Opinion & Expert Testimony; Raising a Daubert Challenge (2003); State Bar College Spring Training: Current Events in Family Law (2003); SBOT Practice Before the Supreme Court: Texas Supreme Court Trends (2003); SBOT 26th Annual Advanced Civil Trial: Distinguishing Fact Testimony, Lay Opinion & Expert Testimony; Challenging Qualifications, Reliability, and Underlying Data (2003); SBOT New Frontiers in Marital Property: Busting Trusts Upon Divorce (2003); American Academy of Psychiatry and the Law: Daubert, Kumho Tire and the Forensic Child Expert (2003); AICPA-AAML National Conference on Divorce: Cutting Edge Issues–New Alimony Theories; Measuring Personal Goodwill (2006); New Frontiers` - Distinguishing Enterprise Goodwill from Personal Goodwill; Judicial Conference (2006); SBOT New Frontiers in Marital Property Law: Tracing, Reimbursement and Economic Contribution Claims In Brokerage Accounts (2007); SBOT In-House Counsel Course: When an Officer Divorces: How a Company can be Affected by an Officer's Divorce (2009)

Table of Contents

TROUBLING ISSUES OF CHARACTERIZATION, VALUATION, AND DIVISION UPON DIVORCE

by

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I. INTRODUCTION. This Article is a mix of topics united only in that they represent troubling issues, where the law appears to be conflicting, or where no consensus has emerged on how to apply the law in question to marital property disputes. Unless otherwise stated, the rules of law and conclusions presented in this Article are based on Texas family law with no consideration given to a premarital or postmarital agreement.

II. WHAT IS SUFFICIENT PROOF OF SEPARATE PROPERTY? There is much confusion in the case law about what constitutes sufficient proof of separate property. This partly results from confusion between the burden of persuasion in the trial court and the standard for sufficiency of the evidence in the appellate court. The appellate standard for sufficiency of the evidence itself is complicated by the elevated burden of proof in the trial court.

A. BURDEN OF PROOF AND BURDEN OF PERSUASION IN THE TRIAL COURT.

1. The General Burdens of Proof and Persuasion. In civil litigation in Texas trial courts, the party seeking affirmative relief has the burden of proof on the claims asserted, meaning the obligation to present sufficient evidence and secure a favorable finding. The defendant has the burden of proof on any defenses or affirmative defenses that have been raised. Under Texas law, the burden of persuasion of a party with the burden of proof in a civil case is a preponderance of the evidence, invariably defined as "the greater weight and degree of credible evidence admitted in this case." TEXAS PATTERN JURY CHARGES (Family) PJC 200.3.

2. Elevated Burden for Separate Property. The burden of proof and burden of persuasion applied to claims of separate property in the trial court are set out in Texas Family Code § 3.003(a) & (b):

> § 3.003. Presumption of Community Property
>
> (a) Property possessed by either spouse during or on dissolution of marriage is presumed to be community property.
>
> (b) The degree of proof necessary to establish that property is separate property is clear and convincing evidence.

By establishing a presumption of community property, Subsection (a) assigns the burden of producing evidence and securing a favorable finding in the trial court to the party claiming separate property. Unless the party claiming separate property introduces sufficient evidence of separate character, and secures a finding of separate character, then an asset possessed by a spouse during marriage or upon dissolution of marriage will be considered to be community property.

Subsection (b) established the "clear and convincing evidence" standard as the burden of persuasion, or the degree of proof necessary to secure a finding of separate property. "Clear and convincing evidence" is not defined in Title 1 of the Family Code (relating to the marriage relationship). However, the term is defined in Title 5 of the Family Code (relating to the parent-child relationship and suits affecting the parent-child relationship), in TFC § 101.007:

> § 101.007. Clear and Convincing Evidence
>
> "Clear and convincing evidence" means the measure or degree of proof that will produce in the mind of the trier of fact a firm belief or conviction as to the truth of the allegations sought to be established.

This definition derives from case law, and is used to define the burden of persuasion in marital property cases. *See* Texas Pattern Jury Charges PJC 202.11 (containing the definition of clear and convincing evidence in a separate property character question).

Thus, as a general rule there are two burdens of proof in a typical trial involving marital property: (i) clear and convincing evidence as to separate property; (ii) preponderance of the evidence as to all other issues. However, there are other presumptions that can come into play during a marital property trial that create exceptions to the general rule.

3. Vanishing Presumptions. One court has said that the community presumption is nullified when contrary evidence is introduced. In *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex. App.–Houston [14th Dist.] 1989, writ denied), the court said:

> Property possessed by either spouse during or on dissolution of marriage is presumed to be community property. Section 5.02, Tex. Fam. Code. The party claiming property as separate has the burden to overcome this presumption by clear and convincing evidence. *Id.*; *Horlock v. Horlock*, 614 S.W.2d 478, 480 (Tex. Civ. App.–Houston [14th Dist.] 1981, writ ref'd n.r.e.). To discharge this burden a spouse must trace and clearly identify the property claimed as separate. *Cockerham v. Cockerham*, 527 S.W.2d 162, 167 (Tex. 1975); *McKinley v. McKinley*, 496 S.W.2d 540, 543 (Tex. 1973). If separate property and community property have been so commingled as to defy resegregation and identification, the statutory presumption prevails. *Tarver v. Tarver*, 394 S.W.2d 780 (Tex. 1965). However, when separate property has not been commingled or its identity as such can be traced, the statutory presumption is dispelled. *Peaslee-Gaulbert Corp. v. Hill*, 311 S.W.2d 461, 463 (Tex. Civ. App.--Dallas 1958, no writ). **The presumption, which is not evidence, ceases to exist upon introduction of positive evidence to the contrary and is not then to be weighed or treated as evidence.** *Empire Gas and Fuel Co. v. Muegge*, 135 Tex. 520, 143 S.W.2d 763, 767 (1940); *Roach v. Roach*, 672 S.W.2d 524, 530 (Tex. App.--Amarillo 1984, no writ); *In re: Estate of Glover*, 744 S.W.2d 197, 200 (Tex. App.--Amarillo 1987, writ denied). [Emphasis added].

4. Gifts From Parents to Children. A conveyance of property from parent to child is presumed to be a gift, but the presumption is rebuttable by evidence showing the facts and circumstances surrounding the deed's execution in addition to the deed's recitations. *Woodworth v. Cortez*, 660 S.W.2d 561, 564 (Tex. App.–San Antonio 1983, writ ref'd n.r.e.); *In re Royal*, 107 S.W.3d 846 (Tex. App.– Amarillo 2003, no pet.) (donor grandparent testimony regarding gift to Husband rebutted by contrary evidence of gift to couple). In *Somer v. Bogert*, 762 S.W.2d 577 (Tex.1988) (per curiam), the Supreme Court said that a presumption of gift arose when a mother and father-in-law made a gift to their son-in-law and that the degree of proof of a lack of donative intent was clear and convincing evidence.

5. Gifts Between Spouses. A spouse can make a gift of community property to the other spouse. *See Pankhurst v. Weitinger & Tucker*, 850 S.W.2d 726, 730 (Tex. App.–Corpus Christi 1993, writ denied) (husband gave one-half of his community property interest in a cause of action to wife, to hold as her separate property). When a spouse transfers separate property to the other spouse, there is a rebuttable presumption of gift, even absent a recital in the instrument of conveyance. *Kahn v. Kahn*, 94 Tex. 114, 58 S.W. 825, 826 (1900). Where the separate property is land, and the deed recites separate property consideration paid by the grantee-spouse, the presumption is irrebuttable absent fraud or mistake. *Id.*

6. Taking Title to Land in Other Spouse's Name. Where one spouse furnishes separate property consideration and title is taken in the name of the other spouse, a rebuttable presumption of gift arises. *Pemelton v. Pemelton*, 809 S.W.2d 642, 646 (Tex. App.–Corpus Christi 1991), *rev'd on other grounds sub nom. Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992).Where one spouse uses separate property to acquire property during marriage and takes title to that property in the names of both spouses, a rebuttable presumption arises that the purchasing spouse intended to make a gift of a one-half separate property interest to the other spouse. *In re Marriage of Thurmond*, 888 S.W.2d 269, 273 (Tex. App.–Amarillo 1994, no writ), citing *Cockerham v. Cockerham*, 527 S.W.2d 162, 168 (Tex. 1975); *see Graham v. Graham*, 836 S.W.2d 308, 310 (Tex. App.–Tyler 1992, no writ) (recognizing rule but holding it was not applicable); *Peterson v. Peterson*, 595 S.W.2d 889, 892-93 (Tex. Civ. App.–Austin 1980, writ dism'd) (presumption overcome by Husband's testimony that no gift was intended); *accord*, *Whorrall v. Whorrall*, 691 S.W.2d 32, 35 (Tex. App.–Austin 1985, writ dism'd) (wife's testimony that she did not intend a gift was sufficient to support the trial court's finding of separate property). Where land is acquired with community property and title is taken in the name of one spouse alone, no presumption of gift arises and the presumption of community applies. *Kahn v. Kahn*, 94 Tex. 114, 58 S.W. 825, 826 (1900).

7. Income from Interspousal Gifts. If one spouse gives separate or community property to the other spouse, the gift is presumed to include the income and property arising from the gifted property. Tex. Const. Art. XVI, § 15; Tex. Fam. Code § 3.005. As a result of this presumption, proof of a gift of an asset constitutes (rebuttable) proof that the income from that asset is separate property.

B. SUFFICIENCY OF THE EVIDENCE AT TRIAL. There is a difference between the degree of proof necessary to secure a favorable finding of separate property in the trial court, and the degree of proof necessary to sustain or overturn the trial court's finding on appeal. The degree of proof necessary to establish separate property in the trial court is clear and convincing evidence. The proof may consist of direct or circumstantial evidence showing ownership of an asset prior to marriage, or receipt of the asset during marriage by gift or inheritance, or showing that a separate property asset mutated in form, or by proving facts that give rise to a presumption of separate property (as when the deed transferring land to a spouse recites separate property). If the trial judge believes that separate property has been proven by clear and convincing evidence, the trial court should render judgment in favor of the proponent. If not, the trial judge should rule that the property is community property. If a jury has found separate property, the trial court must render a judgment on the verdict if there is more than a scintilla of evidence to support the jury's finding of separate property. If the trial court believes there is not more than a scintilla of evidence to support the jury's finding, then the judge should JNOV the jury's answer. If the trial court believes that there is more than a scintilla of supporting evidence, but that the evidence is nonetheless "factually insufficient," then the trial court should render judgment on the verdict but then grant a new trial. See TRCP 324(b)(2). If a jury rejects a claim of separate property, the trial court must render judgment on the jury verdict unless it finds that the separate property claim was proven as a matter of law, in which event the trial court should JNOV the jury's answer. If the trial court believes that the separate property claim was proven by the "overwhelming weight of the evidence" but not as a matter of law, then the trial court should render judgment on the verdict but then grant a new trial. See TRCP 324(b)(3).

C. SUFFICIENCY OF THE EVIDENCE ON APPEAL. On appeal, the appellate court should not concern itself with the question of whether the evidence of separate property was clear and convincing. This is a question for the finder of fact. The degree of proof necessary to sustain or overturn a trial court finding on appeal is evaluated by the appellate standard for sufficiency of the evidence review. In appellate review of the sufficiency of the evidence, there are six states of the evidence: (i) legally insufficient evidence; (ii) legally sufficient evidence; (iii) factually insufficient evidence; (iv) factually sufficient evidence; (v) the great weight and preponderance of the evidence; and (vi) conclusive evidence. The appellate court can reverse based on (i), (iii), (v), and (vi), but not (ii) and (iv).

Where the burden of proof at trial was by clear and convincing evidence, as on the issue of separate property, the appellate court must apply a heightened standard of legal and factual sufficiency review. *See In re J.F.C.*, 96 S.W.3d 256, 265-66 (Tex. 2002); *In re C.H.*, 89 S.W.3d 17, 26 (Tex. 2002). This intermediate standard falls between the standard for appellate review of the sufficiency of the evidence to support a finding based on the preponderance of the evidence standard of civil proceedings and the reasonable doubt standard of criminal proceedings. *In re G.M.*, 596 S.W.2d 846, 847 (Tex. 1980). The proof must weigh more heavily than merely the greater weight of the credible evidence, but the evidence need not be unequivocal or undisputed. *Boyd v. Boyd*, 131 S.W.3d 605, 611 (Tex. App.–Fort Worth 2004, no pet.).

In reading an appellate opinion on the sufficiency of the evidence for or against a claim of separate property, it is necessary to distinguish cases that find the evidence: (i) legally insufficient to support the trial court's finding of separate; (ii) legally sufficient to support the trial court's finding of separate;(iii) factually insufficient to support a trial court finding of separate; (iv) factually sufficient to support the trial court's finding of separate; (v) of such weight and preponderance that the failure to separate was reversible error;(vi) so conclusive as to require a finding of separate property as a matter of law: Points (ii) and (iv) result in affirmance of the trial court's finding of separate property. Points (i), (iii), (v), and (vi) result in the reversal of a finding of separate property, with (i) and (vi) resulting in reversal and rendition and (iii) and (v) resulting in reversal and remand for a new fact finding.

The appellate opinions on what constitutes sufficient evidence of separate property are sometimes hard to interpret due to the appellate court's failure to describe with precision the appellate standard it is using in its review of the sufficiency of the evidence. Speaking technically, an appellate court should never say "the evidence was clear and convincing" or "the evidence was not clear and convincing." That is the standard for the trial judge sitting as the trier of fact. The standard for the appellate judge is whether the evidence was factually or legally insufficient to support a finding of separate, or of such great weight or conclusive weight as to require a finding of separate.

A way to clarify an unclear explanation by a court of appeals is to look at the trial court ruling being affirmed or overturned, or look at the disposition of the case if it is reversed. The appellate court in *Trawick v. Trawick*, 671 S.W.2d 105, 111 (Tex. App.--El Paso 1984, no writ), upheld a JNOV in which the trial court ignored a jury verdict of community property and rendered judgment that the property was separate property. We can tell from the trial court's ruling that the question was whether the proof established separate property as a matter of law.

For a detailed analysis of different appellate court rulings on the sufficiency of the evidence to support findings for and against separate property, see Richard R. Orsinger, *Different Ways to Trace Separate Property*, State Bar of Texas' Advanced Family Law Course ch. 62 (August 3-6, 2009).

III. THE INCEPTION OF TITLE RULE VS. THE DOCTRINE OF MUTATIONS. It is often said that the character of marital property as separate or community or mixed is determined at the time of "inception of title." Inception of title occurs when a party first has a right of claim to the property by virtue of which title is finally vested. *Welder v. Lambert*, 22 S.W. 281, 284-86 (1898); *Henry S. Miller Co. v. Evans*, 452 S.W.2d 426, 430 (Tex. 1970); *Saldana v. Saldana*, 791 S.W.2d 316, 319 (Tex. App.--Corpus Christi 1990, no writ) (citing *Strong v. Garrett*, 148 Tex. 265, 224 S.W.2d 471 (1949)). In many instances (such as purchases of personal property for cash) inception of title occurs at the same time that title is acquired. This is not true, however, with interests in real estate, which are almost always put under contract prior to the time that title is acquired.

A conceptual question arises: whether to characterize real estate acquired during marriage based on the earnest money, or the contractual obligation arising from an earnest money contract, or instead based upon the character of the funds used to pay the purchase price at closing.

A. INCEPTION OF TITTLE IN ACQUISITIONS OF LAND.

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

2. Contract For Deed Before Marriage. In *Riley v. Brown*, 452 S.W.2d 548 (Tex. Civ. App.--Tyler 1970, no writ), where realty was acquired under a contract for deed (i.e., installment land contract) inception of title occurred when the contract was entered into, not when title was ultimately conveyed. In *Welder v. Lambert*, 91 Tex. 510, 44 S.W. 281, 284-85 (1898), land was put under contract for colonization with Husband and Wife; after Wife died, despite Husband's remarriage, that contract right still belonged to the first marriage, so that title ultimately acquired during the second marriage was not community property of the second marriage. Such a contract may be oral. *Evans v. Ingram*, 288 S.W. 494 (Tex. Civ. App.–Waco 1926, no writ). In *Dawson v. Dawson*, 767 S.W.2d 949 (Tex. App.–Beaumont 1989, no writ), realty placed by Husband under contract for deed prior to marriage was his separate property, despite the fact that title was taken during marriage in the name of both spouses, there being no evidence that a gift to Wife was intended. In *In re Marriage of Read*, 634 S.W.2d 343, 347 (Tex. App.–Amarillo 1982, writ dism'd), an oral agreement for mineral lease made prior to marriage did not establish inception of title because the oral agreement was not enforceable due to the Statute of Frauds.

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

4. Earnest Money Contract Before Marriage. In *Wierzchula v. Wierzchula*, 623 S.W.2d 730 (Tex. App.–Houston [1st Dist.] 1981, no writ), where Husband entered into an earnest money contract to purchase realty shortly before marriage, but the deed was received during marriage, inception of title occurred when the earnest money contract was signed, so that the property was Husband's separate property. In *Carter v. Carter*, 736 S.W.2d 775 (Tex. App.–Houston [14th Dist.] 1987, no writ), Husband signed an earnest money contract and paid $1,000.00 in earnest money, shortly before marriage. The deed was received during marriage in the name of both Husband and Wife, and both signed the note and deed of trust. Citing *Wierzchula*, the court of appeals held that, under the inception of title rule, title related back to the date the earnest money contract was signed and, since that date predated marriage and only Husband had signed the earnest money contract, the realty was his separate property.

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

5. Earnest Money Contract During Marriage. Where spouses enter into an earnest money contract to purchase land during marriage, the land is community property. *Leach v. Meyer*, 284 S.W.2d 164 (Tex. Civ. App.–Austin 1955, no writ). However, it is generally said that the character of land purchased during marriage, with separate property funds, is separate property.

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

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

B. CONFLICT WITH THE DOCTRINE OF MUTATION OR TRACING. In *Norris v. Vaughan*, 152 Tex. 491, 496-97, 260 S.W.2d 676, 679 (1953), the Supreme Court said: "so long as separate property can be definitely traced and identified it remains separate property regardless of the fact that the separate property may undergo 'mutations and changes.'" This rule of law dates back to 1851, and indirectly even earlier. The inception of title rule, as applied in the cases cited above, can come into collision with the rule of tracing, in situations where separate property is exchanged for new property during marriage, but title incepts before the purchase price is paid. The Texas Supreme Court needs to reconcile the different interpretations of how to interface the inception of title rule with earnest money contracts and real estate closings where separate property money is used to pay the purchase price of land acquired during marriage.

IV. ENTITIES: CHARACTERI-ZATION OF OWNERSHIP AND OF DISTRIBUTIONS. The entities considered in this section of the

Article are corporations, limited liability companies (LLCs), and partnerships. The Article considers the marital property character of a spouse's ownership interest and the marital property character of distributions from the entity.

The Texas Business Organizations Code ("TBOC") was enacted in 2003 with an effective date of January 1, 2006. The TBOC applies to all Texas corporations, partnerships, limited liability companies and other "domestic filing entities" formed on and after that date. The TBOC replaced the following statutes: the Texas Business Corporation Act; the Texas Non-Profit Corporation Act; the Texas Professional Corporation Act; the Texas Professional Association Act; the Texas Miscellaneous Corporation Laws Act; the Texas Revised Partnership Act; the Texas Revised Limited Partnership Act; the Texas Limited Liability Company Act; the Texas Real Estate Investment Trust Act; the Texas Cooperative Association Act; and the Texas Uniform Unincorporated Nonprofit Association Act. Because for some years we will continue to litigate actions relating to entities governed at the time by one of the forerunner statutes, this Article continues to cite to the old statutes, with updated references to the TBOC.

A. CORPORATIONS. A spouse's ownership interest in a corporation can be separate property or community property, or a combination of both.

1. Corporate Assets are not Community or Separate Property. Since a corporation has a separate legal identity from its shareholders, all assets of a corporation belong to the corporation and not to the shareholder. *Legrand-Brock v. Brock*, 246 S.W.3d 318, 322 (Tex. App.–Beaumont 2008, pet. denied) (citing *Bryan v. Sturgis Nat'l Bank*, 90 S.W. 704, 705 (Tex. Civ. App. 1905, writ ref'd) ("The accumulated earnings or surplus funds of a corporation constitute a part of its assets, and belong to the corporation, and not to the stockholders, until they have been declared and set apart as dividends").

2. Interest Acquired Prior to Marriage. If the spouse's ownership interest in the corporation was acquired prior to marriage, then the ownership interest is the spouse's separate property. *Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex. App.–Dallas 1985, no writ). Any increase in value of the separate property corporation is the owning spouse's separate property, and the community estate has no ownership claim to that increase in value. *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984). The community estate may, however, have a reimbursement claim if the owner-spouse was under- compensated for his labor. *Id*. at 109. See Section X.

3. Creating the Entity During Marriage. Special considerations arise when a spouse is involved in the creation of a corporation during marriage.

a. When a Corporation Comes Into Existence. Under the TBCA, in Texas, a corporation was created by the State, upon the filing of articles of incorporation with the Texas Secretary of State and payment of the required fee. *See* Tex. Bus. Corp. Act ("TBCA") art. 3.03. The articles of incorporation had to be signed by one or more incorporators. TBCA art. 3.01. Incorporators were not necessarily owners, and frequently the incorporator was the attorney who handled the incorporation. Upon filing the articles of incorporation and payment of fees, the Secretary of State issued a certificate of incorporation, stating the date the corporation came into existence. TBCA art. 3.03. Corporations could also be created by merger or conversion, subject to similar filing requirements. See Sections IV.A.3.h(1) & h(2).

Under the TBOC, a corporation is created by the filing of a certificate of formation. TBOC §§ 3.001, 3.005, 4.002, & 4.051. Instead of incorporators, the corporation is created by "organizers." TBOC § 3.004.

While the date of incorporation may establish the earliest date that a spouse could have acquired an interest in the corporation, the date of incorporation is not necessarily the date the spouse's interest is acquired. TBCA art. 4.01B provided that a shareholder has no vested right resulting from the articles of incorporation. *Accord*, TBOC § 21.051.

b. Issuance of Corporate Shares. A corporation is owned by shareholders who own shares of the corporation. TBCA art. 1.02A(23); TBOC §1.002(80). Ownership interests in a corporation are usually reflected by "share certificates," sometimes called "stock certificates" or "shares," although uncertificated shares are allowed. TBCA art. 2.19; TBOC § 3.201. Ownership can exist even though shares were never actually issued. *Estate of Bridges v. Mosebrook*, 662 S.W.2d 116, 121 (Tex. App.–Fort Worth 1983, writ refused n.r.e.). The corporation issues shares in exchange for capital contributed to the corporation. TBCA art. 2.15.A; TBOC § 21.157(b). The consideration to be received by the corporation in exchange for its shares is determined by the board of directors, or in the plan of merger or plan of conversion. TBCA art. 2.15; TBOC §§ 21.158 & 21.160. Prior to 1993, the Texas constitution permitted the issuance of stock only for "money paid, labor done or property actually received." Tex. Const. art. 12, § 6. Thus, a corporation could not accept a promise of future services or a promissory note in exchange for corporate stock. Bromberg, p. 118. Alan R. Bromberg, *Texas Business Organization and Commercial Law–Two Centuries of Development*, 55 SMU L. REV. 83, 118 (2002). In November of 1993, that constitutional provision was repealed and the TBCA was amended to permit consideration for shares to consist of "any tangible or intangible benefit to the corporation . . . including cash, promissory notes, services performed, contracts for services to be performed . . . ." TBCA art. 2.16A. That continues to be the law today. TBOC § 21.159. The issuance of shares in exchange for contributed capital is usually reflected in Minutes of the Initial Board of Directors Meeting, or a written Unanimous Consent that substitutes for that meeting. Capital paid for shares should be reflected in the corporation's Balance Sheet, and on Schedule L of the corporation's tax return (which reports the corporation's balance sheet).

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

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

e. Other Capital Contributions. Corporations can receive contributions from shareholders at the time of start-up, or later. Because the character of an asset is determined at the time the property is acquired (or upon inception of title of if that occurs earlier), making subsequent capital contributions to a corporation will not change the character of the ownership interest. However, where the initial capitalization is designed to be paid in installments or at intervals, all installments may constitute the initial capitalization.

f. Incorporating a Sole Proprietorship. When the operator of a sole proprietorship incorporates the going business during marriage, the assets of the sole proprietorship constitute the capital contributed to the corporation in exchange for its shares. Since all such assets are presumptively community property, it is necessary to trace the character of all of the assets that are contributed to the corporation. Even though all the assets of an unincorporated business may have been separate property on the day of marriage, profits from the unincorporated business are usually reinvested in inventory, equipment, and money, so that the assets of the business will slowly become community property overtime. Tracing through the incorporation of a going business was successful in: *Vallone v. Vallone*, 618 S.W.2d 820 (Tex. Civ. App.–Houston [1st Dist.] 1981), *rev'd on other grounds*, 644 S.W.2d 455 (Tex. 1982); *In re Marriage of Morris*, 12 S.W.3d 877 (Tex. App.–Texarkana 2000, no pet.); *Marriage of York*, 613 S.W.2d 764, 769-70 (Tex. Civ. App.–Amarillo 1981, no writ). Tracing failed in *Allen v. Allen*, 704 S.W.2d 600, 603-04 (Tex. App.–Fort Worth 1986, no writ); and *Hunt v. Hunt*, 952 S.W.2d 564 (Tex. App.–Eastland 1997, no writ).

g. Mutations (Conversions, Mergers, Corporate Reorganizations, Etc.). A corporation can go through a mutation, and if the law regarding mutations applies, then the character of the spouse's ownership interest is not changed by the mutation. *See Horlock v. Horlock*, 533 S.W.2d 52, 60 (Tex. Civ. App.–Houston [14 th Dist.] 1975, writ dism'd w.o.j.) (separate property character of corporate stock preserved despite merger).

(1) Mergers. TBCA art. 5.01 permitted a merger of a corporation into one or more other entities. For the purpose of this statute, another entity included a corporation, general or limited partnership, joint venture or other legal entity. TBCA art. 1.02A(20). Under the TBCA a merger could be either a division of one entity into more than one entity, or a combination of more than one entity into one or more entities. TBCA art. 1.02A(18). There had to be a plan of merger approved by the necessary participants described in the statute. TBCA art. 5.03. If the plan of merger was approved, then someone had to prepare articles of incorporation for any new Texas corporation. TBCA art. 5.04A. When these were filed with the Secretary of State, and all franchise taxes and fees were paid, the Secretary of State was required to issue a certificate of merger. TBCA art. 5.04C. The merger was effective when the certificate of merger was issued. TBCA art. 5.05.

Under the TBCA, when a merger took effect, all corporations that did not survive the merger ceased to exist as separate entities. TBCA art. 5.06A. All rights, title and interests to assets of the vanishing corporation were vested in one or more of the new or surviving entities, and all liabilities of vanishing corporations were to be allocated to one or more of the surviving or new corporations. Id.

TBCA art. 5.16 permitted a merger between a parent company and subsidiaries of which the parent company owns at least ninety percent of the outstanding shares of each class and series of shares, membership interests, or other ownership interests.

Under the TBOC, mergers are covered in Chapter 10.

(2) Conversions. Beginning in 1997, Texas began to allow the conversion of a corporation into an

LLC, or partnership, or other entity, by a then-new legal process called "conversion." A conversion caused the entity to change form (such as from a corporation to a partnership, or LLC, etc.), without interrupting its existence. Because of an omission in the wording of TBCA art. 5.17, there was express authority for a Texas corporation to convert into something else, but not for some "other entity" (such as a Texas partnership, LLC, etc.) to convert into a corporation. TBCA art. 5.17A. However, a foreign corporation or other entity was explicitly authorized to convert into a Texas entity. TBCA art. 5.17B.

Under the TBCA, there had to be a plan of conversion that was approved by the necessary participants described in the statute. TBCA art. 5.17. If the plan of conversion was approved, then articles of conversion had to be prepared. TBCA art. 5.18. When these were filed with the Secretary of State, and all franchise tax and fees have been paid, the Secretary of State had to issue a certificate of conversion. TBCA art. 5.18. The conversion was effective when the certificate of merger was issued. TBCA art. 5.19. In the conversion, the converting entity continued to exist without interruption, and all rights, title and interests to all real estate and other property were unaffected, and all liabilities continued unaffected.

From a marital property perspective, since the same entity emerged from the conversion in a different form, the fact that the entity has changed form should not change the character of the spouse’s ownership interest in the entity.

Under the TBCA, conversions are covered in Chapter 10.

The Texas Supreme Court recently handed down a decision that a conversion from a corporation to a limited partnership did not change the ownership of the business. *See Grohman v. Kahlig*, --- S.W.3d ----, 2010 WL 2635879 (Tex. July 2, 2010). Although the case was a post-divorce dispute that did not involve the marital property character of the ownership interest, the Supreme Court said: “Despite the fact that the business interest technically moved between Kahlig and his holding companies, Kahlig retained ownership of his entire interest in the companies throughout the conversion.” *Id.* at *4.

(3) Corporate Reorganizations. Prior to 1997, in order to change from a corporation to a partnership it was necessary to find or create at least two partners (or for a limited partnership to find or create at least one general partner and one limited partner), then merge the corporation into the partnership or convey some or all of the corporate assets into the limited partnership. See Byron F. Egan, *Choice of Entity Tree After Margin Tax and Texas Business Organizations Code*, 42 TEX. J. OF BUS. LAW 71, 112 (Spring 2007) [available on Westlaw at 42 TXJBL 71]. Using this approach, at some point in time there might be two or three entities where before there was just one. In these types of situations, sometimes a claim is made that the new entity is community property because it was capitalized with a constructive distribution of assets from the old entity.

In *Lifshutz v. Lifshutz*, 199 S.W.2d 9, 27 (Tex. App.–San Antonio 2006, no pet.) ("*Lifshutz II*"), a separate property partnership conveyed its interest in a corporate subsidiary to a separate property corporation in a tax-free business reorganization. *Id.* at 24-28. The trial court found this transfer to be 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. Applying *Lifshutz II* to a reorganization, in which a limited partnership is created and the corporation conveys assets into the limited partnership, could result in a later claim that separate property wealth was inadvertently transformed into community property wealth in the process.

h. Selling an Ownership Interest. If a spouse sells shares of a corporation, the principle of mutation provides that the proceeds from sale will have the same character as the shares. The same is true for a redemption by the corporation of a shareholder's shares.

i. S-Corporations. Corporations that meet certain qualifications can elect to be treated for income tax purpose as a partnership if they make a Subchapter-S election.

To be an S-Corporation, the entity must meet the following requirements (among others): (i) it must be a domestic corporation (or entity taxable as a corporation); (ii) with not more than 75 shareholders who are individuals (excluding nonresident aliens or their spouse), estates or certain trusts; and (iii) have not more than one class of stock. Leslie H. Loffman & Sanford C. Presant, *Choice of Entity–Business and Tax Considerations, Tax Law and Estate Planning Course Handbook Series* (2007) [available on Westlaw at 743 PLI/Tax 575], p. 609 ("Loffman & Presant"). All shareholders must sign the election for Subchapter S treatment (IRS Form 2553). *Id*. at 610.

Distributions from a C-Corporation are usually in the form of dividends and are taxable. Tax treatment of S-Corporation distributions depends on whether the S-Corporation has accumulated earnings and profits. See Internal Revenue Code ("IRC") §§1368 and 301. An S-Corporation typically will not have accumulated earnings and profits unless it was previously a C-Corporation or it acquired another corporation with accumulated earnings and profits. BNA Tax Management Portfolios, Dividends-Cash and Property A-8, Volume 764 (2nd ed. 2001). See IRC §1368 for the taxation scheme.

A S-Corporation election must be signed by all shareholders. An issue can arise where some professional thoughtlessly advised a married shareholder whose shares were separate property to have his/her spouse sign the written election, for no better reason than the fact that "Texas is a community property state." Typically the ownership of each spouse will be erroneously reflected on such an election at 50%. Some parties will offer this election as proof that the shares are owned half by each spouse.

4. Distributions in the Ordinary Course of Business.

a. The Corporate Decision to Make a Distribution. A corporation's board of directors determines what gets distributed to shareholders. TBCA art. 2.38; TBOC § 21.302. Prior to the TBCA, payments of dividends were dependent on "earned surplus," "reduction surplus," and "capital surplus." James C. Chadwick, *Corporations and Partnerships*, 42 S.W.L.J. 249, 267 (April, 1988) ("Chadwick"). These terms were jettisoned in 1987. Thereafter under the TBOC, a corporate "distribution" was "a transfer of money or other property" (but not its own shares), "or issuance of indebtedness by a corporation to its shareholders in the form of: (a) a dividend . . .; (b) a purchase, redemption, or other acquisition . . . of its own shares; or (c) a payment . . . in liquidation of all or a portion of its assets." TBCA art. 1.02A(13); *see* TBOC §21.201 & 21.30321.002(6). Such distributions could not be made if they (i) would render the corporation insolvent or (ii) exceed the surplus of the corporation. TBCA art. 2.38A & B; TBOC § 21.201 & 21.303. "Surplus" was defined as "the excess of net assets of a corporation over its stated capital." TBCA art. 1.02A(27). It is now defined in TBOC § 212.002(12) as "the amount by which the net assets of a corporation exceed the stated capital of the corporation." "Net assets" means "the amount by which the total assets of a corporation exceed the total debts of the corporation." TBCA art. 1.02A(19); TBOC § 21.002(9). "Stated capital" means the par value of all outstanding shares, or the consideration set by the Board of Directors for shares without par value. TBCA art. 1.02.(24); *see* TBOC § 21.002(11). Rules for determining insolvency and surplus are set out in TBCA art. 2.38-3; *see* TBOC § 21.314.

The board of directors can authorize share dividends. TBCA art. 2.38-1A. However, under TBCA art. 2.38-1C, the corporation's surplus (assets less liabilities and stated capital) must be at least equal to the amount required to be transferred to stated capital. Under TBOC §§ 21.301 & 21.202, the dividend cannot exceed the surplus of the corporation, unless it is to retire issued stock, in which event the limit is the net assets of the corporation. TBOC § 21.301(1).

The right to receive a dividend arises on the date specified by the board of directors resolution, called the "ex dividend date." <http://www.sec.gov/answers/dividen.htm> (last visited on 7/5/2010). Only then can a community claim to corporate profits arise. *Snider v. Snider*, 613 S.W.2d 8, 11 (Tex. Civ. App.–El Paso 1981, no writ) ("Prior to the actual declaration of a dividend, all the accumulation of surplus in the corporation merely enhanced the value of the shares held by the husband as his separate property and the community had no claim thereto"). If a corporation declares a dividend before a shareholder's marriage, then pays the dividend during marriage, the dividend should be recognized as separate property, because the right to receive the dividend arose before marriage.

Stock splits <http://www.sec.gov/answers/stocksplit.htm> (last visited on 7/5/2010) are not considered to be a share dividend or distribution. TBCA art. 2.38-2; TBOC § 21.002(6)(B). 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 2, 60 (Tex. Civ. App.–Houston [14th Dist.] 1975, writ dism'd).

b. Cash Dividends. Cash dividends issued by a corporation 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). But not all corporate distributions are dividends; some are distributions in partial or full liquidation of capital. How do you distinguish the two? And what is the character of partial liquidations of capital from a separate property corporation?

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

5. Distributions Upon Dissolution.

a. Dissolution of Corporation. A corporation can be dissolved in several ways. The corporation may have reached the end of the life span set by its governing documents, or the officers or shareholders may decide to dissolve the entity, or a third party (e.g., a court or the Secretary of State) may require dissolution. The process for dissolving the entity varies based on the extent of business conducted by the corporation and whether the dissolution is voluntary or involuntary.

(1) Voluntary Dissolution. A corporation may be voluntarily dissolved by a vote of holders of 2/3 of the outstanding shares. TBOA § 21.364(b). That super-majority can be reduced to a simple majority by the Certificate of Formation. TBOC § 21.365(a).

Any time a corporation is voluntarily dissolving, it must cease to carry on its business, send notice of the dissolution to all its creditors, and liquidate all of the property which will not be distributed in kind. TBOC § 11.052. After the corporation has finished dissolving, a certificate of termination must be filed containing the names of the corporation and its officers and directors, the nature of the event requiring winding up, and other information required by the TBOC. The corporation is considered terminated on the date this certificate of termination is filed. TBOC § 11.102.

(2) Involuntary Dissolution. The Secretary of State may terminate a corporation by issuing a certificate of termination, if the corporation fails to file a required report, or fails to pay any fees or franchise taxes required by law, or fails to maintain a registered agent or office in the state, or fails to pay the filing fee for incorporation. TBOC § 11.251. The Secretary of State must mail a copy of the certificate of termination to the corporation. TBOC § 11.252. If the corporation corrects its failure and is reinstated within three years, it will be deemed to have continued in existence without interruption. TBOC § 11.253(d). When a corporate charter is forfeited, the title to corporate assets is bifurcated, with legal title remaining in the corporation and beneficial title in the shareholders. *Lowe v. Farm Credit Bank of Texas*, 2 S.W.3d 293, 298 (Tex. App.–San Antonio 1999, pet. denied).

A Texas court may also require the termination of a corporation if the Attorney General files an action and the court finds that: (1) the corporation or its organizers did not comply with a condition precedent to formation; (2) the certificate of formation or an amendment thereto was fraudulently filed; (3) a misrepresentation of material fact was made in a document submitted by the filing entity; (4) the corporation has continued to engage in ultra vires acts; or (5) public interest requires winding up due to felonies committed by the entity or management. TBOC §§ 11.301 & 11.303.

The appointment of a receiver for any domestic entity is covered by TBOC chapter 11, Subchapter I. A receiver can be appointed for the entity or its property. TBOC §11.401 -- 11.404.

A creditor may cause either an immediate involuntary dissolution of a corporation or a dissolution through receivership. If the creditor establishes that irreparable damage will ensue to the unsecured creditors of the corporation as a class, generally, unless there is an immediate liquidation, then the court may order a liquidation of the corporation and may appoint a receiver to affect the liquidation. TBOC § 11.405(a)(4).

(3) Characterization of Distributions in 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.

6. Sale of Corporate Stock. "[P]roceeds from the sale of separate property are the separate property of the spouse whose property was sold." *Pace v. Pace*, 160 S.W.3d 706, 715 (Tex. App.--Dallas 2005, pet. denied).

B. LIMITED LIABILITY COMPANIES. Limited liability companies ("LLCs") were introduced into Texas in 1991, with the Texas Limited Liability Company Act ("TLLCA"). Tex. Rev. Civ. Stat. art. 1528n. An LLC is a hybrid between a corporation and a partnership; like a corporation, the owners (referred to in the TLLCA as "members") are not liable for entity debts, but like a partnership, the parties have great latitude in creating an organizational structure and can elect to be taxed like partners. Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer*, 37 S.D. L. Rev. 44, 45 (1991/1992); TLLCA art. 2.02A ("Each limited liability company shall have the power provided for a corporation under the TBCA and a limited partnership under the Texas Revised Limited Partnership Act."). However, the LLC is separate and distinct from either a partnership or a corporation. *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n*, 77 S.W.3d 487, 500 (Tex. App.–Texarkana 2002, pet. denied).

LLCs have become very popular because they combine the best qualities of a corporation with the best qualities of a partnership.

1. Formation. A Texas LLC is created by the Secretary of State, upon the filing of articles of organization and payment of a fee. *Compare* superceded TLLCA, arts. 3.01, 3.04 to TBOC § 3.001 – 3.004. In Texas, an LLC can be organized by any person having the capacity to contract. TBOC § 3.004. There is no minimum capital requirement for forming an LLC.

Under the TBOC, mergers and conversions involving LLCs are governed by Chapter 10.

2. Ownership. There are no restrictions on the types of capital that can be contributed to an LLC, and there is no minimum amount of capital required for an LLC to do business. Effective September 1, 2003, an LLC was permitted to admit a person as a member with a membership interest without requiring a capital contribution. TLLCA art. 4.01. Since September 1, 2003, a person can become a member of an LLC without acquiring a membership interest, as long as at least one person owns an interest. *Id*.

A person named as an initial member of the LLC in the company's certificate of formation on the day the LLC is formed. TBOC § 101.103(a). A person not admitted as an initial member becomes a member of the LLC on the later of: the day the LLC is formed, the date given in the company's records at the date s/he became a member, or the date on which the person's admission is first reflected in the company records. TBOC § 101.103(b). A person joining later can join only with the unanimous consent of all members. TBOC § 101.103(c).

An LLC must have at least one member. TBOC § 101.101(a). A membership interest in an LLC is personal property. TBOC § 101.106(a). A court, upon application by a creditor of a member of an LLC, "may charge the membership interest of the judgment debtor to satisfy the judgment." TBOC § 101.112(a). A charging order is a lien on the interest. TBOC § 101.112(c). A charging order is the exclusive remedy against the member's interest in the LLC. TBOC § 101.112(d). The creditor of a member cannot reach the assets of the LLC. TBOC § 101.112(f).

3. Status as an Entity. An LLC is an entity, with a legal identity that is separate and apart from its members. A member of an LLC has no interest in specific LLC property. TBOC § 101.106(b). Members are not liable for the debts, obligations or liabilities of an LLC. TBOC § 101.114. Given the entity status, assets of an LLC are neither community nor separate property of a married member, in that the member has no ownership interest in the assets of the LLC.

Courts have recognized the ability to pierce the veil of an LLC. *Gonzalez v. Lehtinen*, 2008 WL 668600, *4 n. 6 (Tex. App.–Corpus Christi 2008, no pet. hist.); *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, 590 (Tex. App.–Houston [1st Dist.] 2007, pet. denied) ("[Appellant] has not offered, nor can we find, any judicial support for the proposition that existing state law doctrines of piercing the corporate veil should not be applied to LLCs"); *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n*, 77 S.W.3d 487, 500 (Tex. App.–Texarkana 2002, pet. denied) (appellate court applied the alter ego theory to an LLC but found it unsupported on the facts).

4. Contributions and Distributions. A member of an LLC can contribute any tangible or intangible benefit to the entity, including cash, services rendered, contract for services to be performed, a promissory note. *Compare* TLLCA art. 5.01 *with* TBOC § 1.002(9). Under TLLCA art. 4.01B-2(1), the regulations of the company could allow the admission of new members without making a contribution of any kind. That is implicit now under the TBOA. A member's promise to make a future contribution is unenforceable unless it is in writing. *Compare* TLLCA art. 5.02A *with* TBOC § 101.151. Unless the articles of organization or regulations stated otherwise, an enforceable promise to contribute survived the death of the obligor. *Compare* TLLCA art. 5.02B *with* TBOC § 101.152.

Under the TLLCA, distributions from the LLC to its members could be made in any amount and at any time prescribed in the regulations. TLLCA arts. 5.03-5.04. Under TBOC Sections 101.204 and 101.205, an LLC can make "interim distributions" or "distribution on withdrawal." TBOC § 101.204 – 101.205. The only restriction on the amount of a distribution made to the members was that it could not exceed the fair value of the LLC's assets minus its liabilities (but not including liabilities owed to members of the LLC or for which the creditor has recourse only to specific LLC property). *Compare* TLLCA art. 5.09 *with* TBOC § 101.206. When a member becomes entitled to receive a distribution, that member acquires all of the rights of a creditor of the LLC. *Compare* TLLCA art. 5.08 *with* TBOC § 101.207. A member of an LLC is entitled to receive distributions only in cash. *Compare* TLLCA art. 5.07 *with* TBOC § 101.202.

5. Dissolution of the LLC. Like a regular corporation, an LLC terminates when the stated term of its existence expires, the happening of a stated event occurs, the members consent to termination, or a judge issues a decree terminating the LLC because it cannot carry on its business in conformity with its articles of incorporation and regulations. *Compare* TLLCA art. 6.01A(1)-(3), (6); art. 6.02 *with* TBOC chapter 11, subchapter B (Winding Up of Domestic Entity).

6. Marital Property Issues. A member's interest in an LLC is separate or community property depending on when and how the interest was acquired. Absent piercing the entity veil, a divorce court has no power to include any assets of the LLC in the property division. Given the restrictions on the rights of a judgment creditor in TBOC § 101.112(d), which limit the creditor's remedy to a charging order, it can be argued that even a community property interest in an LLC cannot be awarded to the non-member spouse, in that the spouse is a creditor of the LLC member. A contrary argument is that a community property interest is a co-ownership interest, not a creditor's claim, so that the court should be allowed to award a membership interest to the non-member spouse.

A situation may arise where family assets have been placed into a family limited partnership. Often the general partner of the family limited partnership is an LLC that is entirely community property. The trial court could, by awarding all or at least 50+% of the LLC to one spouse, perpetuate that one spouse's control over the marital estate after the divorce.

C. PARTNERSHIPS.

1. What is a Partnership? TBOC defines a partnership in this way:

> [A]n an association of two or more persons to carry on a business for profit as owners creates a partnership, regardless of whether: (1) the persons intend to create a partnership; or (2) the association is called a "partnership," "joint venture," or other name.

TBOC § 152.051. Partnerships can also come into existence through merger or conversion. TBOC § 10.002.

Because other entity statutes, with all their conditions, were engrafted onto the common law, the general partnership is the default form for an unincorporated business with multiple owners. See Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. Colo. L. Rev. 1065, 1075 (1995) ("Hamilton"). Consequently, if corporate or LLC status fails, and the de facto corporation doctrine does not apply, the business most likely becomes a general partnership.

Since a partnership arises from an agreement of the partners, many of the rights and liabilities as between the partners can be varied by agreement. The rights and liabilities as to third parties, however, are not susceptible to modification in the partnership agreement. John Morey Maurice, *A New Personal Limited Liability Shield for General Partners: But Not All Partners Are Treated The Same*, 43 GONZ. L. REV. 369, 373 (2007-08) ("Maurice").

2. A Partnership is an Entity. TRPA and TBOC both provide that "[a] partnership is an entity distinct from its partners." TRPA art. 2.01; TBOC § 152.056. Partners can own an interest in the entity, but they do not own an interest in specific partnership assets. TRPA art. 2.04; TBOC § 154.001(c). While Texas courts considered the Texas Uniform Partnership Act ("TUPA") to be an entity theory statute, *Burnap v. Linnartz*, 914 S.W.2d 142, 150 (Tex. App.–San Antonio 1995, writ denied), in some ways it was not. In 1993, TRPA explicitly recognized general partnerships as an entity. Alan R. Bromberg, *Texas Business Organization and Commercial Law–Two Centuries of Development*, 55 SMU L. REV. 129 (2002) ("Bromberg").

TRPA provided:

> Partnership property is not property of the partners. Neither a partner nor a partner's spouse has an interest in partnership property.

TRPA art. 2.04; TBOC § 152.101. A partner is not a co-owner of partnership property and cannot in his individual capacity, transfer an interest in partnership property. TRPA art. 5.01; TBOC §§ 154.001 & 154.002. Thus, partnership assets are neither separate property nor community property of a partner. "It is . . . elemental law in Texas that specific assets of a partnership are not owned by a partner individually." *In re Murchison*, 54 B.R. 721, 727 (Bkrtcy. Tex. 1985). "The interest of each partner is his share in the surplus after the partnership debts are paid, and after partnership accounts are settled and the rights of the partners inter se are adjusted." *Id.* at 727. TRPA art. 2.05and TBOC § 152.102 set out the rules governing the partnership's acquisition of partnership assets.

All general partners are jointly and severally liable for all partnership debts. TRPA art. 3.04; TBOC § 152.304. An exception exists for limited partners of a limited partnership. Also, if the general partner of a limited partnership is a corporation or limited liability company, then all owners enjoy limited liability. A new partner joining an existing partnership does not have personal liability for an obligation of the partnership that: (1) arose before the partner's admission to the partnership; (2) relates to an action taken or omissions occurring before the partner's admission to the partnership; or (3) arises before or after the partner's admission under a contract or commitment entered into before the partner's admission to the partnership. TRPA art 3.07; TBOC § 152.304(b).

Two Texas courts have held that partnerships are not susceptible to a piercing of the entity veil: *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 518 (Tex. App.–San Antonio 2001, pet. denied); *Pinebrook Properties, Ltd. v. Brookhaven Lake Prop. Owners Ass'n*, 77 S.W.3d 487, 499-500 (Tex. App.-Texarkana 2002, pet. denied).

3. Partnership Interest. When a partner joins a partnership, s/he acquires a right to participate in management and s/he acquires a partnership interest. "'Partnership interest' means a partner's interest in a partnership, including the partner's share of profits and losses or similar items, and the right to receive distributions." TRPA art. 1.01(13); TBOC § 1.002(68). However, "[a] partnership interest does not include a partner's right to participate in management." TRPA art. 1.01(13); TBOC § 1.002(68). The partnership interest is personal property. TRPA art. 5.02(a); TBOC § 1.002(68).

The State Bar of Texas Committee that drafted TRPA art. 1.01(13) said this:

> This definition [of partnership interest] is similar to that in TRLPA (Texas Revised Limited Partnership Act) and is intended to define what may be transferred when a partnership interest is assigned. This provision differs from TUPA § 26 by replacing the right to share in profits and surplus with the right to share in profits and losses and the right to receive distributions. These are the rights to which an assignee is entitled under TRLPA § 7.02. The addition of the right to share in losses should not be construed to require an assignee of the partnership interest to assume the debts of the partnership. The right to receive distributions does not give the partner or the partner's transferee the right to compel distributions by a partnership.

Tex. Rev. Civ. Stat. Ann. art. 6132b-1.01, Comment of Bar –1993. A partner can have a "capital interest" in a partnership, or a "profits interest." A "capital interest" is an interest which entitles the partner not only to a share of future profits and losses, but also to a payment upon withdrawal from the partnership or upon liquidation of the partnership, based upon partnership assets. *See Central State, Southeast and Southwest Areas Pension Fund, v. Creative Development Co.*, 232 F.3d 406, 425 (Dennis, J., dissenting); Alan J. Tarr, *Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances*, Tax Law and Estate Planning Course Handbook Series p. 19 (Practicing Law Institute, 2007) [available on Westlaw at 747 PLI/Tax 9]. A "profits interest" is a right that entitles the partner to receive a share of earnings and profits, with no right to payment upon withdrawal or liquidation. Mark Winfield Brennan, *The Receipt of a Profits Interest in a Partnership as a Taxable Event After Campbell and Mark IV*, 57 MO. L. REV. 273, 276 (1992).

4. Admission of Partners. Unless the partnership agreement provides otherwise, a person can become a partner in a general partnership only with the consent of all partners. TRPA art. 4.01(g); TBOC § 152.201.

5. Acquiring an Interest in a Partnership from the Partnership. Persons who acquire a partnership interest from the partnership do so in exchange for a contribution of capital. TUPA and TRPA and the TBOC do not restrict the types of consideration that can be contributed to a general partnership in exchange for a partnership interest. The normal rules of marital property govern whether a partnership interest is separate or community property at the time it is acquired. *See In re Marriage of Higley*, 575 S.W.2d 432 (Tex. Civ. App.–Amarillo 1978, no writ) (partnership interest acquired prior to marriage was separate property); *Horlock v. Horlock*, 593 S.W. 2d 743 (Tex. Civ. App.–Houston [1st Dist.] 1980, writ ref'd n.r.e.) (limited partnership interest acquired by husband after divorce was his separate property); *York v. York*, 678 S.W.2d 110 (Tex. App.–El Paso 1984, writ ref'd n.r.e.) (partnership interest acquired during marriage deemed to be community property). It should be noted that, as partners acquire partnership interests from the partnership, or have the partnership redeem their ownership interest, the remaining partners' percentage of ownership interest in the partnership will rise or fall. This does not indicate that the other partners are acquiring or losing interest is the partnership. They have the same interest. It just represents a greater or lesser percentage of outstanding ownership interests.

Persons who buy another partner's interest in the partnership are effecting a purchase, as distinguished from making a capital contribution. In such a transaction, the other partners' percentage of total partnership ownership interests does not change.

6. Transferring an Interest in a Partnership . Transfers of an interest in a general partnership are governed by TRPA arts. 5.03 and 5.04. TBOC §§ 152.401 - 152.405. Subject to an agreement to the contrary, a partner in a general partnership can transfer his/her partnership interest in whole or in part. TRPA art. 5.03(a)(1); TBOC § 152.401. The transfer is not an act of withdrawal, TRPA art. 5.03(a)(2) and TBOC § 152.402(1), and does not by itself cause a winding of the partnership, art. 5.03(a)(3) and TBOC § 152.402(2). The transferee does not acquire the right to participate in the management or conduct of the partnership business. TRPA art. 5.03(a)(4); TBOC § 152.401(3). After the transfer, the transferee is entitled to receive the distributions which the transferor would have been entitled to receive, to the extent that right was transferred. TRPA art. 5.03(b); TBOC § 152.404(a). The transferor retains all rights and duties that were not transferred. Id. The transferee does not have liability of a partner until the transferee becomes a partner. *Id*. The transferee has a right to reasonable information about the partnership and to inspect the partnership books. *Id*. In the event of winding up, the transferee is entitled to receive, to the extent transferred, the net amount that would have been distributed to the transferor. TRPA art. 5.03(c); TBOC § 152.404(b). A partnership has no duty to recognize a transfer prohibited by the partnership agreement. TRPA art. 5.03(e); TBOC § 152.405.

On divorce, a non-partner spouse receiving an interest in the partnership is considered to be a transferee. TRPA art. 5.04 (a); TBOC § 152.406(a)(1). The same is true if a partner dies and a spouse or heir receives an interest in the partnership. TRPA art. 5.04(b); TBOC § 152.406(a)(2). Same for heirs of a partner's spouse who dies. *Id*. A transfer to a spouse does not constitute an event of withdrawal. TRPA art. 5.04(d); TBOC § 152.406(b).

7. Withdrawal. Under TBOC, the withdrawal of a partner from a general partnership is referred to as an event of withdrawal. There are ten distinct events of withdrawal: (1) the partnership receives notice of partner's express intent to withdraw; (2) an event specified in the partnership agreement requiring the withdrawal of a partner occurs; (3) a partner is expelled pursuant to the partnership agreement; (4) a partner is expelled by a vote of a majority-in-interest of the other partners; (5) a partner is expelled by judicial decree; (6) a partner becomes a debtor in bankruptcy; (7) a partner dies, has a guardian appointed, or becomes incapable of performing their partnership duties; (8) the partner's existence is terminated (as with a corporation); (9) a partner transfers all of their partnership interest and the interest is redeemed; or (10) a partner requests that the partnership be wound up but the other partners agree to continue the partnership. TRPA art. 6.01(b); TBOC § 52.501. A partnership continues in existence after an event of withdrawal, TRPA art. 2.06(a); TBOC § 152.502, unless an event requiring winding up also occurs.

a. Redemption. When a partner withdraws, their interest is redeemed by the partnership provided the partnership does not begin winding up within 61 days after the withdrawal. TRPA art. 7.01(a); TBOC § 152.601. The redemption price is the “fair value” of the interest on the date of withdrawal, unless a partner wrongfully withdraws, in which case the redemption price is the lesser of the fair value or the amount the partner would have received if the partnership was wound up as of the date of the wrongful withdrawal. TRPA art. 7.01(b)(1); TBOC § 152.602(b). A wrongfully withdrawing partner is liable for any capital contributions he would have been required to make had he not withdrawn. TRPA art. 7.01(c); TBOC § 152.603. A process of tender, demand and, if necessary, litigation is set out in the statute. TRPA art. 7.01(g)-(s); TBOC §152.607.

Note that "fair value" used in art. 7.01(b)(1) and Section 152.602(b) is not defined in TRPA or TBOC. The phrase is a term of art in corporation law, meaning the proportionate ownership percentage of value of the entity as a going concern, without adding a premium for control or discounting for lack of control or lack of marketability, and disregarding any change in value resulting from anticipation of the upcoming event. TBCA art. 5.12A(1)(a); TBOC § 10.36. However, this definition is limited to disputes involving the rights of dissenting shareholders. *Id.* Be aware that accountants now use the term "fair value" to mean "fair market value." In entity law, fair value is not the same as fair market value.

In *Coleman v. Coleman*, 170 S.W.3d 231, 237-38 (Tex. App.–Dallas 2005, pet. denied), the court applied the redemption process to the widow of a partner. The partnership contended that the widow was entitled only to her husband's capital account. The court of appeals noted that one event of withdrawal that triggers redemption is a partner's death and that, upon the death of a partner, the partner's surviving spouse and his or her heirs become "transferees" of the partnership interest from the partner. The court held that the widow was entitled to the redemption value of her husband's interest in the partnership, and not just her husband's capital account. Thus, although the partnership tried to limit the widow's recovery to her late husband's share of book value, the widow received her husband's pro-rata share of the partnership valued as an entity at fair market value, including unrecorded increase in the value of assets and unbooked intangibles like goodwill.

8. Management. Each partner in a general partnership has an equal right of management and conduct of the partnership business. TRPA art. 4.01(d); TBOC § 152.203(a). "A partner's right to participate in the management and conduct of the business is not community property." TRPA art. 4.01(d); TBOC § 152.203(a). This exclusion will affect the valuation of what would otherwise be a spouse's controlling interest in a partnership, since any value attributed to a spouse's right to manage the partnership, even if it is a community property interest, must be excluded from the community estate. An interesting question could arise for an out-of-state partnership, as to whether the "internal affairs doctrine" means that the TRPA art. 4.01(d) and TBOC § 152.203(a) provisions, excluding management rights from the community estate, would apply to the foreign partnership.

9. Limited Partnership. In Texas, limited partnerships have the essential features of general partnerships, except that: registration with the state is necessary to bring the limited partnership into existence; limited partners have ownership without management rights; and the liability of limited partners is restricted to their investment in the business.

The Texas legislature adopted its first limited partnership act in 1846. Bromberg, at 91. That law continued in effect until the Texas Uniform Limited Partnership Act ("TULPA") was adopted in 1955, in response to demand from the real estate and oil and gas sectors of the Texas economy. Bromberg, at 106; James C. Chadwick, *Corporations and Partnerships*, 42 S.W.L.J. 249, 249 (April, 1988) ("Chadwick"). TULPA was based on the National Conference of Commissioners on Uniform State Laws ("NCCUSL") 's 1916 version of the Uniform Limited Partnership Act. Chadwick, at 249 n. 5. TULPA continued in effect until the Texas Revised Partnership Act ("TRLPA") was adopted effective September 1, 1987, and as to then-existing partnerships that did not elect to be covered by TRLPA, for a period of five more years. The TRLPA, which was patterned after the NCCUSL's 1985 revised ULPA (with adaptations taken from Delaware law and some features unique to Texas), Bromberg, at 125, governs all limited partnerships formed on or after September 1, 1987, and all then-existing limited partnerships that elected coverage up through September 1, 1992, at which time TRLPA became effective for all Texas limited partnerships, new and old. TRLPA increased the flexibility of partners to agree to entity governance, and enhanced limited partners' protections against entity liabilities. Chadwick, at 249. Since January 1, 2006, Texas limited partnerships have been governed by TBOC. In today's world with the availability of other entities like the limited liability company that better suit many business needs, limited partnerships are used mostly as vehicles to make long term investments in one asset or one activity (like one real estate venture) and for estate planning purposes (family limited partnerships).

The provisions of the TRLPA, and the chapters of the TBOC pertaining to limited partnerships, are not comprehensive statutes and, to the extent that they do not speak to an issue, limited partnerships are governed by the general partnership provisions of the TRLPA or TBOC, or the common law. TRLPA § 13.01(a) ("In any case not provided for by this Act, the applicable statute governing partnerships that are not limited partnerships and the rules of law and equity, including the law merchant, govern"); TBOC § 153.003 ("Except as provided by Subsection (b), in a case not provided for by this chapter and the other limited partnership provisions, the provisions of Chapter 152 governing partnerships that are not limited partnership and the rules of law and equity govern"); see Daniel S. Kleinberger, *A User's Guide to the New Uniform Limited Partnership Act*, 37 SUFFOLK U.L. REV. 583, 584-85 (2004) (limited partnership acts "recognize and depend on linkage" with the law of general partnerships); Bromberg, at 127 (common law describes fiduciary duties). A few matters must be governed by the TRLPA, regardless of what the partnership agreement says. Chadwick, at 251.

a. Formation. A Texas limited partnership is created like a general partnership, by agreement of the partners. TRLPA§ 2.01(a); TBOC ch.3 subch. A. The agreement may be written or oral. TRLPA § 1.02(10). Under TRLPA, the general partners had to sign a certificate of limited partnership, TRLPA §§ 2.01(a), 2.04(a)(1), which was then filed with the Secretary of State, who stamped the certificate "filed" and dated it. TRPLA § 2.07(a). The limited partnership came into existence when the certificate of limited partnership was filed with the Secretary of State. TRLPA § 2.01(b). Over the years, several courts have held in various instances that substantial compliance with the filing requirements was sufficient for the limited partnership to come into existence with liability protections for limited partners. *Laney v. Commissioner*, 674 F.2d 342,342 (5th Cir. 1982); *In re Oakgrove Village, Ltd.*, 90 B.R. 246, 251 (Bankr. W.D. Tex. 1988); *Shindler v. Marr & Assoc.*, 695 S.W.2d 699, 703 (Tex. Civ. App.–-Houston [1st Dist.] 1985, writ ref'd n.r.e.); *Garrett v. Koepke*, 569 S.W.2d 568, 570-71 (Tex. Civ. App.–Dallas 1978, writ ref'd n.r.e.); *Voudouris v. Walter E. Heller & Co.*, 560 S.W.2d 202, 206 (Tex. Civ. App.–Houston [1st Dist.] 1977, no writ).

Under TRLPA, as under TBOC, a limited partnership can also be created by the merger of one or more limited partnerships with one or more other business entities through a plan of merger. TRLPA § 2.11; TBOC ch. 10, subch. A. A certificate of merger had to be filed with the secretary of state who stamped it as "filed" with the date of filing, TRPLA § 2.11(e), at which time the merger became effective. TRPLA § 2.11(f). Upon merger, all property of the merging entities was "allocated and vested in one or more of the surviving or resulting entities as provided in the plan of merger." TRLPA § 2.11(g)(2); *see Allen v. United of Omaha Life Ins. Co.*, 236 S.W.3d 315, 321 (Tex. App.–Fort Worth 2007, pet. denied). The same was true of all liabilities and obligations. TRLPA § 2.11(g)(3). A similar rule applied to the creation of a limited partnership by "conversion" from another entity. TRLPA § 2.15.

Under the TBOC, a limited partnership is considered to be a “filing entity,” just like a corporation, and the requirements for filing are governed by TBOC ch. 3, subch. A.

Under TBOC § 153.105, rights of limited partners can be created by the certificate of formation, or the partnership agreement, or TBOC chapter 153, or other limited partnership provisions of the TBOC.

b. Ownership Rights. Limited partnerships present the same marital property issues as general partnerships: specific partnership property is neither separate nor community; the partnership interest can be either separate or community property; and management rights cannot be community property. In a divorce, the trial court cannot award specific partnership assets. *Gibson v. Gibson*, 190 S.W.3d 821, 823 (Tex. App.–Fort Worth 2006, no pet.) (trial court reversed for awarded limited partnership asset to non-partner spouse). If a spouse's community property partnership interest in a limited partnership is awarded to the non-partner spouse, the spouse receives an assignee's interest.

c. Distributions. As with general partnerships, a dispute can arise as to the character of distributions made during marriage by a separate property partnership. It should be noted that both TRLPA and TBOC clearly contemplate distributions of capital, because TRLPA § 5.04 and TBOC § 153.208 provide that distributions that are a return of capital shall be made based upon agreed values. These two sections also say that distributions "that are not a return of capital" are made in proportion to the allocations of profit. It can be argued that a distribution that is not made in proportion to the allocation of profits is a return of capital.

d. Assignee's Interest. The limited partnership agreement can specify how a partnership interest is assigned. *Compare* TRLPA § 7.02 *with* TBOC § 153.251. Unless the agreement provides otherwise, the assignor continues as a partner with all unassigned rights of a partner until the assignee becomes a partner. Id. The assignee can become a partner as provided in the partnership agreement, or by unanimous consent of all partners. *Compare* TRLPA § 7.04(a) *with* TBOC § 153.253(a). An assignee who becomes a partner is subject to the terms of the partnership agreement and the prevailing partnership law, including the assignor's obligation to meet future capital calls. *Compare* TRLPA § 7.04(a) *with*; TBOC § 153.253(b). The assignor, however, is not released from his/her financial obligation to the limited partnership. *Compare* TRLPA § 7.04(c) *with* TBOC § 153.255.

V. INTERESTS IN TRUSTS AND DISTRIBUTIONS FROM EXPRESS TRUSTS.

A. WHAT IS A TRUST? In Texas, an express trust is created when legal and beneficial ownership in assets are severed, with legal title being held by a trustee and equitable title being held by a beneficiary. *Interfirst Bank-Houston, N.A. v. Quintana Petroleum Corp.*, 699 S.W.2d 864, 874 (Tex. App.–Houston [1st Dist.] 1985, writ ref'd n.r.e.) ("legal title to the property, as well as the right to possession and control, is vested in the trustees . . . "). Therefore an express trust is not an entity; it is a relationship.

Express trusts were controlled by the common law in Texas until April 19, 1943. On that date, the Texas Trust Act went into effect. See Tex. Rev. Civ. Stat. art. 7425a et seq.; *Land v. Marshall*, 426 S.W.2d 841, 845 (Tex. 1968). The Texas Trust Act controlled express trusts until its repeal, effective December 31, 1983. On January 1, 1984, the Texas Trust Code went into effect. See Tex. Prop. Code chs. 111-115 ("TPC"). The old Texas Trust Act still controls the validity of trusts created while the Act was in effect, and actions taken relating to express trusts while the Act was in effect. The new Texas Trust Code applies to trusts created on or after January 1, 1984, and to transactions relating to prior trusts, but which occur on or after January 1, 1984.

B. FORMATION OF THE TRUST. Before there can be a trust, the settlor must intend the creation of the trust. See TPC § 112.002 ("A trust is created only if the settlor manifests an intention to create a trust."); *Gonzalez v. Gonzalez*, 457 S.W.2d 440 (Tex. Civ. App.–Corpus Christi 1970, writ ref'd n.r.e.); *Tolle v. Sawtelle*, 246 S.W.2d 916, 918 (Tex. Civ. App.–Eastland 1952, writ ref'd).

The Texas Trust Code provides that an express trust containing real or personal property is unenforceable unless it is created by a written instrument, signed by the settlor (or his agent), and contains the terms of the trust. TPC § 112.004. The mere designation of a party as "trustee" on an instrument does not alone create a trust. *Nolana Development Ass'n v. Corsi*, 682 S.W.2d 246, 249 (Tex. 1985). There are two exceptions to this rule for trusts which involve only personalty: (i) where the personalty is transferred to a trustee who is not a beneficiary or settlor, and the settlor expresses the intention to create a trust, either before or at the time of the transfer; (ii) where the owner of personalty makes a written declaration that s/he holds personalty in trust for another. TPC § 112.004(1) & (2). This exception would apply to funds which the party has deposited in a financial institution, where the account reflects the party as "trustee" for another. *See Jameson v. Bain*, 693 S.W.2d 676 (Tex. App.–San Antonio 1985, no writ). This exception would also apply to stocks, bonds, CD's, etc. carried in the name of the party "as trustee" for another. *See Citizens Nat. Bank of Breckenridge v. Allen*, 575 S.W.2d 654, 658 (Tex. Civ. App.–Eastland 1979, writ ref'd n.r.e.).

There must be a present transfer of legal title of property from the settlor to the trustee for the trust to be valid. *Cutrer v. Cutrer*, 334 S.W.2d 599, 605 (Tex. Civ. App.–San Antonio 1960), aff'd, 162 Tex. 166, 345 S.W.2d 513 (1961). However, the settlor may "transfer" legal title to the property to himself as trustee as long as his words or acts clearly reflect his intent to relinquish individual ownership in favor of holding the property merely as trustee for the beneficiary. *Westerfeld v. Huckaby*, 474 S.W.2d 189 (Tex. 1972); accord, TPC § 112.004(2). The settlor may retain rights in the property, or may be the initial trustee, and may retain the right to revoke the trust, without violating this rule. *Westerfeld*, 474 S.W.2d at 193.

C. OWNERSHIP RIGHTS IN THE TRUST PROPERTY. As noted above, the core concept of an express trust is the separation of legal from beneficial title, where legal title is held by the trust for the benefit of the beneficiaries. The legal and beneficial title to trust property must remain separated at all time or the trust collapses under a doctrine called “merger”:

> If a settlor transfers both the legal title and all equitable interests in property to the same person or retains both the legal title and all equitable interests in property in himself as both the sole trustee and the sole beneficiary, a trust is not created and the transferee holds the property as his own.

TPC § 112.034(a); *Moody v. Pitts*, 708 S.W.2d 930, 936 (Tex. App.–Corpus Christi 1986, no writ) ("Where one person has both the legal title to the property and the entire beneficial interest, he holds it free of trust. There is no separation of the legal and beneficial interests, and there are no duties to assume or to provide.").

D. TRUST ASSETS AND LIABILITIES. The assets of a trust (more accurately "assets held in trust") come from the settlor, or anyone else who transfers assets into trust. TPC § 112.001, 112.006, 113.004. Assets can be purchased by the trustee and the trustee can incur indebtedness for the trust. The trustee can also invest in business entities. TPC § 113.008.

If a trust is a spendthrift trust, the trust assets are protected from creditors of the beneficiary. TPA § 112.035. However, the Texas Family Code permits a court to order trustees of a spendthrift trust to pay child support for the beneficiary's child to the extent the trustees are required to make distributions to the beneficiary. TFC § 154.005(a). If distributions are discretionary, the court can order child support paid from trust income but not trust principal. *Id.* at 154.005(b). If the trust is self-settled (i.e., the beneficiary is the settlor), then the beneficiary's creditors can reach trust assets to pay debts of the beneficiary. TPC § 112.035(d), subject to certain exceptions. One is that the beneficiary of a self-settled spendthrift trust may, without jeopardizing the protection against creditors, retain the power to compel distribution of trust property for his/her own benefit if that power to compel is "limited by an ascertainable standard." TPC § 112.035(f)(1)(a)(ii). The Property Code lists as examples of an ascertainable standard "health, education, support or maintenance." Id. The question of what the essential difference is (if any) between this type of spendthrift trust and a non-spendthrift trust where the beneficiary has the unlimited discretion to invade principle has not been fully answered by the case law. If a spouse's claim that undistributed income of a self-settled trust is community property, is measured by the same standard as a creditor's claim to a self-settled spendthrift trust, then the test for community property claims is not whether a third party trustee has sole discretion to distribute or not distribute–the test is whether the exception in TPC § 112.035(f) applies, which is a broader standard.

E. MARITAL PROPERTY ISSUES. There are three types of relationships involving trusts that can become an issue in marital property suits: the settlor, the trustee, and the beneficiary.

1. Married Settlor. A settlor who is married could contribute community property or separate property to a trust. A married person has sole management and control over his/her separate property, and the other spouse has no ownership interest in that separate property, so the transfer of separate property assets to a trustee should not cause a problem. *In re Marriage of Burns*, 573 S.W.2d 555, 556-57 (Tex. Civ. App.–Texarkana

1978, writ dism'd) (wife had no claim where husband funded trust during marriage using his separate property). Where a spouse conveys separate property into trust for the benefit of the other spouse, the beneficiary spouse could argue that the conveyance in trust gave rise to a presumption of gift. *See Roberts v. Roberts,* 999 S.W.2d 424, 432 (Tex. App.–El Paso 1999, no pet.) ("where the conveyance [deed] is from one spouse to the other spouse, there is a presumption of gift"). If the other spouse is a beneficiary of the trust, and the transfer consists of community property, it is likely that no presumption of gift arises. In either event, if the trust is revocable, it would seem that the delivery component of gift does not exist since the transfer can be cancelled at the will of the settlor.

If a spouse conveys community property into trust without the consent of the other spouse, the potential for actual or constructive fraud can arise.

Under the Texas Trust Code, an express trust is revocable by default unless the trust instrument expressly makes it irrevocable. TPC § 112.051. A revocable trust is a valid trust until it is revoked. However, the right of the settlor to revoke the trust and take control of the assets may support the view that, for a married settlor, income received on trust assets is constructively received by the settlor and the income is community property. Note that property held in a self-settled spendthrift trust (even a non-revocable one) is in some instances subject to the claims of the settlor's creditors. TPC § 112.035(d). If a spouse is considered a creditor for purposes of Section 112.035(d), then even a power in the settlor/beneficiary to invade principal might protect the income if for example, the power to invade is limited by an ascertainable standard.

2. Married Trustee. The trustee of an express trust holds bare legal title, without equitable title, to the trust property, and thus has no individual ownership interest in the trust property. A spouse of a trustee can have no community property interest in trust property solely by virtue of being married to the trustee. Tex. Prop. Code §§ 114.0821 ("trust property is not liable to satisfy the personal obligations of the trustee").

3. Married Beneficiary. Where the beneficiary of an express trust is married, there can be questions as to the character of (i) the beneficial interest, (ii) the trust assets, and (iii) trust distributions.

a. *Beneficial Interest.* The character of the beneficial interest is determined like other assets: if the beneficial interest is acquired before marriage, or acquired during marriage by gift or inheritance, or can be traced to other separate property, then the beneficial interest is separate property. If the beneficial interest is acquired during marriage and is not separate property, then it is community property.

b. *Trust Assets.* It is inherent in the concept of an express "trust" that the beneficiary does not have legal title to trust assets. It follows, then, that assets held in trust for a married beneficiary are not owned by a spouse and therefore have no character as separate or community property.

It has long been held that, where the trust is a spendthrift trust, and the trustee has sole discretion whether or not to distribute income or principal, the beneficiary has no ownership interest in the trust assets, so they are not property of a spouse and are neither separate nor community property. *Lipsey v. Lipsey*, 983 S.W.2d 345, 351 (Tex. App.–Fort Worth 1998, no pet.); *In re Marriage of Burns*, 573 S.W.2d 555, 557 (Tex. Civ. App.–Texarkana 1978, writ dism'd); *Buckler v. Buckler*, 424 S.W.2d 514, 515-16 (Tex. Civ. App.–Fort Worth 1968, writ dism'd). However, it is has also been held that, when a beneficiary's right to the principal of a trust has matured, and the property is no longer subject to the trust, then the assets belong to the beneficiary even if they remain in the possession of the trustee. *In re Marriage of Long*, 542 S.W.2d 712, 717 (Tex. Civ. App.–Texarkana 1976, no writ). Thus, income earned on the portion of the trust property that is free from trust will be community property, even if the income is received and retained by the trustee. *Id*.

In *Lemke v. Lemke*, 929 S.W.2d 662, 664 (Tex. App.–Fort Worth 1996, writ denied), the court considered a self-settled discretionary distribution spendthrift trust created by the husband prior to his marriage, with a third party serving as trustee. Upon divorce, the wife claimed that the undistributed trust income was community property. The appellate court held that, since this was a discretionary distribution spendthrift trust, the income was not community property.

c. *Trust Distributions.* Controversy surrounds the question of whether trust distributions received from a gift or testamentary trust by a married beneficiary are received as separate or community property. If trust principal is distributed, and if the trust was created by gift or in a will, or was funded by property given or willed, or using separate property, then it follows that trust principal would come out of trust as separate property.

As for trust income, some argue that income on separate property is community property under Texas marital property law, so that income on "separate property" principal, or of a separate property beneficial interest, should be community property once the income has been actually or constructively received by the beneficiary. The proposition is more difficult to sustain if the income beneficiary has no residuary right to the trust principal (as in a generation-skipping trust). Others reason that, if a trust is created as a gift or inheritance, then the property in trust, as well as the property distributed from trust, is the very subject matter of the gift or of the inheritance, and so is received by the beneficiary as separate property. This argument is easier to understand if the spouse is an income beneficiary with no eventual right to receive trust principal.

An important bu less-litigated issue is the character of trust property in the hands of a residuary beneficiary when the life estate terminates and the property is distributed free of trust. If the trust was set up by gift or inheritance, presumably the principal (and anything that can be traced to the principal) would be separate property. What is the character of previously-undistributed income that is received by the residuary beneficiary as separate or community property? Would income earned on the trust property before the beneficiary's right in the principal matured be separate, and income since that time be community property? What about undistributed income from prior years that, according to the trust instrument, was added to the principal? *Long*, 542 S.W.2d at 718, said that "[t]rust income which a married beneficiary does not receive, and to which he has no claim other than an expectancy interest in the corpus, has been held not to be community property." *Long* essentially held to be separate property any income earned on the trust principal prior to the beneficiary's receipt (or constructive receipt) of the principal free of trust.

In *Sharma v. Routh*, 302 S.W.3d 355, 364 (Tex. App.--Houston [14 Dist.] 2009, no pet.), the court of appeals held: "[W]e conclude that, in the context of a distribution of trust income under an irrevocable trust during marriage, income distributions are community property only if the recipient has a present possessory right to part of the corpus . . . ."

d. *Tracing Inside a Trust.* Since a trust is not an entity, there should not be any impediment to tracing principal and income "inside" the trust. Trustees routinely keep track of principal and income, so the records should be available to do tracing. If income is retained, does the expert have to follow income dollars that get invested and have capital growth, or is tracing no more than calculating the total amount of income that was retained in the trust?

If part of the principal of the trust has matured, or if mandatory distribution income is retained in the trust, the income on that property will be community property. So in some situations there are up to four categories of assets to trace: trust principal, trust income, and income on "free" principal or "free" income. When a distribution is made from such a trust does the category of funds used depend on the settlor's intent control? Does the trustee's intent? Does the trustee's intent have to have been expressed in writing at the time to be controlling? Do we presume that the distributions are from "free" income first, then "free" principal, then trust income, then trust principal?

VI. CROSS-OVER PAYCHECKS AND BONUSES. Property that is acquired after, or which has its inception of title after, the marriage is dissolved is not marital property. *See Burgess v. Easley*, 893 S.W.2d 87, 90-91 (Tex. App.–Dallas 1994, no writ) (although deed was executed by Husband's father during marriage, it was not delivered to Husband until after divorce; since a conveyance is not effective until delivery, the property was not community property); *Snider v. Snider*, 613 S.W.2d 8, 11 (Tex. Civ. App.–El Paso 1981, no writ) (dividend declared after death of Husband belonged to his heirs, not the community estate); *Berry v. Berry*, 647 S.W.2d 945, 948 (Tex. 1983). However, deferred compensation in the form of retirement benefits have been recognized as being community property, even if they are received after the marriage is dissolved. *Cearley v. Cearley*, 544 S.W.2d 661, 662 (Tex. 1976).

The inception of title generally does not apply to compensation from employment. *See Dessommes v. Dessommes*, 543 S.W.2d 165 (Tex. Civ. App.–Texarkana 1976, writ ref'd n.r.e.); *Moore v. Moore*, 192 S.W.2d 929 (Tex. Civ. App.–Fort Worth 1946, no writ); *compare with Loaiza v. Loaiza*, 130 S.W.3d 894, 906 (Tex. App.–Fort Worth 2004, pet. denied) (post-divorce payments to husband, made under a employment agreement with professional baseball team, were his separate property, where husband's performance was a condition precedent to payment, so husband's right to payment under the contract did not accrue until he performed his services.); TFC § 3.007(c) (character of an employees rights under a stock option plan or a restricted stock plan is time-allocated based on the vesting period).

What about compensation received during marriage for work done before marriage, or compensation received after divorce for work done during marriage? This issue can arise in connection with the first paycheck received during marriage, and the first paycheck received after divorce. It can also arise in connection with incentive bonuses, which are routinely declared and paid in the February or March of the year following the year when the work is done. In *Echols v. Austron, Inc.*, 529 S.W.2d 840 (Tex. Civ. App.–Austin 1975, writ ref'd n.r.e.), the appellate court held that a bonus paid to the husband after divorce was his separate property. It is unclear to what extent there was evidence in that case that the bonus was paid partly or entirely for work done during marriage. The common practice today is to time-allocate such bonuses, based on how much of the “bonus period” occurred during marriage. However, some case law on this point would be helpful to clarify the law on the point.

VII. DEFERRED COMPENSATION. The law is fairly well settled as far as characterizing deferred compensation in the form of defined benefit retirement plans and defined contribution retirement plans. Retirement benefits are considered by Texas courts to be "a mode of employee compensation earned during a given period of employment." *Cearley v. Cearley*, 544 S.W.2d 661, 662 (Tex. 1976). Thus, retirement, annuity and pension benefits earned during marriage are part of the community estate, *Id.* at 662, while benefits earned before and after the marriage are the employee spouse's separate property. *See Berry v. Berry*, 647 S.W.2d 945, 947 (Tex. 1983).

A. DEFINED BENEFIT RETIREMENT PLAN. An employee Defined Benefit retirement plan are broken down into monthly increments, each of which is separate or community, depending upon whether the increment accrued before, during, or after marriage. *Taggart v. Taggart*, 552 S.W.2d 422, 424 (Tex. 1977), established that the extent of the community interest is determined by a fraction, the numerator of which represents the number of months the parties were married while retirement benefits accrued, and the denominator of which represents the total number of months that the employee spouse *accrued benefits under the plan*. (Note that the *Taggart* rule is sometimes mis-described as saying that the denominator is the number of months of total employment, but that is only true when the employee accrues a retirement benefit during his entire employment; if the employee did not accrue benefits for the entire period of employment, the period of accrual should be used in the fraction).

B. DEFINED CONTRIBUTION RETIREMENT PLAN. Defined contribution retirement plans are characterized based on the character of the assets in the plan on the date of marriage, and the amount of assets deposited into the plan during marriage, and the earnings on those assets during marriage. *Smith v. Smith,* 22 S.W.3d 140, (Tex. App.–Houston [14th Dist.] 2000, no pet.); *accord*, *McClary v. Thompson*, 65 S.W.3d 829 (Tex. App.–Fort Worth 2002, pet. denied); *Iglinsky v. Iglinsky,* 735 S.W.2d 536, 538 (Tex. App.–Tyler 1987, no writ). The rule developed in the case law that the community share of a defined contribution plan can be calculated by subtracting value at date of marriage from value at divorce. Things changed when TFC § 3.007(c) became effective on September 1, 2005, which provides:

> Section 3.007(c)
>
> (c) The separate property interest of a spouse in a defined contribution retirement plan may be traced using the tracing and characterization principles that apply to a nonretirement asset.

Since part of the increase in value of a defined contribution retirement plan could come from the increase in value of separate property assets in the plan, and since Section 3.007(c) permits such tracing, the subtraction approach is no longer required (although it may continue as a form of proving a separate property component to the plan).

C. STOCK OPTIONS AND RESTRICTED STOCK PLANS. A number of intermediate Texas appellate courts ruled that employee stock options were characterized under the inception of title rule, so that options granted during marriage were 100% community property even if the parties divorced before the options vested and became exercisable. *See Bodin v. Bodin*, 955 S.W.2d 380, 381 (Tex. App.–San Antonio 1997, no pet.); *Farish v. Farish*, 982 S.W.2d 623, 625 28 (Tex. App.–Houston [1st Dist.] 1998, no pet.); *Charriere v. Charriere*, 7 S.W.3d 217 (Tex. App.–Dallas 1999, no pet.), *Kline v. Kline*, 17 S.W.3d 445 (Tex. App.–Houston [1st Dist.] 2000, pet. denied), *McClary v. Thompson*, 65 S.W.3d 829, 834 (Tex. App.–Fort Worth 2002, pet. denied); *Boyd v. Boyd*, 67 S.W.3d 398 (Tex. App–Fort Worth 2002, no pet.). This case law has been supplanted by TFC § 3.007(d), which requires that the character of stock options and restricted stock be determined on a time allocation basis, with the portion of the vesting period that expired during marriage being divided by the total vesting period, to determine the percentage of vesting that occurred during marriage. That portion is community property.

D. OTHER DEFERRED BENEFITS. Given that the appellate courts said that the inception of title rule applied to characterizing stock option plan benefits, but that rule has been supplanted by legislation, the question remains as to how to characterize deferred compensation other than defined benefit plans, defined contribution plans, stock option plans, and restricted stock plans, whose characterization rules are firmly established either by case law or statute. The court of appeals cases relating to stock options reflected the common law view that such benefits are governed by the inception of title rule. While the Legislature has provided a time-allocation rule for stock options and restricted stock, the Legislature did not choose to extend that rule to other benefits, such as performance units, performance bonuses, and the like. To argue that the statute requires that a time-allocation rule be applied to deferred compensation other than options and restricted stock goes beyond the wording of the statute. It raises the question of whether a statute changing the common law is limited to its express terms, or can be taken widely as a broad change in the law applicable to matters not covered in the statute.

VIII. BUY/SELL PROVISIONS AND THEIR EFFECT ON THE VALUE OF A CLOSELY-HELD BUSINESS INTEREST. Restrictions on the transfer of ownership interests in closely-held businesses have complicated the valuation of those ownership interests for many years. The business valuation community is not of one mind about how such restrictions affect the determination of fair market value. The extent to which a transfer restriction affects valuation, for purposes of divorce in Texas, is governed by Texas law, not the prevailing practices of business valuation professionals whose perceptions are colored by the Internal Revenue Code.

An alternative model that could be used is Texas law governing tax consequences of the property division in a divorce. Tex. Fam. Code § 7.008 permits (but doesn't require) a court to consider whether a specific asset will be subject to taxation, and if so, when. Translated to the present discussion, a rule could be fashioned that says a court may consider whether an interest in a business is subject to a restriction on transferability or withdrawal, and if so, when.

A. RESTRAINTS ON ALIENATION. There is a public policy against restraints on alienation. As stated in *Tenneco Inc. v. Enterprise Products Co.*, 925 S.W.2d 640, 646 (Tex. 1996):

> Sound corporate jurisprudence requires that courts narrowly construe rights of first refusal and other provisions that effectively restrict the free transfer of stock.

In *Dixie Pipe Sales, Inc. v. Perry*, 834 S.W.2d 491, 493 (Tex. App.--Houston [14th Dist.], 1992, writ denied), the Fourteenth Court of Appeals said:

> Restrictions on the power of a corporate shareholder to transfer his or her shares of stock may validly be imposed in the charter or the bylaws of a corporation, provided such restraints are reasonable and not contrary to public policy. The reasonableness of such a restriction is ordinarily to be determined by applying the test of whether the provision is sufficiently necessary to the particular corporate enterprise to justify overruling the usual policy of the law in opposition to restraints on the alienability of personal property.

In *Consolidated Bearing & Supply Co. v. First Nat'l Bank*, 720 S.W.2d 647, 650 (Tex. App.--Amarillo 1986, no writ); the Amarillo Court of Appeals said:

> [S]tock restrictions are not looked upon with favor and are strictly construed

B. TYPES OF TRANSFER RESTRICTIONS. Not all transfer restrictions are created equal. A good list of allowable restrictions on the transfers of shares in a Texas corporation is contained in TBOC §21.211:

> § 21.211. Valid Restrictions on Transfer
>
> (a) Without limiting the general powers granted by Sections 21.210 and 21.213 to impose and enforce reasonable restrictions, a restriction placed on the transfer or registration of transfer of a security of a corporation is valid if the restriction reasonably:
>
>> (1) obligates the holder of the restricted security to offer a person, including the corporation or other holders of securities of the corporation, an opportunity to

acquire the restricted security within a reasonable time before the transfer;

(2) obligates the corporation, to the extent provided by this code, or another person to purchase securities that are the subject of an agreement relating to the purchase and sale of the restricted security;

(3) requires the corporation or the holders of a class of the corporation's securities to consent to a proposed transfer of the restricted security or to approve the proposed transferee of the restricted security for the purpose of preventing a violation of law;

(4) prohibits the transfer of the restricted security to a designated person or group of persons and the designation is not manifestly unreasonable;

(5) maintains the status of the corporation as an electing small business corporation under Subchapter S of the Internal Revenue Code;

(6) maintains a tax advantage to the corporation;

(7) maintains the status of the corporation as a close corporation under Subchapter O;

(8) obligates the holder of the restricted securities to sell or transfer an amount of restricted securities to a person or group of persons, including the corporation or other holders of securities of the corporation; or

(9) causes or results in the automatic sale or transfer of an amount of restricted securities to a person or group of persons, including the corporation or other holders of securities of the corporation.

In keeping with the statute, 20 Tex. Practice, Business Organizations § 31.22 suggests that restrictions on the transfer of interests in closely-held businesses fall into seven categories:

First-Option Restrictions–the shareholder must offer his shares to the company first, then other shareholders (or vice-versa), before they can be sold to outsiders. The price to other shareholders or the company is often a price stated in the restriction clause, such as a fixed price, a multiple of book value, a multiple of earnings, or use of an appraisal/arbitration process to determine the fair market value or fair value.

First-Refusal Restrictions–the shareholder is free to negotiate a sale of the interest to an outsider, but the selling shareholder must offer the interest at that price first to the company and then to other shareholders, or vice versa.

Buy-Sell Agreements–the company or other shareholders have an absolute right to buy the owner's interest in the business for a set price or according to a formula. The trigger could be termination of employment, death, disability or retirement. Typically the award of an ownership interest to the shareholder's spouse through a divorce will trigger the right of the company or other shareholders to buy the interest awarded to the owner's spouse.

Consent Restrictions–the company or other shareholders have the right to consent to the transfer of an ownership interest to an outsider.

Prohibition of Transfer to Designated Persons–the restriction prohibits the transfer of an ownership interest to classes of persons, such as non-residents of the state, competitors, etc.

Prohibitions to Preserve Legal Status–the restriction prohibits transfers that would affect the business's status, such as status as a Sub-S corporation or as a close corporation.

Other Restrictions–restrictions such as one imposing a penalty, such as loss of voting rights.

There are limits on the enforceability of transfer restrictions. *Dixie Pipe Sales, Inc. v. Perry*, 834 S.W.2d 491, 493 (Tex. App.--Houston [14th Dist.], 1992, writ denied), says:

> Restrictions on the power of a corporate shareholder to transfer his or her shares of stock may validly be imposed in the charter or the bylaws of a corporation, provided such restraints are reasonable and not contrary to public policy. The reasonableness of such a restriction is ordinarily to be determined by applying the test of whether the provision is sufficiently necessary to the particular corporate enterprise to justify overruling the usual policy of the law in opposition to restraints on the alienability of personal property.

C. DIVIDED AUTHORITY ON EFFECT IN A DIVORCE. The cases involving the effect given to a transfer restriction, when valuing a spouse's interest in a closely-held company for purposes of divorce, reflect differing perspectives on the issues.

1. The Earthman Case. In *Earthman Earthman's, Inc. v. Earthman*, 526 S.W.2d 192, 201-202 (Tex. Civ. App.--Houston [1 Dist.] 1975, no writ), the court of civil appeals held:

> The legal justification for the refusal to effectuate transfer of the 1300 shares of capital stock of Earthman's, Inc. was based upon a provision of Article V of the articles of incorporation of that company which provides as follows:
>
> 'The shares of stock of the corporation are to be held by each shareholder upon the condition that he will not sell, assign, transfer, pledge or in any way dispose of or encumber any of such shares without first offering (in writing, mailed to the Corporation's office) the same for sale to the Corporation which shall have the right to purchase all or any portion of such shares within sixty (60) days from the date of the offer. . . . If for any reason the Corporation does not purchase any shares of stock which it has the right to purchase under any provision of this Article, the remaining shareholders of the Corporation so electing shall have the right to purchase all or any portion of such shares (prorata, according to their stock ownership, or as they may otherwise agree) within ten (10) days following the end of the time during which the Corporation had the right to purchase such shares under this Article . The price for purchase of shares of stock under any provision of this Article shall be the book value of such shares as at the close of the month preceding the date of the offer . . . such book value to be determined by the certified public accountants serving the Corporation at such time, in accordance with the accounting practices followed in preparing the most recent annual financial statement to the corporation. Such purchase price shall be paid in cash forthwith after notification of the election to purchase or, at the option of the purchaser, 20% Of the purchase price may be so paid in cash and the balance may be paid in no more than four equal annual installments with interest at the rate of 6% Per annum.'
>
> In the letter of April 5, 1972 counsel for Earthman's, Inc. stated that Earthman's, Inc. construed the delivery of the two certificates representing 1300 shares of the company stock as an attempt by J. B. Earthman, III to transfer stock to Mrs. Earthman in derogation of Article V, that the company was therefore entitled to purchase such stock at book value and that it exercised its right and option to purchase such stock on terms as stated in the article.

A provision which restricts a stockholder's right to sell or transfer his stock, particularly one which affords a prior right of purchase to the corporation or to another stockholder, is not looked upon with favor in the law and is strictly construed. *Casteel v. Gunning*, 402 S.W.2d 529 (Tex. Civ. App.1966, writ ref'd n.r.e.); *Gulf States Abrasive Manufacturing, Inc. v. Oertel*, 489 S.W.2d 184 (Tex. Civ. App.--Houston (1st), 1972, writ ref'd n.r.e.). It has generally been held that such a restriction is inapplicable to a transfer occurring as a result of an involuntary sale or by operation of law unless by specific provision in the restriction it is made applicable. 18 C.J.S. Corporations s 391 (1939); 2 A.L.R.2d 745, 754, Restrictions on Corporate Stock.

In *Messersmith v. Messersmith*, 229 La. 495, 86 So.2d 169 (1956), it was contended that certain community owned stock should not be divided in kind, as decreed by the divorce court, and that the husband should be permitted to retain the stock and to pay his wife one-half its book value in accordance with a restrictive clause in the corporate charter requiring a stockholder, who wished to sell his stock, to first offer it to the other stockholders or officers of the corporation. The Louisiana Supreme Court determined that the restrictive provision of the charter could not prevent the recognition of the wife's share of ownership in the corporation and held that she was entitled to have delivered to her in kind the interest awarded to her under the divorce decree. In so holding that court stated:

'. . . The restriction in the charter cannot affect the status of the stock purchased during the existence of the community or the rights the wife may assert thereunder. Such a restriction cannot negative the wife's present interest as a co-owner, and as a co-owner in community she is clearly entitled to be recognized as such and obtain the exclusive management and control of her vested interest. (citing cases).' (86 So.2d p. 173)

We are of the opinion that the restrictive provision in question should not be construed so as to preclude Mrs. Earthman's right to have her shares of ownership reflected on the books of the corporation and to have the stock certificates evidencing her ownership issued to her. We hold that the trial court properly determined that this provision did not afford to the corporation the right or option to purchase the shares of Earthman's, Inc. so awarded to Mrs. Earthman.

2. The *Finn* Case. The Dallas Court of Appeals split on the effect of a buy-sell restriction on valuation for divorce. In *Finn v. Finn*, 658 S.W.2d 735, 742, 749-750 (Tex. App.--Dallas 1983, writ ref'd n.r.e.), two Opinions were issued that touched on this subject:

VANCE, Justice.

The lack of any legal right of the husband to realize the value of the firm's goodwill is a decisive factor. It distinguishes the present case from Geesbreght wherein the corporate structure provided a mechanism which enabled Dr. Geesbreght to realize the value of accrued goodwill by enhancing the value of his stock. In the present case the only mechanism through which the husband may possibly realize the value of the accrued goodwill is through continuing to practice law as a member of the firm, a circumstance depending not only on his own individual capacity, but also on the uncontrolled discretion of his partners. Thus his position is no better than that of the physician in *Nail*, in which the supreme court found the value of accrued goodwill in an individual professional practice to be realized only through enhanced future earning capacity. Such realization in the future is no more than an expectancy entirely dependent on the husband's continued participation in the firm, and, therefore, is not property in the community estate. *Nail*, 486 S.W.2d at 764. Consequently, we hold that the trial court properly instructed the jury not to consider the law firm's accrued goodwill or future earning capacity FN3 when placing a value on the community interest in the husband's law practice.

STEWART, Justice, concurring.

The partnership agreement does not control the value of the individual partnership interests. The asset being divided is the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. *Slater v. Slater*, 100 Cal.App.3d 241, 160 Cal.Rptr. 686, 688-689 (1980). The formula in the partnership agreement may represent the present value of the husband's interest, but it should not preclude a consideration of other facts. *Slater*, 160 Cal.Rptr. at 689; *Stern v. Stern*, 66 N.J. 340, 331 A.2d 257 (1975). The value of the husband's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill, if any. Goodwill is property and, although intangible, it is an integral part of a business, the same as its physical assets. *Taormina v. Culicchia*, 355 S.W.2d 569, 573 (Tex. Civ. App.--El Paso 1962, writ ref'd n.r.e.); *Ordway-Saunders Co. v. Little*, 568 S.W.2d 711, 717 (Tex. Civ. App.--Amarillo 1978, writ ref'd n.r.e.). Whether the law firm possessed goodwill, and, if so, its value are fact questions for the trier of facts. *Taormina*, 355 S.W.2d at 574.

The majority are concerned with future contingencies. All assets of the community estate are valued as of the time of dissolution of the marriage. There is no valid reason to exclude a professional partnership interest from this basic rule when the partner intends to continue as a member of the firm.

3. The *Keith* Case. In the case of *Keith v. Keith*, 763 S.W.2d 950, 953 (Tex. App.--Fort Worth 1989, no writ), the Court of Appeals said:

Charles asserts in point of error number three that the trial court erred by failing to find the market value of the partnership by applying the formula set forth in the partnership agreement, since his wife, Glenda, signed the agreement stating her approval of the agreement and her acceptance of its provisions, agreeing to be bound by it.

The partnership agreement entered into between Charles and Ty provided a method for determining the value of the business in the event it was terminated due to the withdrawal, other act, or death of one of the partners. The trial court did not use the method provided in determining the value of the partnership. Since the partnership is not being terminated, we do not find this provision of the agreement has any applicability to the matter before the trial court. Accordingly, the trial court did not err in failing to use the formula.

4. The *R.V.K.* Case. The San Antonio Court of Appeals split on the effect of a transfer restriction on a divorce valuation in *R.V.K. v. L.L.K.*, 103 S.W.3d 612 (Tex. App.--San Antonio 2003, no pet.). The Court issued three Opinions, none of which garnered majority support, so none of the Opinions standing alone is stare decisis:

Opinion by: SARAH B. DUNCAN, Justice, joined by Justices Paul W. Green and Karen Angelini:

Contrary to R.V.K.'s argument, the divorce proceeding has not triggered the buy/sell agreements. There has not been an "operative event"--an attempted sale, transfer, gift, mortgage, or pledge of stock without the corporations' consent; termination of R.V.K.'s employment; or termination of his marriage by death or divorce in a manner that dictates that R.V.K. will not succeed to L.L.K.'s community interest in the Medical Practice Group and the Medical Equipment Business stock.

* * *

Concurring and Dissenting opinion by: ALMA L. LÓPEZ, Chief Justice.

I concur in the majority's conclusion that the trial court erred in failing to properly derive a fair market value for *R.V.K.*'s ownership interest, but I agree with the dissent that we should address whether *Finn* or *Keith* should be followed in determining whether goodwill should be included in valuing a professional practice. I also agree with the dissent that we should follow the holding in *Keith* and the reasoning in Justice Stewart's concurring opinion in *Finn*.

* * *

Dissenting opinion by: SANDEE BRYAN MARION, Justice, joined by CATHERINE STONE, Justice.

I respectfully dissent and I would affirm the trial court's judgment. I believe this court should answer the question presented at trial and on appeal: should the *Finn* decision or the *Keith* decision be followed when determining the value of a professional practice upon divorce? I agree with Annette Stewart's concurring opinion in *Finn* and the court in *Keith*, and would hold that the value of *R.V.K.*'s interest should be based on the present value of the entities as ongoing businesses, which would include such factors as limitations associated with the buy/sell agreements and consideration of commercial goodwill. [Footnote omitted].

5. The *Von Hohn* Case. In *Von Hohn v. Von Hohn*, 260 S.W.3d 631 (Tex. App.--Tyler 2008, no pet.), the Court of Appeals said this about a transfer restriction in the partnership agreement:

> Based on these facts, we agree with the concurrence in *Finn* that the Nix Law Firm partnership agreement does not control the value of the individual partnership interests in the event of a divorce. *See Finn*, 658 S.W.2d at 749. The Nix Law Firm was an ongoing partnership as of the time of divorce, Edward had not died nor had he withdrawn from the partnership, and, thus, none of the triggering events specified in the partnership agreement had occurred. *See R.V.K.*, 103 S.W.3d at 623; *Keith*, 763 S.W.2d at 953. Consequently, the formula in the partnership agreement was not determinative of the value of Edward's interest in the Nix Law Firm. *See Keith*, 763 S.W.2d at 953. Therefore, the trial court did not err when it determined that the proper measure of the value of the community interest in the Nix Law Firm could include methods other than those set forth in the partnership agreement.

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

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

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

IX. THE WILLING BUYER/WILLING SELLER FORMULATION OF FAIR SALE/PURCHASE MARKET VALUE. The near-universal concept of fair market value is the cash price at which the asset in question would change hands between a buyer and a seller, neither of which is acting under compulsion. The lack of an actual willing buyer or actual willing seller is rendered irrelevant by this definition. In the views of most professional business valuators, the lack of a *market* value of an asset is no problem either. In the absence of a real market, the valuator imagines a sale/purchase between two imaginary people. The formulation of a hypothetical sale between imaginary people disconnects the valuation determination from the real market for the asset and it also frees the valuator from supporting the valuation opinion with true market data. This raises a host of problems that have not been adequately analyzed in Texas divorces.

A. MEASURES OF VALUE. In Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES (5th ed.) pp. 41-47 & 350-51, Pratt recognizes seven types of value: (i) fair market value; (ii) fair value; (iii) investment value; (iv) intrinsic or fundamental value; (v) going-concern value; (vi) liquidation value; and (vii) book value. In business valuation parlance, these are called "standards of value." *See* James R. Hitchner, FINANCIAL VALUATION: APPLICATIONS AND MODELS (2d ed. Wiley 2006) pp. 3-6. It is commonly assumed that “fair market value” is the proper measure of value of assets in a divorce. This assumption needs to be more closely examined.

B. THE EFFICIENT MARKET HYPOTHESIS. The belief that the marketplace is the best indicator of value is an economic, political, and philosophical tenet that goes back 250 years, and underlies our “free market” economy. When the concept is applied to investment analysis and business valuation, this belief is called the “Efficient Market Hypothesis.” Larry J. Kasper, BUSINESS VALUATIONS: ADVANCE TOPICS (Quorum Books 1997) pp. 13-20, discusses the efficient market hypothesis:

> The efficient market hypothesis is the cornerstone for the foundation of modern financial theory. It also provides a basis for examining many well-established and long-held assumptions and concepts in the valuation of privately held businesses. The validity of the definition of fair market value, the basis for comparisons to publicly held companies, the development of capitalization rates, and the application of premiums and discounts can all be tested by reference to the efficient market hypothesis. . . .
>
> The efficient market hypothesis states that security prices in a market reflect all relevant and ascertainable information about a company. Because the security price reflects all relevant information about the security, that price must represent its fair market value. Security analysts of publicly held companies and business valuators of privately held companies must implicitly believe in the correctness of the hypothesis each time they make comparisons to and draw inferences from the prices of other publicly traded stocks and securities. The efficient market hypothesis is one of the most tested hypotheses in the financial literature. . . .
>
> The implicit assumption in the efficient market hypothesis (in any form) is that there exists a market where securities can be traded with little effort or cost. When this is not true, efficient (information) markets cannot exist. Small private company stocks do not have an established market. If they did, there would be little need for business valuations.

C. THE HIERARCHY OF INDICATORS OF VALUE. There are several different schemes for determining the value of assets and liabilities. The reason for, or planned use of, the valuation can affect the scheme that applies. Valuations are done for different purposes: for condemnation; for tax; for purchase/sale; for accounting; in determining minority shareholders' rights; for divorce; etc.

1. Pattern Jury Charges (Family Law). The Texas Pattern Jury Charges (Family) state a two-tiered hierarchy of approaches to determining value for purposes of divorce.

PJC 203.1 Value

The value of an asset is its fair market value unless it has no fair market value.

"Fair market value" means the amount that would be paid in cash by a willing buyer who desires to buy, but is not required to buy, to a willing seller who desires to sell, but is under no necessity of selling.

If an asset has no fair market value, its value is the value of its current ownership as determined from the evidence.

2. IRS Regulations. The IRS Regulations set out a multi-tiered hierarchy of information to consider in estimating fair market value for estate and gift tax purposes.

IRS Regulation § 20.2031-2 Valuation of stocks and bonds.

(a) In general. The value of stocks and bonds is the fair market value per share or bond on the applicable valuation date.

(b) Based on selling prices. (1) In general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond. [Editor's note: the closing price is not used to fix value for tax purposes.] If there were no sales on the valuation date but there were sales on dates within a reasonable period both before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the valuation date. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the valuation date. If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be employed if such records are available in a generally available listing or publication of general circulation. In the event that such records are not so available and such stocks or bonds are listed on a composite listing of combined exchanges available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed. In valuing listed securities, the executor should be careful to consult accurate records to obtain values as of the applicable valuation date. If quotations of unlisted securities are obtained from brokers, or evidence as to their sale is obtained from officers of the issuing companies, copies of the letters furnishing such quotations or evidence of sale should be attached to the return.

* * *

(c) Based on bid and asked prices. If the provisions of paragraph (b) of this section are inapplicable because actual sales are not available during a reasonable period beginning before and ending after the valuation date, the fair market value may be determined by taking the mean between the bona fide bid and asked prices on the valuation date, or if none, by taking a weighted average of the means between the bona fide bid and asked prices on the nearest trading date before and the nearest trading date after the valuation date, if both such nearest dates are within a reasonable period. The average is to be determined in the manner described in paragraph (b) of this section.

(d) Based on incomplete selling prices or bid and asked prices. If the provisions of

paragraphs (b) and (c) of this section are inapplicable because no actual sale prices or bona fide bid and asked prices are available on a date within a reasonable period before the valuation date, but such prices are available on a date within a reasonable period after the valuation date, or vice versa, then the mean between the highest and lowest available sale prices or bid and asked prices may be taken as the value.

(e) Where selling prices or bid and asked prices do not reflect fair market value. If it is established that the value of any bond or share of stock determined on the basis of selling or bid and asked prices as provided under paragraphs (b), (c), and (d) of this section does not reflect the fair market value thereof, then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value. Where sales at or near the date of death are few or of a sporadic nature, such sales alone may not indicate fair market value. In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. Complete data in support of any allowance claimed due to the size of the block of stock being valued shall be submitted with the return. On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

(f) Where selling prices or bid and asked prices are unavailable. If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

(g) Pledged securities. . . .

(h) Securities subject to an option or contract to purchase. Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

* * *

3. FAS 157. The Financial Accounting Standards Board promulgated FAS 157 in September 2006. FAS 157 established a three-tiered hierarchy of information to use in determining the "fair value" of assets or liabilities, under Generally Accepted Accounting Principles.

Here is the Federal Reserve Bank of New York's summary of FAS 157:

> FASB Statement No. 157, Fair Value Measurements (FAS 157), issued in September 2006, defines fair value, establishes a framework for measuring the fair value of assets and liabilities based on a three level hierarchy, and expands disclosures about fair value measurements. The FASB's three-level fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the reporting branch or agency has the ability to access at the measurement date (e.g., the FFIEC 002 reporting date). Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

<http://www.newyorkfed.org/banking/regrept/2q08002.pdf> (Last visited 7/5/2010).

Note that the accounting profession no longer purports to determine fair market value. Quoted prices in active markets are given the highest priority in determining value, but they are just data used by the accountant to assess "fair value."

Here is what FAS 157 itself says about the hierarchy for estimating fair value:

> Fair Value Hierarchy
>
> 22. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to

unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

23. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

Level 1 inputs

24. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 25 and 26.

25. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

26. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

27. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.11

[FN11] The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

Level 2 inputs

28. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)
c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

29. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.11 The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

Level 3 inputs

30. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, un-observable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

D. "FAIR VALUE" FOR MINORITY DISSENTERS. A different measure of value, called “fair value,” has been developed to protect minority owners of a business in certain types of sale, merger transactions. In Texas this “fair value” concept is contained in TBOC § 10.362, "Computation and Determination of Fair Value of Ownership Interest," which provides:

> § 10.362. Computation and Determination of Fair Value of Ownership Interest
>
> (a) For purposes of this subchapter, the fair value of an ownership interest of a domestic entity subject to dissenters' rights is the value of the ownership interest on the date preceding the date of the action that is the subject of the appraisal. Any appreciation or depreciation in the value of the ownership interest occurring in anticipation of the proposed action or as a result of the action must be specifically excluded from the computation of the fair value of the ownership interest.
>
> (b) In computing the fair value of an ownership interest under this subchapter, consideration must be given to the value of the domestic entity as a going concern without including in the computation of value any control premium, any minority ownership discount, or any discount for lack of marketability. If the domestic entity has different classes or series of ownership interests, the relative rights and preferences of and limitations placed on the class or series of ownership interests, other than relative voting rights, held by the dissenting owner must be taken into account in the computation of value.
>
> (c) The determination of the fair value of an ownership interest made for purposes of this subchapter may not be used for purposes of making a determination of the fair value of that ownership interest for another purpose or of the fair value of another ownership interest, including for purposes of determining any minority or liquidity discount that might apply to a sale of an ownership interest.

E. WHEN THERE IS NO REAL MARKET. The idea that a hypothetical sale between an imaginary seller and an imaginary buyer can be substituted for information taken from a real market, has been rejected by several Texas cases. In *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ), the court said:

> Fair market value has been consistently defined as the amount that a willing buyer, who desires to buy, but is under no obligation to buy would pay to a willing seller, who desires to sell, but is under no obligation to sell. *City of Pearland v. Alexander*, 483 S.W.2d 244 (Tex. 1972). This standard or test presupposes an existing, established market.

In *Strenk v. Strenk*, 2001 WL 1379924, *6 (Tex. App.--Austin 2001, no pet.) (unpublished opinion), the court said:

> Swanson's expert, Peña, testified as to the stock's "book value"; he did not calculate its fair market value. Strenk objected to the evidence of book value and questioned Peña regarding his failure to analyze the stock's fair market value. Strenk cites authority for the proposition that the value of an asset is its fair market value. *See City of Pearland v. Alexander*, 483 S.W.2d 244 (Tex. 1972); *Wendlandt v. Wendlandt*, 596 S.W.2d 323 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ). Neither case holds that fair market value is the only basis for valuing a closely held stock; indeed, *City of Pearland* involved the narrow question of valuation damages for severed property in an eminent domain proceeding. *See City of Pearland*, 483 S.W.2d at 245-46.

In *Elliott v. Whitten*, 2004 WL 2115420 at *12 (Tex. App.--Houston [1st Dist.] 2004, pet. denied) (mem. op.), the court said:

> There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price.

The case of *Roberts v. Harvey*, 663 S.W.2d 525, 528 (Tex. App.--El Paso 1983, no writ), says:

> There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price. Where there is no evidence of market value, it is error to submit to the jury an issue on market value. *Continental Oil and Cotton Co. v. Wristen & Johnson*, 168 S.W. 395 (Tex. Civ. App.--Fort Worth 1914, no writ). In the absence of testimony or evidence of a reasonable cash market value of corporate stock, the method employed in determining the worth or value of such stock is to determine the difference between the value of the assets and the amount of liabilities of the corporation. *Citizens National Bank of Lubbock v. Maxey*, 461 S.W.2d 138 (Tex. Civ. App.--Amarillo 1970, writ ref'd n.r.e.).

Beavers v. Beavers, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ), said:

> Mr. Beavers' third point of error addresses the proper valuation to be placed on the community one-third interest in all outstanding stock of Great West Energy, Inc. The valuation problem arises because the sale of these shares is restricted by a requirement that they be offered first to other shareholders at book value. Experts from both parties testified that essentially because of this restriction, the market value of the stock was zero. This does not mean, however, that the trial judge erred in assigning a value of $170,000.00 to the stock for the purpose of making an equitable division of the community property. While market value is usually the best evidence of the value of the personal property, in the absence of a market value, the actual value of the property to the owner may be shown. *Bryant v. Stohn*, 260 S.W.2d 77, 83 (Tex. Civ. App.--Dallas 1953, writ ref'd n.r.e.); *Ft. Worth and D.C. Railway v. Hapgood*, 210 S.W. 969 (Tex. Civ. App.--Amarillo 1919, no writ). There is expert testimony from Mrs. Beavers' witness that, based on the value of the assets of the company, a one-third interest would be worth as much as $395,850.00. Even according to Mr. Beavers' expert witness, the book value of the company was $173,000.00 when substantial oil reserves were valued at only development costs. In assigning values to closely held corporations in contested divorce actions, those considerations given here by the trial judge to company assets and to the realities of corporate control are appropriate. *Dorfman v. Dorfman*, 457 S.W.2d 417 (Tex. Civ. App.--Texarkana 1970, no writ). The third point of error is overruled.

The Fort Worth Court of Appeals recently addressed this issue in the context of a transfer restriction on the spouse's ownership interest in a closely-held company, in *Mandell v. Mandell*, 310 S.W.3d 531, 536-37 (Tex. App.--Fort Worth 2010, pet. pending):

> As a general rule, the value to be accorded community property that is to be divided in a divorce proceeding is "market value." *See R.V.K. v. L.L.K.*, 103 S.W.3d 612, 618 (Tex. App.--San Antonio 2003, no pet.) (citing *Walston v. Walston*, 971 S.W.2d 687, 690 (Tex. App.--Waco 1998, pet. denied)). "Fair market value has been consistently defined as the amount that a willing buyer, who desires to buy, but is under no obligation to buy would pay to a willing seller, who desires to sell, but is under no obligation to sell." Id. (quoting *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ)).
>
> A straight fair market value is not an

appropriate valuation method, however, when a community estate owns shares in a closely held corporation and, by agreement, any sale of the shares of stock is restricted to the corporation or other stockholders. *See Beavers v. Beavers*, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ). When the sale of stock is restricted by a requirement that the shares be offered first to the corporation or to other shareholders, then essentially the fair market value of the stock is zero. *See id.*FN5 In this situation, the parties may show the actual value of the property interest to the owner. *See R.V.K.*, 103 S.W.3d at 618. Such evidence might include the value of being able, by virtue of ownership of the closely held stock, to drive a new automobile, to have health insurance paid for by the company, to have a company-financed life insurance policy, to belong to a country club at company expense, and other similar financial benefits. See James M. Loveless & Kimberly M. Naylor, Handling a Divorce Involving a Closely-Held Corporation, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, M, M-3 (1996).

F. LIQUIDITY AND MARKETABILITY DISCOUNTS. If a controlling interest in a closely-held business is being valued, business valuators will sometimes take a “liquidity discount” based on the cost and time delay in selling the business. If a minority interest in a closely-held business is being valued, business valuators will sometimes take a “marketability discount” for the cost and delay of selling a minority interest. While the validity of the prevailing approaches to determining these discounts can be debated, Texas divorce cases, on the whole, suggest that such discounts are not necessarily applicable in divorce.

1. Texas Case Law. Divorce business valuations were litigated in *Nail v. Nail*, *Geesbreght v. Geesbreght*, *Finn v. Finn*, *Beavers v. Beavers*, *Keith v. Keith*, *Ashley v. Ashley*, *R.V.K. v. L.L.K.*, *Strenk v. Strenk*, *Von Hohn v. Von Hohn*, and *Mandell v. Mandell*. Of the cases listed, only *R.V.K.* dealt with a marketability discount, and in that case the evidence pitted testimony regarding the formula price set in buy-sell agreements against testimony of a hypothetical sale between a willing buyer and a willing seller. None of these Opinions (save Justice Duncan's Plurality Opinion in *R.V.K.*, which was supported by only one other judge) say whether a marketability discount should or should not be considered when valuing a closely-held business interest on divorce.

2. Does a Liquidity/Marketability Discount Apply to Divorce Valuation? The question should be asked whether a liquidity/marketability discount is ever or always or sometimes appropriate in a divorce valuation. From a legal point-of-view, the question can be asked in the abstract whether a liquidity/marketability discount should be applied to valuing an interest in a closely-held business in the absence of evidence that the interest will be sold in the near future? From a business valuator's point-of-view, the question can be posed as follows: if there is no active and efficient market with multiple transactions that reflect a fair market value for identical assets (i.e. no Level 1 inputs under FAS 157), and if there are no quoted prices for similar assets (i.e., no Level 2 inputs under FAS 157), and the business valuator is reduced to unobservable information (i.e. Level 3 inputs under FAS 157), then how can a reliable discount for lack of marketability (DLOM) be drawn by reference to stock exchange-listed companies? Are there any follow-up studies testing the validity of applying liquidity discounts and DLOMs drawn from restricted stock studies, pre-IPO sales, and costs of going public, to closely-held companies? If not, then how do we know that the technique is valid?

One model that could be used for divorce valuation is the approach in corporate law that precludes the use of lack of control, and lack of marketability discounts in determining the "fair value" to be paid to dissenting shareholders. In a sense, a non-owning spouse is comparable to a minority shareholder: both are instances of a forced sale by an unwilling seller.

X. MARITAL PROPERTY REIMBURSEMENT CLAIM FOR UNDERCOMPENSATION. The common law marital property reimbursement claim for under compensation is stated in *Vallone v. Vallone*, 644 S.W.2d 455, 459 (Tex. 1982), and *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984).

A. WHAT DOES THE *JENSEN* CASE SAY AND WHAT DOES IT MEAN?

1. The Holding and Reasoning of the *Vallone* and *Jensen* Cases. In *Vallone*, 644 S.W.2d at 459, the Supreme Court said:

> A right of reimbursement arises when the funds or assets of one estate are used to benefit and enhance another estate without itself receiving some benefit. *Dakan v. Dakan*, *supra*. We hold it also arises when community time, talent and labor are utilized to benefit and enhance a spouse's separate estate, beyond whatever care, attention, and expenditure are necessary for the proper maintenance and preservation of the separate estate, without the community receiving adequate compensation.

In *Jensen*, 665 S.W.2d at 109:

> The point of first impression squarely before us is how to treat, upon divorce, corporate stock owned by a spouse before marriage but which has increased in value during marriage due, at least in part, to the time and effort of either or both spouses.
>
> *   *   *
>
> A consideration of the writings of various scholars in this field, the treatment of the issue by our sister community property states, and the constitutional, statutory and case law of Texas leads to the conclusion that the reimbursement theory more nearly affords justice to both the community and separate estates. This theory requires adoption of the rule that the community will be reimbursed for the value of time and effort expended by either or both spouses to enhance the separate estate of either, other than that reasonably necessary to manage and preserve the separate estate, less the remuneration received for that time and effort in the form of salary, bonus, dividends and other fringe benefits, those items being community property when received.

B. BRINGING A *JENSEN* CLAIM.

1. Pleading a *Jensen* Claim. In *Vallone*, 644 S.W.2d at 459, the Supreme Court said: "[i]n the absence of pleadings either specifically for or referable to reimbursement premised on uncompensated time, talent or labor, such recovery is waived and the failure of the trial court to consider the matter does not constitute error." *See Jones v. Jones*, 699 S.W.2d 583, 586 (Tex. App.--Texarkana 1985, no writ) ("the specificity of reimbursement pleading as required in *Vallone v. Vallone*, 644 S.W.2d 455 (Tex. 1982), is apparently no longer required"), citing *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984). *See Holloway v. Holloway*, 671 S.W.2d 51, 60 (Tex. App.--Dallas 1983, writ dism'd) ("There is evidence that as a result of the time and effort of Pat Holloway the value of his stock in Humble Exploration rose from $1,000 to $30,000,000, and the value of his stock in Sterling Pipeline rose from $3,000 to $60,000,000. Nevertheless, Robbie Holloway failed to carry her burden to plead, prove, and request jury findings on the value of the time and effort expended by Pat over and above the salaries, bonuses, and dividends received.")

2. Elements of Proof of a *Jensen* Claim. The *Jensen* Opinion sets out the elements of the reimbursement claim:

- the value of time and effort expended by either or both spouses;
- to enhance the separate estate of either;
- other than that reasonably necessary to manage and preserve the separate estate;

- less the remuneration received.

a. The Value of Time and Effort Expended. An essential part of a *Jensen* claim is proof of the value of time and effort expended by a spouse. This ordinarily will require some evidence of reasonable compensation, and that evidence may have to come from an expert. Proof of the increase of value of the business does not, standing alone, establish the value of the spouse's services.

b. Enhancement of the Separate Estate. The *Vallone* and *Jensen* cases require that the separate estate of the benefitted spouse be enhanced. The reimbursement claim is not just for undercompensation. The undercom-pensation must have enhanced the separate estate. *Trawick v. Trawick*, 671 S.W.2d 105, 108 (Tex. App.--El Paso 1984, no writ). *See Faulkner v. Faulkner*, 582 S.W.2d 639, 641 (Tex. Civ. App.--Dallas 1979, no writ) ("whether any enhancement occurred as a result of the value of the husband's services as a mechanic and manager or the wife's services as a waitress above and beyond the salaries they received is a matter of pure speculation under this record"). Whether the amount of enhancement is a cap on the reimbursement claims is a question that has been asked, but not answered. *Trawick*, *supra* at 109 ("In given cases, the total enhanced value may equal or exceed the demonstrated right to reimbursement. We are not yet confronted with a question of right to reimbursement exceeding the enhanced value of a specific separate property asset and will not attempt to suggest the outcome of such a conflict.").

c. Reasonably Necessary to Manage and Preserve the Separate Estate. The Supreme Court said in *Vallone*, *supra* at 458, that "the law contemplates that a spouse may expend a reasonable amount of talent or labor in the management and preservation of his or her separate estate without impressing a community character upon that estate," (citing *Norris v. Vaughn*, 152 Tex. 491, 260 S.W.2d 676 (1953)). In *Lifshutz v. Lifshutz*, 199 S.W.3d 9, 28 (Tex. App.-- San Antonio 2006, pets. denied) , the court reversed a *Jensen* reimbursement claim, saying:

> In order to establish that the efforts did more than was required to maintain the separate estate, evidence must be introduced to show the amount of time that was reasonably necessary for the party to spend managing and preserving the separate estate.

d. Less the Remuneration Received. *Vallone* and *Jensen* require that the claim for undercompensation exists only to the extent that the value of the services contributed to the separate property company exceeds the "remunerations received" by the community estate. In *Jensen*, the Supreme court listed offsetting benefits as including "salary, bonuses, dividends and other fringe benefits." The inclusion of dividends was a bit odd, in that the other categories listed are all forms of employee compensation, while dividends are a return on ownership. However, if the Supreme Court was looking at *all* of the benefits derived by the community estate from the separate property company, then dividends should be included in the list.

e. The Claim is Discretionary. The Supreme Court said in *Vallone*, at 458, that "[t]he rule of reimbursement is purely an equitable one. *Colden v. Alexander*, 141 Tex. 134, 171 S.W.2d 328 (1943). It obtains when the community estate in some way improves the separate estate of one of the spouses (or vice versa)." The Court went on to say: "Reimbursement is not available as a matter of law, but lies within the discretion of the court." *Id.* at 459. *See Gutierrez v. Gutierrez*, 791 S.W.2d 659, 663 n. 5 (Tex. App.--San Antonio 1990, no writ) ("We recognize that there is language in the cases that suggests otherwise. The supreme court spoke of the "right to reimbursement" in *Jensen* . . . and *Vallone*, and in *Jensen* it remanded to the trial court with instructions that did not suggest that the court had much discretion in deciding the issue. But in *Penick v. Penick*, 783 S.W.2d at 197-98, the court repeatedly used the term "claim for reimbursement" and stressed the discretionary and equitable nature of the court's task.").

f. Can The Claim Be Secured By a Lien? In *Jensen*, the Supreme Court cryptically stated: "[h]owever, if the right to reimbursement is proved, a lien shall not attach to Mr. Jensen's separate property shares. Rather, a money judgment may be awarded." In *In re Parrish*, 144 B.R. 349, 352 (Bkrtcy. W. D. Tex.,1992), the court noted: "Commentators have speculated that that decision may indicate that equitable liens cannot be imposed on separate property of one spouse to reimburse the community for community funds advanced to improve it. Fred C. Weekley, *Reimbursement Between Separate and Community Estates--The Current Texas View*, 39 BAYLOR. L.REV. 945, (1987). The pending *Pemelton* decision would seem to follow that thought, unless the lien meets the requirements for other enforceable liens which are set out in the Texas Constitution." Beyond this, very little has been said about the prohibition against imposing a lien on the company stock to secure a judgment for reimbursement.

C. STATUTORY CLAIM FOR REIMBURSEMENT. The law of marital property reimbursement has been through several stages: for 130+ years, the law of reimbursement was case law. In 1999, the Legislature created "equitable interests," which in 2001 was replaced by "economic contribution claims." In 2009 the Legislature abolished economic contribution claims, but left the statutory framework in place and called the remedy "reimbursement." The new law applies to divorces filed on or after September 1, 2009, and deaths on and after that date. For pending divorces filed, or deaths occurring, prior to that date, the old law still applies. Beginning September 1, 2009, claims for reimbursement were explicitly recognized in the Texas Family Code for the first time. *See* Tex. Fam. Code § 3.402(a)(2). However, the statute containing this provision is effective only for cases filed on or after September 1, 2009. Cases filed prior to that date continue to be governed by the law in effect prior to that date.

Unfortunately, this statutory provision is not totally congruent with the common law rules of reimbursement, raising the question of whether the statutory provisions coexist with the common law principles, or replaced them in whole or in part, and raising questions of statutory interpretation.

1. Section 3.401. Section 3.401 specifies that there are three marital estates: the community estate, the husband's separate, and the wife's separate estate. This section also defines a spouse as a man or a woman, but not a same-sex member of a civil union, etc.

2. Section 3.402. Section 3.402 undertakes to list marital property reimbursement claims. The list includes 9 categories of reimbursement. Section 3.402(a)(1), (3), (4), (5), (6), and (7) provide for reimbursement for the reduction in principal of a debt of another marital estate secured by lien, in contrast to the common law which allowed reimbursement for payment of principal, interest, insurance, and taxes. Are payments of interest, insurance, and taxes no longer reimbursable?

Section 3.402(9) permits reimbursement for payment of unsecured debts of another marital estate. Section 3.402(8) permits reimbursement for "capital improvements" (the term is not defined) to property of another marital estate.

A problem is presented by Section 3.402(a)(2), which provides for reimbursement for "inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse." This is a version of the rule of reimbursement announced in *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984): "the community will be reimbursed for the value of time and effort expended by either or both spouses to enhance the separate estate of either, other than that reasonably necessary to manage and preserve the separate estate, less the remuneration received for that time and effort in the form of salary, bonus, dividends and other fringe benefits, those items being community property when received." The statutory claim is not conditioned, like the *Jensen* claim is, on the spouse's labors enhancing the value of his/her separate estate. Nor does the statute tie the reimbursement claim to the amount of enhancement, which may be part of the common law rule. *See Trawick v. Trawick*, 671 S.W.2d 105, 110 (Tex. App.--El Paso 1984, no writ) ("As previously stated, we are not yet confronted with a claim, jury finding or award exceeding the attributable enhanced value of the specific separate asset, and that is an issue unresolved by *Jensen* III. . . . Arguments can be made both for and against the use of the enhanced value figure as a ceiling of recovery."). The statute does not say when a business entity is "under the control or direction of that spouse." Does it require exclusive control? Or a majority of voting rights? What if the spouse is a one-third owner with his two brothers? What if the spouse if a limited partner, but nonetheless enhances his separate estate through uncompensated labor? Also, the statute makes no mention of the use of community labor to enhance separate real estate.

Section 3.402(c) provides that reimbursement claims can be offset, except that no offset is allowed against a community property claim against a primary or secondary residence owned by a separate estate. Section 3.402(d) provides that the measure of reimbursement for improvements (the term "capital improvements" is not used) to another marital estate is measured by the enhancement. In contrast, the Section 3.402(a) measure of reimbursement for paying unsecured liabilities, or the principal balance of debt secured by lien, is the reduction in unsecured debt or reduction of principal balance (i.e., dollar-for-dollar). Section 3.402(d) places the burden of proving offsets on the party claiming them.

3. Section 3.404. Section 3.404 provides that the statutory reimbursement claims do not alter the inception of title rule, but are instead equitable claims against the benefitted estate which mature upon divorce or death.

4. Section 3.405. Section 3.405 says that statutory reimbursement provisions do not alter the rules governing management of separate and community property.

5. Section 3.406. Section 3.406 provides that the court can impose an equitable lien to secure a claim for reimbursement, whether upon divorce or upon death.

6. Section 3.409. Section 3.409 provides that reimbursement is not available for: (1) payment of child support, alimony, or spousal maintenance; (2) living expenses of a spouse or child of a spouse; (3) contributions of nominal value; (4) payments of nominal amount; and (5) payment of a student loan owed by a spouse.

The fact that Section 3.409 lists claims that are not subject to reimbursement suggests that the list of reimbursable claims in Section 3.402 must not be exclusive. If Section 3.402 were an exclusive listing of allowable claims, there would be no purpose in listing in Section 3.409 reimbursement claims that are not allowed.

7. Section 3.410. Section 3.410 provides that the 2009 amendments do not impair the effectiveness of a waiver or partition and exchange of reimbursement or economic contribution claims contained in a premarital or post-marital agreement.

XI. THE DIVISIBILITY OF INCOME TAX-RELATED "ASSETS" UPON DIVORCE. Behind the same tab of the course book as this Article is an article by Geoffrey S. Poll and Patrice L. Ferguson, J.D.s and CPAs. In their Article they discuss tax carrybacks and carryovers, including: Net Operating Losses (NOLs), Capital Loss Carryovers (CLCs), Charitable Contribution Carryovers (CCCs), Passive Loss Carryovers (PLCs), and Investment Expense Carryovers (IECs). They suggest that TFC § 7.002 is authority for spouses, in conjunction with a divorce, to partition income, earnings, and other forms of compensation, and that this provision might allow spouses to equitably allocate the foregoing tax claims or rights in a property division.

There is some confusion and disagreement regarding the extent to which the parties or a divorce court have the power to allocate tax carrybacks and carryovers as part of the property division. This is a survey of what courts have held around the country.

- *Mills v. Mills*, 663 S.W.2d 369 (Mo. Ct. App. 1983). In *Mills*, the husband appealed, challenging the trial court's finding that capital loss carryforwards were community property. The wife testified that the capital loss carryforward arose from the sale of shares acquired during marriage, and the husband did not contradict her or put on contrary evidence, so his challenge failed. The court also rejected the husband's argument that the award of a portion of the carryforwards to the wife violated federal income tax Treasury Regulation 1.1212-1(c). The court find no violation of the Reg.

- *Thomas v. Thomas*, 407 N.W.2d 124 (Minn. Ct. App. 1987) (treating sole proprietorship's tax credit as marital property). In Thomas, the appellate court said:

  The court made no findings concerning its treatment of the $17,765 tax credit. Because the tax credit can be applied either toward James Thomas' personal income tax as a sole proprietor, or toward CU's business income taxes, it is apparent that the $17,765 tax credit is a marital asset. Failure to include it in the companies' valuation renders the sum set manifestly contrary to the evidence. On remand the tax credit must be accounted for in the distribution of property, either by adding it to the value of CU or by treating it as a known asset of the parties and dividing its value between them.

- *Dombrowski v. Dombrowski*, 131 N.H. 654, 559 A.2d 828 (1989) (charitable contribution carry-forward). In *Dombrowski*, the issue was the value of a charitable tax loss carryforward. The appellate court held that "the value of the carry-forward is the tax savings that result when the deduction is subtracted from gross income." *Id*. at 830.

- *But see Cerratani v. Cerratani*, 221 A.D.2d 814, 634 N.Y.S.2d 228 (1995) (capital loss carryforward is not divisible property). In *Cerratani*, the appellate court considered whether a tax loss carryforward fit the statutory definition of marital property subject to division upon divorce. The statute read: "The term 'marital property' shall mean all property acquired by either or both spouses during the marriage and before the execution of a separation agreement or the commencement of a matrimonial action, regardless of the form in which title is held, except as otherwise provided in agreement pursuant to subdivision three of this part. Marital property shall not include separate property as hereinafter defined." The appellate court held that "this tax circumstance is not the type of 'property' addressed in" the statute. However, the court also said that it was not "determining whether this is marital property subject to equitable distribution." *Id*. at 816-17.

- *Silverstein v. Silverstein,* 943 S.W.2d 300, 303 (Mo. Ct. App. 1997). In *Silverstein*, the appellate court found that a passive loss carryforward generated by the husband during marriage was a marital asset and that the trial court was wrong to have failed to divide it. The Court cited *Mills*.

- *Finkelstein v. Finkelstein*, 268 A.D.2d 273, 274, 701 N.Y.S.2d 52, 54 (2000). In *Finkelstein*, the trial court awarded a tax loss carryforward to the husband, and granted the wife a judgment for $155,785.60 for her share of the value. The appellate court held that a capital loss carryforward constituted marital property that could be divided upon divorce, but that the right had been overvalued. The judgment was reformed downward to $70,000, which was the expert testimony as to the reduction in taxes that the wife would receive over a two year period. The wife presented no evidence to support a higher number.

- *Beard v. Beard*, 49 S.W.3d 40 (Tex. App. 2001) (passive activity loss carry-forward under I.R.C. 469). In *Beard*, the Waco Court of Appeals considered the trial court's division of a passive activity loss carryforward that arose from husband's separate property condominium that had been rented during the marriage. It appears that the parties filed joint tax returns during the years in question. The husband made no claim on appeal that the carryforward was his separate property. The wife argued that the tax carryforward was worthless to her and that it was error for the trial court to award her half. The appellate court ruled that the carryforward did have value to the wife, and that the trial court did not abuse its discretion in awarding her half.

- *Magee v. Garry-Magee*, 833 N.E.2d 1083, 1091-92 (Ind. Ct. App. 2005). In the *Magee* case, the spouses executed a prenuptial agreement, listing among Wife's non-marital assets a brokerage account. The wife's investment losses generated a tax loss carryover of approximately $52,000. The tax loss carryforward was not separately listed in the premarital agreement. The agreement required the wife to file a joint return with the husband if it would "produce the smallest amount of aggregate tax." For one year during the marriage, the wife refused to file a joint return, and which permitted her to have the sole benefit of her tax loss carryforward. The trial court required the wife to reimburse the husband for his increased tax liability arising from the filing of separate returns. The appellate court agreed with the courts in *Mills* and *Finkelstein*, that the tax attribute was marital property. However, although the tax loss carryforward might have been wife's separate property due to the premarital agreement, wife was stopped by the contractual provision requiring her to file joint returns, so the judgment against the wife was proper. *Id*. at 1092.

- *Haley v. Haley*, 936 So.2d 1136 (Fla. 5th DCA 2006). In *Haley*, the Florida Court of Appeals considered the post-divorce division of a capital loss carry forward. Despite a settlement agreement which said: "Any asset owned by a particular entity shall remain with that entity and any liabilities relating to an asset shall remain with the asset," *Id*. at 1137, the appellate court found that the tax benefit that had not been divided in the divorce. The court also held that the tax benefit was an asset, but ruled that since the former wife's separate property corporation gave rise to most of the asset, that portion of the asset could not be awarded to the former husband. The court distinguished the *Mills* case, despite the fact that in that the tax loss in *Mills* arose from selling the husband's separate property stock, on the ground that in *Mills* the husband had acquired the stock during marriage and it was therefore marital property. *Id*. at 1139. The *Haley* court also distinguished the *Smith* case on the ground that in *Smith* the wife had contributed substantial non-marital funds to the husband's business giving rise to the loss.

- Melvyn B. Frumkes, Marjorie O'Connell, and Daniel J. Jaffe, *A Potpourri of Seldom-discussed Tax Issues in Divorce*, Divorce Litigation 173 (October 2003) [On Westlaw at "15 No. 10 DIVLIT"]:

  Charitable contribution deductions not permitted in one year can be carried forward until exhausted, for a maximum of five years. They are allocated based on who could have taken the deduction if separate returns had been filed. They cannot be privately divided differently. Rev. Ruling 76-267, 1976-2 C.B. 71.

* * *

If the asset carrying the passive loss is transferred to the other spouse, the loss is treated as a gift under I.R.C. § 1041(b), and I.R.C. § 469(j)(6) provides that suspended losses are added to the basis of property just before the gift.

- Rev. Rul. 76--267, 1976--29 I.R.B. 9
  Charitable contributions carryover;
  allocation between spouses (1976):

  The filing of a joint return by married taxpayers does not convert the charitable contribution deduction of one into the joint charitable contribution of both. Accordingly, married taxpayers must use the method of allocation provided in section 1.170A-10(d)(4)(i) of the regulations and may not allocate by agreement an excess charitable contribution deduction in the carryover years for which they do not file a joint return.

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CHAPTER 36

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State Bar of Texas, *22nd Annual Advanced Family Law Course*, August 1996 “Reading, Understanding and Using Various Tax Returns, [What they can tell you.]” writing credit

National Business Institute, Inc., *Tax Aspects of Divorce in Texas*, October 1996, “Retirement Benefits in Divorce” and “Valuation of a Closely-Held Business Asset”

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State Bar of Texas, *28th Annual Advanced Family Law Course*, August, 2002, “Tax Tricks and Traps Update”

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Houston Bar Association, *2004 Family Law Institute*, March 26, 2004, “Reading and Understanding Income Tax Returns as a Discovery Tool”

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State Bar of Texas, *Marital Dissolution Institute*, April 2005, “A Walk Through a Tax Return”

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Accountant, Ernst & Ernst - Four years on the tax staff.

Speaking and Writing Credits, including:

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State Bar of Texas, "*Marriage Dissolution Institute*, May 2002, "Slam Dunk the Mediation (Preparing for Effective Mediation of Property and Custody Issues in Divorce)" (co-authored and presented with Jan DeLipsey, JD and Randall B. Wilhite, JD, CPA)

State Bar of Texas, *Marriage Dissolution Institute*, May 2003, "Demystifying Tax Returns (Using Tax Returns as a Discovery Tool)"

State Bar of Texas, *Advanced Family Law Course*, August 2003, "Tax Issues - Significant Income Tax Developments" (presented with Edwin W. Davis, JD and Randall B. Wilhite, JD, CPA)

Practising Law Institute, *Basics of Accounting & Finance Summer 2003: What Every Practicing Lawyer Needs to Know*, "How Lawyers Use Financial Information—Mergers, Acquisitions, Valuations and Other Transactions and Their Impact on Reported Financial Results"

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2003, "Has the Golden Gate Rusted?" (presented with Mike Gregory, JD; J. Kenneth Huff, Jr., CPA/ABV; and Randall B. Wilhite, JD, CPA)

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Speaking and Writing Credits, including:

State Bar of Texas, *Advanced Family Law Drafting and Advocacy: Art and Form 2003*, December 2003, "Drafting for Tax Issues" (co-authored with Cynthia Phuong Nguyen, CPA, JD)

State Bar of Texas, *Advanced Expert Witness Course,* February 2004, "Difficult Issues Relating to Lost Profits (Including Start-Up Businesses): Discussion and Demonstration" (co-authored with Cynthia Phuong Nguyen, CPA, JD; presented with Robert S. Harrell, JD)

State Bar of Texas, *Advanced Family Law Course*, August 2004, "Property Trial Demonstration" (presented with Gary L. Nickelson, JD, Melissa Nickelson, Hon. Mary Ellen W. Hicks, Brian L. Webb, JD, and G. Thomas Vick, Jr., JD)

State Bar of Texas, *New Frontiers in Marital Property Law,* October 2004, "Sophisticated Corporate Structures" (co-authored with Cynthia Phuong Nguyen, CPA, JD; presented with Randall B. Wilhite, JD, Robert J. Piro, JD, and William W. Rucker, JD)

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Houston Bar Association Family Law Section, March 2007, "Qualified Business Appraisers – Different Conclusions" (co-presented with Haran Levy, CPA/ABV, CVA)

State Bar of Texas, *Advanced Family Law Course*, August 2007, "Mi Casa Es Su Casa–Unless I Prove Otherwise" (co-authored Cynthia Phuong Nguyen, CPA/BV, JD, NACVA and co-presented with Michelle May O'Neil, JD) and panelist on "Looking Ahead: Long-Term Financial Planning In Connection with Divorce" (moderated by Jim Penn, CPA with Mark McLeland, CFM, CIMA; Paul A. Premack, JD, CELA, and Wesley E. Wright, JD, CELA)

State Bar of Texas, *New Frontiers in Marital Property Law Course*, October 2007, "Tracing, Economic Contribution, and Reimbursement Claims in Brokerage Accounts," (moderated by Donn Fullenweider, JD, and co-presented with Richard Orsinger, JD, and Stewart Gagnon, JD)

State Bar of Texas, *Representing Small Businesses*, March 2008, "Select Valuation Topics" (co-authored with John E. Camp, CPA/ABV, CFA, ASA) as part of "Valuation of Small Business" presentation (moderated by John Palter, JD and co-presented with David Fuller, CFA, ASA)

State Bar of Texas, *Advanced Family Law Course*, August 2008, "Effect of Choice of Entities: How Organizational Law, Accounting, and Tax Law for Entities Affect Marital Property Law" (co-authored and co-presented with Richard Orsinger, JD)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2008, "Dealing with Complex Business Entities on Divorce" (moderated by Warren Cole, JD and co-authored and presented with Joan F. Jenkins, JD, Stewart Gagnon, JD, Jim Loveless, JD)

State Bar of Texas, *Marital Dissolution Institute*, April 2009, "Avoiding Financial Pitfalls"

State Bar of Texas, *Advanced Family Law Course*, August 2009, "Dealing with Complex Business Entities in a Divorce (Supplement)" (moderated by J. Lindsey Short, JD and co-authored and presented with Mike Gregory, JD and Jim Loveless, JD)

TABLE OF CONTENTS

TAX ATTRIBUTES AND DIVORCE

I. INTRODUCTION

When we talk about characterization, valuation, and division of the marital estate, the tax issues related to the estate should be addressed. There is a good chance that the family lawyer will run into complications and challenges presented by income tax attributes when involved in a high income and asset divorce case. When we talk about "tax attributes" we are generally referring to a deduction or a credit under the Internal Revenue Code that is not used in a tax year because of some limitation imposed by statute, but which can be carried forward or backward to another tax year and used to reduce income or taxes in another year. It may be best described as an asset with a potential economic benefit that raises valuation, allocation, and timing issues. The current economic climate may be contributing to a rise in the frequency of occurrence of tax attributes, as it is easier to accrue economic losses today than to secure gains. The more common tax attributes that may be encountered include:

- net operating loss carryover
- capital loss carryover
- charitable contribution carryover
- passive loss carryover
- investment interest expense carryover

A brief discussion of each of these attributes follows. The calculation, characterization, value, and division of these attributes is complicated, and appropriate tax professionals should be retained to adequately evaluate economic benefits.

A. Net Operating Losses

The Internal Revenue Code (IRC) provides rules for computing and applying a net operating loss ("NOL") carryback and carryover in circumstances where individuals have not had the same marital or filing status for all the years involved in the NOL computation.[1] No real complications arise where joint returns are filed for all the years involved in the NOL computation. In this instance, the carryback or carryover is computed as though all the income and deductions reported on the return were attributable to a single taxpayer.[2] However, what if one spouse incurs an NOL prior to marriage, and that NOL is being carried forward to a year in which a joint return is filed? In this case, the spouse's separate NOL may not be used to offset the other spouse's income on the joint return.[3] The rule here is based on IRC Reg. §1.172-7(f) which provides that a married person who sustains an NOL in a year in which a separate return is filed may not use the separate NOL to offset their spouses' income in a later joint return year. This effectively limits an individual's potential ability to "traffic" in NOLs by marriage. Conversely, when an NOL occurs in a year where husband and wife file a joint return and the NOL is subsequently carried to a year after divorce where a separate return is filed, then each spouse's share of the joint NOL must be computed. The deductions attributable to each spouse would be compared to the gross income attributed to them and the excess of the deductions over income is that spouse's share of the loss to be carried to the separate return. If separate income and deductions attributable to either spouse are reported on the joint return, then this is the manner in which each spouse's share of the loss would be computed. However, if there are only community income and deductions reported on joint return where the NOL arises, then the loss would be allocated one-half to each spouse.

B. Capital Loss Carryover

A deduction is allowed for the aggregate of all capital losses to the extent of the aggregate of all capital gains plus $3,000 ($1,500 in the case of married filing separately).[4] To the extent that capital losses exceed the capital gains plus $3,000, the excess may be carried forward indefinitely to offset capital gains in subsequent years.[5]

When spouses have capital losses from years in which they filed separate returns, they may carry the losses over and use them on a joint return.[6] If capital losses are carried over from a joint return to a separate return year, the short-term and long-term capital losses must be allocated separately to each spouse based on the short-term and long-term losses attributable to each.[7]

Only the capital losses that were not offset by short-term or long-term capital gains (attributable to either spouse) and reported on the joint return may be carried forward from a joint return year to a separate return year.[8] The carryover is either short-term (from assets held for less than a year) or long-term (from assets held for more than a year), and retains its character.[9]

When capital losses are incurred on a jointly-filed return in a community property jurisdiction and they arise from community assets, then they are divided equally between the spouses based on the directives found under the Treasury Regulations. In a case of first impression, a Florida appellate court determined that a capital loss carryforward from a married couple's joint returns was not subject to equitable allocation between the individuals upon their divorce. The underlying losses were accrued during the marriage by entities created during the marriage; therefore, the couple's entitlement to the loss carryover arose during marriage. However, most of the capital loss carryforward was generated by an entity that was a non-marital asset belonging to the wife, to which the husband had made no special contribution.

The appellate court held that the trial court's equitable allocation of one-half of the carryover to each individual ignored Treas. Reg. §1.1212-1(c)(1)(iv) which determines how the losses should be allocated.[10]

C. Charitable Contribution Carryover

Individuals are allowed to carry forward charitable contributions that exceed certain percentage limitations based on adjusted gross income for a tax year. The excess may deducted in each of the succeeding five tax years until it is used up. When a couple files a joint return, the percentage limitations are applied against the couple's aggregate income.[11] When a joint return produces an excess charitable deduction giving rise to a carryover, and separate returns are filed for one or more of the five succeeding years to which the carryover can be carried, the excess charitable deduction must be allocated between the spouses.[12]

The allocation is made by determining how much of the excess charitable deduction carryover would be attributable to each spouse had each spouse filed a separate return in the year that the contribution was originally made. Therefore, the allocation of the carryover may be affected by whether separate property or community property funds are used to pay the charitable contribution, even if a joint return was filed in the year the carryover arises.

D. Passive Loss Carryover

Passive activities are activities that involve the conduct of a trade or business in which the taxpayer does not materially participate. Generally, losses from passive activities may not be deducted from non-passive income (e.g., wages, interest, or dividends).[13] The disallowed loss is suspended and carried forward as a deduction from the passive activity in the next succeeding year.[14] Unused suspended losses are allowed as a deduction in full when the taxpayer disposes of the entire interest in the activity in a fully taxable transaction.[15]

The transfer of a passive activity incident to a divorce is not considered a fully taxable transaction and any suspended losses would not be freed-up and allowed as deductions under IRC §469(g). However, IRC §1014(b) states that any transfer incident to divorce is treated as a gift and, therefore, the losses of the donor spouse are added to the basis of the passive activity. Therefore, if preserving a suspended passive loss carryover is a goal on the division of assets pursuant to divorce, care and consideration must be paid to how those assets are awarded.

E. Investment Interest Expense Carryover

Individuals are allowed to deduct investment interest in any tax year only to the extent that it does not exceed their net investment income for the year.[16] Investment interest that is disallowed as a deduction because it exceeds net investment income may be carried forward and treated as investment interest in the succeeding tax year.[17] This is yet another carryover that must be considered in the property settlement.

II. EFFECT OF PARTITION UNDER TEXAS FAMILY CODE §7.002(c)(2)

I have wondered from time to time if it is possible to retroactively partition income, deductions, or credits using Texas Family Code §7.002(c)(2) and use this as a tool when dividing various income tax attributes. The relevant portion of the statute follows:

> Sec. 7.002. DIVISION AND DISPOSITION OF CERTAIN PROPERTY UNDER SPECIAL CIRCUMSTANCES.
> (a) *****
> (b) *****
> (c) In a decree of divorce or annulment, the court shall confirm the following as the separate property of a spouse if partitioned or exchanged by written agreement of the spouses:
> (1) income and earnings from the spouses' property, wages, salaries, and other forms of compensation received on or after January 1 of the year in which the suit for dissolution of marriage was filed; or
> (2) income and earnings from the spouses' property, wages, salaries, and other forms of compensation received in another year during which the spouses were married for any part of the year.
>
> Added by Acts 1997, 75th Leg., ch. 7, Sec. 1, eff. April 17, 1997. Amended by Acts 1999, 76th Leg., ch. 692, Sec. 4, eff. Sept. 1, 1999; Acts 2001, 77th Leg., ch. 838, Sec. 4, eff. Sept. 1, 2001; Acts 2003, 78th Leg., ch. 230, Sec. 4, eff. Sept. 1, 2003.

On its face, the language "received in another year during which the spouses were married for any part of the year" would appear to be applicable to any year of the marriage. This may provide a mechanism for equitably allocating a tax attribute by drafting language to retroactively partition income and deductions for prior years of marriage where joint returns were filed.

END NOTES

1.See IRC §1.172-7

2.See IRC Reg. §1.172-7(c)

3.See A.E. Calvin, 66-1 USTC ¶9108

4.See IRC §1211(b)(1)

5.See IRC §1211-1(b)(2)

6.See Treas. Reg. §1.1212-1(c)(1)(i)

7.See Treas. Reg. §1.1212-1(c)(1)(iii)

8.See Treas. Reg. §1.1212-1(c)(2), Ex (2)

9.See Treas. Reg. §1.1212-1(c)(1)(i)

10.See *M. Haley v. J. Haley*, App. Ct. Fla., 2006-2 USTC ¶50,457

11.See *Taft v. Commissioner*, 40-2 USTC ¶9828

12.See Treas. Reg. §1.170A-10(4)

13.See IRC §469

14.See Treas. Reg. §1.469-1(f)(4)

15.See IRC §469(g)

16.See IRC §163(d)(1)

17.See IRC §163(d)(2)