CLOSELY HELD BUSINESS INTERESTS: CHARACTERIZATION AND TRACING

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. CHARACTERIZATION OF SOLE PROPRIETORSHIP ASSETS. 1
- A. The 19th Century Origins of 20th Century Case Law. 1
- B. Modern Cases. 2
- C. Comparison of Partnership Profits to Corporate Profits. 3

III. CHARACTERIZATION OF ENTITIES AT TIME OF FORMATION. 4

IV. ACQUISITION OF AN INTEREST IN AN EXISTING ENTITY. 6

V. DISTRIBUTIONS: DIVIDENDS, LIQUIDATIONS, PARTIAL LIQUIDATIONS, AND REDEMPTIONS. 6
- A. Cash Dividends, Stock Splits and Stock Dividends. 7
- B. Liquidations, Partial Liquidations and Redemptions. 7
  - 1. The Early Cases. 7
  - 2. *Le-Grand Brock I*. 8
  - 3. *Le-Grand Brock II*. 8
  - 4. Summary of the Current State of the Law on Complete Liquidations. 9
  - 5. Example Comparing Complete Liquidation to Sale of Shares. 9
  - 6. Complete Liquidations of Partnerships. 9
  - 7. Partial Liquidations of Corporations. 10

VI. BUSINESS REORGANIZATIONS: NAME CHANGES, MERGERS, CONVERSIONS, SPIN-OFFS, SPLIT-OFFS AND SPLIT-UPS. 11
- A. Name Change. 11
- B. Mergers. 11
- C. Conversions. 12
- D. Spin-Offs. 12
- E. Split-Offs and Split-ups. 13

VII. REIMBURSEMENT CLAIMS. 14
- A. Sole Proprietorships. 14
- B. Funds Expended to Benefit a Separate Estate Entity. 14
- C. Professional Fees Paid in Conjunction with Acquisition of an Interest. 14
- D. Offsetting Benefits Received. 14
- E. Payment of Taxes on Income from Pass-Through Entities. 15
- F. Payments from Entities for the Benefit of the Community. 15

ATTACHMENT 16

I. INTRODUCTION.

This paper is a survey and comment upon Texas law regarding the characterization of transactions involving closely held business interests, including the tracing and characterization of activity in a sole proprietorship during the marriage, the acquisition of an interest in an entity, the contribution of assets to form an entity, distributions from entities, the reorganization of entities and the asserting of reimbursement claims with respect to closely held entities.

Following are the main conclusions of this paper:

- The tracing and characterization of sole proprietorship assets is treated differently from the tracing of assets that are not held for sale in the ordinary course of business. Gain on the sale of each item of inventory can never be characterized as a separate property mutation in form. *See* Section II, "Characterization of Sole Proprietorship Assets."

- The total consideration conveyed in return for an ownership interest in an entity, and not simply the recital(s) in the organizing documents, determines the character of the interest received. *See* Section III, "Characterization of Entities at Time of Formation."

- Contributions to an entity can be characterized differently depending on the form of the contributions as either consideration for stock or as additional paid-in capital. *See* Section IV, "Acquisition of an Interest in an Existing Entity."

- Proceeds received in complete liquidation of an entity will have the character of the interest held in the entity, but the characterization of a partial liquidation depends upon the form of the transaction. *See* Section V.B., "Liquidation, Partial Liquidations and Redemptions."

- Interests received as a result of both mergers and divisive reorganizations (spin-offs, split-offs and split-ups) are a mutation in form of the original interests held and take the character of the original interest held. *See* Section VI, "Business Reorganizations."

- Both contributions to separate property entities and amounts expended in payment of fees to acquire an interest in separate property entities create claims for reimbursement, but are subject to reductions for offsetting benefits. *See* Section VII, "Reimbursement Claims."

The characterization of distributions from partnerships is discussed in a separate paper presented with this paper at the 2010 New Frontiers in Marital Property Law course.

II. CHARACTERIZATION OF SOLE PROPRIETORSHIP ASSETS.

The sole proprietorship is the most basic form of a closely held business interest. There are no documents that are required to be filed with the Secretary of State's office, and no separate tax return to be filed with the Internal Revenue Service.[1] If an assumed name is needed, it is registered in the county records office of the county in which the business is located (or in which the services are provided if there is no office). *See* TEX. BUS. & COM. CODE § 71.054. A sole proprietorship has no existence separate and apart from its owner, and is not a domestic entity (i.e., Texas entity) as that term is defined by the Texas Business and Organizations Code ("TBOC"). *See* TBOC § 1.001(18). As discussed below, the tracing characterization of sole proprietorship assets does not follow the typical tracing rules.

A. The 19th Century Origins of 20th Century Case Law.

Wallace & Company v. Finberg, 46 Tex. 35 (1876), is one of the earliest Texas Supreme Court cases in which the character of sole proprietorship assets was at issue. In that procedurally convoluted case, the plaintiff, Wallace & Co., sued the husband to recover on three notes signed by both the husband and wife. Wallace & Co. immediately obtained an attachment on the merchandise of the proprietorship.

The wife alleged that the property attached was her separate property by virtue of an instrument executed by her husband and hand filed of record in Louisiana giving her a lien on $1,500 of future merchandise to be acquired by husband. The lien arose as a result of funds loaned by wife's separate estate to husband, and the wife alleged that the merchandise levied upon was her separate property as a result of repayment of the debt owed her separate estate by her husband. The husband and wife in effect claimed that the husband ran the business as his proprietorship but that the property attached was the wife's separate property.

In its analysis, the Texas Supreme Court observed that, because of coveture, the wife would not be liable on the notes unless it was shown that the goods for which the notes were given were "for the use of herself or child, or the benefit of her separate property." *Id.* at 5. The Texas Supreme Court held

[1] Sole Proprietorships are reported on Schedule C of Form 1040 (U. S. Individual Income Tax Return).

that merchandise purchased to replenish her separate property merchandise that had been sold during the course of her husband's business could not have possibly been for the benefit of her separate estate, and the wife therefore was not be liable on the notes.

The Court reasoned that the goods purchased from the plaintiff Wallace & Co. could not be for the benefit of the wife's separate estate because, if this were the case, "the wife's separate property could be invested in a stock of goods for trade and she and her husband could carry on the business of merchandising as a means of increasing her separate property." In other words, the Texas Supreme Court was not going to allow a wife to increase her separate estate by the efforts of her husband to sell merchandise for profit that was then reinvested in new merchandise in a continually expanding separate property estate of the wife.

Note that, at that time, Texas did not have a class of protected separate property for husbands. *See* JOSEPH W. MCKNIGHT & WILLIAM A. REPPY, JR., TEXAS MATRIMONIAL PROPERTY LAW at 4 (2004). Also, wives were generally not running businesses in the 19th century because of the limitations on both their right to contract and their roles in society. At one point in its decision, the Texas Supreme Court noted that the marital relationship was already sufficiently complicated without adding to it the concept of a mercantile partnership between husband and wife. Little did the Texas Supreme Court realize how complicated marital property law would become during the next century.

The Texas Supreme Court again addressed the issue of characterization of property in the context of the collection of a debt owed by a "mercantile business" in a second debt collection case: *Green v. Ferguson*, 62 Tex. 525 (1884). Quoting from *Finberg*, the Court held that:

> In consideration of the relationship of husband and wife, together with the statutes declaring what shall be considered community property, and what contracts a married woman might make, would seem to lead to the conclusion that she cannot thus engage in trade, and thereby convert into her separate estate that which the law declares shall constitute community property; …. *Id*. at 2.

The Texas Supreme Court reached the same result in *Epperson v. Jones*, 65 Tex. 425 (1886), in which it held that profits from the sale of wife's separate property goods in a mercantile business were community property.

The holding in a later case heard by the Texas Supreme Court in 1889 has created some confusion regarding characterization of proprietorship assets. In *Schmidt v. Huppman*, 11 S.W. 175 (Tex. 1889), the husband held a stock of goods in his business valued at $2,000 at the time of his marriage to his wife. After the death of his wife, the husband charged the community estate for the $2,000 stock of goods, which was challenged in court by several of the beneficiaries of the wife's estate.

In its decision, the Texas Supreme Court observed that, although none of the original stock of goods was on hand at the date of the wife's death, at no time during the marriage was the stock of goods reduced below the value held at the date of marriage. The Supreme Court then appears to hold that even though the original merchandise had been sold, the character of the replacement merchandise was separate to the extent of the value of the merchandise that existed as of the date of the parties' marriage. However, in spite of seeming to hold that a portion of the inventory on hand at the time of the his wife's death was separate property, the Texas Supreme Court nevertheless goes on to hold that the husband's separate estate was entitled to reimbursement for the value of the merchandise on hand at the date of the parties' marriage. *Id*. at 176.

B. Modern Cases.

In *Hardee v. Vincent*, 147 S.W.2d 1072 (Tex. 1941), another debt collection case, the wife alleged that the stock of goods and fixtures in her store were her separate property. The husband had conveyed all interest in the parties' store, including merchandise and trade fixtures, to his wife two years before a creditor attempted to attach the merchandise in satisfaction of debts owed for its purchase. The wife claimed that the merchandise was her separate property due to the conveyance of the business to her by her husband. Observing that the trial record showed that goods had been both bought and sold during the years subsequent to the conveyance, the Texas Supreme Court stated that the controlling fact was whether funds used to purchase additional goods and fixtures were from profits or from capital investment. Because the wife could not demonstrate that the goods purchased came from her capital investment and not profits, the Court held that the subject goods were community property. *Id*. at 102-103.

In more recent times, the Texas Supreme Court has considered the effect that the expenditure of community funds and efforts has upon the character of sole proprietorship assets. *See Norris v. Vaughn*, 260 S.W.2d 676 (Tex. 1953), and *Moss v. Gibbs*, 370 S.W.2d 452 (Tex. 1963). In *Norris*, the husband held

a lease on seven gas producing wells. The husband's stepdaughter alleged in a probate action that community funds ($9,146) and efforts were expended by the husband in making repairs on the wells, and therefore a community character was impressed upon the gas. The Texas Supreme Court recognized the validity of her argument, but held that the record did not show a sufficient expenditure of community funds or effort to impress a community character on the gas produced. *See Norris*, 260 S.W.2d at 498. In its opinion, the Texas Supreme Court expressed its approval of earlier cases in which bricks formed from clay removed from separate property land were considered community property and lumber processed from timber harvested from separate land was also community.

In *Moss*, the wife received several gifts of cattle, which she bred and sold for profit and then reinvested the profits in additional cattle. Observing that it was undisputed that the wife was "in the business of buying, feeding and selling cattle," the court held that the revenues from her business were community property. *Id*. at 454.

The decisions of the courts of appeals have for the most part followed the rule that to prove that the assets of a sole proprietorship on hand at the time of divorce are separate property, a spouse must prove that they were acquired with capital investment, and not purchased with profits. For example, in *Gibson v. Gibson*, 202 S.W.2d 288 (Tex. Civ. App.—San Antonio 1947, no writ), the San Antonio court of appeals relied on *Hardee* in holding that the husband, who acquired a sole proprietorship immediately prior to the parties' marriage, failed to prove which assets on hand at the time of divorce were purchased with profits versus capital, and therefore had not proved his separate property interest in the merchandise. *See also, Waheed v. Waheed*, 423 S.W.2d 159 (Tex. Civ. App.—Eastland 1967, no writ) (failure to prove whether sole proprietorship funds were from profit or capital); *Blumer v. Kallison*, 297 S.W.2d 898 (Tex. Civ. App.—San Antonio 1957, writ refused n.r.e.) (wife kept records distinguishing capital from profits).

Since any profits arising from the activities of a spouse's sole proprietorship are community property, it is virtually impossible for the separate property component of a sole proprietorship to increase in value during the parties' marriage, absent an infusion of additional separate property funds during the marriage. To the extent that assets are bought with profits, they will be community, and, to the extent purchased on credit, they will also be community. I suspect that very few merchants pay cash upon delivery of inventory. However, any furniture, fixtures and equipment on hand at the time of marriage that are still held by the proprietorship at the time of divorce would be separate property as part of the capital invested at time of marriage.

The tracing of assets in a sole proprietorship is an exception to the general tracing rules. Normally, if a spouse sells an asset, the proceeds will have the character of the asset sold. However, the profit component of an asset sold by a spouse engaged in a trade or business as a sole proprietor is community property. Whether a spouse is engaged in a trade or business can therefore alter the normal tracing rules. If a spouse sits at home all day engaged in day trading he or she is presumably "in the business" of day trading. *See Moss*, 370 S.W.2d at 454. If he or she is engaged in business, then any gains realized from trading constitute profits of his or her business, and hence would be community property notwithstanding the fact that the securities held in the account at time of divorce can be traced to securities held at time of marriage. This treatment of profits arising from a business is analogous to the distinction that the Internal Revenue Code of 1986 draws between the sale of a capital asset versus the sale of assets in the ordinary course of business. The former is accorded capital gain or loss treatment and the latter is treated as ordinary income or loss.

C. Comparison of Partnership Profits to Corporate Profits.

It is worth noting the different treatments accorded profits earned by an entity and profits earned by a proprietorship. Assume that there are two retail stores, Store I and Store P. Store I is owned by I, Inc., and Store P is owned by Proprietorship P. Both I, Inc. and Proprietorship P are engaged in the business of selling gemstones. Both were owned by the wife prior to her marriage, and both held in inventory twenty gemstones with a total value of $500,000 on the date of marriage. Assume further that Proprietorship P and I, Inc. both purchased additional inventory during the marriage using only cash generated from the sale of gemstones. During her short marriage, both Proprietorship P and I, Inc. each generated net profits of $300,000, which came from the sale of forty gems by both the proprietorship and the corporation. The entire $300,000 of profits generated by I, Inc., because it is held in corporate solution, constitutes neither a community asset nor a separate asset. *See Mandell v. Mandell*, 310 S.W.3d 531, 539 (Tex.App.—Fort Worth 2010, pet. filed). The profits generated by Proprietorship P, on the other hand, would be community property, even if it could be shown that each and every gemstone purchased could be traced back to the proceeds of sale from the original 20 gems owned by the proprietorship at date of marriage. The principle of mutation in form simply does not apply to the characterization of transactions within a

proprietorship to the extent of the profit element in each Transaction.

III. CHARACTERIZATION OF ENTITIES AT TIME OF FORMATION.

If a spouse can prove that he or she contributed the separate property assets of his or her sole proprietorship to form an entity, then that spouse will hold a separate property interest in the entity in proportion to the value of separate property assets contributed to the value of total assets contributed in formation of the entity. *See Vallone v. Vallone*, 618 S.W.2d 820, 822 (Tex. Civ. App.—Houston [1st Dist.] 1981, rev'd on other grounds, 644 S.W.2d 455 (Tex. 1982)). The spouse claiming separate property must prove by clear and convincing evidence that the assets were contributed for an ownership interest, not just that they were contributed. *Vallone*, 618 S.W.2d at 822. In *Vallone*, the husband was able to prove that assets of his sole proprietorship restaurant were contributed to Tony's Restaurant, Inc. upon its incorporation in return for shares of stock in that corporation. However, because he was only able to prove by clear and convincing evidence that 47% of the assets he contributed came from his separate property proprietorship, only 47% of the shares were received by him as his separate property. *See also Koss v. Koss*, 2005 WL 1488070 p. 2 (Tex. App.—Waco 2005, no pet.)(unreported) (shares capitalized entirely with separate property are separate property).

In a factually simpler case, the husband was a partner with his father in a separate property partnership that owned and operated two helicopters. *See Hunt v. Hunt*, 952 S.W.2d 564 (Tex. App.—Eastland 1997, no pet.). The partnership in *Hunt* was terminated upon the death of the husband's father, and the helicopters were distributed to the husband. The husband subsequently capitalized a new corporation, contributing the helicopters in return for shares in the company. The trial court confirmed the new corporation as the husband's separate property. Noting that there was nothing in the record to show that the husband either used community assets or incurred community debt to form the corporation, the Eastland court of appeals upheld the characterization of the corporation as husband's separate property as a mutation in form of the helicopters.

Frequently in divorce cases in which a spouse has transferred proprietorship assets to an entity, an issue arises as to whether those assets were contributed in return for an ownership interest. This issue can arise with respect to the formation of virtually any entity. For example, it can occur when a sole proprietorship is incorporated. On occasion, corporations are formed by a contribution of sole proprietorship assets to form the corporation. Sometimes the incorporation is accomplished without any written acknowledgment that the assets of a previously existing sole proprietorship are being contributed to the formation of the corporation. The owner of the business simply has an attorney prepare articles of incorporation, and the attorney uses his or her standard form, which frequently recites that the corporation was formed by the contribution of $1,000.00 of funds or services.[2] This recitation creates an issue as to whether the former proprietor received shares of the newly-formed corporation in return for the contribution of his or her proprietorship assets to the corporation, or, alternatively, received the shares in exchange for $1,000.00 plus those assets.

Another example of a formation issue occurs in the context of a sole proprietorship incorporated as a limited liability company ("LLC"). It is not unusual for the operating agreement of a newly-formed LLC to recite the respective percentage ownership interests that are allocated to each member, without indicating what, if anything, was contributed by the member(s) in return for that interest. For example, assume that a husband owns a sole proprietorship that holds mineral leases, all of which were owned prior to his marriage. He wants to develop the leases, but he also wants to avoid personal liability for any accidents that might occur during the drilling of wells on the leases. Therefore, for purposes of avoiding personal liability, he forms an LLC, and contributes the leases to it. The husband has a business associate who will also contribute his mineral leases to the LLC.

The operating agreement provides that the husband and his associate each hold a 50% interest in the LLC. There is no recitation in the LLC's operating agreement that the husband is contributing his leases in return for his interest in the LLC. On the same day that the husband forms the LLC, he also executes assignments conveying his interest in each of the leases to the LLC. Does the failure of the operating agreement to recite that the husband is receiving his one-half interest in the LLC in return for the contribution of his leases result in his interest in the LLC being characterized as community property? If an inquiry regarding the characterization of an interest in an LLC is limited solely to an examination of an operating agreement that does not identify the capital contributed, then this would be the case because the

[2] Incorporation in Texas previously required that a corporation could not commence business until it had received at least $1,000 in value as consideration for its shares. The composition of the $,1000 consideration could at various times be cash, or cash, services or property. *See* TEX. REV. CIV. STAT. ANN. ART. 3.05 (Vernon 1956, 1980 and 2003 Supplement). This requirement was repealed effective September 1, 2003. *See* Acts 2003 78th Leg., ch. 238, § 44(2).

interest received is not tied to the contribution of the separate property.

Some attorneys and forensic CPAs believe that if the articles of incorporation recite that the initial capitalization is $1,000, shares received upon incorporation of a proprietorship are community property absent clear and convincing evidence that the $1,000 initial capital that is recited in the articles of incorporation is separate property, in spite of the fact that there was clearly an incorporation of an existing proprietorship. The basis for their belief is that, based upon the inception of title rule, a recitation in the articles of incorporation that $1,000 was contributed to the corporation conclusively establishes the character of the shares received.

I do not believe that there are any Texas cases that hold that an inquiry as to the character of shares received upon incorporation is limited exclusively to an examination of the character of the $1,000 that is stated as the initial capital in the articles of incorporation. The Fort Worth court of appeals is clearly of the opinion that a recitation in the articles of incorporation that certain funds were contributed in formation of the corporation does not prevent a spouse from giving evidence that separate property assets of a proprietorship were also contributed in return for shares. *See Allen v. Allen*, 704 S.W.2d 600 (Tex. App.—Fort Worth 1986, no writ).

In *Allen*, the wife owned a beauty salon prior to the marriage, and she incorporated the business during the marriage. The court of appeal's opinion states that $1,000 was required for initial capitalization, and, in the absence of evidence to the contrary, this was presumptively community property. The proprietorship had no tangible assets. However, the wife provided evidence that the management, employees and clientele were the same for the corporation as for the proprietorship, and asserted that she contributed her separate property commercial goodwill to the corporation. The Fort Worth court of appeals accepted the wife's theory that separate property commercial goodwill contributed to a corporation upon formation could be the basis for separate property ownership in shares received in spite of a recitation (presumably in the articles of incorporation) that there was only $1,000 of initial capital contributed to form the corporation. However, because the wife put on no testimony regarding the value of the goodwill, she failed to prove her separate property interest in the shares. The difficulty with determining the views of the courts of appeals on this issue is that the cases typically do not discuss what recitations may have been in the articles of incorporation regarding initial capital, but instead describe the assets contributed and the character of those assets.

The Houston court of appeals considered a somewhat analogous situation in a case involving the gifting of shares by the husband's father. *See Rusk v. Rusk*, 5 S.W.3d 299 (Tex. App.—Houston [14th Dist.] 1999, pet. denied). In *Rusk*, the husband's father transferred all shares of a corporation to him during the parties' marriage, and the share certificates recited that they were transferred for value received. The husband testified that no consideration was exchanged in return for the shares, and that all income generated by the corporation was distributed to him from the time it was incorporated five years prior to the marriage. Additionally, the wife presented no controverting evidence that the shares were obtained in return for either funds or the efforts of the spouses. The trial court had found that the shares were community property.

In spite of the recitation on the shares that they were issued for consideration, the Houston court of appeals held that the shares were the husband's separate property. In reaching its decision, the court of appeals in *Rusk* held "[t]he major consideration in determining the characterization of property as community or separate is the intention of spouses shown by the circumstances surrounding the inception of title."[3] *Rusk*, 5 S.W.3d at 303. The Fort Worth and El Paso courts of appeal also have adopted this approach. *See Boyd v. Boyd*, 131 S.W.3d 605, 612 (Tex. App.—Fort Worth 2004, no pet.); *Scott v. Estate of Scott,* 973 S.W.2d 694, 695 (Tex. App.—El Paso 1998, no pet.). These cases support an inquiry into the full circumstances under which a spouse received an interest in an entity.

There is also another basis for extending the characterization inquiry beyond a mere examination of the document forming the entity. In construing contracts, separate documents that are executed "at the same time, for the same purpose, and in the course of the same transaction are to be construed together." *Jim Walter Homes, Inc. v. Schuenemann*, 668 S.W.2d 324, 327 (Tex. 1984). Thus, in *Jim Walter's Homes, Inc.* the Texas Supreme Court held that three documents, all executed on the same day, constituted the entire contract. *Id. See also Frost National Bank v. Burge*, 29 S.W.3d 580 (Tex. App.—Houston [14th Dist.] 2000, no pet.); *Bristol-Myers Squibb Co. v. Barner*, 964 S.W.2d 299, 302 (Tex. App.—Corpus Christi 1998, no pet.) (construing documents together

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[3] However, mere intention alone, without supporting facts, will not affect the character of property. *See Matter of Marriage of York*, 613 S.W.2d 764 (Tex. Civ. App.—Amarillo 1981, no writ); *see also*, *Holloway v. Holloway*, 671 S.W.2d 51 (Tex. App.—Dallas 1983, writ dism'd) (unilateral intention of spouse insufficient to establish separate character of borrowed funds).

even though not signed contemporaneously). Thus, in *Bush v. Brunswick Corp.*, 783 S.W.2d 724 (Tex. App.—Fort Worth 1990, pet. denied), the Fort Worth court of appeals construed a merger agreement with a shareholder agreement in concluding that seven controlling shareholders were third party beneficiaries of the merger agreement. The Fort Worth court of appeals also noted that application of this rule of construction applies to instruments that are executed at different times and that do not refer to each other. *Id*. at 728 – 729.

To the extent that an entity's formation document can be considered a contract, then this rule of construction would apply, and all related documents should be read together. For example, an LLC is formed upon the filing of a certificate of formation, as is true for all entities governed by the TBOC. *See* TBOC § 3.001(c). The operations of the company are governed by an operating agreement and, to the extent the operating agreement does not otherwise provide, are also governed by Title 3 (Limited Liability Companies) of the TBOC and by the provisions of Title 1 (General Provisions) that are applicable to limited liability companies.[4] See TBOC § 101.052(a) and (b). Generally, the operating agreement will state the relative ownership interests of the various members. If the operating agreement does not identify the assets contributed by each member, then the rule of construction that allows separate documents to be construed together if they deal with the same transaction would permit consideration of related documents such as assignments and other transfer documents in determining the character of the interest acquired by the members. If formation documents cannot be considered a contract, then the holding in *Rusk* would apply, and would permit an examination of the circumstances of the formation of the entity.

IV. ACQUISITION OF AN INTEREST IN AN EXISTING ENTITY.

Frequently, closely held entities will change owners or add additional owners. This circumstance usually presents factually simpler characterization issues than the formation of a new entity using the assets of an existing proprietorship. The same tracing concepts apply in these situations as in the case of interests acquired in any public entity. That is to say, if the assets used to purchase an interest in an entity are separate in character, then the interest acquired is separate. *See Estate of Hanau*, 730 S.W.2d 663 (Tex. 1987).

However, acquisitions of additional interests in closely held entities can create unforeseen characterization issues. Assume for example that a husband owns shares of a closely held corporation. The corporation owns unimproved land which is being held for investment, and the shareholders make payments pro rata based on their respective ownership interests to the corporation each year for a number of years to cover the carrying costs of the land. There are two possible treatments for the additional amounts contributed: either shares are issued to the shareholders in return for their contributions or no shares are issued and, instead, additional paid-in capital is credited for the amount of the contributions to the corporation. Assume further that the original shares are the separate property of the husband, and all subsequent contributions to the corporation are made from community funds.

Regardless of which method is used to fund the corporation's investment, all shareholders continue to hold the same relative interests in the corporation. However, when the husband is issued shares in return for his additional investment in the corporation, those shares will be community property because they represent a mutation in form of the community cash contributed to the corporation. On the other hand, if no shares are issued and the contribution is treated as additional paid-in-capital, then the husband's entire interest in the corporation remains his separate property because he holds the same number of shares both before and after the contribution to the corporation. In that circumstance, the community estate has only a reimbursement claim against the husband's separate estate. Is it a breach of fiduciary duty for the husband to structure the contribution to the corporation as additional paid-in-capital so that the community estate will not acquire an interest in the corporation in return for the funds remitted?

V. DISTRIBUTIONS: DIVIDENDS, LIQUIDATIONS, PARTIAL LIQUIDATIONS, AND REDEMPTIONS.

Corporate distributions are defined under TBOC Title 2 (Corporations), § 21.002(6)(A), as including three categories of transfers of property by a corporation: a dividend, a purchase or redemption of a corporation's own shares, and payments in liquidation of all or a portion of its assets. The board of directors may authorize distributions, but distributions may not violate the corporation's certificate of formation, and are limited in other respects. *See* TBOC §§ 21.302 and 21.303. If made in dissolution of a corporation,

[4] An operating agreement (referred to in the TBOC as a "company agreement") can either be in writing or can be oral. The fact that there is only one member of an LLC does not cause the operating agreement to be unenforceable. *See* TBOC § 101.001(1). Any provision permitted in an operating agreement can alternatively be included in the certificate of formation of an LLC. *See* TBOC § 101.051(a).

distributions must comply with the requirements of TBOC Chapter 11 (Winding Up and Termination of Domestic Entity). *See* TBOC § 21.303. Distributions that are not made pursuant to a plan of dissolution may not be made if they would result in the corporation becoming insolvent or if they exceed the amount of corporate surplus (i.e., the excess of net assets over stated capital). *See* TBOC §§ 21.303, 21.301(1)(B) and §21.002(12). There are also other limitations on corporate distributions that apply in certain very narrow circumstances. *See* TBOC §21.301.

A. Cash Dividends, Stock Splits and Stock Dividends.

It is hornbook law that cash dividends paid on stock are community property absent an enforceable agreement between spouses to the contrary, regardless of the character of the underlying stock. *See, e.g., Alsenz v. Alsenz***,** 101 S.W.3d 648 (Tex. App.—Houston [1st Dist.] 2003, pet. denied). The characterization of stock splits is similarly intuitive. Stock splits occur when the corporate directors decide to reduce the market value of their shares by issuing additional shares. A 2-for-1 split is one of the more common ratios. This results in each shareholder holding double the number of shares that he or she originally held. On the corporate books of record, the effect of the split is to reduce the per-share par value in proportion to the number of additional shares being issued.

For example, in a 2-for-1 stock split the par value of each share would be one half that of the par value prior to the split, resulting in the same total amount of capital reported on the books after the split as was reported prior to the split. Shares received in a stock split simply represent smaller pieces of the same pie, resulting in a mutation in the form of the shares previously held. As such, the additional shares have the same character as the original shares. *See Tirado v. Tirado*, 357 S.W.2d 468, 473 (Tex. Civ. App.—Texarkana 1962, writ dism'd).

The treatment of stock dividends, i.e., dividends paid in the form of shares of stock, are counterintuitive. Since they are styled as dividends, you might believe that they represent income, and therefore would constitute community property upon their receipt. On the books of record of the corporation, the issuance of the share dividend is recognized by debiting (reducing) retained earnings and crediting (increasing) capital and/or paid in capital. Thus, the effect of the issuance of a share dividend is similar to the issuance of a cash dividend in that both are charged to retained earnings.

However, dividends paid in stock are not actually dividends. Under TBOC § 21.002(6)(A)(B)(ii), the transfer of a corporation's own shares is excluded from the definition of "distribution," which is the category that includes dividends. Thus, since a share dividend is not a distribution, it cannot be a dividend, in spite of the fact that it reduces the retained earnings of a corporation. Texas courts have consistently held that stock dividends take the character of the shares with respect to which they are paid. *See, e.g.*, *Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. App.—Corpus Christi 1997, no pet.) (holding that stock received as dividends on stock purchased prior to marriage remains the separate property of the spouse owning the shares); *Wohlenberg v. Wohlenberg***,** 485 S.W.2d 342 (Tex. Civ. App.—El Paso 1972, no writ); and *Johnson v. First Nat. Bank of Fort Worth*, 306 S.W.2d 927 (Tex. Civ. App.—Fort Worth 1957, no writ).

In perhaps the only case in which there is any legal analysis regarding characterization of stock dividends, the Fort Worth court of appeals observed in *Johnson* that there was no increase in the husband's proportionate ownership interest in the corporation as a result of a stock dividend, and any increase in value of the stock was attributable to retained earnings, which are not regarded as community property. *See Johnson*, 306 S.W.2d at 930. Although not controlling with respect the characterization of property under Texas law, it is worth noting that stock dividends generally are not treated as income under the Internal Revenue Code. *See* 26 U.S.C.A. § 305.

B. Liquidations, Partial Liquidations and Redemptions.

A corporate dividend is defined as "[a] portion of a company's earnings or profits distributed pro rata to its shareholders, usually in the form of cash or additional shares." BLACK'S LAW DICTIONARY 547 (9th ed. 2009). Liquidating distributions of a corporation, on the other hand, include "a transfer of money by a corporation to its shareholders in liquidation of all or a portion of its assets." *Le-Grand Brock v. Brock*, 246 S.W.3d 318, 322 (Tex. App.—Beaumont 2008, pet. denied) (citing BLACK'S LAW DICTIONARY 508 (8th ed. 2004)). Liquidating distributions can be made with respect to all owners of an entity or with respect to fewer than all. They can be in complete liquidation of an entity, or in partial liquidation. There have been only a few Texas cases in which courts have considered the issue of the character of liquidating distributions.

1. The Early Cases.

Wells v. Hiskett, 288 S.W.2d 257 (Tex. Civ. App.—Texarkana 1956, writ refused n.r.e.), was one

of the earliest cases, if not the earliest case, to consider the issue of the characterization of a liquidating distribution received by a shareholder with respect to shares held in a dissolving corporation. In *Wells*, the husband held shares of a corporation as his separate property, and the corporation distributed interests in an oil and gas lease to both him and the other shareholders in complete liquidation and in consideration of the cancellation of their shares. The Texarkana court of appeals held that the leases were received by the husband as his separate property. *Id.* at 259.

In the year following *Wells*, the El Paso court of appeals considered the issue of the characterization of a liquidating distribution in *Fuhrman v. Fuhrman*, 302 S.W.2d 205 (Tex. Civ. App.—El Paso 1957, writ dism'd). In that case, the husband, Fred Fuhrman, owned shares of Fuhrman Petroleum Company ("Fuhrman Company") prior to the parties' marriage. During their marriage, Fuhrman Company was liquidated, and shares of Fuhrman Petroleum Corporation ("Fuhrman Corporation"), a wholly-owned subsidiary of Fuhrman Company, were distributed to the shareholders in proportion to their ownership. The trial court held that the shares of Fuhrman Corporation distributed to Fred in liquidation of Fuhrman Company were community property.

The El Paso court of appeals held, however, that "there is no question but what said stock was the separate property of Fred Fuhrman by virtue of his ownership of the stock in the company which was acquired prior to his marriage." There is no analysis of the law in this decision other than the foregoing holding. Also, there were presumably other assets distributed in liquidation of Fuhrman Company, but no mention is made of any other assets being distributed pursuant to the plan of liquidation.

2. *Le-Grand Brock I.*

The issue of the character of a liquidating distribution from a corporation was more recently considered in *Legrand-Brock v. Brock*, 2005 WL 2578944 (Tex. App.—Waco 2005, no pet.) (unreported) (hereafter "*Le-Grand Brock I*"). In that case, the husband, Roy, owned 740.5 shares of BTH Holdings, Inc. ("BTH") prior to his marriage to his wife Stace. Within one month of the parties' marriage, the shareholders of BTH voted to dissolve the corporation. The corporation was chartered under Delaware law, which allows the dissolution process to continue over a three-year period. Roy received four payments from BTH totaling approximately $7 million over a thirty-two month period. During the trial, Stace's expert attempted to offer testimony regarding the character (separate or community) of the corporate distributions. The trial judge ruled that, as a matter of law, the liquidating distributions were received by Roy as his separate property, and therefore excluded Stace's expert's testimony. Stace preserved error by making an offer of proof. As shown by the offer of proof, Stace's expert was prepared to testify that BTH paid "liquidation dividend distributions" to Roy from its retained earnings.

Stace subsequently appealed on numerous grounds, including an argument that the exclusion of her expert's testimony was reversible error. Under a docket equalization order, Stace's appeal was heard by the 10th Circuit Court of Appeals in Waco. The Waco Court of Appeals held that there was a fact issue as to whether the payments to Roy represented proceeds from the sale or exchange of his stock (separate property) or were dividends (community property). Therefore, the court of appeals held that it was error to exclude the testimony of Stace's expert. Chief Justice Gray dissented, noting that liquidating distributions retain the character of the stock with respect to which they are paid. Since it was undisputed that the BTH shares were Roy's separate property, Chief Justice Gray believed that, as a matter of law, the liquidating distributions were Roy's separate property.

3. *Le-Grand Brock II.*

In the second trial, the trial judge once again concluded that BTH's payments to Roy were liquidating distributions made under BTH's plan of liquidation, and therefore "were in redemption or cancellation of his separate property stock." *See Le-Grand Brock v. Brock*, 246 S.W.3d 318, 320 (Tex. App.—Beaumont 2008, pet. denied) (hereafter, *Le-Grand Brock II*). As such, the payments were received by Roy as his separate property.

Stace again appealed, contesting the trial court's characterization of the liquidating distributions. The second appeal, however, was heard by the Beaumont court of appeals. The issue to be decided by the Beaumont court of appeals was whether the distributions of retained earnings by the corporation were simply dividends paid to Roy, and therefore income from separate property, or whether the distributions to Roy were an exchange of the corporate assets for his stock, and therefore were received as a mutation in form of the stock.

The Beaumont court of appeals noted that the controlling facts in the case were uncontroverted by Stace's expert on remand, and it held that the characterization of the liquidating distributions based on uncontroverted evidence was a matter of law for the court to decide. Citing both Black's Law Dictionary and TEX. BUS. CORP. ACT ANN. Art. 1.02(A)(13)(c) (Vernon Supp. 2007) (now codified as

TBOC § 21.002(6)(A)(iii)), the court of appeals further held that a liquidating distribution includes the transfer of funds to shareholders in complete or partial liquidations of the corporation. The Beaumont court of appeals then held that "[i]t is immaterial to the characterization of the property in this case that the assets distributed on dissolution were the corporation's retained earnings." *Le-Grand Brock II*, 246 S.W.3d at 322. The court of appeals therefore held that the liquidating distributions were exchanged for Roy's separate property stock, and were consequently received as his separate property.

In its decision, the Beaumont court of appeals cited the earlier cases of *Wells*, 302 S.W.2d, and *Fuhrman*, 288 S.W.2d, as well as a case dealing with a buyout of a partnership interest (*Harris, see infra*) in support of its position, and also observed in a footnote that the Internal Revenue Code, although not controlling, treats liquidating distributions as payments received in exchange for stock. The Beaumont court of appeals also cited a U.S. Supreme Court case from 1927 that drew a distinction between liquidating distributions and dividends.

4. Summary of the Current State of the Law on Complete Liquidations.

In the three Texas cases that address the issue of the complete liquidation of a corporation (*Wells*, *Fuhrman* and *Le-Grand Brock II*), the courts of appeals of Texarkana, El Paso, and Beaumont all take the position that amounts distributed in total liquidation of a corporation have the character of the underlying shares. *Le-Grand Brock I*, heard by the Waco court of appeals, is the only case in which there is any indication of even a possibility that the character of a liquidating distribution might be community property regardless of the character of the cancelled shares. As noted above, in *Le-Grand Brock I* the Waco court of appeals held that there was a fact issue as to whether the liquidating distributions received by Roy were in exchange for his stock or were received by him as dividends. However, in *Le-Grand Brock II*, the Beaumont court of appeals held that the fact that the assets distributed to Roy represented the retained earnings of the corporation was not relevant to the characterization of the liquidating distributions. Additionally, there is an unpublished case from the Dallas court of appeals holding that funds received in liquidation of the husband's separate property company were his separate property. *See Moore v. Key*, 2003 WL 194725 (Tex. App.—Dallas 2003, no pet.) (unreported) (characterizing checks received in total liquidation of husband's separate property company as separate property). Thus, the weight of Texas cases clearly favors the treatment of liquidating distributions received in the dissolution of a corporation in cancellation of its shares as a mutation in form of that corporation.

5. Example Comparing Complete Liquidation to Sale of Shares.

The treatment of complete liquidations of interests in corporations as a mutation in form for those entities is entirely consistent with the treatment of the sale of an interest in an entity as a mutation in form. For example, assume that a spouse owns one-half of the issued and outstanding shares in a closely held corporation that has net equity of $1,004,000.00, consisting of retained earnings of $1,000,000 and share capital of $4,000.00. One half of the net equity is therefore $502,000.00. Assume further that the spouse owned the shares prior to marriage, and that he or she, with the other shareholder's agreement, arranged to sell his or his or her shares for $802,000. The law is clear that the proceeds of sale would be the spouse's separate property because they are a mutation in form of the original shares, which were separate. Now assume that instead of selling his or her shares, the corporation liquidated, and the spouse received his or her one-half interest in the net equity of the corporation, which would be $502,000.00, and the shares were canceled. In both examples, the spouse is receiving payments related to retained earnings. In the first scenario, the value of the retained earnings is factored into the purchase price. In the second, retained earnings are being paid directly to the spouse by the corporation. In both instances, whether it is a sale of shares or a liquidation of the corporation, the spouse receives payments that derive at least in part from the retained earnings of the corporation. It is entirely consistent, then, to characterize both liquidating distributions and sales proceeds as a mutation in form of the related stock. This same analysis applies to liquidations of other forms of entities.

6. Complete Liquidations of Partnerships.

There does not appear to be any Texas cases in which the courts of appeal consider the characterization of the proceeds received by the partners in complete liquidation of a partnership. However, the Houston court of appeals has considered the issue of the characterization of a liquidation of a single partner's interest in a law partnership. In 1988, that court considered the character of a liquidating distribution paid by a partnership to a partner. *See Harris v. Harris*, 765 S.W.2d 798 (Tex. App.—Houston [14th Dist.] 1988, writ denied). In *Harris*, the Houston court of appeals considered the character of a payment by a partnership to redeem a partner's interest. The court of appeals held that payments to

the Husband in total liquidation of his interest in a partnership were his separate property because they represented a mutation in form of his partnership interest. If the redemption of a single partner's interest results in a mutation in form of his partner's interest, then the redemption of all partners' interests in total liquidation of the partnership would also represent a mutation in form, and the proceeds of liquidation would have the same character as the partnership interests surrendered.

7. Partial Liquidations of Corporations.

Although there have been several Texas cases dealing with the characterization of liquidating distributions received by the shareholders in dissolution of a corporation, I am not aware of any that deal with the characterization of funds received in partial liquidation of a corporation. Do partial liquidations paid with respect to shares that are separate in character represent a mutation in form of the underlying shares, as is the case for complete liquidations, or do they represent a dividend, and therefore are income from separate property? The definition of "distribution" under TBOC § 21.002(6)(A)(iii) includes both partial and total liquidating payments ("a payment by the corporation in liquidation of all or a portion of its assets"). Also, the TBOC distinguishes liquidation payments, both partial and total, from dividends. *See* TBOC § 21.002(6)(A)(i) and (iii). In order to be characterized as income from separate property, and hence a community asset, does a payment in partial liquidation of a corporation have to qualify as a dividend? If partial liquidations are not dividends, then what does a partial liquidation represent?

a. Partial Liquidations Accompanied by a Redemption of Shares.

For federal income tax reasons, partial liquidations have historically been accompanied by a redemption of shares in order to qualify for capital gains treatment under 26 U.S.C.A. §302.[5] It would seem that when a partial liquidation is in redemption of all of the shares of a single shareholder, it is a mutation in form of those shares, and the liquidating proceeds would have the character of the redeemed shares. This conclusion is reached from a reading of *Le-Grand Brock II* and the other cases discussed above that hold that distributions in total liquidation of a company represent a mutation in form of the underlying shares. The holding in *Le-Grand Brock II* is based on the premise that a liquidating distribution of assets accompanied by the cancellation of all corporate shares represents a mutation in form of those shares. What constitutes a mutation in form for all shareholders should also constitute a mutation in form for a single shareholder who redeems all of his or her shares in return for a liquidating distribution.

As noted by Richard Orsinger and Patrice Ferguson in their comprehensive article written for the 2008 Advanced Family Law course, some attorneys and forensic CPAs believe that it is necessary to trace assets within a corporation in order to characterize a distribution from a corporation in partial liquidation as separate property. *See* Richard R. Orsinger and Patrice L. Ferguson, *Effect of Choice of Entities: How Organizational Law, Accounting, and Tax Law for Entities Affect Marital Property Law*, 2008 Advanced Family Law Course, Ch. 30, p. 15. Those attorneys and CPAs further reason that, because corporate assets are not owned by the shareholders, they cannot be characterized as either separate or community property, and therefore you cannot trace "through" a corporation. *Id.*; *see also Mandell v. Mandell*, 310 S.W.3d 531, 539 (Tex.App.—Fort Worth 2010, pet. filed) (holding that property held by a corporation is neither separate nor community property of the shareholders). Their reasoning is based on the premise that in order to prove the separate character of a liquidating distribution, it is necessary to trace inside a corporation. This is essentially the holding of the Dallas court of appeals in *Marshall*, which concluded that because it was impossible to trace assets inside a partnership, it was impossible to prove the separate property character of any partnership distributions. For the reasons discussed in my article discussing the characterization of partnership distributions, tracing inside an entity is not needed in order to characterize distributions from an entity. *See* Jim Wingate, *Whose Money Is It? The Characterization of Partnership Distributions*, 6 State Bar of Tex. Family Law Section Report, 10 (2009). A copy of the foregoing article is being provided along with this paper to those attending the 2010 New Frontiers in Marital Property course.

b. Partial Liquidations Unaccompanied by a Redemption of Shares.

There is no requirement, however, that a partial liquidation be accompanied by a redemption of shares. Implicit in the definition of a partial liquidation as stated in the TBOC is a sale by an entity of part of its assets, followed by the distribution of the proceeds of liquidation to the owners. *See* TBOC § 21.002(6)(A)(iii) ("a payment by the corporation in liquidation of all or a portion of its assets"). A typical

[5] Although capital gain treatment has been less important during the era of the Bush tax cuts due to the reduction of the tax rate for dividends, this treatment still matters for those who have capital losses to offset against capital gains. Also, those tax reductions are due to expire at the end of 2010.

fact pattern involves a corporation that has disposed of a line of business by selling the assets of that line and then distributing the proceeds of sale to the shareholders. When the sales proceeds are ultimately distributed to the shareholders, the corporation will charge retained earnings, thereby reducing retained earnings in the same manner as it would be reduced by the payment of a dividend. If no shares are redeemed, there is obviously no mutation in form of the shares of the corporation because the same shares are held both before and after the partial liquidation.

There are two possible sources for a payment in partial liquidation of a corporation: retained earnings and stated capital. However, there are only certain conditions under which stated capital of a corporation can be reduced. *See* LAWRENCE G. NEWMAN, TEXAS CORPORATION LAW, § 9.7 (Release #9, 2009). Except in the case of shares without par value, reduction of stated capital must involve either an amendment of the certificate of formation or cancellation of shares. *Id*. For shares without par value, stated capital can be reduced only by the affirmative vote of a majority of the shareholders. *Id*. Thus, there can be a reduction of stated capital in the context of a partial liquidation only if there is a concurrent redemption of shares, amendment of the certificate of formation or the approval of the majority of shareholders. If any of the foregoing conditions are met, it would be possible for a partial liquidation to include a return of capital to the extent of the reduction in the stated capital of the corporation. Any return of stated capital of the corporation to its shareholders would represent a mutation in form of the investment held in the corporation. If the shares are separate, the capital returned would also be separate.

A partial liquidation unaccompanied by a redemption of shares creates something of an anomaly for purposes of the characterization of marital property. As noted above, dividends appear to be excluded from the category of liquidating payments under the three categories of distributions in the TBOC. If a liquidating payment is not a dividend, can it be classified as income from separate property for purposes of marital property characterization? To the extent that it is not a return of the invested capital, every partial liquidation is a distribution of retained earnings. The only reason that the receipt of a distribution of retained earnings in redemption of shares is treated as separate property is because it is viewed as an exchange of the shares in return for the distribution, and therefore a mutation in form. Without an exchange, there can be no mutation in form, and without a mutation in form, any distribution of retained earnings, regardless of whether it is characterized as a dividend or a partial liquidation, represents income from separate property.

VI. BUSINESS REORGANIZATIONS: NAME CHANGES, MERGERS, CONVERSIONS, SPIN-OFFS, SPLIT-OFFS AND SPLIT-UPS.

A. Name Change.

Perhaps the simplest of all reorganizations is a name change. Texas courts have recognized the obvious: the change of an entity's name does not create a new entity. *See Northern Natural Gas Company a Div. of Enron Corp. vs. Vanderburg*, 785 S.W.2d 415,421 (Tex. App—Amarillo 1990, no writ) (changing the name does not change the identity of a corporation) Obviously, a change in name does not change the entity in which a spouse has invested, and the character of the property remains the same.

B. Mergers.

A merger occurs when one entity merges into another. Under the TBOC, any entity formed under or governed by the TBOC can merge with any other such entity. *See* TBOC §§ 1.002(55) and 10.001. Thus, all the various forms of entities—corporations, limited liability corporations, partnerships, limited liability partnerships, etc.—can participate in a merger. With large corporations, the methods for accomplishing mergers can become quite complex, employing techniques such as reverse triangular mergers in which a subsidiary of the acquiring corporation merges into the target corporation with the shareholders of the target corporation receiving shares of the acquiring corporation. This results in the target corporation surviving the merger as a subsidiary of the acquiring corporation. For most closely held entities, however, the circumstances of the merger are much simpler—one entity (the acquired entity) merges into another (the acquiring entity), with the shareholders of acquired entity receiving an ownership interest in the acquiring entity.

Horlock was one of the earliest Texas cases to consider the effect of a merger on the characterization of shares received in a merger. *Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Civ. App.—Houston [14th Dist.] 1976, writ dism'd w.o.j.). In that case, the husband owned stock in the corporation prior to the parties' marriage. During the marriage, the corporation in which the husband originally held shares merged with two other corporations, and the husband received shares in the surviving corporation. Surprisingly, the trial court found that the shares of stock that the husband received in exchange for his old shares were community property. The Houston court of appeals overturned the trial court, holding that the shares received in exchange for the original shares were a

mutation in form of the original shares, and therefore had the same character as the original shares.

More than just an exchange of shares can be involved in the merger. In a case heard this year by the Amarillo court of appeals, the husband received not only shares of stock in the merger but also cash, and the amount of cash was based upon post-merger performance of the surviving company under an "earnout agreement." *See In re Marriage of Watson*, 2010 WL 346153 (Tex. App.—Amarillo 2010, no pet.) (unpublished). The wife in *Watson* argued that the earnout cash was community property either because it was compensation paid to her husband for services to the company or because it was income from his separate property shares. The trial court ruled that the earnout cash was the husband's separate property, and the Amarillo court of appeals upheld this ruling. In its opinion, the court of appeals pointed to several factors as evidence of the fact that the earnout cash represented a mutation in form of the shares and not compensation or income from separate property. These were that it is paid to each of the former shareholders in proportion to their ownership, it was not conditional on continued employment and it was consistent with a conditional share price based upon future performance of the merged entity.

Although *Horlock* dealt with the characterization of shares received pursuant to a merger, there is no reason for not applying its rationale to an interest received in the merger of any entity.

C. Conversions.

Conversions of entities from one form to another are governed by Chapter 10, Subchapter C of the TBOC. *See* TBOC §§ 10.101 *et seq*. Any form of entity governed by the TBOC can convert to any other form. The Texas Secretary of State's office has promulgated forms for each type of conversion. *See* http://www.sos.state.tx.us/corp/forms_boc.shtml (Sept. 10, 2010). TBOC § 10.106 governs the effects of a merger. For the purposes of this paper, the most important characteristic of a conversion is that the "converting entity continues to exist without interruption" as the new entity. *See* TBOC § 10.106. Clearly, the converted entity is simply a mutation in form of the original entity.

D. Spin-Offs.

In a spin-off, an existing corporation (the distributing corporation) transfers some part of its operating assets to a new corporation (the controlled corporation), and then immediately distributes the stock of the controlled corporation to its shareholders on a pro rata basis, with the foregoing transactions treated as a tax-free divisive reorganization under the Internal Revenue Code of 1986 if certain requirements are met. *See* 26 U.S.C.A. § 355; *see also* BORIS I. BITTKER and JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 11.01[1][e], at 11-5 (6th ed. 1996).

Spin-offs are perhaps not a common occurrence for a closely-held corporation, but are definitely a more common occurrence with large conglomerates, which divest themselves of underperforming assets by transferring operations to a newly created, wholly owned subsidiary, and then distributing shares of the controlled corporation to its shareholders. For example, in 2006, Verizon transferred its print and Internet yellow pages operations to a wholly-owned corporation (Idearc, Inc.) that it then spun off to its shareholders, in a transaction that was later described in a 2010 lawsuit brought by Idearc shareholders against both Verizon and its bankers as an attempt to off-load Verizon debt. *See* http://currents.westlawbusiness.com/Articles/2010/04/20100427_0027.aspx (Sept. 10, 2010).

The distribution of shares of the controlled corporation is treated as a dividend by the distributing corporation. *See, e.g.*, the spin-off of Allstate from Sears in 1995 (http://www.secinfo.com/d9Nxn.a2a.htm) (September 10, 2010) and the spin-off of AOL from Time Warner in 2009 (http://www.timewarner.com/corp/newsroom/pr/0,20812,1939809,00.html) (Sept. 10, 2010).

There are two Texas cases that mention stock spin-offs in the context of a divorce, but neither addresses the issue of characterization of the shares. In the first case, *Flores*, the trial court ruled that, as a discovery sanction, the wife could not offer into evidence her Sears retirement account statements that would evidence shares of Dean Witter and Allstate that she received during the marriage as a spin-off from her ownership of Sears shares. *Flores v. Flores*, 2001 WL 837527 (Tex. App.—Houston [14th Dist.] 2001, no pet.) (unreported). The wife offered some vague testimony at trial that she might have received shares in Allstate as a spin-off with respect to the shares that she held in Sears. The Houston court of appeals held that her testimony was "incomplete, confusing, equivocal, and contradictory," and therefore would not support a separate property claim. In the second case, *Le-Grand Brock I*, the husband received shares of stock in a spin-off from a company that was his separate property, but the wife conceded at trial that these shares were received by her husband as his separate property. *See Le-Grand Brock I*, 2005 WL 2578944 at 1.

As with any transaction involving a distribution from an entity, the determination of the character of shares received in a spin-off centers on whether the

transaction should be characterized as income from separate property or a mutation in form of the ownership interest held in the distributing entity. All of the assets held in corporate solution just prior to a spin-off are still held in corporate solution subsequent to the spin-off, the only difference being that they are now held within two corporations instead of one. From this viewpoint, the shares of the controlled corporation distributed to the shareholders do appear to be a mutation in form, with the operations of a single corporation now being split between two corporations, and with shares in the controlled corporation being issued to reflect this new reality. This analysis would indicate that the distribution of the shares of the controlled corporation is essentially the equivalent of a stock dividend, but with shares of the controlled corporation being substituted for the shares of the distributing corporation.

As discussed *supra*, the Fort Worth court of appeals based its holding in *Johnson* that stock dividends were a mutation in form of the underlying stock on the fact that there was no increase in the husband's proportionate ownership interest in the corporation as a result of the stock dividend, and that any increase in value of the stock was attributable to retained earnings, which are not regarded as community property. *See Johnson*, 306 S.W.2d at 929. That same analysis applies to shares received in a spin-off when the spin-off transaction is viewed at the consolidated level. The total assets, liabilities, and retained earnings of the distributing corporation are divided between it and the controlled corporation, with no broadening of the owning spouse's total interest in the combined corporations as a result of the receipt of shares in the controlled corporation. Consistency in the characterization of similar transactions would seem to require that distributions of shares from a corporation, whether as a stock dividend or as a stock split, should be accorded the same treatment.

However, an analysis that emphasizes the dividend nature of a spin-off results in a different conclusion. As noted *supra*, a dividend is defined as "[a] portion of a company's earnings or profits distributed pro rata to its shareholders, usually in the form of cash or additional shares." BLACK'S LAW DICTIONARY at 547. There is no requirement that a dividend be paid in cash, and it can be in the form of any type of asset, including shares of stock of a subsidiary. Therefore, the distribution of shares of a controlled corporation by the distributing corporation takes the form of a dividend. When viewed simply as a dividend, shares received in a spin-off represent income from separate property, and therefore would be considered community property.

To conclude that stock splits should be characterized as income from separate property simply because they are accomplished by means of a dividend is to exalt form over substance. The substance of the transaction is a division of the operations of a single corporation into two separate corporations, with no resulting increase in the overall ownership interests of the shareholders of the distributing corporation. However, as with anything in the financial arena, it is possible for companies to attempt to characterize as a reorganization a transaction that is simply a dividend. This is why the U.S. Treasury has promulgated page after page of regulations and hypothetical examples that establish the boundaries for what will qualify as a tax-free reorganization. *See* 26 C.F.R. § 1.355-2. Taking their cue from the U.S. Treasury, Texas courts should closely scrutinize any transaction that purports to be a spin-off.

E. Split-Offs and Split-ups.

A split-off is a form of reorganization in which some or all of the shareholders of a parent corporation surrender their shares in return for shares of a subsidiary of the parent. *See* BORIS I. BITTKER and JAMES S. EUSTICE at 11-6. Viacom Inc.'s 2004 split-off of the shares it held in Blockbuster, Inc. is a good example of a split-off. Viacom's shareholders exchanged a portion of their shares for shares of Blockbuster. *See* http://www.secinfo.com/d14D5a.14Wgb.htm#1stPage (Sept. 10, 2010). A split-up, on the other hand, involves the exchange of shares in one or more subsidiaries of a parent corporation for the stock of the parent corporation, resulting in a total liquidation of the parent. *See* BITTKER AND EUSTICE at 11-6. Perhaps the most famous corporate split-up in American history was the split-up of Standard Oil that was ordered by the Supreme Court in 1910. *See Standard Oil Co. of New Jersey v. U.S.*, 221 U.S. 1 (1910). Standard Oil split into thirty-four separate companies. *Id.* Both split-offs and split-ups involve an exchange of shares, and both are treated as tax-free exchanges under the Internal Revenue Code of 1986 provided they meet the requirements of 26 U.S.C.A. §355. *See* BITTKER AND EUSTICE at 11-5 – 11-6. In the case of a split-off, shares of the parent corporation are exchanged for shares of the subsidiary. *Id.* And in a split-up, shares of the liquidating parent corporation are exchanged for shares of one or more subsidiaries. The receipt of shares in exchange for shares previously held that occurs in both split-offs and split-ups is directly analogous to the shares received by the husband in *Horlock* as a result of the merger of his separate property company into another company. In all three instances, there is a mutation in form of the

parent's shares. Therefore, the shares received in exchange for the parent's shares take the character of the parent's shares. *See Horlock*, 533 S.W.2d at 60. The same logic that applies to the receipt of shares as a result of a split-off or split-up would apply to similar transactions involving other forms of entities.

VII. REIMBURSEMENT CLAIMS.

Reimbursement claims can arise between estates as a result of both the operations of closely held entities and the acquisition of these entities.

A. Sole Proprietorships.

As discussed above, establishing a separate property claim with respect to the assets of a sole proprietorship can be difficult. However, establishing a reimbursement claim for the inventory held by a proprietorship on the date of marriage presents an easier alternative. An early example of this can be found in the 1889 Texas Supreme Court case of *Schmidt v. Huppman*, 11 S.W. 175 (Tex. 1889). In *Schmidt*, the husband was a merchant who owned a stock of goods at the date of marriage with a value of $2,000. His wife subsequently died, and the husband asserted a $2,000 reimbursement claim against the community estate for the value of his separate property goods that were sold and benefitted the community. The Supreme Court held that the husband was entitled to reimbursement for the value of his separate property merchandise that was sold for the benefit of the community.

B. Funds Expended to Benefit a Separate Estate Entity.

More commonly however, a claim for reimbursement is brought by the community estate for funds expended for the benefit of a separate property interest held by a spouse in a closely held entity. This occurs when funds are transferred to an entity as additional contributions of capital, but with no increase in ownership. This is especially common in limited partnerships that are organized for purposes of the development of either real estate or natural resources. Of course, contributions to capital must be distinguished from payments that are in the nature of a loan, which represent a community asset and are not subject to the rules regarding offset for benefits received. Obviously, the community's burden at trial will be much less if funds advanced to an entity can be shown to be a loan, and not a contribution to capital.

There are numerous examples of reimbursement claims asserted for contributions to partnerships. In *Jacobs*, the Houston court of appeals upheld the trial court's award of a $21,000 reimbursement claim for contributions made by the husband to his separate property real estate partnership. *Jacobs*, 687 S.W.2d 759 (Tex. App.—Houston [14th Dist.] 1984, rev'd on other grounds (687 S.W.2d 731 (Tex. 1985)). Similarly, in *Horlock*, the husband owned separate property stock, and he expended community funds for the "maintenance" of the stock. *Horlock*, 533 S.W.2d at 60. No indication is given as to the purpose of the payments to the corporation, but presumably they were reported on the books of the company as additional paid-in-capital, and not as a loan. The Houston court of appeals held that the community estate was entitled to reimbursement from the husband's separate estate in the amount of the funds expended for "maintenance" of his separate property stock. *Id*.

C. Professional Fees Paid in Conjunction with Acquisition of an Interest.

Reimbursement claims can also arise as a result of professional or other fees that are paid from community funds and that are related to the acquisition of shares purchased using separate property funds of a spouse. The stock is characterized as the separate property because it was purchased with separate property, even though the professional fees were paid with community funds. For example, in a Houston case, professional fees of approximately $30,000 were paid from community funds to acquire shares of stock that were the husband's separate property. *Jacobs*, 687 S.W.2d at 763. The trial court awarded the community estate reimbursement for the funds expended by the husband to pay these fees, and this was upheld by the court of appeals.

D. Offsetting Benefits Received.

In that same opinion, however, the court of appeals upheld the trial court's failure to award the community reimbursement for amounts expended for repairs and improvements the wife made to her separate property real estate. The Houston court of appeals upheld the trial court on the basis that the husband had failed to show that the community estate had not received any offsetting benefit. There is no mention by the court of appeals in *Jacobs* of the requirement for proving there were no offsetting benefits to the community with respect to the contributions made to husband's corporation and partnership. However, *Jacobs* was decided prior to the Supreme Court's decision in *Penick v. Penick,* 783 S.W.2d 194 (Tex. 1988).

Prior to the Texas Supreme Court's decision in *Penick*, the law was unsettled as to whether the lack of an offsetting benefit had to be demonstrated in a claim for reimbursement for payment of expenses benefitting another estate. Before, *Penick*, the courts of appeal drew a distinction between reimbursement for capital improvements versus payment of purchase

money debt, requiring proof that there was no offsetting benefit for the former but not for the latter. The Texas Supreme Court ruled in *Penick* that lack of an offsetting benefit had to be shown in both instances in order for a marital estate to be awarded a reimbursement claim. The requirement to prove that no offsetting benefit has been received has undoubtedly impacted community reimbursement claims for contributions made to business entities. To the extent that income is received from an entity, then any claim for reimbursement will be reduced.

E. Payment of Taxes on Income from Pass-Through Entities.

Another area that is fertile grounds for establishing reimbursement claims are taxes owed by a partner on partnership income or a shareholder on Subchapter S income of a corporation. For federal income tax purposes, neither a partnership nor a Subchapter S corporation is a taxable entity, but rather are "pass-through" entities. *See* 26 U.S.C.A. §§ 701 and 1366.[6] In a "pass-through" entity, the Internal Revenue Code "looks through" the entity to tax the owners directly on entity income. The effect of this is that the income, gains, losses, credits, etc. generated by the entity are reported on the personal income tax returns of the partners or shareholders. Even if absolutely no income is distributed by a pass-through entity, the owners will have to pay taxes on their pro rata share of income. There is therefore a disconnect between distributions to the partners/shareholders and the taxes paid on partnership or Subchapter S income. The former is totally unrelated to the latter. Upon divorce or death, this disconnect could be the basis for a reimbursement claim by the community estate for taxes paid on income that has been retained by the partnership or Subchapter S corporation. By way of example, if a spouse holds a separate property interest in a family limited partnership that fails to make any distributions to its partners, then that spouse will presumably be paying taxes on that undistributed income from community funds. The community estate would have a reimbursement claim to the extent that taxes owed on partnership income exceed the distributions from the partnership, which in this example would amount to the entire amount of the taxes paid.

An example analogous to this is found in *Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.—Dallas 1987, writ ref'd n.r.e). In that case, the husband held a separate property partnership interest, and federal income taxes were paid by the partnership directly to the U.S. Treasury on behalf of the husband. Because taxes owed prior to marriage were paid from partnership income that accrued during the marriage, the wife asserted a community claim for reimbursement for the taxes paid by the partnership. The trial court denied the wife's reimbursement claim with respect to the tax payments, but the court of appeals remanded the case back to the trial court for a determination on the community estate's reimbursement claim with respect to the payment of the Husband's pre-marital income taxes. *Id*. at 596. If the tax payments related to income received prior to marriage, there would be no offsetting benefit to the community.

F. Payments from Entities for the Benefit of the Community.

In a case considered by the Waco court of appeals, the husband asserted a reimbursement claim for community liabilities paid by his separate property corporation, which the trial court had held was his alter ego. *See Brooks v. Brooks*, 612 S.W.2d 233 (Tex. Civ. App.—Waco 1981, no writ) The husband in *Brooks* was able to prove the amount of his claim simply by showing that his corporation had distributed both all current income and a portion of retained earnings held by the corporation as of the date of marriage. The trial court calculated the reimbursable amount by subtracting the net equity of the corporation as of the date of divorce from the net equity of the corporation as of the date of marriage. The judgment recited that the sum of $48,020.88 "represents the loss in corporate assets suffered by the corporation during the marriage and used for the purchase and payment of the community assets now owned by the parties." *Brooks*, 612 S.W.2d at 237. The court of appeals upheld the trial court's award. Obviously, this approach will not work if there is a book loss in any of the years of the marriage.

[6] By default, limited liability corporations are also treated as pass-through entities under the Internal Revenue Code. A single-member LLC is treated as a sole proprietorship (i.e., a disregarded entity), and a multiple-member LLC is treated as a partnership. However, any LLC can elect to be treated as an association taxable as a corporation or an S corporation. *See* 26 C.F.R. § 301.7701-3.

EFFECT OF CHOICE OF ENTITIES:

HOW ORGANIZATIONAL LAW, ACCOUNTING, AND TAX LAW FOR ENTITIES AFFECT MARITAL PROPERTY LAW

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TABLE OF CONTENTS

I. INTRODUCTION. 1

II. STATUTES GOVERNING ENTITIES. 1

III. FEATURES OF DIFFERENT TYPES OF BUSINESS ENTITIES. 2
A. CORPORATIONS. 2
1. Formation. 4
2. Ownership. 5
3. Management. 6
a. Shareholders. 6
b. Board of Directors. 6
c. Officers. 7
d. Close Corporations. 7
e. Ultra Vires. 7
f. Receiver. 7
4. Books and Records. 7
5. Assets and Liabilities. 8
6. Contributions/Distributions. 8
7. Accounting/Financial Reporting. 9
8. Tax Reporting. 11
a. C-Corporations. 11
b. S-Corporations. 11
9. Dissolution. 12
10. Marital Property Issues. 14
a. Acquisition of Shares. 14
b. Mutations. 15
c. Redemptions. 15
d. Corporate Distributions. 15
e. Loans to Shareholders. 16
f. Disposition Upon Divorce. 17
g. Piercing the Corporate Veil. 17
11. Valuation. 17
B. GENERAL PARTNERSHIPS. 18
1. Formation. 19
2. Ownership. 19
3. Management. 23
4. Books and Records. 23
5. Assets and Liabilities. 23
6. Contributions/Distributions. 24
7. Accounting/Financial Reporting. 26
8. Tax Reporting. 26
9. Dissolution. 27

Effect of Choice of Entities

10. Marital Property Issues. 29
a. Ownership Rights. 29
b. Specific Partnership Assets. 29
c. Distributions. 29
d. Partnership Interest. 31
e. Transferee's Interest. 32
f. Capital Calls. 32
g. Spousal Joinder. 32
h. Phantom Income. 33
11. Valuation. 33
C. LIMITED PARTNERSHIPS. 34
1. Formation. 35
2. Ownership. 35
Admission of Partners. 35
Contributions. 36
Interest Does not Include Specific Partnership Assets. 36
Date of Acquisition. 36
Classes. 36
Assignment. 36
Withdrawal. 36
3. Management. 37
4. Books and Records. 37
5. Assets and Liabilities. 37
6. Contributions/Distributions. 38
7. Accounting/Financial Reporting. 38
8. Tax Reporting. 38
9. Dissolution. 38
10. Marital Property Issues. 39
a. Ownership Rights. 39
b. Distributions. 39
c. Assignee's Interest. 39
d. Family Limited Partnerships. 39
11. Valuation. 40
D. LIMITED LIABILITY PARTNERSHIPS. 40
1. Formation. 41
2. Ownership. 41
3. Management. 41
4. Books and Records. 41
5. Assets and Liabilities. 41
6. Accounting/Financial/Tax Reporting. 42
7. Dissolution. 42
8. Marital Property Issues. 42
9. Valuation. 42
E. LIMITED LIABILITY COMPANIES. 43
1. Formation. 43
2. Ownership. 43

Effect of Choice of Entities

3. Management. 44
4. Assets and Liabilities. 44
5. Contributions/Distributions/Allocations of Profits and Losses. 44
6. Accounting/Financial/Tax. 45
7. Dissolution. 45
8. Marital Property Issues. 45
9. Valuation. 45

F. PROFESSIONAL CORPORATIONS. 45
1. Formation. 46
2. Ownership. 46
3. Management. 46
4. Liability. 46
5. Dissolution. 46

G. PROFESSIONAL ASSOCIATIONS. 46
1. Formation. 47
2. Ownership. 47
3. Management. 47
4. Assets and Liabilities. 47
5. Dissolution. 47
6. Division. 47
7. Valuation. 48

H. SOLE PROPRIETORSHIP BUSINESSES. 48
1. Beginning Assets. 48
2. Profits. 48
3. Accounting/Financial/Tax Reporting. 49
4. Dissolution. 49
5. Marital Property Issues. 49
6. Valuation. 49

I. EXPRESS TRUSTS. 50
1. Formation. 50
2. Ownership. 51
3. Management. 51
4. Assets and Liabilities. 52
5. Accounting/Financial Reporting. 52
6. Tax Reporting. 53
7. Termination. 53
8. Marital Property Issues. 53
a. Married Settlor. 54
b. Married Trustee. 54
c. Married Beneficiary. 54
9. Valuation. 56

IV. SOURCES OF INFORMATION. 57
A. SECRETARY OF STATE. 57
B. STATE COMPTROLLER. 57
1. Texas Franchise Tax Public Information Report. 58

Effect of Choice of Entities

2. Franchise Tax Report. 58
3. Sales & Use Tax Report. 58
C. LOCAL RECORDS. 58
1. Appraisal District Records. 58
2. Assumed Name Certificates. 58
3. Deeds and Deeds of Trust. 59
4. Court Records. 59
5. Abstracts of Judgment. 59
D. LICENSES. 59
E. ACCOUNTING/FINANCIAL RECORDS. 60
F. FEDERAL TAX RETURNS. 60
1. U.S. Individual Income Tax Return (Form 1040). 60
a. Schedule C--Sole Proprietorship Information. 60
b. Schedule E. 60
c. Schedule F. 60
2. U.S. Fiduciary Income Tax Return (Form 1041). 60
3. U.S. Partnership Income Tax Return (Form 1065). 60
4. U.S. Income Tax Return for an S-Corporation (Form 1120S). 60
5. U.S. Corporation Income Tax Return (Form 1120). 61
G. EMPLOYEES/FORMER EMPLOYEES. 61
H. INDUSTRY INFORMATION. 61
I. SEC FILINGS. 63
J. PATENTS AND TRADEMARKS. 63

V. IMPORTANT CONCEPTS REGARDING ENTITIES. 63
A. EARNINGS. 63
B. OWNER'S EQUITY/CAPITAL/RETAINED EARNINGS. 63
C. CAPITAL CONTRIBUTIONS. 65
1. Legal Aspects. 65
2. Accounting Aspects. 66
3. Tax Reporting Aspects. 66
D. DIFFERENCES IN TAX TREATMENT. 66
1. Two Ways of Taxing Corporations. 66
2. Timing Issue With S-Corporations. 67
E. SUBSIDIARY/AFFILIATE. 69
1. Subsidiaries. 69
2. Affiliates. 69
3. Accounting Aspects of Subsidiary/Affiliates. 70
3. Tax Aspects of Subsidiary/Affiliates. 70
F. MERGER. 71
1. Legal Aspects. 71
2. Accounting Aspects. 71
3. Tax Aspects. 72
G. CONVERSION. 72
1. Legal Aspects. 72
2. Accounting Aspects. 73

Effect of Choice of Entities

3. Tax Aspects. 73
H. SPIN-OFF. 73
1. Legal Aspects. 73
2. Accounting Aspects. 73
3. Tax Aspects. 73
I. SHARE EXCHANGE. 74
1. Legal Aspects. 74
2. Accounting Aspects. 75
3. Tax Aspects. 75
J. ASSET SALE. 75
1. Legal Aspects. 75
2. Accounting Aspects. 75
3. Tax Aspects. 75
K. CONSOLIDATED REPORTING. 76
1. Accounting Aspects. 76
2. Tax Aspects. 76
L. ATTORNEY-CLIENT PRIVILEGE. 76
M. REPRESENTING BUSINESS ENTITIES. 77
N. DISCOVERY OF ENTITY RECORDS. 78
O. SELF INCRIMINATION. 79

VI. VARIOUS MARITAL PROPERTY AND DIVORCE-RELATED ISSUES. 79
A. ACQUIRING AN OWNERSHIP INTEREST. 79
1. Formation Versus Acquisition of Interest. 79
2. Acquisition of Interest vs. Inception of Title. 79
3. Subsidiary. 79
B. INITIAL VERSUS SUBSEQUENT CAPITAL CONTRIBUTION. 79
1. Capital Contributed in Exchange for Ownership Interest. 79
2. Capital Contributed Without Acquiring More Ownership. 80
3. Using Community Credit for Business Loans. 80
C. RETAINED EARNINGS. 81
D. MUTATIONS OF OWNERSHIP INTEREST. 81
E. TRACING INSIDE AN ENTITY. 82
F. PIERCING THE ENTITY. 83
G. DISTRIBUTIONS OF PROFITS AND CAPITAL. 84
H. IRC SECTION 1041. 87
I. REDEMPTION OF INTEREST. 88
J. LIQUIDATION. 90
1. Complete Liquidation. 90
2. Partial Liquidation. 90
3. Tax Aspects of Complete and Partial Liquidations. 92
K. RECEIVERSHIPS. 93
L. CO-OWNERSHIP AFTER DIVORCE. 94

VII. VALUATION ISSUES. 96
A. MEASURES OF VALUE (THE LEGAL PERSPECTIVE). 96

Effect of Choice of Entities

B. MEASURES OF VALUE (THE ACCOUNTING PERSPECTIVE). 97
C. TANGIBLE VERSUS INTANGIBLE ASSETS. 99
D. VALUING "PASS THROUGH" ENTITIES. 99
E. GOODWILL. 100
1. The Legal Aspect of Goodwill. 100
a. The Legal Definition of Goodwill. 100
b. Goodwill in Texas Commercial Cases. 102
c. Goodwill in a Texas Divorce. 102
2. The Accounting/Tax Concept of Goodwill. 104
3. The Business Valuation Concept of Goodwill. 105
F. RESTRICTIONS ON TRANSFERS OF OWNERSHIP INTERESTS. 105
1. The Legal Perspective. 105
2. The Practical Perspective. 106

VIII. 10,000 FOOT VIEW OF THE COUNTRYSIDE. 107

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Effect of Choice of Entities

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State Bar of Texas, *27th Annual Advanced Family Law Course*, August 2001, "Valuation of Business Interests - Addressing Common Errors" (co-authored with John E. Camp, CPA/ABV, CFA) and "Valuation of Business Interests in Divorce" panel discussion (presented with J. Kenneth Huff, CPA/ABV, CVA and Milton N. Frankfort; moderated by Richard R. Orsinger, JD)

American Bar Association *Family Law Quarterly*, Volume 5, Number 2, Summer 2001, "Valuation Basics and Beyond: Tackling Areas of Controversy" (co-authored with John E. Camp, CPA/ABV, CFA)

American Academy of Matrimonial Lawyers, *Mid-Year Meeting*, March 2002, "Valuation Issues Related to 'Hard to Value' Entities"

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Effect of Choice of Entities

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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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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)

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State Bar of Texas, *Advanced Family Law Drafting Course*, December 2005, "Tax Considerations and Drafting" (co-authored with Cynthia Phuong Nguyen, CPA, JD)

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Effect of Choice of Entities

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Effect of Choice of Entities

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- 1987 Advanced Family Law Course

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)

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

Effect of Choice of Entities

Litigation: Restitution/Unjust Enrichment (2006); The Law of Interpreting Contracts (2007)

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)

CURRICULUM VITAE OF STEPHEN M. ORSINGER

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CLE Articles

The Ethics of ADR Negotiation and Settlement (co-authored with Hon. Frances Harris)
Marriage Dissolution Institute, Galveston, 2008

Effect of Choice of Entities: How Organizational Law, Accounting, and Tax Law for Entities Affect Marital Property Law (co-authored with Richard R. Orsinger and Patrice L. Ferguson)
Advanced Family Law Course, San Antonio, 2008

EFFECT OF CHOICE OF ENTITIES: HOW ORGANIZATIONAL LAW, ACCOUNTING, AND TAX LAW FOR ENTITIES AFFECT MARITAL PROPERTY LAW

Patrice L. Ferguson
Richard R. Orsinger
Stephen M. Orsinger

I. INTRODUCTION. This article addresses entities you may encounter in family law cases: what they are, how they differ, accounting and tax treatment, and marital property issues. The entities include: corporations, general partnerships, limited partnerships, limited liability partnerships, limited liability companies, professional corporations, professional associations, sole proprietorships, and trusts. The differences between entities can be confusing and this confusion can be compounded when an entity of one kind has an ownership interest in an entity of a different kind. Additionally, an entity of one kind can be merged into or converted to an entity of another kind. The effects of entity law on marital property law is an area of great difficulty. Most of the entity-related transactions encountered by family lawyers were designed and drafted by transactional attorneys who were focused on a business purpose or a tax purpose, and community property law was furthest from their minds.

The complexities of entity law are both illuminated and obscured when you mix in accounting, financial reporting, and tax reporting, for the different kinds of entities. These accounting and tax reporting practices were developed with little awareness of or concern for marital property law. And yet many divorces can become embroiled in arguments based on the way transactions were "booked" or reported by an accounting or tax professional who was not contemplating the effects that his/her accounting or reporting might have on separate and community property claims in a later divorce.

Two good reference sources for the variety of entities are articles by attorney Byron F. Egan, *Choice of Entity Tree After Margin Tax and Texas Business Organizations Code*, 42 TEX. J. OF BUS. LAW 71 (Spring 2007) (Egan, "Choice of Entity Tree") [available on Westlaw at 42 TXJBL 71], and Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer*, 37 S.D. L. Rev. 44 (1991/1992) ("Geu").

This article was written by Richard R. Orsinger, assisted by Stephen M. Orsinger. Patrice Leigh Ferguson, a CPA/attorney with Ferguson Camp Poll in Houston, contributed various accounting, tax and forensic comments to this Article. These are identified as "[Comments by PLF]." Ms. Ferguson is not responsible for the legal analysis outside of the identified areas. The Authors wish to acknowledge and thank Diane Wiles, paralegal at McCurley, Orsinger, McCurley, Nelson & Downing, LLP, for her many tireless hours making many rounds of edits from the three authors.

II. STATUTES GOVERNING ENTITIES. Many business entities you encounter in family law practice will be Delaware entities, or entities that were formed in other states. Non-Texas law is not covered by this article.

If you have a case involving a Delaware entity, a good (but somewhat dated) comparison of Texas to Delaware corporate law is Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation–Texas Versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. REV. 249 (Winter 2001) ("Egan & Huff"). In determining which state's law to apply, under the "internal affairs doctrine," the law of the jurisdiction of organization applies to rights and responsibilities of directors, officers and shareholders. *See* Thomas E. Rutledge, *To Boldly Go Where You Have Not Been Told You May Go: LLCS, LLPS, and LLLPS in Interstate Transactions*, 58 BAY. L. REV. 105, 213 (2006) ("Rutledge"); the Texas Limited Liability Company Act art. 7.02 (applying the internal affairs doctrine to foreign companies). The Restatement (Second) of Conflict of Laws says that shareholder liability is governed by the laws of the jurisdiction of organization. *See* Rutledge, at 231. Nonetheless, a shareholder domiciled in Texas would be subject to the marital property rules of this State. Tex. Fam. Code § 1.103; *Legrand-Brock v. Brock*, 246 S.W.3d 318, *1 (Tex. App.--Beaumont 2008, pet. denied) (applying Texas marital property law to Texas shareholder of Delaware corporation). But the susceptibility of an entity to "piercing," or the powers the divorce court may have in awarding an interest in an entity chartered in another state, do not fall into neat categories. Depending on the issue, the question of which state's law to apply to a particular issue in a divorce can be problematic.

Texas has a comprehensive statute for "domestic entities" called the Texas Business Organizations Code ("TBOC"). The TBOC was enacted in 2003 and became effective on January 1, 2006. It governs the full range of domestic entities that are created on or after January 1, 2006. Domestic entities created prior to January 1, 2006, continue to be governed by prior law unless they elect to be covered by the TBOC. However, on January 1, 2010, the old laws become ineffective and the TBOC will apply to all domestic entities. Since most of the business transactions you are likely to encounter in your practice at this time will have occurred prior to the TBOC, the prior business organization statutes which continue in effect for most pre-2006 entities will be discussed, and the terminologies of the previous statutes will be used in this article.

III. FEATURES OF DIFFERENT TYPES OF BUSINESS ENTITIES.

A. CORPORATIONS. The idea of a business enterprise with a legally-recognized existence separate from its owners was developed in ancient Rome, as a way for Roman Senators to circumvent a prohibition against public officials engaging in commerce during their tenure in office. Amir Aaron Kakan, *Evolution of American Law, From Its Roman Origin to the Present*, 48 Orange County Lawyer 31 (February 2006) [available on Westlaw at 48-FEB OCLAW 32]. Caesar Augustus decreed that only the Senate could create and regulate corporations, and provided further that corporations could own property and enter into contracts. *Id.* The existence of modern corporations is traced back to Stora Kopparberg, chartered in 1347 by King Magnus Eriksson IV of Sweden to mine copper from a lode in central Sweden. Two centuries later, publicly-held joint-stock corporations (called "chartered companies") were formed in connection with the challenges of undertaking international trade in the 16-17th centuries. The first of these "modern" entities, the English East India Company (1600), and the second, the Dutch East India Company (1602), were formed to develop commercial

opportunities in India and the Near East. Timur Kuran, *The Absence of the Corporation in Islamic Law: Origins and Persistence*, 53 AM. J. COMP. L. 785, 808-08 (2005). The Dutch East India Company was a big success, providing an annual return of 18 percent on its original capital during its existence from 1602 to 1796. Niall Ferguson, EMPIRE: THE RISE AND DEMISE OF THE BRITISH WORLD ORDER p. 15 (2002). The Virginia Company, chartered in 1606 to colonize Virginia, successfully founded the community of Jamestown, the first permanent English settlement in North America, but the joint stock company was unable to return a profit, so it was dissolved in 1624 and replaced by a Royal colony. The oldest American corporation is Harvard College, founded in 1636.

The Dutch East India Company was the first "corporation" to actually issue shares, which it did on the Amsterdam Stock Exchange in 1602. The first stock exchange in London was established in 1688. It is no coincidence that modern corporations developed in tandem with the rise of capital as an important form of wealth. Corporations were a vehicle for businessmen to raise large amounts of money for long-term, uncertain projects from investors who wanted no part of management but were willing to risk the amount of their investment, with no personal liability, in hopes of extraordinary profits. The concomitant rise of stock markets in the 1600s added the ready ability of owners to liquidate their investment by selling their shares, thus assuring the corporation success as a vehicle for large-scale business enterprise.

In nineteenth century America, the use of corporations was dampened by the requirement that the corporation be chartered by the legislature, as well as the prevalence of safeguards for investors who had been badly abused by unscrupulous promoters, so that in the 1800s the captains of industry chose other vehicles to build business conglomerates. "Andrew Carnegie formed his steel operation as a limited partnership, and John D. Rockefeller set up Standard Oil as a trust" <http://en.wikipedia.org/wiki/Corporations> (last visited 7/16/08). In the late 1800's, New Jersey (1888) and Delaware (1899), picking up on trends from the European continent, recognized the possible revenue that could be derived from attracting corporate business, so they started a trend to liberalize their corporate laws (a process which Justice Louis Brandeis, in *Ligget Co. v. Lee*, 288 U.S. 517, 558-59 (1933), termed a "race to the bottom"). Thus the era of chartered companies was replaced by the era of statutory corporations.

Texas was initially hostile to corporations, as evidenced by the provision in the 1845 Constitution providing that corporations could be created only by the Legislature, upon a supermajority 2/3 vote. Alan R. Bromberg, *Texas Business Organization and Commercial Law–Two Centuries of Development*, 55 SMU L. REV. 83, 86 (2002) ("Bromberg"). Texas' first corporation was chartered by the Republic of Texas in 1836, to connect the Rio Grande and Sabine Rivers by rail and other means, and to establish a bank. *Id*. p. 88. The corporations that were later chartered were often for roads, canals, harbors, and railroads, and carried with them a monopoly and power of eminent domain. *Id.* at 87. In 1874, Texas law was changed to allow corporations to be created upon filing documents with a state official, albeit only for one or more of 27 permitted purposes. *Id.* at 94-95. The 1874 law continued, with some modifications, until Texas corporate law was modernized with the adoption of the Texas Business Corporation Act in 1955. *Id.* at 102.

Effect of Choice of Entities

A corporation is an artificial legal entity (i.e., "corporate fiction") recognized as having an existence separate and apart from its owners, managers, and employees. A corporation is, in many respects, treated in law as a living person, and courts have even afforded corporations certain constitutional rights. *See, e.g.*, *United States v. Martin Linen Supply Co.*, 430 U.S. 564, 97 S.Ct. 1349, 51 L.Ed.2d 642 (1977) (corporation protected by Fifth Amendment Double Jeopardy Clause); *G. M. Leasing Corp. v. United States*, 429 U.S. 338, 353, 97 S.Ct. 619, 628, 50 L.Ed.2d 530 (1977) (corporation protected by Fourth Amendment search and seizure clause); *First Nat. Bank of Boston v. Bellotti*, 435 U.S. 765, 98 S.Ct. 1407 (1978) (recognizing corporation's right to free speech, but saying that "purely personal" constitutional protections do not apply to corporations); *Austin Nat. Bank of Austin v. Sheppard*, 123 Tex. 272, 71 S.W.2d 242 (1934) (recognizing a constitutional right for a corporation under the Texas constitution). Key components of a corporation include (i) a legal identity separate from its owners; (ii) a duration not dependent on continuity of ownership; (iii) owners owing interests (shares) that are transferrable; (iv) no personal liability of shareholders for corporate debt; and (v) centralized management different from the owners.

1. Formation.

Creation. In Texas, a corporation is created by the state, upon the filing of articles of incorporation with the Texas Secretary of State and payment of a fee. *See* Tex. Bus. Corp. Act ("TBCA") art. 3.03. The articles of incorporation must be signed by one or more incorporators. TBCA art. 3.01. Incorporators are not necessarily owners, and not infrequently the incorporator is the attorney who handles the incorporation. Upon filing the articles of incorporation and payment of fees, the Secretary of State will issue a certificate of incorporation, stating the date the corporation came into existence. TBCA art. 3.03. Corporations can also be created by merger or conversion, subject to similar filing requirements. *See* sections V.F and V.G *infra*.

De Facto. A corporation that is created by the state upon the filing of articles of incorporation is said to exist *de jure*. A corporation may also exist *de facto*. A de facto corporation is "an organization of persons intending in good faith to form a corporation under a permissive statute, but failing to comply with one or more of its provisions [who], nevertheless exercised some of the powers of a de jure corporation." *Payne v. Bracken*, 90 S.W.2d 607, 609 (Tex. Civ. App. 1936), *aff'd*, 131 Tex. 394, 115 S.W.2d 903 (1938). The test for whether a de facto corporation exists are: (1) a colorable corporate organization; (2) a statute authorizing the proposed corporation; (3) a user of corporate powers; and (4) good faith in the transactions. *Id.*; *see also Wilson v. Reed*, 74 S.W.2d 415, 416 (Tex. Civ. App.–Waco 1934, no writ).

Estoppel. Another way for a court to recognize the existence of a corporation is through the doctrine of "corporation by estoppel." Under this theory, a party who deals with an entity as if it was a corporation, when that entity is not in fact incorporated, is estopped from asserting that the organizers or putative shareholders are personally liable to that party. *See Payne v. Bracken*, 90 S.W.2d 607 (Tex. Civ. App.–Dallas 1936), *aff'd*, 115 S.W.2d 903 (1938); *Cavaness v. General Corporation*, 272 S.W.2d 595 (Tex. Civ. App.–Dallas, 1954), *aff'd*, 283 S.W.2d 33 (1955). No case applying this doctrine can be found subsequent to the codification of the TBCA and the doctrine really accomplishes

just a limitation of liability as to the estopped party.

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 and accountants 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 $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.

2. Ownership. A corporation is owned by shareholders who own shares of the corporation. TBCA art. 1.02A(23). Ownership interests are usually reflected by “share certificates,” sometimes called “stock certificates” or “stocks,” although uncertificated shares are allowed. TBCA art. 2.19. However, ownership can still 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. The consideration to be received by the corporation in exchange for its shares is set by the board of directors, or in the plan of merger or plan of conversion. TBCA art. 2.15. 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. 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. 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 is reflected in the corporation’s Balance Sheet, and on Schedule L of the corporation’s tax return, which reports the corporation’s balance sheet.

[Comment by PLF:] Typically, for financial reporting purposes, the par value paid for shares of stock is reflected as capital and amounts in excess of par value are "paid-in capital." *See* Section V.B *infra*.

Shares of a corporation are personal property that is transferrable under the terms of UCC Chapter 8 (Investment Securities). TBCA art. 2.22A. The transfer of shares can be restricted in the articles of incorporation, by-laws, or written agreements among shareholders. TBCA art. 2.22D. Such restrictions should be reflected on the share certificate. TBCA art. 2.22C.

Some corporations have different classes of shares. Typically the principal voting stock is called “Class A” stock. “Class B” stock typically has fewer or no voting rights. “Common stock” is distinguished from “preferred stock” in that preferred stock is usually issued to

investors who have a preference or superior right to receive dividends or to receive proceeds upon liquidation of the corporation, as compared to owners of common stock.

A shareholder can terminate ownership by transferring the shares to another person or entity. The corporation also can "redeem" shares by paying the shareholder for the shares. TBCA art. 4.08. Upon redemption, the shares may be cancelled. Redemption effects a reduction of "stated capital" of the corporation by the amount of stated capital represented by the shares redeemed. TBCA art. 4.10. If the shares are not cancelled and are instead placed in the treasury, they are available for reissuance. In either event, owners' equity is reduced. A reduction in capital resulting from the redemption of shares causes the percentage ownership interest of the other shareholders to increase, although no new shares were acquired. See the discussion of redemptions in section VI.I *infra*.

3. Management. Generally, in a corporation, shareholders elect directors who hire executive officers who run the business. Basic rules of corporate governance are dictated by the TBCA, or are set out in by-laws adopted by the board of directors, TBCA art. 2.23, or shareholder agreements. TBCA art. 12.32 permits shareholders of close corporation to unanimously adopt shareholder agreements for corporations whose shares are not traded on an exchange.

Minority shareholders have limited recourse to the courts when dissatisfied with management. While management owes a fiduciary duty to shareholders, the traditional way of enforcing this right is by a shareholder derivative suit. This remedy is burdened with "obstacles almost impossible to overcome." Bromberg, at 119-121. *See* TBCA art. 5.14.

a. Shareholders. The corporation is supposed to hold annual meetings of the shareholders, although the failure to do so does not dissolve the corporation. TBCA art. 2.24B. Special shareholders meetings can also be called. TBCA art. 2.24.

Unless the articles of incorporation provide differently, each outstanding share, regardless of class, is entitled to one vote on each matter submitted for action at a shareholder meeting. TBCA art. 2.29A. Shareholders are also by law entitled to vote, by class, on amendments to the articles of incorporation, mergers and share exchanges that impact the class, and on corporate dissolution. TBCA arts. 5.03F(1), 5.03F(2), 6.03A(3).

Shares can be subject to voting trusts and other allocations of the right to vote the shares. *See* TBCA art. 2.30 (Voting Trusts and Voting Agreements), art. 2.30-1 (Shareholder Agreements). Shareholder agreements can also alter or restrict the normal management of the corporation. TBCA art. 2.30-1.

TBCA art. 9.10A permits the shareholders and directors to act through unanimous consents instead of meetings. The articles of incorporation can authorize shareholders' written consents that are less than unanimous.

b. Board of Directors. The Board of Directors manages the affairs of the corporation. TBCA art. 2.31. The names of the initial members of the board of directors are stated in the articles of incorporation. TBCA art. 2.32A. Thereafter, the directors are elected by the shareholders at annual meetings. *Id.* The board of directors can conduct business through committees, except in certain instances. TBCA art. 2.36. After the Secretary of State issues a certificate of incorporation, the board of directors must conduct its initial

meeting. TBCA art. 3.06.

TBCA art. 9.10B permits the directors to act through unanimous consents instead of meetings.

c. Officers. The officers are responsible for managing the operations of the corporation. The TBCA prescribes that a corporation is only required to have a president and secretary, although other official positions may be created by the corporation's bylaws. TBCA art. 2.42. The president and secretary must be elected by the Board of Directors, but all other officers may be either elected or appointed in any manner set out in the bylaws. *Id.* The purview of the officer's control over the corporation is not regulated by the TBCA, but is instead determined by the bylaws. The Sarbanes-Oxley Act section 302, 15 U.S.C.A. § 7241, imposes further duties on the executive and financial officers of a corporation which is registered on a national securities exchange and required to file periodic reports with the SEC under the Securities Exchange Act. *See* 15 U.S.C.A. § 7241; *see also* 15 U.S.C.A. §§ 78m, 78o(d). These requirements include the duty to review those periodic reports and verify that the financial data contained therein are accurate and the duty to establish internal controls to prevent fraud. *See* 15 U.S.C.A. § 7241(a). Any officer may be removed by the Board of Directors at their discretion. TBCA art. 2.43.

d. Close Corporations. Close corporations were introduced to Texas by adoption of a special statute in 1973. Robert W. Hamilton, *Corporations and Partnerships*, 36 SW. L.J. 227, 227-28 (1982). Article 12 of the TBCA now governs close corporations. Close corporations are essentially managed by the shareholders, under rules established primarily in the articles of incorporation or in shareholder agreements. TBCA art. 12.37.

e. Ultra Vires. Corporations are created to accomplish a stated goal or to conduct a stated type of business. When a corporation acts outside of this boundary, it performs an "ultra vires" act. Traditionally an ultra vires act was null and void because it exceeded the powers stated in the articles of incorporation, or went beyond the powers of corporations under the relevant corporate law. Ultra vires is addressed in TBCA art. 2.04, where the doctrine is eliminated as a basis for a claim or defense in law or in equity, except in a few instances involving suits by shareholders and by the attorney general. *See* Stephen J. Leacock, *The Rise and Fall of the Ultra Vires Doctrine in United States, United Kingdom, and Commonwealth Caribbean Corporate Common Law: A Triumph of Experience Over Logic*, 5 DEPAUL BUS. & COM. L.J. 67 (2006).

f. Receiver. A trial court can appoint a receiver for specific corporate assets under TBCA art. 7.04. A district court in the county of the corporation's registered office can appoint a receiver to rehabilitate a corporation under TBCA art. 7.05. A district court in the county of the corporation's registered office can appoint a receiver to liquidate the assets and business of the corporation. TBCA art. 7.06.

4. Books and Records. A corporation must keep books and records of account, together with minutes of meetings of shareholder, directors and committee of the board of directors. TBCA art. 2.44. The corporation must also keep a record of all shares issued, and subsequent transfers of those shares. *Id.* A director is entitled to review these documents. TBCA art. 2.44B. Persons who have been shareholders for at least six months, or who hold at least five percent of outstanding

Effect of Choice of Entities

shares, have a right to review these documents. TBCA art. 2.44C. A court may permit other owners or beneficial owners of shares to review these records "upon proof of proper purpose." TBCA art. 2.44E. The corporation must, upon request, mail to shareholders annual statements "showing in reasonable detail its assets and liabilities and the results of its operations." TBCA 2.44F. The corporation must also provide the most recent interim statements that have been filed of public record or otherwise published. *Id.*

5. Assets and Liabilities. Since a corporation has a separate legal identity from the shareholders, all assets of a corporation belong to the corporation and not 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*, 40 Tex. Civ. App. 307, 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.")). TBCA art. 4.01B provides that a shareholder has no vested right resulting from the articles of incorporation.

One of the signature qualities of a corporation is that shareholders are not liable for corporate debts. However, shareholders can be held liable for corporate debts under the equitable doctrine of "piercing the corporate veil." *See Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986). The holding in *Castleberry*, that a complaining party may show either actual or constructive fraud in order to prove that a corporation had been used as a sham to perpetrate a fraud, has been limited by TBCA art. 2.21A(1) & (2) as to contract creditors, effective August 28, 1989. Piercing the corporate veil based on "failure of the corporation to observe any corporate formality" has been eliminated as to any "obligation of the corporation." *Id.* The statute has been held to be retroactive. *Farr v. Sun World Sav. Ass'n*, 810 S.W.2d 294, 296 (Tex. App.--El Paso 1991, no pet.). The effect, if any, of *Castleberry* and Article 2.21A on piercing the corporate veil in divorce proceedings is still being worked out. *See* Section VI.F *infra*.

6. Contributions/Distributions. Corporations can receive contributions from shareholders at the time of start-up, or later. Consideration for the issuance of shares may consist of "any tangible or intangible benefit to the corporation or property of any kind or nature, including cash, promissory notes, services performed, contracts for services to be performed, other securities of the corporation, or securities of any other corporation or other entity." TBCA art. 2.16.

The board of directors can make distributions to shareholders. TBCA art. 2.38. 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 jetisoned in 1987. Since then under the TBCA, a corporate "distribution" is "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). Such distributions cannot be made if they (i) would render the corporation insolvent or (ii) exceed the surplus of the corporation. TBCA art. 2.38A & B. "Surplus" is defined as "the excess of net assets of a corporation over its stated capital." TBCA art.

Effect of Choice of Entities

1.02A(27). “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). “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). Rules for determining involvency and surplus are set out in TBCA art. 2.38-3.

The board of directors can authorize share dividends. TBCA art. 2.38-1A. However, the corp-oration’s surplus (assets less liabilities and stated capital) must be at least equal to the amount required in art. 2.38-1C to be transferred to stated capital.

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 7/16/08). 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 7/16/08) are not considered to be a share dividend or distribution. TBCA art. 2.38-2. 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).

7. Accounting/Financial Reporting. [Entire section provided by PLF]

a. Underlying all financial information from the standpoint of generally accepted accounting principles (GAAP) is the concept of "historical costs." That is, accountants record transactions at their costs. This is true of most assets recorded on the books.

There are some situations where market value may be affected by the way assets were recorded, as in a last in-first out (LIFO) inventory discussed below. Particular emphasis should be taken in the area of investments (debt and equity securities), potential intangible assets or patents which may be booked at little (or no) cost, but whose fair market value could be much different than cost. In the case of equity securities, most internally prepared financial statements carry these investments at cost. However, CPA-prepared financial statements should carry these investments at fair (market) value and any difference in fair (market) value and cost may or may not be reflected in the income statement, depending on whether the securities are held for investment or resale.

b. There are a number of bases for business accounting. The most typical accounting bases are the cash and accrual basis of accounting. It is important to know which basis of accounting is being used on the financial statements to reflect the results of operations. Federal income tax returns may also be reported on the cash or accrual basis. In the cash basis financial statement, no provision is made for incurred-but-not-paid expenses, nor for

Effect of Choice of Entities

revenues earned but not received. For example, typically a physician's office will record their books and records on a cash basis and it becomes necessary to book the "accrual" for the accounts receivable and work-in-process related to patient production. Once the services have been rendered, a right exists to receive those fees and a proper accrual can be made. The accrual basis of accounting simply records revenues and expenses when the right to receive revenues (that must be measurable) arises and expenses are incurred, even though not paid.

c. Other important bases of accounting concern the treatment of inventory on either a first-in first-out (FIFO) basis, lower-of-cost-or-market, or a last-in first-out (LIFO) basis. These various approaches may affect value in that they cause inventory to be reported on a cost basis which may or may not reflect market value and which may or may carry an unrealized tax liability.

d. Another basis of accounting frequently encountered is generally referred to as "contractor accounting," which includes the percentage-of-completion and the completed contract methods. The two methods will yield the same net results at the end of the contract; however, before completion, the amounts reported on the balance sheet and income statement can be significantly different. Under the percentage-of-completion method, profits are recognized as the contract progresses; whereas, the completed-contract method recognizes no profit until the job is complete.

e. "Book value" is based on assets and liabilities recorded at historical cost. Book value can apply to individual assets or to an entity as a whole. References to book value are often found in provisions of buy-sell agreements as a basis for determining redemption values. But book value doesn't reflect goodwill or other intangible values of the business (except purchased goodwill or under a provision of capitalized costs related to research and development) and may not reflect even the values of assets that can be marked to market. Book value can provide helpful information but it is generally not considered "value" for business valuation purposes.

f. For financial reporting purposes, closely-held businesses may or may not keep books on a GAAP basis, may or may not choose to make relevant disclosures, may or may not include statements of cash flows, depending on the type of financial statements provided. Financial statements can be divided into the following categories”

(1) *Company Prepared Internal Use Only Statements.* These are statements with which an outside CPA has not been associated.

(2) *Compiled Financial Statements.* This is the minimum level of service provided by outside CPAs or accountants with respect to financial statements. Accountants are not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. There is no assurance from the accountants about the accuracy of the information contained in the statements. The accountant reads the statements looking for obvious clerical or accounting principle errors, and may assist in compiling the information in good financial statement format, but no other verification procedures are required to be performed.

(3) *Reviewed Financial Statements.* Reviewed statements involve limited assurance from the accountants that there are no material

modifications that should be made in the statements. The accountant primarily makes inquiries of the company personnel and applies analytical procedures to the financial data. A review of financial statements does not contemplate the study and evaluation of internal accounting control, although certain control and accounting-oriented inquiries are performed.

(4) *Audited Financial Statements.* Audited statements are the most complete and reliable type of statements provided by accountants. The accountant expresses assurance that there are no material modifications that should be made in the statements which are presented in accordance with generally accepted accounting principles, unless specifically noted. The accountants perform inquiry, analytical procedures, compliance tests and, on a "spot check" test basis, examine evidence supporting the amounts and disclosures in the financial statements.

The importance of knowing which type of assurance, if any, is provided by the financial statements is that it informs the evaluator and the attorney of the amount of reliance that they can safely place on the financial information presented in the financial statements.

8. Tax Reporting. From the investor's standpoint, the key tax feature of corporations is double-taxation of income: corporate profits are taxed when earned by the corporation, and corporate profits are taxed again when they are distributed as dividends to the shareholders.

a. C-Corporations. [Comments by PLF:] A C-Corporation is a taxable entity for federal income tax purposes. It is subject to double taxation: once at the corporate level at corporate tax rates, then again on the shareholder's tax returns upon distribution of dividends. Tax rates for corporations for 2007 are reflected in the following chart:

Tax Rate Schedule

If taxable income (line 30, Form 1120) on page 1 is:

Over—	*But not over—*	*Tax is:*	*Of the amount over—*
$0	$50,000	**15%**	$0
50,000	75,000	**$ 7,500 + 25%**	50,000
75,000	100,000	**13,750 + 34%**	75,000
100,000	335,000	**22,250 + 39%**	100,000
335,000	10,000,000	**113,900 + 34%**	335,000
10,000,000	15,000,000	**3,400,000 + 35%**	10,000,000
15,000,000	18,333,333	**5,150,000 + 38%**	15,000,000
18,333,333	- - - - -	**35%**	0

Dividend income is taxable to recipients at their own rates; for example, an individual will report dividends at personal income tax rates.

An eligible C-Corporation may make an S-Corporation election to avoid tax at the corporate level and tax income to the shareholders as a pass-through entity.

b. S-Corporations. Corporations that meet certain qualifications can elect to be taxed 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").

Effect of Choice of Entities

All shareholders must sign the election for Subchapter S treatment (IRS Form 2553). *Id.* at 610.

[Comments by PLF:] The election of S-Corporation status is usually based on the desire to pass through earnings to shareholders but retain the protection afforded under state law for the corporate form of business. It is elected under IRC §1362 by filing a Form 2553 with the IRS.

> 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* 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, Volume764 (2nd ed. 2001). *See* IRC §1368 for taxation scheme.

A S-Corporation election must be signed by all shareholders. An issue can arise where someone thoughtlessly advised a married shareholder whose shares were separate property to have his/her spouse sign the written election, "because Texas is a community property state." Typically the ownership of each spouse will be erroneously reflected on the election at 50%. Some parties will offer this election as proof that the shares are owned half by each spouse.

9. Dissolution. 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.

Voluntary Dissolution. A corporation may be voluntarily dissolved by a majority of its incorporators or directors if the corporation has not issued shares and has not commenced business. TBCA art. 6.01.A. If a corporation has issued shares or commenced business, it may be voluntarily dissolved by corporate act or unanimous shareholder consent. For a corporation to be wound up solely by its shareholders, the decision must be unanimously approved in writing by all shareholders. TBCA art. 6.02. For a corporation to be dissolved by corporate act, the board of directors of the corporation must adopt a resolution recommending dissolution and directing that the issue be submitted to the shareholders who, after being given notice, must also approve dissolution by a two-thirds super majority. TBCA art. 6.03. Equivalent procedures are followed to stop the dissolution process if that decision is revoked. TBCA art. 6.05.

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. TBCA art. 6.04. After the corporation has finished dissolving, articles of dissolution must be filed containing the names of the corporation and its officers and directors, and a statement that the assets of the corporation have been liquidated, all obligations have been discharged, and the remaining assets have been distributed

to the shareholders. TBCA art. 6.06.A.(1)-(5). If the corporation was dissolved by unanimous shareholder consent, the articles must also contain a statement that the consent approving dissolution was signed by all shareholders or their agents. TBCA art. 6.06.A.(6). If the corporation was dissolved by corporate act, the articles must also contain a statement that the resolution was adopted by the shareholders on a specific date, and must indicate the number of shares entitled to vote on the resolution and how many voted for and against it. TBCA art. 6.06.A.(7). A certificate from the Comptroller stating that all taxes have been paid must also be filed. TBCA art. 6.07.A. If the Secretary of State finds that the filings conform to law, s/he will file-stamp the articles and issue a certificate of dissolution. *Id*. The corporation is considered terminated on the date this certificate is issued. TBCA art. 6.07.B.

Involuntary Dissolution. A corporation may be involuntarily dissolved by the action of the state, a minority of shareholders, or its creditors. The Secretary of State may terminate a corporation without court action if it 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. TBCA art. 7.01.B. The Secretary of State must give the corporation notice of its failure to fulfill any of these conditions. TBCA art. 7.01.C(1). When the corporation is involuntarily terminated, the Secretary of State must deliver a certificate of dissolution stating the date of and reason for dissolution. TBCA art. 7.01.C(2), (D). If the corporation corrects its failure within three years, the Secretary of State must reinstate the corporation. TBCA art. 7.01.E. 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 incorporators did not comply with a condition precedent to formation; (2) the articles of incorporation or an amendment thereto was fraudulently filed; (3) the corporation has continued to engage in ultra vires acts; or (4) a material misrepresentation was made in any document filed pursuant to the TBCA. TBCA art. 7.01.A.

A minority shareholder may file an action with a court who may appoint a receiver if: (1) the corporation is insolvent or in imminent danger of insolvency; (2) the directors are deadlocked in management of corporate affairs, the shareholders are unable to break the deadlock, and corporation is suffering or being threatened with irreparable injury; (3) the directors' actions are illegal, oppressive, or fraudulent; (4) the property of the corporation is misapplied or wasted; or (5) the shareholders have been deadlocked for at least two years in electing successor directors. TBCA art. 7.05.A.(1). If after being in receivership for one year, the corporation does not remedy the condition which caused the appointment of the receiver or present a feasible plan for remedying that condition, the court may order the liquidation of the corporation. TBCA art. 7.06.A.(3).

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

Effect of Choice of Entities

immediate liquidation, then a court may order such liquidation. TBCA art. 7.06.A.(4). If there is no immediate liquidation, the creditor may seek the appointment of a receiver if the corporation is insolvent, the creditor's claim has been reduced to a judgment, and execution on the judgment was unsuccessful, or if the corporation is insolvent and has admitted in writing that the creditor's claim is due and owing. TBCA art. 7.05.A.(2). The corporation in receivership may then be terminated in the same manner as described above. TBCA art. 7.06.A.(3).

Third Party Claims. Ordinarily, creditors can assert claims against the corporation for up to 3 years after dissolution. TBCA art. 7.12D. This period can be shortened as to a particular creditor to 120 days after notice of dissolution is provided to that creditor. *Id.*

Accounting/Tax Aspects of Dissolution: [Comments by PLF:] In accounting for the dissolution of a corporation, the liabilities are paid and the net assets are distributed. To the extent the assets can be converted to cash, the distribution is straightforward. Complications arise when actual assets must be distributed in kind. You would imagine that a dissolution of a corporation would be for a business purpose which could result from a completion of a business plan and winding up of those efforts. But conversion and reorganization could also occur. Care should be taken when placing shareholders receiving assets in the position of loss of the protection the corporation affords them, such as from undisclosed or contingent liabilities.

From an income tax standpoint, potential gain or loss on liquidation of shares of a corporation will be recognized. If shares are redeemed, a complete redemption will be treated as a sale or exchange of the stock with certain exceptions. A number of Code sections deal with the tax treatment of dividends.

10. Marital Property Issues.

a. Acquisition of Shares. If a spouse owns shares of a corporation at the time of marriage, the shares are that spouse's separate property. *Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex. App.–Dallas 1985, no writ). Any increase in value of the separate property corporation is the owning spouse's separate property, and the community estate has no ownership claim to that increase in value. *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984). If shares are acquired during marriage, the character of the shares depends upon the consideration furnished to the corporation in exchange for the stock (i.e., the character of the assets contributed during the formation of the corporation). *Id.* at 604; *Hunt v. Hunt*, 952 S.W.2d 564, 567 (Tex. App.–Eastland 1997, no pet.) ("[w]hen a corporation is funded with separate property, the corporation is separate property"). Tracing through the incorporation of a going business was successful in: *Vallone v. Vallone*, 618 S.W.2d 820 (Tex. Civ. App.–Houston [1st Dist.] 1981), *rev'd on other grounds*, 644 S.W.2d 455 (Tex. 1982); *In re Marriage of Morris*, 12 S.W.3d 877 (Tex. App.–Texarkana 2000, no pet.) ; *Marriage of York*, 613 S.W.2d 764, 769-70 (Tex. Civ. App.–Amarillo 1981, no writ). Tracing failed in *Allen 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). Separate property capitalization of a business started and incorporated during marriage was established in *Holloway v. Holloway*, 671 S.W.2d 51, 56-57 (Tex. App.–Dallas 1983,

Effect of Choice of Entities

writ dism'd).

b. Mutations. If a spouse sells shares of a corporation, 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. Character will follow through a merger or conversion of the corporation. Distributions upon complete liquidation of the corporation will also have the same character as the shares. Distributions in partial liquidation are currently the subject of dispute. These issues are discussed in Section VI.I below.

c. Redemptions. Distributions for the redemption of shares are a form of mutation, and have the same character as the shares. If one owner's shares are redeemed, it will increase the percentage interest held by the remaining shareholders, but the remaining shareholders will still own the same shares that they held before the redemption. *See* section VI.I *infra*.

d. Corporate Distributions. Cash dividends from corporate stock are community property. *See Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex. App.–Dallas 1985, no writ); *Bakken v. Bakken*, 503 S.W.2d 315, 317 (Tex. Civ. App.–Dallas 1973, no writ).

In *Fuhrman v. Fuhrman*, 302 S.W.2d 205, 212 (Tex. Civ. App.–El Paso 1957, writ dism'd), the court held that stock issued to a married shareholder upon dissolution of the holding corporation was received by the spouse as separate property. However, the character of distributions in liquidation of a corporation was recently disputed in *Legrand-Brock v. Brock*, 2005 WL 2578944, *2 (Tex. App.–Waco 2005, no pet.) (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.

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

must come from capital, and must therefore be in partial liquidation and have the same character as the ownership interest. Here is what *Brock II* said:

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

Brock II, at 323. Note that two cited authorities speak of "liquidation of all or a portion of its assets." This suggests that there can be a liquidating distribution that is in liquidation of only a portion of the corporations' assets. The *Brock II* court also cited the U.S. Supreme Court in *Hellmich v. Hellman*, 276 U.S. 233, 235, 48 S.Ct. 244, 72 L.Ed. 544 (1928), a tax case:

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

Brock II, 246 S.W.3d at 324. *See* section VI.J *infra*.

[Comments from PLF:] If a distribution is effectively a sale or exchange of an interest, why would there be any amount of income (community) recorded as part of the proceeds that are received on the stock that would normally be separate (assuming separate property stock)? Such is not the treatment when shares of publicly-held stock are sold–there is no allocation of a portion of the earnings that might be considered embedded in the value of the shares sold.

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. The tax rules are more complex, however distributions are treated as dividends coming first out of current earnings and profits ("E&P"), then out of accumulated earnings and profits and finally out of capital.

See further discussion in sections VI.G, J *infra*.

e. Loans to Shareholders.

[Comments from PLF:] In some separate property corporations that are 100% owned by a spouse, or when the spouse effectively has control of the corporation, money is withdrawn as loans rather than as compensation or dividends. At divorce, the community estate is presented with a debt owed to the corporation, rather than a history of dividends received by the spouse as community property. Is the debt really disguised dividends, or is there a valid debt owed to the separate property corporation?

Shareholder loans provide cash flow to

Effect of Choice of Entities

the marital estate, make the corporation appear to be more profitable than it may be, create an income tax liability for the corporation, and defer the tax on the personal income to the shareholder if the loan is ultimately "repaid" through bonuses. The repayment of the loan may be taxed at the marginal tax rate instead of 100% of the face value of the loan.

A variation of this point was presented In *Hasselbalch v. Hasselbalch*, 2002 WL 188826 (Tex. App.–Houston [1 Dist.] 2002, no pet.) (unpublished), where a trial court's failure to recognize a forthcoming partnership distribution as a community asset was affirmed when the husband had received advances from the partnership in a greater amount.

f. Disposition Upon Divorce. Because a corporation is an entity, and the assets of the corporation do not belong to the spouses, a divorce court cannot award specific corporate assets to either spouse, absent piercing the corporate veil. *Siefkas v. Siefkas*, 902 S.W.2d 72, 79 (Tex. App.–El Paso 1995, no writ) ("unless the corporation is a spouse's alter ego, a court may only award a spouse's interest in the corporation, not specific corporate property"). The court can divide community shares, or can award shares to one spouse and offsetting property or a money judgment to the other spouse.

The parties have more flexibility when settling the case using a transfer of corporate assets.

[Comment by PLF:] To facilitate the transfer of assets to one or several transferees, consider transferring the assets into an LLC in a transaction disregarded for federal tax purposes. This would enable the assets held by the LLC to be treated as transferred for federal tax purposes but enable the avoidance of many of the mechanical property transfer issues in shifting the ownership of individual assets. In some situations the transfer of a "business interest" rather than actual business assets may also avoid certain state transfer taxes.

In the case of an operating business, where important operating real estate, plant and/or equipment is used but owned *individually* by the Husband and Wife, interesting issues arise with not only the valuation issue of fair market rentals, but the overall structure of the post-divorce entity. If Husband is taking the business at a value, is it good practice to have his Wife as his landlord after the date of divorce? What about Wife's fear that the property has limits in its use to this one tenant–the Husband's business? Determining the fair market value of the lease, term of lease, renewal options, and personal guarantees, becomes a significant challenge in evaluating the marital estate.

g. Piercing the Corporate Veil. Various courts have disregarded the separate identity of a corporation in connection with divorce. Doing so subjects assets of the corporation to the jurisdiction of the court, and may cause some assets to be treated as community property, even though the spouse's interest in the corporation is separate property. *See* Section VI.F *infra*.

11. Valuation. [Section provided by PLF:] There are several approaches to valuation that apply to all types of entities, based on the premise that the value of the business equals the present value of the future benefits of ownership. Those future benefits are what

provide the underlying concepts for the primary methods of valuation. They are:

- Income Approach
- Market Approach
- Cost Approach
- Other

The choice of form for an entity can affect the approach to valuation. For example, because corporations can have various classes of stock (some voting, some non-voting, some with preference rights), warrants with or without conversion rights, and/or phantom stock rights, the total invested capital must be allocated among all classes of shares.

Most appraisers calculate value based upon the corporate after-tax earnings of the entity. This treatment has come under fire, especially in the "pass through" entity context of S-Corporations. See further discussion in Section V.D. *Infra*. The result of deducting income taxes is to reduce cash flows upon which multiples would be applied, theoretically reducing value.

Prior to the enactment of the Texas Margin Tax, the impact on valuations of Texas entities of Texas franchise taxes was usually minimal. That changed with the Margin Tax, which is applied to margins (revenues less some costs of goods sold) that is effectively an income tax. Indeed, even the Financial Accounting Standards Board ("FASB") considers the Margin Tax to be an income tax for purposes of GAAP.

For valuations of entities which are subject to the Margin Tax (which includes most corporations), it becomes necessary to calculate the tax which may affect earnings and cash flow.

B. GENERAL PARTNERSHIPS. The partnership is a form of business entity that dates back to the Code of Hammurabi in 2300 BC, was carried forward through Roman Law, through the Middle Ages, and into modern law. 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, 371-72 (2007-08) ("Maurice"). The general partnership was the basic model for a business organization that developed under the common law. Gordon B. Schneider, *A Historical View of Limited Partnership Roll-Ups: Causes, Abuses, and Protective Strategies*, 72 DENVER U. L. REV. 403, 404 (1995).

In 1914, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") promulgated the Uniform Partnership Act ("UPA"). It was eventually adopted in all states but Louisiana. The Texas version of the Act ("TUPA") was adopted in 1961 and became effective January 1, 1962. The NCCUSL revised the UPA in 1992, 1993, 1994 and 1997, and the 1994 and later versions are all called "the Revised Uniform Partnership Act" ("RUPA"). Texas adopted the 1993 version of RUPA in 1993, effective January 1, 1994 ("TRPA"). Thus, TUPA was in effect from January 1, 1962 to January 1, 1994. Since that time TRPA has been in effect. The TRPA is set out in Tex. Rev. Civ. Stat. art. 6132b.

Historically, key features of partnerships were the agreement of two or more businessmen to join together, without the involvement of the state, to operate a business on an equal basis, sharing profits and losses. Historically partnerships automatically terminated upon withdrawal of a partner, which was a major difference from a corporation. Also, in general partnerships there was no distinction between ownership and management, and all partners

were personally liable for all partnership debts. Finally, because a partnership was an aggregate of individuals and not an entity, U.S. income tax law ignored the partnership as a taxable entity, avoiding the double-taxation problem which investors in corporations suffered.

As noted, under the common law, partnerships were considered to be "an aggregate of individuals acting under a contract." *Hanye v. Fenley, Bate, Deaton & Porter*, 618 S.W.2d 541, 541 (Tex. 1981) (per curiam); *Aboussie v. Aboussie,* 270 S.W.2d 637, 639 (Tex. Civ. App.--Fort Worth 1954, writ ref'd) ("A partnership is not a legal entity. The law recognizes no personality in a partnership other than that of the partners who compose it."). However, when "TUPA became law in Texas," "a partnership was recognized as an entity legally distinct from its partners for most purposes." *Id.* at 542. (In point of fact, TUPA was based on the aggregate theory of partnerships, not the entity theory. *See* Maurice, pp 379-80. At this time, however, the issue is moot because current partnership law explicitly provides that "a partnership is an entity distinct from its partner." TRPA arts. 1.01 (11), 2.01; TBOC § 152.056).

A joint venture is a form of partnership that is subject to partnership laws. TRPA § 2.02(a), *Austin v. Truly*, 721 S.W.2d 913, 920 (Tex. App.--Beaumont 1986), *aff'd*, 744 S.W.2d 934 (Tex. 1988). Tenants-in-common may or may not have a partnership.

The TRPA is a default statute, meaning that it provides rules for the operation of a general partnership that apply unless otherwise provided in the partnership agreement. A few provisions of the TRPA cannot be varied by agreement. *See* TRPA art. 1.03(b). TRPA itself provides that principles of law and equity supplement the Act, unless displaced by a particular provision. TRPA art. 1.04(a).

1. Formation. TRPA defines a partnership in this way:

> [A]n association of two or more persons to carry on a business for profit as owners creates a partnership, whether the persons intend to create a partnership and whether the association is called a "partnership," "joint venture," or other name.

TRPA art. 2.02(a). Partnerships can also come into existence through merger or conversion. TRPA art. 2.02(d).

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. Maurice, at 373.

2. Ownership.

Entity. TRPA provides that "[a] partnership is an entity distinct from its partners." TRPA art.

2.01. Partners can own an interest in the entity, but they do not own an interest in specific partnership assets. TRPA art. 2.04. While Texas courts considered TUPA to be an entity theory statute, the 1993 TRPA is the first statute to explicitly recognize general partnerships as an entity. Bromberg, p. 129.

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). However, "[a] partnership interest does not include a partner's right to participate in management." *Id.* The partnership interest is personal property. TRPA art. 5.02(a).

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

> This definition [of partnership interest] is similar to that in TRLPA 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] ("Tarr"). 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).

[Comments by PLF:] A general partnership may be formed by the oral or written agreement of two or more individuals. The decision as to the type of interest each will own has impact on distributions of profits, capital, and perhaps possible priority distributions. In accounting, there are normally two types of capital included in the capital of the partnership: a capital interest and a profits interest. Both are entitled to a share of future profits of the partnership. Only a capital interest is entitled to a share of the capital of the partnership.

[Comments by PLF:] The Schedule K-1

Effect of Choice of Entities

attached to the Form 1065 provides information that can be useful in determining ownership. Box "G" describes whether the partner is a general or limited partner (or LLC member-manager or other LLC member). Box "J" asks for the partner's share of profit, loss and capital at both the beginning and ending of year. As stated above, a partner may not have a capital interest or may have a profits interest different from the capital interest. Because a partnership can specifically allocate profits to reflect economic reality, partners might share capital on a 50%-50% basis, but profits could be shared 80%-20% based on other determinations. Over time, the percentage interest in the profits percentage could vary. Likewise, in the section listing the capital of a partner, the percentage on an historical basis might also vary, depending on certain transactions in the partnership. If a partner withdraws from the partnership his capital might be removed, but the remaining partners will be deemed to own a greater portion of the capital interests and their individual percentage interests might rise. If no additional partnership interests are issued, and if no additional capital is contributed is this to be considered an "acquisition" of an interest during marriage and hence a community asset? Consider this example: three partners each have a 1/3 interest in a partnership; one partner withdraws and receives his redemption distribution; the remaining partners now each own a ½ interest in the partnership (which no longer holds the capital that has been distributed to the withdrawing partner); although the remaining partners have gone from 1/3 interest to ½ interest, have they *acquired* an additional interest in the partnership? On these straightforward facts, one would conclude so.

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).

Contributions. TUPA and TRPA do not restrict the types of consideration that can be contributed to a general partnership in exchange for a partnership interest.

Transfers. Transfers of an interest in a general partnership are governed by TRPA arts. 5.03 and 5.04. 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). The transfer is not an act of withdrawal, art. 5.03(a)(2), and does not by itself cause a winding of the partnership, art. 5.03(a)(3). The transferee does not acquire the right to participate in the management or conduct of the partnership business. TRPA art. 5.03(a)(4). 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). 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). A partnership has no duty to recognize a transfer

Effect of Choice of Entities

prohibited by the partnership agreement. TRPA art. 5.03(e).

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

Withdrawal. Under TRPA, 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). A partnership continues in existence after an event of withdrawal, TRPA art. 2.06(a), unless an event requiring winding up also occurs. *See* section III.B.9 *infra*.

[Comment by PLF:] In the case of distributions to a withdrawing partner, no gain or loss will be recognized except to the extent that the distributions exceed the tax basis of the partner's interest.

Wrongful Withdrawal. In all types of partnerships, a withdrawal is considered "wrongful" if it is a breach of the partnership agreement or if the partner is removed by judicial decree. TRPA art. 6.02(b)(1), (3). In partnerships for a definite term or specific undertaking, or those which wind up upon the happening of a stated event, a withdrawal is wrongful if it occurs before the end of the term, the completion of the undertaking, or the happening of the event either by the partner's express will, bankruptcy, or willful dissolution. TRPA art. 6.02(b)(2). A partner who wrongfully withdraws is liable to the partnership for damages. TRPA art. 6.02(c).

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). 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). 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). A process of tender, demand and, if necessary, litigation is set out in the statute. TRPA art. 7.01(g)-(s).

Note that "fair value" used in art. 7.01(b)(1) is not defined in TRPA. The phrase is a term of art in corporation law, meaning the percentage of value of the entity, without adding a premium for control or discounting for lack of control or lack of marketability, and disregarding any change in value resulting

Effect of Choice of Entities

from anticipation of the upcoming event. TBCA art. 5.12A(1)(a). 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.

3. Management. Each partner in a general partnership has an equal right of management and conduct of the partnership business. TRPA art. 4.01(d). "A partner's right to participate in the management and conduct of the business is not community property." TRPA art. 4.01(d). 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. 1.01(13) provision excluding management rights from the community estate would apply to the foreign partnership.

4. Books and Records. A general partnership is not required to keep "books and records," but if it does they must be kept at its chief executive office. TRPA art. 4.03(a). The partnership must provide access to its books and records to partners, their agents, and their attorneys. TRPA art. 4.03(b). Each partner and the partnership must, upon request, furnish to a partner, his legal representative, and assignee (i.e., transferee) "to the extent just and reasonable," "complete and accurate information concerning the partnership." TRPA art. 4.03(c). Partnerships keep books of account for management purposes and to serve as the foundation for preparing a partnership tax return. To some extent the partnership tax return itself is an accounting of profits and losses and of contributions and distributions, and constitutes a tax-based balance sheet and profit-and-loss statement.

5. Assets and Liabilities. TRPA provides:

> 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. 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. 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

Effect of Choice of Entities

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. 2.05 sets 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. An exception exists if the partnership is a limited liability partnership. *See* section III.D *infra.* 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 § 3.07.

Two Texas courts have held that partnerships are not susceptible to a piercing of the 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).

6. Contributions/Distributions. Partners of a general partnership can make contributions of money, property or past services. *See* TRPA art. 4.01(a) (recognizing cash and other assets as contributions). A contribution of money or property is a non-taxable event for both the partner and the partnership. 26 U.S.C.A. § 721 ("No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership") However, a contribution of past services in exchange for a partnership interest constitutes an immediate taxable event to the extent the partnership interest received has a liquidation value and no substantial risk of forfeiture. *See* IRC Reg § 1.721-1(b)(2) and IRC § 707(c). Under very limited circumstances, this taxation may be deferred. *See* IRC § 83.

[Comments by PLF:] A person who provides services and receives in exchange a vested interest in a partnership must include in income the excess of the liquidation value of the partnership interest at the time it is issued over any amounts s/he paid for the interest. This rule applies to both profits interests and capital interests in a partnership. The test to determine if a partnership interest is substantially vested at the time it is received is whether or not the right to the associated partner capital account is subject to a substantial risk of forfeiture or whether the interest is transferrable.

The liquidation value of a partnership interest is the amount the person providing services would receive as a distribution in the event the partnership immediately sold all of its assets for cash at their fair market value and then distributed the proceeds to the partners in liquidation of their respective partnership interests. If the receipt of the partnership interest by the service provider triggers income, then the partnership is able to either deduct or capitalize the amount the service provider has to include in income. Whether the partnership deducts

or capitalizes the amount will depend on the nature of the services provided.

Proposed regulations have been issued under IRC Section 83 which give guidance regarding different situations and the general applicability to the transfer of a partnership interest in connection with the performance of services. IRC Section 83 deals generally with the taxability of property received for providing services, including employee stock options. The proposed regulations state clearly that all partnership interests constitute property for purposes of IRC Section 83(b). Further, the Internal Revenue Service issued Notice 2005-43 that contains a proposed revenue procedure under authority of the proposed regulations that provides elective safe harbor rules for a partnership's transfer of interests for services. The Notice includes multiple examples illustrating differing fact patterns and the applicable income tax treatment for each. Initial contributions are exchanged for an ownership interest. Under the law of tracing, the partnership interest acquired will have the same character as the capital contributed. Later capital contributions may or may not result in an increased ownership interest. These contributions would create a reimbursement claim, but not an ownership claim. Some argue that such a later capital contribution may constitute a "capital improvement" under the economic contribution claim statute, Tex. Fam. Code § 3.403.

[Comment by PLF:] When contributions are made to the partnership, the initial contribution will determine the character of the partnership interest based on the surrounding circumstances (when title is acquired or upon inception of title, as the case may be). Subsequent capital contributions, without issuance of additional interests, will not increase the spouse's ownership interest.

A "distribution" is defined in TRPA as "a transfer of cash or other property from a partnership to: (A) a partner in the partner's capacity as a partner; or (B) the partner's transferee." Distributions can be distributions of profit or of capital. *See* section VI.G *infra*. Distributions can be in full liquidation or partial liquidation of the partnership. *See* section VI.I *infra*.

[Comment by PLF:] Distributions to partners are recognized for tax purposes in the following way: generally, a partner recognizes gain on a partnership distribution only to the extent that the money or marketable securities distributed exceed the adjusted tax basis of the partner's interest in the partnership; gains are generally treated as capital gains; if the distribution consists of partnership property other than money or marketable securities, the gain is not recognized until the property is disposed of by the partner who receives it.

Thus, a distribution of assets from a family limited partnership (FLP) will be recognized as a gain or loss unless certain "safe harbor" conditions are met. The rules applying to real estate differ from the rules applying to securities. In this situation, consult a CPA or tax lawyer.

[Comment by PLF:] The partnership agreement may specify when or if

certainpartners are to receive "priority" distributions based upon the underlying business terms of the entity. For example, partners may determine when distributions are considered to be from current or previously earned profits or capital distributions.

7. Accounting/Financial Reporting.

[Comments by PLF:] Just as with a corporation, partnerships generally record their assets and liabilities at "historical cost."

One prominent difference between a partnership and a corporation is the ability to allocate income among partners in a partnership; it may be "specifically allocated" to the partners based upon the business arrangement and agreement reached, so long as the allocation is based on substantial economic effect. No such allocation is afforded C-Corporations (or S-Corporations, for that matter). The partnership form provides flexibility to reflect the partners' intentions with respect to distributions and dissolution.

The central issue in partnership accounting from a divorce lawyer's standpoint is the "capital account." In TRPA, a "capital account" is defined as "the amount of a partner's original contribution to a partnership, which consists of cash and the agreed value of any other contribution to the partnership, increased by the amount of additional contributions made by that partner and by profits credited to that partner under Section 4.01(b), and decreased by the amount of distributions to that partner and by losses charged to that partner under Section 4.01(b)." TRPA art. 1.01(2). TRPA art. 4.01 discusses debits and credits to the capital account. Each partner is credited with cash and the value of property contributed, and his share of partnership profits, and is charged with the cash and value of all property distributed to him plus his share of partnership losses. TRPA art. 4.01(b). Profits and losses are to be charged in proportion to each partner's share of the profits. TRPA art. 4.01(b). A partner who contributes more than his agreed amount is entitled to be repaid the excess, plus interest. TRPA art. 4.01(c). In a divorce, in addition to valuing a spouse's interest in a partnership, a further assessment of the spouse's capital account is required, which may embody a claim or a liability independent from the ownership interest.

The total capital account is reflected in the partnership tax return, Schedule L, and in Section 1 of the Form K-1 issued by the partnership to each partner on an annual basis. (Prior to 2004, the capital account information was in Section J of the K-1).

8. Tax Reporting. The key issue in partnership taxation is the fact that the IRS does not recognize partnerships as an entity for most tax purposes. The income or losses of the partnership flow through to partners, in proportion to their percentage interest in profits and losses. Partnerships are, however, required to file an informational income tax return.

Check-the-box IRS regulations now govern partnership tax reporting. The regime has been explained:

> On December 17, 1996, the IRS released final regulations concerning the classification of business organizations, popularly

> known as the "check-the-box" rules (Treas. Reg. § 301.7701-3). These regulations substantially revise the manner in which it is determined whether a purported partnership should be characterized as a corporation for federal income tax purposes. In general, these rules establish a federal income tax regime under which domestic partnerships, limited liability companies and business trusts will be able to elect whether they will be taxed as partnerships (pass- through treatment) or corporations (entity level taxation).

Loffman & Presant, at 584.

The pass-through aspect of partnership income can create a problem with "phantom income"–income that appears on partner's individual tax return even when the partnership generating the income does not actually distribute the income to the partners. *See* section VI.G *infra*.

[Comment by PLF:] Tax reporting for a general partnership is based upon the fact that profits, losses, and other items of income and distributions are "passed through" to the individual partners and reported on their individual Forms 1040 subject to personal income tax rates.

Form 1065 Partnership U.S. Return of Partnership Income merely provides the tools for partners to recognize their share of partnership income and expenses. The partnership doesn't pay tax at the entity level as a C-Corporation does.

Items of income or loss are reported on a Schedule K of the Form 1065 and are reported out to the individual partners on a Schedule K-1. The Schedule K-1 also discloses the percentage interest of each partner.

Various forms on the individual Form 1040 tax return (i.e., Schedule B, Schedule E) report an individual's partnership income.

9. Dissolution. Under TUPA, the three steps for ending a partnership were (1) dissolution, (2) winding up, and (3) termination. TUPA § 29; *Bader v. Cox*, 701 S.W.2d 677, 681 n. 1 (Tex. App.–Dallas 1985, writ ref'd n.r.e.). When TUPA was amended by TRPA effective January 1, 1994, one of the biggest changes made was the elimination of the concept of dissolution; when a partner withdraws or dies, the partnership is no longer "dissolved," but instead the partnership may elect to continue to exist by redeeming that partner's interest. Tex. Rev. Civ. Stat. 105, Ch. 1, Art. I, Comment ("Main Changes: Dissolution not used; withdrawal does not require winding up (liquidation), only requires redemption (buyout) of withdrawn partner at fair value unless majority in interest of remaining partners choose to wind up, §§ 6.00 to 7.01."). When the term "dissolution" is used in partnership cases applying TUPA prior to 1994, it should be translated to mean "the happening of an event requiring winding up under TRPA § 8.01" in terms of current law.

Events Requiring Winding Up. Under the TRPA, the dissolution of a partnership is referred to as "winding up." The winding up of a partnership may occur due to the occurrence of one of several different events, which vary based on the type of partnership. For partnerships created without a specific undertaking or for an indefinite duration and whose partnership agreements do not require winding up upon the occurrence of a stated

event (i.e. partnerships "at will"), the withdrawal of a partner does not itself end the partnership and only the consent of a majority-in-interest of partners who haven't assigned their interests requires the partnership to wind up. TRPA art. 8.01(a). However, in a partnership at will, a request from any partner other than one who has agreed not to withdraw requires the partnership to wind up unless a majority-in-interest of partners consents to continue the partnership. TRPA art. 8.01(g). For all other types of partnerships, however, the unanimous consent of all partners is necessary to require winding up. TRPA art. 8.01(b)(1), (c)(1). These types of partnerships must wind up upon the expiration of the term or completion of the undertaking stated in their partnership agreement, TRPA art. 8.01(b)(2), or upon the happening of an event stated in their partnership agreement which requires winding up. TRPA art. 8.01(c)(2). All types of partnerships must wind up if an event occurs which makes the partnership's business illegal, TRPA art. 8.01(d), if a judicial decree requires the partnership to wind up, TRPA art. 8.01(e), or if the partnership sells all or substantially all of its assets outside the ordinary course of business. TRPA art. 8.01(f).

Distributions Upon Winding Up. When a partnership is winding up, the assets of the partnership must first be used to pay the partnership's outstanding debts before any surplus is distributed among the partners. TRPA art. 8.06(a). "[T]he profits and losses that result from the liquidation of the partnership property must be credited and charged to the partners' capital accounts." TRPA art. 8.06(b); *Torres v. Kelley*, 2007 WL 528849, at *5 (Tex. App.–Corpus Christi 2007, no pet.). Any remaining assets are distributed among the partners in the amount of the balance of each partner's capital account. TRPA art. 8.06(b). This latter clause has been interpreted by one court to mean that the capital accounts must be brought into parity, with partners having higher capital accounts receiving money and those having lower capital accounts paying into the partnership. *Farnsworth v. Deaver*, 147 S.W.3d 662, 664-65 are (Tex. App.–Amarillo 2004, no pet.). Once the capital accounts of the partners are adjusted, any remaining profits of the partnership are distributed to the partners in the proportion recited in the partnership agreement. If the debts of the partnership exceed its assets, the partners are obligated to satisfy those debts in the proportion to each partner's share of partnership losses, unless the creditors for those debts agreed to look only to partnership property for satisfaction. TRPA art. 8.06(c)(1). If a partner does not contribute his/her share to satisfying these debts, the remaining partners must pay this amount in those same proportions. TRPA art. 8.06(c)(2). Partners who cover the debts of other partners in this way may seek "contribution" (i.e. reimbursement) from partners who do not pay their share. TRPA art. 8.06(c)(3).

[Comments by PLF:] From an accounting perspective, a partnership is wound up by first paying partnership creditors and determining the remaining net assets (or liabilities). If partners are 50%-50% capital partners, the capital balances of each may be adjusted to equalize balances. To the extent any profits are earned, the profits may be "posted" to a drawing account for partners that have capital and profits interests. Distributions of profits are made subject to provisions in the partnership agreement. Accounting tenets would call for the distribution of current profits first, previously earned

Effect of Choice of Entities

profits next, and capital last.

Tax Perspective. [Comments by PLF:] From a tax perspective, the termination of an entire business enterprise can occur through two alternative mechanisms: (1) the transfer or sale to a third party of all the ownership units in the enterprise; or (2) the pro rata distribution to the owners of all the assets held by the business or investment enterprise in the liquidation of that venture.

The sale of all of the partnership interests of a partnership will be treated as a capital transaction for measuring gain or loss by the individual partner and be capital in nature, except to the extent of the possible "hot" assets (such as unrealized receivables, work in progress, or inventory assets). In that case, the value of the hot assets will serve to convert the capital gains from the sale to ordinary income.

10. Marital Property Issues. Some of the Texas marital property cases involving partnerships were decided at a time when Texas followed the aggregate theory of partnership. On January 1, 1962, it is said that TUPA ushered the entity theory of partnership into Texas. TUPA was replaced effective January 1, 1994, by TRPA. The holdings and analysis in Texas cases involving partnerships and marital property law should be considered in the context of the common law or partnership statute that governed the case. For example, the significant Texas Supreme Court case of *Norris v. Vaughn*, 152 Tex. 491, 260 S.W.2d 676 (1953), was decided before TUPA.

a. Ownership Rights. 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).

The fact that the partners amend the partnership agreement during marriage does not establish that an interest in the partnership was acquired during marriage and is thus community property. Unless the partnership was dissolved then recreated, the same partnership interest continues through the amendment. *See Harris v. Harris*, 765 S.W.2d 798, 803 (Tex. App.–Houston [14th Dist.] 1989, writ denied).

b. Specific Partnership Assets. TRPA establishes that specific partnership assets do not belong to a spouse. TRPA art. 5.01. They therefore are neither separate nor community property. A court in a divorce cannot award specific partnership property to either spouse. *McKnight v. McKnight*, 543 S.W.2d 863, 867-68 (Tex. 1976).

c. Distributions. Partnership profits distributed to a married partner are community property, regardless of whether the spouse's partnership interest is separate or community property. *Harris v. Harris*, 765 S.W.2d 798, 804 (Tex. App.–Houston [14th Dist.] 1989, writ denied); *Marshall v. Marshall*, 735 S.W. 2d 587, 594 (Tex. App.–Dallas 1987, writ ref'd n.r.e.).

Effect of Choice of Entities

A debate exists about the character of partnership distributions to a married partner that are not clearly from partnership profits. Some lawyers and forensic CPAs take the position that all distributions from a partnership are community property, except perhaps distributions upon complete liquidation of the partnership. Others say that distributions of capital from a separate property partnership, even an ongoing partnership, are separate property. If they are, then the question arises as to how to determine whether a distribution from a partnership is considered to be profits or capital.

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

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

Id. at 595. *Marshall* clearly states that distributions of current income or profits are community property. However, the opinion does not expressly say that *all* distributions from a partnership are community property. *Marshall* establishes that separate property capital, once contributed to the partnership, loses its character as separate property, so that distributions cannot be mutations of the separate property contribution. The significance of *Marshall* to a great degree depends on whether you read some of the statements in the Court's Opinion as broad principles of law, or whether you read them as conclusions drawn from the facts in the particular case (in particular, the language of the partnership agreement and the fact that all distributions were from current income).

Marshall was reiterated if not extended in *Lifshutz v. Lifshutz*, 199 S.W.2d 9, 27 (Tex. App.–San Antonio 2006, no pet.) ("*Lifshutz II*"). In *Lifshutz II*, a subsidiary corporation was transferred directly from a separate property family partnership to a separate property family corporation in a tax-free business recapitalization. *Id.* at 24-28. The

Effect of Choice of Entities

trial court found this to be a "non-liquidating community distribution" from the partnership, and held the stock of the subsidiary to be community property of the husband. *Id.* at 24. After an extensive analysis of the facts and citation to *Marshall*, a 2-to-1 majority of the court of appeals wrote:

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

The court recognized that a Louisiana appellate court had "drawn a distinction between distributions of income and distributions of a capital asset," but commented the Louisiana court did not analyze the effect of the entity theory of partnerships and further noted that in the present case, "the accumulated profits of [the partnership] exceeded the aggregate distributions, which included the [subsidiary] stock distribution." *Id.* at 27 n. 4.

See section VI. G, H & I *infra*.

[Comment by PLF:] This language suggests the court measured accumulated profits again st the distributions and in essence performed an income-out-first analysis.

d. Partnership Interest. A spouse's partnership interest is personal property, TRPA art. 5.02(a), that can be either separate property or community property. A partnership interest can include either a claim on profits and losses, or a claim on capital, or both.

Management Rights. A partner in a general partnership automatically has an equal right to manage the partnership business, but the right cannot be community property. TRPA art. 4.01(d). Therefore the element of control must be excluded from the value of the community property interest in the partnership. *See Bader v. Cox*, 701 S.W.2d at 681 n. 2 ("The property rights of a partner are (1) his interest in the partnership, (2) his rights in specific partnership property, and (3) his right to participate in management....Ms. Bader, as decedent's wife, has a community property interest in decedent's interest in the partnership *but has no interest in decedent's right to participate in management* and has a right in partnership property only to the extent [TUPA] section 42 allows.") (emphasis added).

[Comment by PLF:] Some commentators have suggested that the general partnership statutory provision on management rights affects not only the character of management rights, but also the valuation of the spouse's partnership interest. Since the statute provides that a partner's management rights cannot be community property, the argument goes that any portion of the value of the spouse-partner's interest that is attributable to control–or even the right to vote–cannot be considered to be part of the community estate's value.

Under this view, if the partnership interest is going to be awarded to the partner-spouse and an offsetting amount of property will be awarded to the non-partner spouse, the portion of the value of the partner-spouse's interest in the partnership attributable to management rights should be excluded from the value of the estate to divide.

Applying the willing buyer/willing seller

construct to this view, the value of a community property interest in the partnership is what a willing buyer would pay for the partnership interest without management rights. However, this position as to the effect of management rights on value assumes that TRPA art. 4.01(d) is conclusive on characterization of the management rights as a matter of law– and no court has expressly held this.

e. Transferee's Interest. A non-partner spouse who receives some or all of the partner-spouse's partnership interest, is a transferee (under TRLPA called an "assignee") and has a transferee's interest. TRPA 5.04(a). A transferee has no right to participate in managing the partnership or conducting its business. TRPA art. 5.03(a)(4). A transferee is entitled to receive, to the extent transferred, distributions to which the transferor would have been entitled. The transferee can require "reasonable information or an account of the partnership transactions and make reasonable inspection of the partnership books." TRPA art. 5.03(b). In the event of winding up, the transferee is entitled to receive the net amount of what would have been distributable to the transferor. Notice of the transfer must be given to the partnership for the partnership to be bound to give effect to the transfer. The State Bar Committee that drafted TRPA art. 1.01(13) noted that a transferee cannot compel distributions by the partnership. *See* section III.B.2, *Partnership Interest*. The transferee has a right to receive the transferred share of partnership distributions, TRPA art. 5.03(b), but no right to participate in the management or conduct of the partnership business. TRPA art. 5.03 (a)(4).

[Comments by PLF:] A non-partner spouse who succeeds to the interest of a partner-spouse acquires a transferee's interest, which does not have the full rights of a partner. Limits on the ability to require distributions and control partnership actions also result. The lack of control over distributions for an assignee interest restricts the enjoyment of the interest and makes it of less value in the hands of the non-partner spouse.

While a historical pattern of distributions from a partnership in a situation where the partner spouse did not have control suggests that distributions may continue after the divorce, the facts and circumstances of the management and control of the entity should be evaluated to determine any potential reduction in value attributable to the risk that future distributions will not follow the historical pattern.

f. Capital Calls. In certain circumstances, it may not be advantageous for a non-partner spouse to take a transferee's interest in a general partnership. Some partnerships can require partners to contribute capital, called a "capital call," and there are usually penalties written into the partnership agreement so that a partner who does not meet a capital call may forfeit or downgrade his/her partnership interest, etc. A transferee of an interest in a general partnership is not liable for capital calls solely as a result of the transfer. TRPA art. 5.03(b).

g. Spousal Joinder. In the case of *In re Kirby Highland Lakes Surgery Ctr.*, 183 S.W.3d 891 (Tex. App.–Austin 2006, no pet.), the wife of a partner signed the following "Joinder of Spouse" addendum to the partnership agreement:

> The Partners' spouses join in the execution and delivery of this Agreement for the express purpose of binding their respective community property interests, if any, in the Partnership Units. The Partners' spouses are fully aware of, understand, and fully consent and agree to the provisions of this Agreement and its effect upon any community property interests they may now or hereafter own, and agree that the termination of their marital relationship with any Partner for any reason or for no reason will not have the effect of removing any Partnership Units of the Partnership otherwise subject to this Agreement from coverage and that their awareness, understanding, consent, and agreement are evidenced by their signing this exhibit to the Agreement.

The appellate court held that this addendum subjected the wife to an arbitration clause contained in the partnership agreement in a dispute with parties who purchased the partnership's business. *Id.* at 902-03.

h. Phantom Income. Because partnership income is passed through to the personal tax returns of the partners, it is possible that a partner will have to report partnership income on his/her return, but will not have received the distributions which are needed to pay tax on the income. Since an assignee's interest has no management rights, the spectre of phantom income is a disincentive to taking an assignee's interest in a partnership. *See* section VI.G *infra*.

11. Valuation. The valuation principles developed in connection with corporations apply to valuing partnerships as well. IRS Rev. Rul. 65-192, sec. 4.01,:

> The general approach, methods, and factors outlined in Revenue Ruling 59-60 are equally applicable to valuations of corporate stocks for income and other tax purposes as well as for estate and gift tax purposes. They apply also to problems involving the determination of the fair market value of business interests of any type, including partnerships, proprietorships, etc., and of intangible assets for all tax purposes.

However, there are ways in which partnerships vary from corporations that require special consideration when valuing partnerships and interests in partnerships.

Another valuation difference between a corporation and a partnership has to do with a premium for having a controlling interest in the business. If the community interest in a corporation is a controlling interest, a control premium may be appropriate. However, under TRPA art. 4.01(d), management rights of a partner cannot be community property. As a consequence, any control premium for a spouse's community property controlling interest in a partnership must be disregarded when valuing the community interest in the partnership, and the community interest is to be considered as having no management rights. There is a potential argument that this particular statutory provision may be unconstitutional, so the non-partner spouse may want to obtain a value that includes management rights.

[Comments by PLF:] The most obvious

distinction in evaluating a partnership interest as compared to shares of stock has to do with the liability of general partners compared to the limited liability of shareholders. With a corporation, assuming the value is determined for the enterprise, the shareholders will typically not have any liability for the unknown or undisclosed obligations, whether real or contingent. The same is not true for a general partnership. The unknown obligation could mean that the personal assets of the general partner are at risk. The risk of possible claims is always a factor in the professional services area, and insurance coverage is designed to mitigate this risk.

C. LIMITED PARTNERSHIPS. 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.

Limited partnerships were known to Roman law. 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; Chadwick, at 249. TULPA was based on the 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. 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).

TRLPA is not a comprehensive statute and, to the extent the TRLPA does not speak to an issue, limited partnerships are governed by TRPA 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"); *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 linkeage" 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.

The statutory defaults discussed herein apply if the limited partnership agreement does not provide to the contrary. However, in many

instances the actual limited partnership agreement will provide for something completely different from the statutory default. *McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex. App.–Dallas 1993, pet. denied) ("The partnership agreement governs the parties' rights. Only where it is silent do the provisions of the Texas Uniform Partnership Act come into play."). While a limited partnership agreement can be oral, only a written partnership agreement can override the statute as to assignability of partnership interests, non-dissolution by assignment of an interest, enforceability of capital calls against limited partners, and release of an obligation to make contributions. Bromberg, at 125. In practice, most limited partnerships are not only in writing, they are elaborate and complicated. Therefore a close reading of the limited partnership agreement, in the context of the relevant statutes and the principles and practices discussed in this article is required in forming opinions about the rights and liabilities of limited partners. Often it would be wise to associate a partnership law specialist for this purpose.

1. Formation. A Texas limited partnership is created like a general partnership, by agreement of the partners. TRLPA§ 2.01(a). The agreement may be written or oral. TRLPA § 1.02(10). The general partners must sign a certificate of limited partnership, TRLPA §§ 2.01(a), 2.04(a)(1), which is then filed with the Secretary of State, who stamps the certificate "filed" and dates it. TRPLA § 2.07(a). The limited partnership comes into existence when the certificate of limited partnership is 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).

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. A certificate of merger must be filed with the secretary of state who will stamp it as "filed" with the date of filing, TRPLA § 2.11(e), at which time the merger becomes effective. TRPLA § 2.11(f). Upon merger, all property of the merging entities is "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 is true of all liabilities and obligations. TRLPA § 2.11(g)(3). A similar rule applies to the creation of a limited partnership by "conversion" from another entity. TRLPA § 2.15.

2. Ownership.

Admission of Partners. At formation of the limited partnership, any person may be admitted as a general partner as provided in the written partnership agreement. Thereafter, general partners can be admitted as provided in a *written* partnership agreement, or absent such agreement, with the written consent of all partners. TRLPA § 4.01(a).

Effect of Choice of Entities

Contributions. Under TULPA, a person was allowed to contribute cash or other property but not services to acquire an interest in a limited partnership. TULPA § 5. In contrast, TRLPA permits contributions of any tangible or intangible benefit to the partnership, including cash, property, services rendered, promissory notes, contracts to perform future services, and interests in other entities. TRLPA §§ 1.02(c), 5.01. Since September 1, 2003, TRLPA § 4.01 permits a limited partnership to admit a general partner who does not make a capital contribution, and a general partner can even be admitted without acquiring a partnership interest. TRLPA § 4.01.

A limited partner's liability to make a contribution to the partnership must be in writing to be enforceable. TRLPA § 5.02(a). The obligation survives death of the partner. TRLPA § 5.02(b). Assigning the partnership interest to another person does not suspend the assignor's obligation to make a capital contribution. TRLPA § 7.04(c).

Interest Does not Include Specific Partnership Assets. A partner's interest in a limited partnership is personal property. TRPLA § 7.01. Whether it is community property or separate property is governed by marital property rules. A partner has no interest in specific limited partnership property. *Id.*

Date of Acquisition. Upon formation of a limited partnership, a limited partner acquires his limited partner interest on the later of (i) the date of formation, or (ii) the date stated in the records or, absent that, the date the partner's admission is first reflected in the partnership records. TRLPA § 3.01. If the limited partnership interest is acquired after formation directly from the limited partnership itself, the new person becomes a partner upon complying with the terms of the partnership agreement governing admission of new partners. TRLPA § 3.01. If the interest is acquired from another partner, then the rules governing assignments apply. *See* TRLPA § 7.01.

Classes. TRLPA Sections 3.02 and 4.05 permit a limited partnership to establish classes of general and limited partners.

Assignment. A partnership interest in a limited partnership is assignable, unless the partnership agreement prohibits it. TRLPA § 7.02(a)(1). Unless otherwise provided by the partnership agreement, an assignment of an interest does not dissolve the limited partnership. TRLPA § 7.02(a)(2). Unless otherwise provided by the partnership agreement, an assignee is entitled "to be allocated income, gain, loss, deduction, credit, or similar items, and to receive distributions, to which the assignor was entitled, to the extent those items are assigned." TRLPA § 7.02(a)(3). An assignee can become a partner only if the partnership agreement so provides, or all partners consent. TRLPA § 7.04(a). Unless the *written* partnership agreement provides otherwise, the assignee who becomes a limited partner *is* liable to make capital contributions to the partnership in accordance with TRLPA § 5.02. *See* TRLPA § 7.04(b). In any event, the transferor continues to be liable to the limited partnership under Articles 5 & 6 of TRLPA. *See* TRLPA § 7.04(c).

Withdrawal. For general partners in a limited partnership, the "events of withdrawal" are the same as in a general partnership. TRLPA § 4.02. *See* III.B.2 *supra*. A limited partner, on the other hand, may only withdraw at the time or on the occurrence of the events specified in the partnership agreement.

TRLPA § 6.03. This different treatment helps to support a discounted value of a limited partner interest in a family limited partnership. Bromberg, at 127. A withdrawing limited partner is entitled to receive, within a reasonable time after withdrawal, the *fair value* of his interest as of the date of withdrawal. TRLPA § 6.04. The limited partner cannot require a distribution other than in cash, nor can the partnership force the withdrawing partner to take in-kind distribution of an asset in excess of his share of distributions. TRLPA § 6.05. Both rules may be overridden by the partnership agreement. *Id.* The partnership cannot make a distribution that would give the partnership a negative net worth. TRLPA § 6.07(a).

3. Management. A general partner of a limited partnership has the rights and powers of a partner in a general partnership. TRLPA § 4.03(a). Generally speaking, limited partners cannot participate in management of the limited partnership without jeopardizing their insulation from partnership liabilities. TRPA § 3.03 does, however, permit limited partners to participate in some management decisions of the limited partnership without jeopardizing their limited liability. Further, A creditor who asserts personal liability of a limited partner based on involvement in management must show that he reasonably believed that the limited partner was a general partner. TRLPA art. 3.03(a).

4. Books and Records. TRLPA § 1.07(a) requires a limited partnership to maintain records that reflect, among other things, the interest each partner owns, copies of tax returns, copies of the partnership agreement and amendments, the amount of cash contributed and value of other property contributed by each partner, the times of all additional contributions, the date when each partner joined the partnership, and "books and records of account."

5. Assets and Liabilities. Under TRLPA a partner in a limited partnership acquires no rights in specific partnership property. TRLPA art. 7.01.

The general partner of a limited partnership is liable for all limited partnership debts. TRLPA § 4.03(b). A limited partner is not liable for obligations of the limited partnership unless the limited partner is also a general partner, or the limited partner participates in the control of the business in a manner not allowed by the TRLPA. TRLPA § 3.03. The statute permits limited partners to consult with and advise the general partner, serve on partnership committees, vote on partnership matters and other matters of management, and perform many other tasks, without jeopardizing their limited liability status. *Id.* A third party can establish liability of a limited partner only when he reasonably believes the partner to be a general partner based on that party's conduct. *Id.*

A judgment creditor of a partner in a limited partnership "may charge the partnership interest of the judgment debtor to satisfy the judgment." TRLPA § 7.03(a). This entitles the creditor to receive only distributions that the judgment debtor would have been entitled to receive. *Id.* This is the judgment creditor's exclusive remedy against the debtor's partnership interest. TRLPA § 7.03(c). The property of the partnership is immune to the credit's claims. TRLPA § 7.03(e).

Two courts have held that piercing the corporate veil does not apply to partnerships: *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 518 (Tex. App.–San Antonio 2001, pet. denied); *Pine-brook Props., Ltd. v. Brookhaven Lake Prop.*

Effect of Choice of Entities

Owners Ass'n, 77 S.W.3d 487, 500 (Tex. App.–Texarkana 2002, pet. denied) ("because the general partner is always liable for the debts and obligations of the partnership to third parties").

6. Contributions/Distributions. A promise by a limited partner to make a contribution to the limited partnership must be in writing and signed by the limited partner to be enforceable. TRLPA § 5.02(a). A limited partner who does not make a promised contribution faces the consequences stated in the partnership agreement, as well as a reduction in percentage interest, subordination of the partner's interest, forced sale, forfeiture, etc. TRLPA 5.02(c).

Distributions of cash or other assets are to be made to the partners "in the manner provided by a written partnership agreement." TRLPA § 5.04. If the partnership agreement doesn't say, then distributions that are a return of capital must be made on the basis of an agreed value stated in the partnership records. Distributions that are not a return of capital "shall be made in proportion to the allocation of profits . . . ." TRLPA § 5.04.

7. Accounting/Financial Reporting. TRLPA § 5.03 provides that "the profits and losses of a limited partnership shall be allocated among the partners in the manner provided by a written partnership agreement." If the agreement does not specify, then profits and losses are allocated in accordance with the then-current percentage interest in the partnership as stated in the partnership's records. TRLPA § 5.03. Absent such records, allocations are in proportion to the capital accounts. TRLPA § 5.03.

In other regards, limited partnership accounting is like accounting for general partnerships.

[Comments from PLF:] The financial reporting for the limited partnership should closely resemble that of the general partnership on an entity basis. The distinction, however, is that with a limited partnership, the operations are typically in the limited partnership and a corporate general partner has a 1% interest (let's say) and little else other than the right to control the entity subject to the provisions of the agreement.

8. Tax Reporting. [Comments from PLF:] Little difference exists between a limited partnership and a general partnership for tax reporting purposes. In fact, in the partnership-related sections of the Internal Revenue Code (the 700s), no distinction is made between limited and general partnerships. General partners usually report their share of partnership income as earnings from self-employment. Not so with limited partners. Most differences seem to be as a result of the operation of state law, including obligations for liabilities. This affects the "at risk" basis in the partnership interest and accordingly the amount of losses that would be deductible by each.

9. Dissolution. TRLPA was designed to provide continuity of interest without going far enough to trigger the tax treatment as a corporation. Bromberg, at 127. Accordingly, events of withdrawal requiring dissolution are recognized, but reconstituting the limited partnership is also allowed. *Id*. The adoption in 1996 of check-the-box IRS regulations permitting non-corporate entities to choose whether to be taxed as a corporation or as a partnership, permitted legislators to ease up

on the easily-triggered partnership dissolution. Bromberg, at 128.

Events Requiring Winding Up. There are only four circumstances under which a limited partnership is required to be wound up: (1) the occurrence of an event stated in the partnership agreement requiring dissolution; (2) the written consent of all partners; (3) an event of withdrawal of a general partner; and (4) the entry of a decree of judicial dissolution. TRLPA § 8.01. However, if the sole general partner withdraws but the partnership agreement allows the remaining general partners to continue the partnership and they do so, or if all the remaining limited partners decide to continue the partnership and they agree to the appointment of one or more general partners, then the partnership will not be wound up. TRLPA 8.01(3). The procedures for winding up the limited partnership and distributing the partnership's assets are nearly identical to those for a general partnership. TRLPA § 8.04, 8.05; *see also* section III.B.9 *supra*.

10. Marital Property Issues.

a. 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.

b. 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 the TRLPA clearly contemplates distributions of capital, because section 5.04 provides that they shall be made based upon agreed values. Section 5.04 also says 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.

c. Assignee's Interest. The limited partnership agreement can specify how a partnership interest is assigned. TRLPA § 7.02. 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. TRLPA § 7.04(a). An assignee who becomes a partner is subject to the terms of the partnership agreement and TULPA, including the assignor's obligation to meet future capital calls. TRLPA § 7.04(a). The assignor, however, is not released from his/her financial obligation to the limited partnership. TRLPA § 7.04(c).

d. Family Limited Partnerships. [Section contributed by PLF:] Frequently limited partnerships are formed as Family Limited Partnerships ("FLPs") for estate planning purposes or other control reasons. A marital property issue arises when the husband and wife transfer wealth to the FLP and, say, the husband becomes the General Partner with all of the control over distributions resting with him and to the exclusion of the wife. This affects the value of the interest she

receives and the ability to compel distributions. Attempts to unwind such transfers are not easy to accomplish, if at all, and make the divorce more challenging.

11. Valuation. Valuation of a limited partnership is like valuation of a general partnership. *See* section III.B.11 *supra*. Valuation of an ownership interest in a limited partnership is affected by whether the interest being valued is a general partner interest (*i.e.*, subject to entity liabilities) or a limited partner interest (*i.e.*, shielded from entity liabilities). Although the general partners of a limited partnership collectively have control of the partnership, a control premium would apply to a particular general partner only if the general partner whose interest is being valued has control, through owning a majority of the general partner interests or through a control agreement. Remember, however, that management powers in a partnership cannot be community property. TRPA art. 4.01(d). So, a community property general partner interest must be valued without regard to control.

Another problem with valuing interests in a limited partnership is that limited partnerships are so "deal specific" that the valuator must make adjustments for a variety of advantages or disadvantages under the limited partnership agreement in question. Additionally, limited partnerships are sometimes invested in illiquid investments, or investments with negative value, or have minimum durations extending far into the future with no right to withdraw. These limited partnerships can be difficult or impossible to value.

[Comment from PLF:] Usually in the valuation of a limited partnership, the partnership is controlled by the general partner (often a corporation or LLC) and an allocation is made to the general partner for its interest in the enterprise. In the case of family limited partnerships, often value is determined by reference to closed-end stock, bond, and mutual funds. This treatment is particular to FLPs because they are often created as an estate planning tool to facilitate the transfer of interests to other family members, yet keep control in the hands of the patriarch or matriarch, the general partners (and away from the children).

D. LIMITED LIABILITY PARTNERSHIPS. A registered limited liability partnership ("LLP") is a partnership where partners have no personal liability for professional malpractice claims and other entity obligations, unless they are liable by their own actions. As Professor Hamilton describes it:

> The original conception of an LLP – and the conception that has been accepted by the great bulk of the state LLP statutes – is that it provides what might be described as "peace of mind" insurance for innocent partners. The LLP is designed to avoid the fear by a partner that her personal assets may be at risk because of negligence or malpractice by a partner over whom she has no control and quite possibly whom she has never met.

Robert W. Hamilton, at 1066. The LLP had its nationwide genesis in Texas in 1991, Egan, *Choice of Entity Tree*, at 96, in reaction to the collapse of banks and savings and loans in Texas in the 1980s, with consequent lawsuits brought by the federal government against the law firms and accounting firms who advised the lenders or were involved in the failed

transactions. Hamilton, at 1069; Bromberg, at 131.

Texas LLPs formed on or after January 1, 2006, are governed by the Texas Business Organization Code. LLPs formed prior to that date can elect to be governed by the TBOC; if they do not so elect, they are covered by the TRPA or TRLPA until January 1, 2010, after which time TBOC will govern. Foreign LLPs are covered by TRPA arts. 10.01-10.05.

1. Formation. A Texas limited liability general partnership is governed by the terms of the TRPA, and the terms of the TRPA govern the formation of a general partnership that is an LLP. A limited partnership also can be an LLP, in which event the TRLPA will apply. TRPA art. 3.08(e); TRLPA § 2.14.

An LLP must register with the Secretary of State by filing an application containing certain information prescribed by statute. TRPA § 3.08(b). The LLP must be re-registered every year to maintain limited liability status. TRPA art. 3.08(b)(5), (7).

2. Ownership. A Texas general partnership that is a registered LLP is governed by the terms of the TRPA, and the terms of the TRPA govern ownership rights. A limited partnership that is a registered LLP is governed by the TRLPA. TRLPA § 2.14. Thus the ownership principles for a general partnership or a limited partnership, as the case may be, will apply to the LLP.

3. Management. An LLP is managed like a general or limited partnership, depending on which kind of partnership it is. *See* sections III.B.3 and III.C.3 *supra*.

4. Books and Records. There are no requirements regarding books and records that are unique to an LLP as distinguished from the underlying form of partnership.

5. Assets and Liabilities. Assets of an LLP have the same status as assets of an ordinary partnership. *See* section III.B.5 *supra*. Article 3.08 does require that an LLP carry at least $100,000 of malpractice insurance, or "put up" $100,000 specifically designated and segregated for the satisfaction of malpractice judgments against the partnership. The deposit must be in a bank escrow in cash, bank CDs, United States Treasury obligations, or by bank letter of credit or insurance company bond. TRPA art. 3.08.

Since many readers will belong to an LLP, the liability rules for LLPs are important enough to quote:

> Art. 6132b-3.08. Liability in and Registration of Registered Limited Liability Partnership
>
> (a) Liability of Partner.
>
> > (1) Except as provided in Subsection (a)(2), a partner in a registered limited liability partnership is not individually liable, directly or indirectly, by contribution, indemnity, or otherwise, for debts and obligations of the partnership incurred while the partnership is a registered limited liability partnership.
> >
> > (2) A partner in a registered limited liability partnership is not individually liable, directly or indirectly, by contribution, indemnity, or otherwise, for debts and obligations of the

partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed while the partnership is a registered limited liability partnership and in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner unless the first partner:

(A) was directly involved in the specific activity in which the errors, omissions, negligence, incompetence, or malfeasance were committed by the other partner or representative; or

(B) had notice or knowledge of the errors, omissions, negligence, incompetence, or malfeasance by the other partner or representative at the time of occurrence and then failed to take reasonable steps to prevent or cure the errors, omissions, negligence, incompetence, or malfeasance.

(3) Subsections (a)(1) and (a)(2) do not affect:

(A) the liability of a partnership to pay its debts and obligations out of partnership property;

(B) the liability of a partner, if any, imposed by law or contract independently of the partner's status as a partner; or

(C) the manner in which service of citation or other civil process may be served in an action against a partnership.

6. Accounting/Financial/Tax Reporting. The accounting and financial reporting for an LLP is the same as for partnerships generally.

7. Dissolution. Limited liability status can be terminated by filing a withdrawal notice with the Secretary of State. TRPA art. 3.08(b)(6). LLP status can also be lost by operation of law due to failure to reregister each year. TRPA art. 3.08(b)(5), (7).

As far as terminating the partnership is concerned, for a general partnership that is a registered limited liability partnership, the events requiring winding up of the LLP as well as the procedures for winding up and distributing the partnership's assets are the same as those for a general partnership. TRPA art. 8.01, 8.06; *see also* section III.B.9. *supra*. For a limited partnership that is a limited liability partnership, the rules governing winding up are the same as those for a limited partnership. TRLPA §§ 8.04, 8.05; *see also* section III.C.9. *supra*.

8. Marital Property Issues. The marital property issues associated with LLPs are like those associated with the underlying type of partnership. Unlike the PC and PA statutes discussed below, there is no express statutory prohibition against awarding an interest in an LLP to a spouse who is not a member of the profession.

9. Valuation. Valuation of an LLP, or of an interest in an LLP, is essentially like valuing a partnership, or an interest in a partnership.

The protection from liability afforded the non-involved partners may affect the value of a spouse's interest in an LLP.

E. LIMITED LIABILITY COMPANIES. The limited liability company ("LLC") originated in Wyoming in 1977, and came to Texas in 1991 with the Texas Limited Liability Company Act ("TLLCA"), effective August 26, 1991. 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. Geu, p. 45; 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. For example, Chrysler, the automobile manufacturer, is now an LLC that is 80% owned by a limited partnership. LLCs offer the benefits of being an entity while still being taxed like 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. TLLCA, arts. 3.01, 3.04. In Texas, an LLC can be formed by "one or more persons." TLLCA art. 3.01. Texas does not limit organizers to "natural persons," as some other states do, and the Act defines the term "person" to include corporations, trusts, and other entities. TLLCA art. 1.02A(4). Thus, an LLC may be formed by both natural persons and entities. There is no minimum capital requirement for forming an LLC.

The merger provisions in the TLLCA are substantively identical to those contained in the TBCA, laying out the conditions under which an LLC may be involved in a merger with another entity (including a subsidiary), the requirements for the plan of merger and the articles of merger, and the effects of the merger on those entities. TLLCA art. 10.01-10.05; TBCA art. 5.01, 5.03, 5.04-5.06. *See* section V.F.1. *infra*. The provisions for a conversion of a limited liability company are also analogous to those of a corporation. TLLCA art. 10.08-10.11; TBCA art. 5.17. *See* section V.G.1 *infra*.

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 can 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 membership interest in an LLC is personal property. TLLCA art. 4.04. A court, upon application by a creditor of a member of an LLC, "may charge the membership interest to the judgment debtor to satisfy the judgment." TLLCA art. 4.06A. A charging order is a lien on the interest. TLLCA art. 4.06B. A charging order is the exclusive remedy against the

member's interest in the LLC. TLLCA art. 4.06C. The creditor of a member cannot reach the assets of the LLC. TLLCA art. 4.06E.

3. Management. The members of an LLC have the power to adopt, alter, amend or repeal the regulations of the LLC. TLLCA art. 2.09. The managers of the LLC may also be given this power by the articles of organization. *Id.* The managers of an LLC have the authority to exercise the powers and direct the affairs of the LLC. *See* TLLCA art. 2.12. When the members of an LLC reserve this authority among themselves, the entity does not need to have separate managers. *Id*. The TLLCA gives broad latitude to the LLC to establish its own protocols for the procedures and rules governing its managers in its articles of organization or regulations. The TLLCA provides the protocols for matters not explicitly covered in the articles of organization or regulations. *See* TLLCA arts. 2.12-2.20. The managers and/or members may also appoint officers and agents and vest them with managerial powers. *See* TLLCA 2.21.

4. Assets and Liabilities. A member of an LLC has no interest in specific LLC property. TLLCA art. 4.04. Members are not liable for the debts, obligations or liabilities of an LLC. TLLCA art. 4.03A.

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).

5. Contributions/Distributions/Allocations of Profits and Losses. The TLLCA provides that a member of an LLC can contribute any tangible *or intangible* benefit to the entity, as well as property of any form. TLLCA art. 5.01. The regulations of the company may allow the admission of new members without making a contribution of any kind. TLLCA art. 4.01B-2(1). A member's promise to make a future contribution is unenforceable unless it is in writing. TLLCA art. 5.02A. Unless the articles of organization or regulations state otherwise, an enforceable promise to contribute survives the death of the obligor. TLLCA art. 5.02B.

Distributions from the LLC to its members may be made in any amount and at any time prescribed in the regulations. *See* TLLCA arts. 5.03-5.04. The only restriction on the amount of a distribution made to the members is that it may 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). *See* TLLCA art. 5.09. When a member becomes entitled to receive a distribution, that member acquires all of the rights of a creditor of the LLC. *See* TLLCA art. 5.08. Unless the regulations state otherwise, the LLC may only make distributions in cash and may not distribute LLC property in kind. TLLCA art. 5.07.

If the regulations do not include a specific method for allocating the profits and losses of the LLC, then those profits and losses will be allocated based on the value of each member's contribution recited in a statement required by the Act. *See* TLLCA arts. 5.02-1; 2.22(4)(a).

6. Accounting/Financial/Tax. [Comment by PLF:] An LLC is free to elect to be taxed as a corporation; otherwise it will be taxed as a partnership. A single-member LLC is disregarded for tax purposes and taxed as a sole proprietorship. There is no "transfer" for tax purposes where debt relief is not an issue and all income is subject to self-employment tax.

Since September 1, 2003, the default rule is that profits and losses are allocated based on the agreed value of the contributions made by each member, unless the LLC regulations provide something different. TALCA art. 5.02-1.

7. Dissolution. 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. TALCA art. 6.01A(1)-(3), (6); art. 6.02.

[Comment from PLF:] A member's disassociation does not cause dissolution unless otherwise provided in LLC agreement or unless the last member disassociates–generally, similar provisions as with general partnerships. Termination results in ordinary liquidation, with no gain or loss and a carryover basis so long as the distributions do not exceed basis. Ultimate sale of property received retains some character of gain or loss as in the hands of entity.

8. 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 TALCA art. 4.06, 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 just 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.

9. Valuation. The valuation issues associated with LLCs are like those of a corporation or partnership.

F. PROFESSIONAL CORPORATIONS. Professional corporations ("PCs") were introduced into Texas law effective January 1, 1970, by the Texas Professional Corporation Act ["TPCA"], V.A.T.S. art. 1528e. TPCA governs PCs formed before January 1, 2006–except for LLCs that elect coverage by the TBOC–until January 1, 2010, at which time the TPCA will be supplanted by the TBOC. TPCA § 21; TBOC § 402.005. A PC is a Texas corporation owned and managed by licensed professionals such as architects, attorneys-at-law, clinical social workers, CPAs, dentists, licensed professional

counselors, psychologists, veterinarians, etc., but excluding medical doctors. TPAC § 3(a), 4(b), 9, 10 & 12. PAs are governed by the TBCA except to the extent the TBCA conflicts with the TPCA. TPCA § 5.

1. Formation. A PC is created by filing articles of incorporation with the Secretary of State, TPCA § 4, and paying the required fees, after which the Secretary of State will issue a certificate of incorporation, TBCA § art. 3.03.

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

3. Management. A PC has a board of directors and officers. TPCA §§ 9, 10. No shareholder has the duty to supervise the "manner or means whereby the officers or employees of the corporation perform their respective duties." TPCA § 5.

4. Liability. The PC is jointly and severally liable for professional liability to the client, but this liability does not extend to shareholders, officer, or directors, by virtue of their positions as such. TPCA § 16. The shareholders of a PC have no greater liability as shareholders than do shareholders of other business corporations. TPCA § 5. The TPCA does not diminish claims a client may have for malpractice or malfeasance against a person rendering professional services. TPCA § 16. The provisions of the TPCA do not alter the professional relationship between the professional and the client. TPCA § 16.

5. Dissolution. A PC has the continuity of existence of a corporation, and is not subject to dissolution like a partnership. TPCA § 17.

G. PROFESSIONAL ASSOCIATIONS. As with professional corporations, professional associations ("PAs") were introduced into Texas law effective January 1, 1970. The Texas Professional Association Act ("TPAA"), Tex. Rev. Civ. Stat. art. 1528f, governs these entities. A PA is not legally considered to be a corporation, but it has many of the procedural and structural elements of a corporation. The TPAA lists several professions whose practitioners may form PAs, including podiatry, dentistry, optometry, therapeutic optometry, chiropractic, medicine, osteopathy, mental health, and veterinary medicine. TPAA § 2(A), 2(B)(2)-(3). This list is interpreted to

be the ***exclusive*** list of professionals that may form a PA because the TPCA and TPAA are mutually exclusive. *See* Op. Tex. Att'y Gen. No. M-551 at 4 (1970); *Welmaker v. Cuellar*, 37 S.W.3d 550, 551 (Tex. App.–Austin 2001, pet. denied). These same sources state that those particular professionals may elect to form ***either*** a PC ***or*** a PA. *Id.* However, medical doctors are ***only*** allowed to form PAs, ***not*** PCs. TPCA § 3(a); *Rockett v. Tex. State Bd. of Med. Exam'rs*, 287 S.W.2d 190, 191-92 (Tex. Civ. App.–San Antonio 1956, writ ref'd n.r.e.). Furthermore, professionals not explicitly enumerated in the TPAA may ***not*** form PAs. *Welmaker*, 37 S.W.3d at 551 (attorneys not permitted to form PAs). The TPAA will be replaced by the TBOC on January 1, 2010.

1. Formation. A PA is created by filing articles of association with the Secretary of State, TPAA § 8, and paying the required fees, after which the Secretary of State will issue a certificate of association, TPAA § 12. The date this certificate is issued is the date the association's existence begins. TPAA § 13.

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

3. Management. Like a corporation, a PA is governed by a board of directors or an executive committee elected by the members of the PA. TPAA § 9(A). No member of the PA has the power to bind the PA within the scope of its business or profession merely by virtue of being a member. TPAA § 9(B).

4. Assets and Liabilities. Because a PA is an entity, the owners of the PA do not have an ownership interest in specific PA assets. Like a PC, a PA is jointly and severally liable with the officer or non-member employee for malpractice or malfeasance against a person while furnishing professional services, but this liability does not extend to the other members of the PA individually who are not involved in the transaction. TPAA § 24. As with the PC, membership in this entity does not impair the personal liability of a tortfeasor. *Id.*

5. Dissolution. The procedures for dissolution of a PA are substantively identical to those for a corporation. TPAA §§ 18-20. In fact, provisions of the TBCA governing the dissolution of corporations may be applied to the dissolution of PAs to fill in any gaps not covered by the TPAA. *Neurobehavioral Assocs., P.A. v. Cypress Creek Hosp., Inc.*, 995 S.W.2d 326, 331-32 (Tex. App.–Houston [1st Dist.] 1999, no pet.).

6. Division. Under the TPAA, only a licensed member of the profession in which the PA practices may hold an ownership interest in the PA. TPAA § 10. As a result, Texas courts have recognized that they cannot award an unlicensed spouse an ownership interest in a community property PA upon divorce. *See, e.g., Eikenhorst v. Eikenhorst*, 746 S.W.2d 882, 887 (Tex. App.–Houston [1st Dist.] 1988, no writ). However, the *Eikenhorst* court's solution to this prohibition was an anomaly: it awarded the unlicensed spouse an interest in the cash assets of the PA. *Id*. This holding does not fulfill the standards for piercing the entity veil established by the

Texas Supreme Court in *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986). It is unclear whether the TBCA's limited codification of the alter ego doctrine from *Castelberry* applies to entities created under the TPAA. *See* TBCA art. 2.21.

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

7. Valuation. Goodwill is one relevant component of the valuation of a PA. *Trick v. Trick*, 587 S.W.2d 771, 773-74 (Tex. Civ. App.–El Paso 1979, writ dism'd). While the *Trick* court did not specifically hold that goodwill is a ***necessary*** component of the valuation of a PA, it seemed to endorse appellant's argument that goodwill is not only a relevant interest for determining the value of stock held in a PA, but also an essential one. *Id*. (citing *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972), and *Geesbreght v. Geesbreght*, 570 S.W.2d 427 (Tex. Civ. App.–Fort Worth 1978, writ dism'd).

H. SOLE PROPRIETORSHIP BUSINESSES. A sole proprietorship is a business, operated by an individual, that is not a legal entity. The business is not a creature of the state, and does not require any certificate from the Secretary of State.

1. Beginning Assets. Business equipment, inventory, furnishings, and other items of a sole proprietorship on hand at the time of divorce, are presumptively community property, and will be divisible unless traced. *Hopf v. Hopf*, 841 S.W.2d 898, 900 (Tex. App.–Houston [14th Dist.] 1992, no writ) (CPA's practice). If a sole proprietorship is started during marriage, then the community presumption applies to all assets of the business, and they would be separate property only if they are traced. If the owner of a going business marries, the inventory and equipment and receivables in the business on the day of marriage are separate property. The problem is tracing them if they are commingled with new assets.

Incorporating a Going Business. A spouse who incorporates a going sole proprietorship cannot argue that inception of title in the corporation arose with the unincorporated business. *Allen v. Allen*, 704 S.W.2d 600, 604 (Tex. App.–Fort Worth 1986, no writ). A corporation comes into existence when the Secretary of State issues a certificate of incorporation, but an ownership interest in the corporation is acquired when the corporation's shares are issued.

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

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

3. Accounting/Financial/Tax Reporting. A sole proprietorship normally would keep accounting records at least sufficient to prepare a Schedule C on the owner's personal tax return. Since there is no entity involved, there is no legal basis to differentiate assets of the business from other assets of the owner. However, accounting software and accounting practices used for business entities are often used for sole proprietorships, resulting in a similarity in accounting and financial reporting.

Tax reporting for a sole proprietorship is done through Schedule C of the owner's personal tax return. Schedule C is essentially a profit and loss statement for the business.

4. Dissolution. There are no legal requirements for discontinuing a sole proprietorship. The owner simply sells or gives away the assets (or lets them be taken by creditors) and shuts the door.

5. Marital Property Issues. As explained above, the chief marital property issue is tracing separate property assets at the time of divorce. The Supreme Court has recognized the power of the court in a divorce to award reimbursement to a spouse whose separate property was commingled with profits in a sole proprietorship. *Schmidt v. Huppman*, 73 Tex. 112, 11 S.W. 175 (1889); *accord*, *Hartman v. Hartman*, 253 S.W.2d 480 (Tex. Civ. App.–Austin 1952, no writ).

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

Valuing a sole proprietorship presents different issues from valuing a business entity. A sole proprietorship consists of individual assets, both tangible and intangible, and ownership of the business means ownership of these individual assets, not ownership of an entity that in turn owns the assets. Since most comparable businesses will be some kind of

Effect of Choice of Entities

entity, it is necessary to correlate the price derived from the sale of comparable entities to the price projected for the sale of individually-owned assets. Such a hypothetical sale could be of all assets grouped together, or piecemeal.

Personal Goodwill. Personal goodwill of a professional is not community property that can be divided upon divorce. *Nail v. Nail*, 486 S.W.2d 761, 764 (Tex. 1972). Goodwill in a professional business is not considered part of the marital estate unless it exists independently of the professional's skills, and the estate is otherwise entitled to share in the asset. *See Hirsch v. Hirsch*, 770 S.W.2d 924, 927 (Tex. App.–El Paso 1989, no writ); *Finn v. Finn*, 658 S.W.2d 735, 740-41 (Tex. App.–Dallas 1983, writ ref'd n.r.e.). While several cases have recognized goodwill of an entity, (*e.g., Finn*, 658 S.W.2d at 740-41; *Geesbreght v. Geesbreght*, 570 S.W.2d 427, 435-36 (Tex. Civ. App.–Fort Worth 1978, writ dism'd), and have found that goodwill to be community property, if the business is a sole proprietorship it is harder to establish goodwill of the enterprise, due to lack of an entity to own the goodwill. *See* section VII.E *infra*.

I. EXPRESS TRUSTS. 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 . . . ").

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.

1. Formation. 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).

Effect of Choice of Entities

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.

2. Ownership. The legal and beneficial title to trust property must remain separated or the trust collapses:

> 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.").

3. Management. The trustee has statutorily-prescribed management powers over the trust property except as limited in the trust document. TPC § 113.001. Absent provisions in the trust instrument to the contrary, under the Texas Trust Code the trustee has broad management powers. TPC § 113.006 (General Authority to Manage and Invest Trust Property).

> Trust instruments can provide for mandatory distribution or discretionary distribution of income and principal. Under a discretionary trust, the beneficiary is entitled only to the income or principal that the trustee, in his discretion, shall distribute to the beneficiary. . . . The beneficiary of a discretionary trust cannot compel the trustee to pay him or to apply for his use any part of the trust property, nor can a creditor of the beneficiary reach any part of the trust property until it is distributed to the beneficiary. . . . A court cannot substitute its discretion for that of a trustee, and can interfere with the exercise of discretionary powers only in cases of fraud, misconduct, or clear abuse of discretion.

Di Portanova v. Monroe, 229 S.W.3d 324, 330 (Tex. App.–Houston [1st Dist.] 2006, pet. denied) (citations omitted).

Effect of Choice of Entities

Where the trust is designed to support the beneficiary, the beneficiary can file suit in court to establish that a trustee has abused its discretion in managing the trust. *State v. Rubion*, 158 Tex. 43, 308 S.W.2d 4, 9 (Tex. 1958) ("The discretion with which a trustee of a support trust is clothed in determining how much of the trust property shall be made available for the support of the beneficiary and when it shall be used is not an unbridled discretion. . . .He may not act arbitrarily in the matter, however pure may be his motives. . . . His discretion must be reasonably exercised to accomplish the purposes of the trust according to the settlor's intention and his exercise thereof is subject to judicial review and control.").

4. 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. TPA § 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. TPA § 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. TPA § 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.

5. Accounting/Financial Reporting. The primary accounting obligation of the trustee is to account for property held in trust. The use of trust assets to pay expenses must be documented. The trustee must also keep track of income, expenses, and distributions for tax reporting purposes, as well as to differentiate trust income from trust principal when the income beneficiaries and the remainder beneficiaries are different.

Trust accounting (i.e., allocating between income and principal) is done on an aggregate basis, not on a line-item, account-by-account basis. Usually, in trusts, dollars are treated as fungible, and no effort is made to differentiate principal dollars from income dollars in the trust. At year end, the trustee: determines the total income (or losses) received and the total

Effect of Choice of Entities

principal received during the year; charges the expenses to income or principal in accordance with the trust instrument, or in accordance with law, or in accordance with prevailing standards; subtracts the income or principal distributed to beneficiaries, and carries forward into the new year the new balances of income and principal. Line item tracing on an account-by-account basis used to trace separate and community in personal accounts is unknown to trust accounting.

[Comment by PLF:] The Uniform Principal And Income Act (UPAIA) is one of the uniform acts that have been promulgated in an attempt to harmonize the law in all fifty U.S. states. The Act was completed by the Uniform Law Commissioners in 1997, and amended in 2000. The purpose of the UPAIA (sometimes referred to as the UPIA) is to provide procedures by which trustees administering trusts, and personal representatives administering estates, allocate receipts and payments to principal and income. The aim of the law is to ensure that the intention of the trust creator or decedent is carried out, and to govern the proper distribution of assets to trust beneficiaries, heirs and devisees. To be enacted into law, the Act must be adopted by the state legislature. To date, most states (including Texas) have adopted the Act (sometimes with modifications).

6. Tax Reporting. The Internal Revenue Code recognizes a trust as a separate taxable entity. However, if the settlor retains the power to decide who receives income, the power to vote or to control the vote of stock held in trust, the power to revoke the trust, or otherwise retains the benefits of the trust property, then the trust is a "grantor trust" and trust income will be taxed to the settlor. IRC §§ 671, 673, 674, 675, 676, or 677.

[Comments by PLF:] Trustees file a Form 1041 and income is taxed either to the fiduciary (as in a complex trust) or to the beneficiary on the Schedule K-1 (as in a simple trust). The fiduciary does get a deduction for amounts paid to or on behalf of the beneficiary. Income tax rates for trusts are at the same marginal rates as individual rates. The return discloses amounts paid to beneficiaries which may be useful information for identifying payments. See Schedule B. Also, income maintained in a trust may present characterization issues.

The different tax brackets are very compressed for a trust compared to an individual. For example, an individual (filing single, married filing jointly, or head of household) does not get taxed at the 35% bracket until taxable income exceeds $349,700 whereas a trust is taxed at the 35% bracket when taxable income exceeds only $10,450. These rates are for 2007 tax returns.

7. Termination. *Revocable trust. Trust expiring after a term. Trust expiring upon a contingency.* (like death, attaining a certain age, suit to terminate trust because purposes have become frustrated)

[Comment by PLF:] A detailed provision in the UPIA outlines the protocol for termination of an income interest in a trust. See TPC § 116.051. From a tax standpoint, the trust is terminated and a final return reports the income on a final schedule K-1.

8. Marital Property Issues. There are three types of relationships with parties to a trust

that could become an issue in marital property suits: the settlor, the trustee, and the beneficiary.

a. 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.

b. 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").

c. 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.

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.

Trust Assets. It is inherent in the concept of

Effect of Choice of Entities

"trust" that the beneficiary does not have legal title to trust assets. It follows, then, that assets held in trust for a married beneficiary 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.

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, and 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 unresolved 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. The question remains as to whether previously-undistributed income 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

Effect of Choice of Entities

community property? What about undistributed income from prior years that, according to the trust instrument, was added to the principal?

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?

[Comments from PLF:] Trustees do not prepare their accounting with characterization in mind. They possess a power to adjust between principal and income based on their judgment. TPC § 116.005 (Uniform Principal and Income Act).

9. Valuation. Valuing assets held in trust is no different from valuing assets held free of trust. However, valuing the beneficiary's interest in trust assets is an entirely different matter. For example, an income beneficiary's interest in trust property has the value of the right to receive income from trust property for as long as the income interest exists. A residuary beneficiary's interest in trust property is measured by the projected value on the date the property will be acquired by the residuary beneficiary, free of trust, discounted to present day. Since many income interests are life estates, the duration of the income interest, and the period of delay for the residuary beneficiary to take ownership, is measured by the income beneficiary's life expectancy and mortality rate. If the trust gives the trustee the discretionary power to distribute principal, valuing such a right would be speculative absent a consistent historical pattern of such distributions that is expected to continue into the future.

Valuing beneficial interests in a trust often arises in connection with federal estate tax. The Treasury Department has published tables to allow you to calculate the value of a life estate and remainder interest, based on the age of the life tenant.

[Comments by PLF:] These tables must be used if an individual transfers less than his full interest in property to a trust. Under general gift tax principles, the taxpayer will be subject to gift tax on the full value of the property transferred to the trust minus the fair market value of the retained interest. Due to abuses in overvaluing these retained interests and undervaluing of the taxable gift, special valuation rules were created for these types of interests. Under the special valuation rules, a retained interest is assigned a value of zero unless it is a "qualified payment". A qualified

payment is a cumulative distribution, determined at a fixed or market rate, that is payable periodically. Such a retained interest is given its actual fair market value. The special valuation rules do not apply to the retained interest if:

1. There is a readily available market quotation for either the retained or transferred interest,

2. the retained interest is the same class of interest as the transferred interest or the sole distinction between the transferred interest and the retained interest is voting rights, or

3. the rights attached to the retained interest are proportionately the same as all the rights in the transferred interest.

Some examples of qualified interests include charitable remainder annuity trusts (CRATs), charitable remainder unitrusts (CRUTs), charitable lead annuity trusts (CLATs), and charitable lead unitrusts (CLUTs). The IRS prescribes certain tables to use when valuing qualified interests and these can be found in Publication 1457 - Actuarial Values Book Aleph, Publication 1458 - Actuarial Values Book Beth, and Publication 1459 - Actuarial Values Book Gimel. These three publications currently comprise of 1,790 pages. The tables provide valuation factors derived from mortality statistics that are updated every 10 years. The valuation factors together with the applicable interest rates are used to compute the present value of the transferred interest. The applicable interest rate to use is 120 percent of the federal mid-term rate for the month in which the valuation date falls. The IRS publishes the current rates each month in a revenue ruling.

IV. SOURCES OF INFORMATION. Apart from the usual state offices discussed *infra*, an interesting website to visit is Texas Records and Information Locator (TRAIL): www.tsl.state.tx.us/trail. This site searches and locates information on more than 180 Texas state agency web servers.

A. SECRETARY OF STATE. The Texas Secretary of State maintains copies of records relating to corporations, limited liability companies, limited liability partnerships, limited partnerships, assumed names, trademarks, foreign and state financial institutions, unincorporated nonprofit associations, probate code filings by foreign corporate fiduciaries, UCC financing statements, and federal liens.

To access information online from the Texas Secretary of State's Office, <www.sos.state.tx.us>, you must establish an account through a program called SOSDirect <SOSDirect@sos.state.tx.us>. Using this service, subscribers can electronically file documents, perform searches for filed documents relating to business organizations, order copies and certificates online, view copies of filed documents online and print those copies directly at their desks. There are charges for all these services (for example, searching for documents costs $1.00 per search). An inquiry or search for a business organization may be performed using the entity name, name of the person listed as a registered agent, officer or director of a corporation.

B. STATE COMPTROLLER. The Texas State Comptroller's Office maintains

information on state franchise taxes, finances and business opportunities. Through the Comptroller’s website you can: obtain franchise tax and sales tax reports filed by businesses; search for unclaimed property; register as a Texas vendor and search for Texas vendors; obtain some forms online at no charge; and, file or pay sales and/or franchise taxes electronically. The website also has searchable taxpayer information databases, a directory of historically underutilized businesses, a searchable list of centralized master bidders, and even a Texas mileage guide. The Texas Comptroller's web site is <www.window.state.tx.us>.

Information concerning franchise taxes is located at <www.window.state.tx.us/taxinfo/franchise>. In addition to electronic reporting and payment options (you must obtain an access code for these services) information regarding whether a taxable entity is in good standing for the Texas franchise tax may be accessed by inputting either the (1) taxable entity's comptroller's taxpayer number, federal employer's identification number or file number; or (2) the name of the taxable entity. The entity’s certificate of account status information, can be viewed and printed and a Public Information Report can be accessed, which contains the names of corporate officers, directors, managers, or members. This information is also available on the Secretary of State's website. All entities subject to state franchise taxes must file initial, and annual, tax reports and the PIR is part of those reports.

1. Texas Franchise Tax Public Information Report. Business entities must file with the Comptroller a Texas Franchise Tax Public Information Report. A blank form is available at <http://www.window.state.tx.us/taxinfo/taxforms/RPinitial.pdf>. The form requires corporations and limited liability companies to give the name, title and mailing address of each officer, director or member. Partnerships must give the name and mailing address of each general partner and each person or entity owning a ten percent or more interest in the company. The report must be filed each year.

2. Franchise Tax Report. The Texas franchise tax report (long form) contains a simplified income statement for a business. This statement sets out revenues, cost of goods sold, and compensation figures. An explanatory booklet detailing Texas franchise tax reports is at available at <http://www.window.state.tx.us/taxinfo/taxforms/05-392.pdf>.

3. Sales & Use Tax Report. A business required to pay sales tax must file a sales and use tax report. An example is available at <http://www.window.state.tx.us/taxinfo/taxforms/01-114.pdf>. The form reflects sales and taxable sales.

C. LOCAL RECORDS.

1. Appraisal District Records. Local appraisal districts have information regarding the ownership and value of real estate located in the appraisal district as well as a business’s furniture, fixtures and equipment, for businesses within the district. The following web page will connect you to all appraisal districts that are on-line: <http://www.texascad.com> (last visited 7/16/08).

2. Assumed Name Certificates. The Assumed Business or Professional Name Act governs businesses that conduct business under an assumed name. Tex. Bus. & Com. Code Ch. 36. Corporations, LPs, LLPs, and

LLCs must file an assumed business or professional name certificate with the Secretary of State and the county clerks of the counties in which the entity has registered offices and its principal office. Tex. Bus. & Com. Code § 36.11(a). The certificate must include the entity's assumed name, actual name, the jurisdiction of inception of the entity, the duration of use of the assumed name, the locations of its registered and principal offices, the counties within the state where business will be conducted, and a statement identifying the type of entity. *Id.* General partnerships and PAs–referred to as "partnerships" and "companies," respectively, in the Act, Tex. Bus. & Com. Code § 36.02(1), (2), need only file their certificates with the county clerks of the counties in which they do business. Tex. Bus. & Com. Code § 36.10(a). For these entities, the certificate must include the entity's assumed name, actual name and address, the name and address of all general partners (if applicable), the jurisdiction in which the entity was associated (if applicable), the duration of use of the assumed name, and a statement identifying the type of entity. Tex. Bus. & Com. Code § 36.10(a). Regardless of what type of entity is using the assumed name, the certificate must be amended any time there is a material change made to the entity, Tex. Bus. & Com. Code § 36.12, and must be renewed every ten years. Tex. Bus. & Com. Code § 36.13. Failure to comply with these provisions may subject a person to civil and/or criminal penalties. Tex. Bus. & Com. Code §§ 36.25-36.27. Texas Rule of Civil Procedure 28 provides that any entity operating under an assumed name may be sued under that assumed named for the purpose of enforcing a substantive right.

3. Deeds and Deeds of Trust. Instruments affecting the title to land are recorded in the deed record office of the county where the land is located. In characterization disputes involving land, including the question about whether land is owned by a spouse or by an entity, the relevant documents should be obtained and examined.

4. Court Records. Court records can help you reconstruct past events if the entity was involved in a lawsuit. Pleadings, motions for summary judgment, and final judgments can provide facts otherwise lost to fading memories.

5. Abstracts of Judgment. A judgment creditor can obtain from a court an abstract of judgment which, when filed, creates a lien on any real property in the county where the abstract of judgment is filed. Tex. Prop. Code § 52.001. On application by the judgment creditor and the paying of a fee, the court shall issue the abstract. Tex. Prop. Code § 52.002. The abstract must contain the names of the plaintiff and defendant, the birthdate, social security number, driver's license number, and address of the defendant, the cause number of the suit in which the judgment was rendered, the date on which the judgment was rendered, the amount for which the judgment was rendered and the balance due, the amount of the balance due, if any, for child support arrearage, and the rate of interest specified in the judgment. Tex. Prop. Code § 52.003. This judgment lien continues for 10 years following the date of recording and indexing the abstract. Tex. Prop. Code § 52.006. The abstracts can lead you to court records of the lawsuit in question.

D. LICENSES. State licensing agencies keep information on their licensees, and some of this information is available to the public. Check the web site of the specific licensing agency for more information.

Effect of Choice of Entities

E. ACCOUNTING/FINANCIAL RECORDS. [Comment by PLF:] *See* section III.A.7 *supra*. for descriptions of financial statements. Other sources of financial information can be from third-party sources, such as banks, bonding companies, probate records, appraisal information (including county appraisal district data) or other share-holders or partners. Personal financial statements prepared for lenders may reflect the owner's view of the value of his/her interest in an entity.

F. FEDERAL TAX RETURNS. [Comments by PLF:] One of the best road maps for information is the tax returns filed by entities and the business forms of a party's personal federal income tax returns. The returns report income, deductions, balance sheet information, capital account information, distributions and other valuable information about ownership, debts, subsidiaries and even foreign bank accounts, all to the Internal Revenue Service, under penalties of perjury.

The most common tax return forms encountered by the family lawyer are as follows:

1. U.S. Individual Income Tax Return (Form 1040).

a. Schedule C--Sole Proprietorship Information. This schedule is the reporting of income and deductions from the parties' sole proprietorship. Business profit and loss statements should be compared to the schedule. Data from this schedule should not be confused with business income from a partnership or joint venture (reportable on Form 1065) or from a corporation (reportable on Form 1120 or 1120S).

b. Schedule E. This schedule reports results of the pass-through items from a partnership or S-Corporation, and includes information regarding the entity name, type of entity, whether a foreign partnership, employer ID number, and passive versus non-passive income and loss data. Supporting information is obtained from Schedules K-1 and depreciation Forms 4562.

c. Schedule F. This schedule details the income and expenses of a farming operation, similar to the detail discussed earlier in Schedule C for a sole-proprietorship

2. U.S. Fiduciary Income Tax Return (Form 1041). Form 1041 is used to report and pay tax for estates, trusts, and bankruptcy estates. Schedule K-1 provides a breakdown allocation of income, deductions, and tax attributes of the estate or trust for each beneficiary.

3. U.S. Partnership Income Tax Return (Form 1065). This form contains financial data for the entity, including a balance sheet and income and expense. Page 3 of Form 1065 is Schedule K, Partner's Share of Income, Credit and Deduction. This schedule reports 100% of various items to be reported to the partners on their individual Schedules K-1.

4. U.S. Income Tax Return for an S-Corporation (Form 1120S). Since an S-Corporation return passes income through to be taxed to the shareholders,

similar to the way a partnership passes through income to its partners, much of the information disclosed on the Form 1120S will be similar to the information reported on the "U.S. Partnership Return of Income" Form 1065. Specific to the S-Corporation is that distributions to the shareholders must be made on a strictly pro rata basis according to their stock ownership. There can be no special allocations of distributions or income and loss items. Non-pro rata distributions can cause a termination of the S-Corporation election. With respect to the S-Corporation election, the election is made on Form 2553, subject to IRC Sec. 1362. The form requires that the name and address of each shareholder be listed and signed under penalties of perjury. Spouses of shareholders also sign the form as community shares would require both husband and wife consent and will often show the shares owned 50%-50%. If shares of a company are the separate property of a shareholder, the tax preparer will nevertheless have the non-shareholder spouse sign the election in case some shares are community or because the fact of the shares being separate is not known by or disclosed to the preparer. Some family lawyers raise the issue that the disclosure that the shares are owned 50%-50% or the consent of the non-shareholder spouse shows the shares are community.

5. U.S. Corporation Income Tax Return (Form 1120). Similar to the Form 1120S but without the pass-through element. Worth noting, Schedule E "Compensation of Officers," page 2, may provide a starting point for gathering information about major shareholders/employees of the corporation. Schedule E provides the names of the officers, their social security numbers, the time they devote to the activities of the corporation and their ownership percentages of the common and preferred stock, as well as the compensation they receive during the year.

G. EMPLOYEES/FORMER EMPLOYEES. Current and former employees can provide much useful information about the history of entities, and can give the human perspective for some intricate transactions.

H. INDUSTRY INFORMATION. [Section by PLF:] Industry information can be obtained for a number of uses. When valuation of a company is being performed, the valuation professional will consider the *market approach* which attempts to estimate the value of a business enterprise or an interest in that enterprise by comparisons with similar businesses, and/or by comparison with exchanges of similar property in the marketplace. In the area of business valuation, certain public and private data is used to compare to the target company, assuming an active market place exists for the similar information. It also includes previous transactions in the company's own stock. The market approach typically includes the comparable sales method and the public company guideline method. The typical sources to search for large company transactions recently involved in a merger or acquisition include: *Mergerstat Review* published annually by Applied Financial Information, LP; *Merger and Acquisition Sourcebook* published

Effect of Choice of Entities

annually by NVST.com, Inc.; *Merger Yearbook* published annually by Securities Data Publishing; and *Mergers and Acquisitions* (a bi-monthly periodical) published by Securities Data Publishing. For smaller company transactions, there are four online databases which appraisers utilize in searching for transactions of similar companies: *Pratt's Stats* maintained by Business Valuation Resources (www.BVLibrary.com); *Done Deals* database maintained by NVST.com, Inc. (www.NVST.com); *Bizcomps* maintained by Jack R. Sanders (www.bizcomps.com); and the *IBA Market Database* maintained by the Institute of Business Appraisers (www.go-iba.org).

Other industry data used to evaluate the business entities includes that we find of particular help includes:

--IBISWorld Industry Report, a service which outlines an industry, analyzes the activities, similar industry, identifies demand and supply industries and provides an overview of economic factors, key statistics, growth and trends.

--The Internal Revenue Service publishes industry data related to its "Market Segment Specialization Program" as part of its "Audit Technique Guides" ("ATG").

--MorningStar publishes *Ibbotson"SBBI"* annually that provides for market results of stocks, bonds, bills and inflation. In addition to the overall economic information, Ibbotson and Associates analyze industry risk premium by looking at aspects and characteristics of the industry by using an elaborate screening process to find similar participants and group them into market groups.

–The Executive Office of the President Office of Management and Budget publishes the *North American Industry Classification System* ("NAISCS") which groups by industry various businesses in order to compare similar businesses by production processes. It is used in conjunction with other data services. This service was formerly the Standard Industrial Classification ("SIC").

--Risk Management Association (formerly Robert Morris Associates) ("RMA"), is an often- mentioned source of industry information and management compensation sources. RMA publishes data on various industry groups by standard industry classifications on an annual basis in its *Annual Statement Studies: Financial Ratio Benchmarks*, which is a source of composite company data, including privately owned company data. It is a member-driven professional association that works in the financial services industry, usually banking. Its members submit financial information about its commercial customers and prospects on an anonymous basis. Its data, though helpful, must be used with great care to avoid mis-use of its statistics.

--Various compensation studies, both industry specific and geographic, are helpful. For example the *Integra* studies and American Medical Association compensation surveys are a source of compensation.

--Trade associations, "twenty groups," and other specific industry organizations will often provide comparable information to businesses.

I. SEC FILINGS. The Securities and Exchange Commission maintains a website which provides registration statements, prospectuses and periodic reports filed on Forms 8-K, 10-K and 10-Q. SEC filings can be searched using the SEC's Edgar search capability. *See* <http://www.sec.gov/edgar/quickedgar.htm>.

J. PATENTS AND TRADEMARKS. The United States Patent and Trademark Office maintains a website. *See* <http://www.uspto.gov/> (Last visited 7/17/08). The site provides numerous helpful databases through which patents and trademarks may be searched using a variety of different fields such as patent number, name and abstract. For patent searches, visit: <http://www.uspto.gov/patft/index.html> (Last visited 7/17/08). For the Trademark Electronic Search System, visit: <http://tess2.uspto.gov/bin/gate.exe?f=tess&state=l8ts87.1.1> (Last visited 7/17/08).

V. IMPORTANT CONCEPTS REGARDING ENTITIES.

A. EARNINGS. [Comments by PLF:]
Earnings in these various entities are usually similar: gross revenues or sales, less cost of sales or cost of goods sold, less general and administrative costs equals net income or net profit or (loss). The terms net earnings, net income and net profits are often interchangeable. Care should be taken to distinguish whether "earnings" on the income statement or statement of earnings is before or after deprecation, interest expense, income taxes and extraordinary income or loss. These distinctions are especially important in the valuation context.

When distributions are made from an entity, the net profits are distributed, keeping in mind that any cash distribution of a partnership (or dividends in the case of a corporation) will be subject not only to surplus requirements (see below) but also to the availability of cash assets to fund the distribution.

B. OWNER'S EQUITY/CAPITAL/RETAINED EARNINGS. The owners' contributions to a business entity are carried on the balance sheet as capital accounts, sometimes called "owner's equity." Geu, at 75 n. 240. A corporation does not have a separate capital account for each owner; a partnership does. *Id.* On a corporate balance sheet, "par value" is a value arbitrarily assigned to each share; "stated capital" is par value multiplied by the total number of shares outstanding; "capital surplus" is the amount of property contributed by owners in exchange for stock, in excess of par value; "paid-in capital" is stated capital plus capital surplus; "earned surplus" reflects profits not distributed to shareholders. *Id.* "Retained earnings" are defined in the Texas Administrative Code for Texas franchise tax purposes:

> Retained earnings represent the accumulated gains and losses of a corporation to date, reduced by any dividend distributed to shareholders and any amounts transferred to either capital stock or paid-in capital.

Tex. Admin. Code § 3.547(6).

Effect of Choice of Entities

On a partnership balance sheet, a partner's capital account reflects the value of the property contributed by the partner, plus that partner's share of profits, less that partner's share of losses, less distributions to the partner. *Id.*

Earnings of an entity that remain undistributed are property of the entity, do not belong to the spouses, and are neither separate nor community property. *See* Section III.A.5, and III.B.5 *supra*, and VI.C *infra*.

[Comment from PLF:] As discussed

> previously, in a corporate entity, ownership is reflected as a number of shares. In a closely held corporation, it's not unusual for shareholders to think of themselves as, say, 25% owners because they may own 250 shares of the 1,000 shares issued and outstanding. Unless additional shares are issued or redeemed, the relative ownership percentage will remain the same. The corporation's issuing additional shares to other people will dilute the overall effective percentage of our 25% shareholder, but he will still own the same 250 shares, even after dilution. On a book value basis per the books of account, the shareholder may think in terms of his own equity as being 25% of the retained earnings or "surplus" of the corporation. Surplus is defined in the Texas Business Corporations Act Art. 1.01 C (27), as the excess of the net assets of a corporation over its stated capital. This definition is the same as that for "retained earnings," the surplus wording being dropped from regular accounting nomenclature in the last century.
>
> A partner's ownership through an interest in his partnership is different than owning shares. The partner may have a 25% capital interest in a partnership when the partnership is initially formed (four equal partners). The subsequent admission of a new capital partner will reduce the effective percentage ownership to say, 20% (five equal partners). In large partnerships, as in law firms, the percentages may be carried out several decimal points and the admission and withdrawal of partners can involve constantly changing percentages of capital interests of partners. TUPA Art. 6132B-8.06(a) provides the mechanism for distribution on winding up of an interest and the application of property to obligations. After all obligations to creditors have been discharged, any surplus must be applied to pay in cash the net amounts distributable to partners. In the event insufficient funds are available to satisfy partnership obligations, partners must contribute in proportion in which they share partnership losses, an amount to satisfy the partnership obligations. Art. 6132B-8.06(c)(1). TUPA also addresses profits and allocation but not the concept of "profits and surplus" together. But profits become part of surplus subject to distribution.

In *Bader v. Cox*, 701 S.W.2d 677, the concurring opinion of Judge Whitham outlines the concepts of profits and surplus as it relates to the widow, Paula Bader's action seeking to recover her deceased husband/partner's interest in law partnership:

> Therefore, we must determine Bertran T. Bader's interest in the partnership at the date of his death. A partner's interest in the partnership is his share

> of the profits and surplus. Article 6132b, section 26. Thus, we must determine Bertran T. Bader's share of the profits and surplus at the date of his death on April 7, 1982. The act does not define "profits and surplus." Neither does the act define "profits" or "surplus." Consequently, we must determine what are "profits and surplus" within the meaning of the act.
>
> The only summary judgment proof directed at our inquiry is the undisputed affidavit of a certified public accountant. The affidavit proved that the partnership's fiscal year was the calendar year and proved the amount of profits for the period January 1, 1982, through April 7, 1982. Therefore, the amount of profit for the period in question can be ascertained by the undisputed summary judgment proof. "Surplus," however, presents a summary judgment problem. The word "surplus" is well adjudicated, and means the excess of assets over liabilities. Anderson v. United States, 131 F.Supp. 501, 502 (S.D.Cal.1954) (applying the Uniform Partnership Act adopted in California).

Id. at 687-688. The affidavit prepared by the CPA as summary judgement proof stated that "it is commonly understood in the accounting profession in Texas that the term "surplus" contained in the Texas Uniform Partnership Act is synonymous with the accepted partnership accounting term 'capital account balance.'" Nevertheless, Judge Whitham objected to the statement in its limitation that it did not "tell us that his concept of the term 'capital account balance' means the excess of assets over liabilities on April 7, 1982. To my mind, the accountant's affidavit does not tell us what we need to know-the amount of money, if any, which equals the excess of assets over liabilities." *Id.* at 688.

C. CAPITAL CONTRIBUTIONS.

1. Legal Aspects. For a corporation, initial capital is supposed to be reflected in the minutes of the organizational meeting of the board of directors (or unanimous written consent in lieu thereof). For partnerships, initial capital is usually described in the partnership agreement. Often the capital contributions are supposedly stated on an exhibit attached to the minutes of the initial directors meeting or the partnership agreement that is never attached. Sometimes the exhibit is attached but the blank line for capital contributions is not filled in. Other times the organizational documents reflect initial capital of $1,000, a manifestation of the now repealed requirement in the TBCA that the corporation have $1,000 in capital before it starts conducting business. *See* Section III.A.1, *Initial Capital of $1,000 supra*. Frequently, the real capital contributed is not reflected in the organizational paperwork. The incorporation of a going sole proprietorship illustrates this point. The day the certificate of incorporation is issued, the corporation comes into existence, and the paperwork usually reflects a $1,000 check as initial capital. Often, however, the real capital contribution was not the $1,000, but instead was the "going concern" that was contributed to the corporation, including tangible assets like equipment and inventory, and intangible assets like the premises lease, the telephone number, the yellow page advertisement, the workforce-in-place, and the goodwill between the business and its suppliers and between the

business and its customers. The $1,000 (if it was ever paid at all) is dwarfed by all this other capital, which in all likelihood is not mentioned in the organizational documents as consideration for the shares issued. *See* section VII.B *infra*.

It should be noted that personal services rendered could not be contributed as initial capital for a limited partnership prior to the effective date of TRPA (September 1, 1987).

2. **Accounting Aspects.** [Comments by PLF:] In the early stages of an entity, the books and records frequently are not kept contemporaneously with the timing of the transactions. It is not unusual to see books prepared some months after the start of the entity or after its first year-end has closed. The requirement that the entity have $1,000 of capital is often booked through a journal entry without the $1,000 ever being paid in. When an entity is the product of incorporating a previously unincorporated business, the assets transferred may represent its initial capital.

   The term "capital contributions" suggests contributions to a partnership or LLC. Capital contributions made to corporations are usually called "additional paid in capital." The primary question that arises from a marital property stand-point is whether the capital contribution is made in exchange for any additional interest in the entity. From a partnership perspective, the partnership would record not only the amount of the contribution, but also may make memo entries to track the basis of the property contributed if other than cash. Contributions may also affect the amount of basis in an entity for purposes of taking tax losses in the case of a pass-through entity.

3. **Tax Reporting Aspects.** [Comments by PLF:] Federal income tax returns generally provide information regarding the income statement and balance sheet of an entity–often when very little other financial reporting information is available (some exceptions apply). It may be the initial tax return that reports the capital structure of an entity (e.g., a corporation or partnership). If all Schedules K-1 are available, the capital contributions of a partnership can be recreated. A word of caution: the form provided by the IRS for purposes of preparing the reconciliation of the partners' capital accounts does not always provide information that can adequately analyze the true nature of contributions and withdrawals. Sometimes these two categories will include journal entries that do not reflect true contributions to capital or amounts withdrawn. And many times the K-1s will reflect the tax basis, not the fair market value, of non-cash assets contributed as capital.

   For tax purposes there is no gain or loss on the contribution of property so long as the liabilities on the property contributed do not exceed the basis of the property contributed.

D. DIFFERENCES IN TAX TREATMENT. [Entire Subsection by PLF:]

1. **Two Ways of Taxing Corporations.** The various entities that have been discussed have different treatments from a federal income tax standpoint. There are two basic constructs: where the entity is a

taxable entity for tax purposes, such as a C-Corporation or a complex trust where the fiduciary is the taxpayer, and as the so-called "pass-through" entity where a Schedule K-1 is issued for an S-Corporation, partnership, LLC (unless the default provision is overridden by election), LP and a Form 1040--Schedule C for a trade or business sole proprietorship on an individual return.

An S-Corporation, as has been pointed out, is simply a C-Corporation that has made a special election to be taxed as a pass-through entity. A tax specialist (such as Geoff Poll, who helped me with many of the tax provisions in this paper) can assist clients with whether it is advisable to make an S-Corporation election. There are a number of differences in the tax treatment of C-Corporations and S-Corporations. For example, profits are taxed to a C-Corporation and then may be taxed again to the shareholders if they are distributed. Profits for an S-Corporation are generally taxed only to the shareholder, whether or not they are distributed. There are limitations on the number (75) and type (individuals, estates, and some trusts) of shareholders for the S-corporation. These shareholder restrictions are not applicable to C-Corporations. Certain taxes apply to a C-Corporation, such as the personal holding company penalty tax, which do not apply to an S-Corporation. The C-Corporation is eligible for the dividends received deduction under IRC Sec. 243, whereas this deduction is not applicable to S--corporations. Also, there are a number of differences in the tax treatment of major medical expense, disability insurance coverage, medical reimbursement plans, cafeteria plans, group term life, and health and disability insurance for a 2% or greater shareholder. In each of the forgoing areas, the deductibility rules are more liberal for the C-Corporation. Further, as mentioned elsewhere in this paper, differences also occur in the tax treatment of asset sales by a C-Corporation or an S-Corporation.

2. Timing Issue With S-Corporations.
Geoff Poll wrote an excellent article about the pitfalls involved in the timing of such a transaction for tax purposes in a paper presented to the Advanced Family Law Course in 2004: "*Stock Redemptions Incident to Divorce–Closely Held Family Corporation.*"

A tax issue relating to S-corporations is the concept of "closing of the S-Corporations books and records." The amount of income and deductions taxable to a shareholder of an S-Corporation whose interest is terminated during a year is affected by the method used by to allocate those items by the corporation. The allocations also affect the basis of the redeemed shareholders' S-Corporation stock because the income allocated and the amount of distributions or redemption proceeds can be different. The default method for allocating income and deductions to a terminating shareholder is a pro rata allocation based on a "per share, per day" calculation. That is, the total income of the S-Corporation for the year is divided by the number of days in the year and that amount is allocated to each day and subsequently to the shares of stock that are outstanding on each day.

Effect of Choice of Entities

In an extreme hypothetical, where a 50% shareholders' interest is redeemed on June 30 of a year, and there was -0- net income for the corporation through June 30 and $1 million of net income for the July 1 through December 31 period, the departing shareholder would be allocated $250,000 on his final Schedule K-1. This allocation can lead to unanticipated results.

To avoid the uncertainty of being allocated amounts for the time period after the date of termination, the S-Corporation may elect to terminate the S-Corporation year for all the affected shareholders and the corporation. The election is commonly called the "closing of the books" method for allocating income and deductions. The election divides the tax year into two separate tax years for purposes of a pro rata allocation with the first year ending on the date of the termination. The books and records of the S-Corporation are used to allocate the items of income and deduction between the two short years and a pro rata allocation is then made to the shareholders on the basis of the two short years. Under the example above, if the election was in place to terminate the S-Corporation's year for pro rata allocation purposes, the shareholder whose interest terminated would have been allocated -0- income on his Schedule K-1 because he would only share in the activity of the corporation through June 30. The two short years created for tax purposes require making two different sets of adjustments to the stock and debt basis of the shareholders' interests for purposes of determining the consequences of distributions, including any adjustments to accumulated adjustments account ("AAA"). An S-Corporation making the termination election assigns each item of taxable and tax exempt income, deduction, and credits to each deemed separate tax year using it normal method of accounting.

An S-Corporation makes the terminating election by attaching a separate return to its timely filed income tax return for the year during which a shareholder's entire interest is terminated. The election statement must include the following information:

1. a declaration by the S-Corporation that it is electing to treat the tax year as if it consisted of two separate tax years;

2. information setting forth when and how the shareholder's entire interest was terminated (for example, a divorce and subsequent stock redemption),

3. for tax years before 2003, the election had to be signed by an authorized officer of the corporation under penalties of perjury. For tax years beginning after 2002, the election statement need not be signed by a corporate officer and is considered to be verified by the signature on the Form 1120S required to be filed by the S-Corporation,

4. a statement by the corporation that the corporation and each affected shareholder consents to the S-Corporation making the terminating election. This is generally done by attaching a page for the affected shareholders to sign that indicates their consent.

E. SUBSIDIARY/AFFILIATE. There are several different types of businesses that are subordinate to another business: two of the most common types are subsidiaries and affiliates.

1. Subsidiaries. *Gigax v. Ralston Purina Co.*, 136 Cal.App.3d 591, 601-02 (Cal. App. 1982), described a subsidiary in this way:

> A "subsidiary" is a corporation whose voting shares of more than a specified percentage are owned directly or indirectly by the parent corporations. (Corp. Code, § 189, subd. (a).) Generally speaking a percentage ownership of more than 50 percent creates the corporation as a 'subsidiary' whether it is owned directly or indirectly through one or more subsidiaries. (Ibid.)

It is generally held that the parent company must own more than 50% of the other entity for the other entity to be a subsidiary.

Although an entity may be a subsidiary of another entity, the two entities maintain separate existances.

> A "subsidiary corporation" is one which is controlled by another corporation by reason of the latter's ownership of at least a majority of the shares of the capital stock. Notwithstanding two corporations may be so related, each is deemed to have an independent existence.

Rimes v. Club Corp. of America, 542 S.W.2d 909, 912 (Tex. Civ. App.–Dallas 1976, writ ref'd n.r.e.). Courts will not disregard the separate identity of the parent and the subsidiary absent grounds for piercing the corporate veil. *Anchia v. DaimlerChrysler AG*, 230 S.W.3d 493, 501 (Tex. App. Dallas 2007, pet. denied), ("We do not disregard separate legal entities simply because one owns stock in the other unless the relationship is being used to defeat public convenience or to justify wrongs"). *See Bell Oil & Gas Co. v. Allied Chem. Corp.*, 431 S.W.2d 336, 339 (Tex. 1968) (discussion of when the separate identity of corporations with stock ownership or interlocking directorship will be disregarded).

2. Affiliates. If the parent company owns 50% or less, the subordinate company can be an "affiliate." According to *Muha v. United Oil Co., Inc.*, 433 A.2d 1009, 1012 n. 3 (Conn. 1983):

> "'Affiliate' has been defined as a branch or unit of a larger organization; a company effectively controlled by another or associated with others under common ownership or control. Webster, Third New International Dictionary."

The Texas Business Combination Law, TBCA part 13, defines "affiliate" as "a person who directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with a specified person." As used, "person" includes an individual, trust, corporation, partnership, limited partnership, other entity, or component of the government. TBCA art. 13.02(7).

There are a number of descriptions of "affiliate" in federal statutes:

> •12 U.S. Code § 4502(1) (Banks and Banking, government sponsored enterprises)– "Except as provided by the Director, the term affiliate means any entity that controls, is controlled by, or is under common control with, an enterprise."

Effect of Choice of Entities

• 17 C.F.R. § 230.144(a)(1) (regarding persons deemed not to be engaged in a distribution and therefore not underwriters)–"An affiliate of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer."

• 15 U.S. Code § 6701(g)(1) (McCarran-Ferguson Act, regarding regulation of the insurance business)–"The term affiliate means any company that controls, is controlled by, or is under common control with another company."

• 47 U.S. Code § 153 (wire or radio communications)–"The term 'affiliate' means a person that (directly or indirectly) owns or controls, is owned or controlled by, or is under common ownership or control with, another person. For purposes of this paragraph, the term own means to own an equity interest (or the equivalent thereof) of more than 10 percent."

• 11 U.S. Code § 101(2) (U.S. Bankruptcy Code)–"'[A]ffiliate' means—

(A) entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor. . . ."

3. Accounting Aspects of Subsidiary/Affiliates. [Comments by PLF:] In general, investments in affiliated companies of less than 20% are generally accounted for on the "cost" method of accounting, booking the cost of the investment on the books of the investor company. Any dividends received are recorded as "investment income" and no adjustment to the original investment cost is made.

Investments in affiliated companies of 20% or more but less than 51%, are generally accounted for on the "equity" method of accounting for affiliates. The investment cost basis is adjusted at least annually to reflect the investor's share of earnings or losses in the affiliated company. Any dividends received are not recognized as investment income, but rather, an increase to the balance sheet cash account (assuming a cash dividend) and a decrease investment cost basis.

If the affiliate is owned in amount greater than 50%, the investor will consolidate the subsidiary with the investor's financial statement. Any intercompany transactions are eliminated in the consolidation.

3. Tax Aspects of Subsidiary/Affiliates. [Comments by PLF:] There are two basic requirements that a group of corporations must meet in order to qualify as an affiliated group of corporations for tax purposes. First, all of the corporations in the group must be "includible corporations," as defined by statute. Corporations are includible corporations unless the statute specifically excludes them from that category. Second, the group must consist of a common parent and one or more subsidiaries that are connected to each other through specified amounts of stock ownership. The required amount of stock ownership is at least 80 percent, and this is measured by both voting power and value. The determination of whether or not a group of corporations is an affiliated group, and

therefore eligible to file a consolidated income tax return, must be determined independently each year. When an affiliated group elects to file a consolidated return for federal tax purposes, it will include From 851–Affiliations Schedule in the return. The Form 851 provides information regarding ownership between members of the affiliated group, tax identification numbers of the members, estimated taxes, overpayments, and amounts paid with an extension of time for filing as they relate to each member. It also discloses the principal business activity of each member, the ownership of voting shares, classes of stock outstanding and changes in ownership that occurred during the tax year among other things.

F. MERGER.

1. Legal Aspects. TBCA art. 5.01 permits a merger of a corporation into one or more other entities. For the purpose of this statute, another entity includes a corporation, general or limited partnership, joint venture or other legal entity. TBCA art. 1.02A(20). A merger can 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 must be a plan of merger that is approved by the necessary participants described in the statute. TBCA art. 5.03. If the plan of merger is approved, then someone must prepare articles of incorporation for any new Texas corporation. TBCA art. 5.04A. When these are filed with the Secretary of State, and all franchise taxes and fees have been paid, the Secretary of State will issue a certificate of merger. TBCA art. 5.04C. The merger is effective when the certificate of merger is issued. TBCA art. 5.05.

When a merger takes effect, all corporations that did not survive the merger cease to exist as separate entities. TBCA art. 5.06A. All rights, title and interests to assets of the vanishing corporation are vested in one or more of the new or surviving entities, and all liabilities of vanishing corporations are allocated to one or more of the surviving or new corporations. *Id.*

TBCA art. 5.16 permits 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.

2. Accounting Aspects. [Subsection contributed by PLF:] From an accounting standpoint, a merger (and all other business combinations) are subject to FAS 141 and are to be accounted for using only one method, that is the "purchase method" of accounting. FAS 141 represents a fundamentally different approach to accounting for business combinations than was taken by the Accounting Standards Board in their APB No. 16 pronouncement. In that case, purchased intangibles would be identified and named and goodwill was amortized for financial purposes.

FAS 141 approves a single-method approach reflecting the conclusion that virtually all business combinations are acquisitions and therefore all business combinations should be accounted for in the same way that other asset acquisitions are accounted for–based on the value exchanged. It requires that intangible assets be recognized as assets apart from goodwill if they meet one of two criteria: contractual legal criterion or the separability criterion.

The changes to accounting for business combinations was implemented to improve financial reporting because the financial statements of entities that engage in business combinations will better reflect the underlying economics of those transactions.

FAS 142 is applicable to financial accounting and reporting for intangible assets acquired individually or with a group of other assets. It does not address assets acquired in a business combination.

Both FAS 141 and FAS 142 are subject to provisions contained in FAS 142 that provides guidance to valuation professionals on the methods to be used to evaluate the possible impairment of goodwill.

3. Tax Aspects. [Section by PLF:] The federal tax aspects of all types of business conversions is a highly complex area. The comments provided in the following sections related to taxation are meant as a limited summary only of the various types of business combinations and transactions.

Generally, tax consequences to an owner on a merger or reorganization are tax free with a carryover basis to the extent the shareholders continue to hold an interest in the successor entity. A broad exception occurs if the liabilities in the successor entity are altered reducing the owner's pro-rata obligations.

Regarding the tax consequences to the entity subject to a reorganization, generally they are also tax free for all entities except for in the case of a corporation, the successor entity must be a corporation. Also in the case of a reorganization, to the extent that S-Corporation has been previously elected, a majority of the shareholders must consent to revoke the S-Corporation status. In order for a corporation to elect S-Corporation status, all shareholders must consent. The election of S-Corporation results in the loss of NOL carryovers from the previous C-Corporation.

G. CONVERSION.

1. Legal Aspects. 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* Egan, *Choice of Entity*, p. 112. Beginning in 1997, Texas began to allow the conversion of a corporation into an LLC, or partnership, or other entity, by a legal process called "conversion." A conversion causes the entity to change form (such as from a corporation to a partnership, or LLC, etc.), without interrupting its existence. Because of a omission in the wording of TBCA art. 5.17, there is 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 is explicitly authorized to convert into a Texas entity. TBCA art. 5.17B.

There must be a plan of conversion that is approved by the necessary participants described in the statute. TBCA art. 5.17. If the

plan of conversion is approved, then articles of conversion must be prepared. TBCA art. 5.18. When these are filed with the Secretary of State, and all franchise tax and fees have been paid, the Secretary of State will issue a certificate of conversion. TBCA art. 5.18. The conversion is effective when the certificate of merger is issued. TBCA art. 5.19. In the conversion, the converting entity continues to exist without interruption, and all rights, title and interests to all real estate and other property is unaffected, and all liabilities continue unaffected.

2. Accounting Aspects. [Comments by PLF:] See discussion above regarding financial reporting in section V.F.2.

3. Tax Aspects. [Section by PLF:] Prior to the enactment of the Texas Margin Tax, a corporate entity could be transformed into a limited partnership structure in order to reduce Texas Franchise Taxes. This procedure was an expensive but useful method to reduce taxes. With the enactment of the Margin Tax, the usefulness of these types of conversions was removed. A conversion to a general partnership, which is not subject to Margin Tax, would certainly lower the cost of taxes but exposes the partners to personal liability without the shield provided by the limited partnership form.

For federal income tax purposes, a conversion of a partnership into another partnership (including entities taxed as partnerships such as GPs, LLPs, LPs, and LLCs) will not cause a tax consequence so long as there is no reduction of the liabilities to which a partner is subject, no increase in the proportional share of liabilities, and the business assets of the entity remain substantially unchanged.

A corporation can be converted into another corporation generally on a tax-free basis. A corporation cannot be converted tax-free into an entity classified as a partnership or sole proprietorship, in which case the transaction is taxable to the extent that the liquidating transaction of the corporation is taxable to the shareholder. The contribution of assets received in liquidation, to the partnership or sole proprietorship is not taxable. For C-Corporations, a double taxation will possibly occur, once at the corporate level for the gain or loss equal to the difference between the fair market value of an asset and the basis to the corporation. Then the distribution of the assets to shareholders will be taxable to shareholders as the difference between the fair market value of the distribution and the shareholders' basis in the stock.

H. SPIN-OFF.

1. Legal Aspects. "In a 'spin-off,' a parent company distributes shares of a subsidiary to the parent company's shareholders. The shares are usually distributed on a pro rata basis and the subsidiary becomes a separate company." <http://www.sec.gov/answers/spinoffs.htm>. No Texas cases discuss the marital property character of stock received by a spouse as a spin-off from a separate property corporation, but one way to view this transaction is as a mutation or as a distribution of capital.

2. Accounting Aspects. [Comment by PLF:] See discussion above regarding financial reporting in section V.F.2.

3. Tax Aspects. [Comments by PLF:] A corporate spin-off is an example of a divisive reorganization. Other divisive

reorganizations include split-offs and split-ups. In these divisive transactions there is a corporation, known as the distributing corporation, that distributes the stock of a controlled corporation to its shareholders. There may be a contribution of assets to the controlled corporation before the stock is distributed to shareholders. In the spin-off, there is a pro rata distribution of the stock of the controlled corporation to the shareholders of the distributing corporation. In a split-off, the stock of the controlled corporation is distributed to only some of the shareholders of the distributing corporation, and those shareholders in turn relinquish their stock in the distributing corporation. In the split-up, the distributing corporation contributes all of its assets into two or more controlled corporations, makes a distribution of the stock of the controlled corporations to its shareholders, and then liquidates in the distribution. Five specific requirements apply to divisive reorganizations. These are:

1. The distribution requirement -- the distributing corporation must only distribute stock of the controlled corporation to its shareholders;

2. The control requirement -- the distributing corporation must distribute enough stock of the controlled corporation to constitute control of the controlled corporation;

3. The active trade or business requirement -- the distributing corporation and the controlled corporation must both be engaged in an active trade or business immediately after the division;

4. The anti device requirement -- the distribution must not be a device for distributing earnings and profits;

5. The business purpose requirement -- there must be a valid corporate business purpose for the division.

A divisive reorganization is the only way for a corporation to distribute appreciated property without triggering a corporate–level tax. As such, Congress was concerned about the use of these reorganizations to avoid gain on transaction the essentially were asset sales to unrelated parties. Therefore, anti-abuse rules exist that are specific to corporate divisions. These include the disqualified distribution rule and the prohibited acquisition rule.

I. SHARE EXCHANGE.

1. Legal Aspects. In 1989, the TBCA was amended to permit a "share exchange," TBCA art. 5.01, as a simplified way for a corporation to acquire a subsidiary. Bromberg, at 116. In a share exchange, a corporation can acquire "all of the outstanding shares of one or more classes or series of one or more domestic corporations." TBCA art. 5.02. There must be a plan of exchange that is approved by the necessary participants described in the statute. TBCA art. 5.03. If the plan of exchange is adopted, then articles of exchange must be prepared. TBCA art. 5.04(A). When these articles are filed with the Secretary of State, and all franchise taxes and fees have been paid, the Secretary of State will issue a certificate of exchange. TBCA art. 5.04(C). The share exchange is effective when the certificate of exchange is issued. When the share exchange is effective, the shares of the acquired corporation are deemed to have been

exchanged as described in the plan of exchange. TBCA art. 5.06(B).

2. Accounting Aspects. [Comments by PLF:] See discussion in Section V.F.2 *supra.* If the shares are simply an exchange of shares of one entity to another, journal entries would record such changes in the books and reported on the financial statements as shares held.

3. Tax Aspects. [Comments by PLF:] The exchange of shares of stock in a stock swap for other shares is generally a non-taxable event. Taxable gain will arise if there are fractional shares that result from the shares exchanged, if there is "boot" in the transaction in the form of cash to equalize the exchange, or if the shareholder has elected to take the shares in cash in lieu of making the swap, in which case the gain is taxable. All gains would be a capital gain so long as the underlying shares were capital assets in the hands of the holder.

J. ASSET SALE. When a business acquisition is planned, the buyer sometimes will prefer an asset purchase to a stock purchase, share exchange, or merger. An asset purchase permits the buyer to pick-and-choose which assets and which liabilities it will acquire. Egan & Huff, at 288-89. The purchaser of all or nearly all of a Texas corporation's assets is *not* liable for the selling corporation's liabilities. TBCA art. 5.10B.

1. Legal Aspects. Corporations have the authority to sell assets in the ordinary course of business. TBCA art. 5.08. The conveyance is accomplished by signature of an officer or agent of the corporation, and supported by resolution of the board of directors. *Id.* A real estate deed, signed by a corporate officer and filed of record, is prima facie evidence of director approval. *Id.*

Where a corporation intends to convey, lease, exchange or otherwise dispose of "all, or substantially all, of the property and assets of a corporation," different considerations arise. If the transaction is "made in the usual and regular course of the business of the corporation," the transaction can proceed as authorized by the board of directors without shareholder approval. TBCA art. 5.09. The same is true for pledging, mortgaging and collateralizing assets. *Id.* The transaction is in the usual and regular course of business if the corporation either continues to engage in one or more businesses, or applies a portion of the proceeds to the conduct of its business. *Id.* Where the conditions just described do not apply, it requires the approval of two-thirds of the corporation's shareholders to conduct the sale or mortgage. TBCA art. 5.10.

2. Accounting Aspects. [Comments by PLF:] See discussion above in Section V.F.2., *supra*. In particular, FAS 142 is applicable to financial accounting and reporting for intangible assets acquired individually or with a group of other assets. It does not address assets acquired in a business combination.

3. Tax Aspects. [Comments by PLF:] The tax consequences and reporting of a corporate asset sale are different than for the sale of corporate stock. When a corporation sells assets, it recognizes a gain or loss based on the sales price less the adjusted basis of the assets being sold. The character of the gain or loss is determined based on the type of asset sold. If the purchase price exceeds the fair market value of the hard assets sold, then there may be an allocation to

goodwill for the difference. Typically, the seller and the buyer have different desires when it comes to allocating the sales proceeds to the various assets purchased. The buyer usually desires the allocation to be weighted toward the assets that have a shorter life and recovery period, like tangible property and equipment or accounts receivable, and the seller usually desires the allocation to be towards goodwill and going concern value. The allocation to goodwill from the sellers perspective may be somewhat less important when the seller is a C-Corporation rather than an S-corporation. Although the C-Corporation will recognize capital gains treatment here, the net long term capital gains are taxed at the regular corporate tax rates. If a C-Corporation has net capital losses though, the allocation to assets generating capital gains is important since those losses will only be offset by capital gains. For the S-Corporation, the gain or loss, capital or ordinary, is generally allocated to the shareholder and the character is retained. Therefore, the allocation to assets producing capital gain income is more important here from the seller's perspective. One exception is the net unrealized built in gains of S-Corporation assets from a year in which it was taxable as a C-Corporation. These assets will generate a corporate level tax to the S-Corporation if they are sold within ten years after the C-Corporation elects S status.

In the C-Corporation, after the sale of assets and calculation of net gain or loss and the associated corporate level taxes, there may also be a tax payable by shareholders when the proceeds are paid out as dividends or in liquidation of the shareholders' interest in the corporation. This is the "double taxation" that is so often the subject of discussions on tax policy. For the S-Corporation shareholder there is generally only one level of tax, and that is at the shareholder level. When the proceeds from the asset sale are distributed, they are not taxable to the extent of the shareholders' basis in his S-Corporation stock.

K. CONSOLIDATED REPORTING. [Entire subsection contributed by PLF:]

1. Accounting Aspects. For purposes of GAAP, when the ownership of one company that has a controlling interest in the voting stock of another company presents two separate legal entities, but in substance is a single economic or accounting, there is a presumption that the entities will be consolidated. This rule is complicated by the fact that control of an entity may be achieved other than through ownership of a majority of the entity's voting stock.

2. Tax Aspects. Consolidation rules for federal income tax purposes differ from GAAP requirements. IRS regulations require 80% ownership to file consolidated tax returns. Thus in some cases consolidated financial statements will be required by GAAP even though the companies do not qualify to file consolidated tax returns.

L. ATTORNEY-CLIENT PRIVILEGE. According to the Texas Supreme Court, the lawyer-client privilege allows “unrestrained communication and contact between an attorney and client in all matters in which the attorney's professional advice or services are sought, without fear that these confidential communications will be disclosed by the

attorney, voluntarily or involuntarily, in any legal proceeding." *West v. Solito*, 563 S.W.2d 240, 245 (Tex. 1978). The privilege is said to "promote effective legal services," which "in turn promotes the broader societal interest of the effective administration of justice." *Republic Ins. Co. v. Davis*, 856 S.W.2d 158, 160 (Tex. 1993).

Tex. R. Evid. 503 sets out the lawyer-client privilege. The definition of a client includes "corporation, association, or other organization or entity, either public or private, who is rendered professional legal services by a lawyer, or who consults a lawyer with a view to obtaining professional legal services from that lawyer." Tex. R. Evid. 503(a) (1). A "representative of the client [is] a person having authority to obtain professional legal services, or to act on advice thereby rendered, on behalf of the client, or . . . any other person who, for the purpose of effectuating legal representation for the client, makes or receives a confidential communication while acting in the scope of employment for the client." *Id.* Rule 503(a)(2). Privileged communications are described in this way:

> A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client:
>
> (1) between the client or a representative of the client and the client's lawyer or a representative of the lawyer;
>
> (2) . . . ;
>
> (3) by the client or a representative of the client, or the client's lawyer or a representative of the lawyer, to a lawyer or a representative of a lawyer representing another party in a pending action and concerning a matter of common interest therein;
>
> (4) between representatives of the client or between the client and a representative of the client . . . .

To determine who is a representative of a business client for purpose of this Rule, the Supreme Court has adopted a "control group test," under which "[a] representative of the client is one having authority to obtain professional legal services, or to act on advice rendered pursuant thereto, on behalf of the client." *National Tank Co. v. Brotherton*, 851 S.W.2d 193, 197 (Tex. 1993).

Regarding a trustee of an express trust, in *Huie v. DeShazo*, 922 S.W.2d 920, 925-26 (Tex. 1996), the Supreme Court held that the attorney-client privilege protected a trustee's communications with a lawyer for the trust, and barred involuntary disclosure of such confidential communications to a beneficiary of the trust.

M. REPRESENTING BUSINESS ENTITIES. Representing a business entity in connection with a divorce can present special problems. Where the entity is community property under the control of one spouse, it may seem natural for the controlling spouse's lawyer to also represent the entity. If there are minority owners, a conflict of interest may exist. If the other spouse ends up receiving the business in the divorce, the opposing party has now become the lawyer's client, with a right to look at information previously protected by the attorney-client relationship. The new owner also could cause the entity to sue the attorney, etc. If the entity is a corporation and

has a board of directors, does the attorney take instructions from the spouse who may be president, or from the board of directors itself?

Burnap v. Linnartz, 914 S.W.2d 142, 150 (Tex. App.–San Antonio 1995, writ denied):

> Texas has adhered to the entity theory of partnership since the Texas Uniform Partnership Act was enacted in 1961, thus an attorney's representation of a partnership does not necessarily include representation of the individual partners. Tex. Rev. Civ. Stat. Ann. art. 6132b, § 1 cmt. (Vernon Supp. 1995); *Haney v. Fenley, Bate, Deaton and Porter*, 618 S.W.2d 541, 542 (Tex.1981).

N. DISCOVERY OF ENTITY RECORDS. In a divorce involving an owner or manager of a business entity, sometimes the opposing party will serve discovery requests on the spouse as a way to obtain records from the company. There is a problem with this approach to discovery. Texas Rule of Civil Procedure addresses requests for the production of documents:

> 192.3. Scope of Discovery
>
> (a) Generally. . . .
>
> (b) Documents and Tangible Things. A party may obtain discovery of the existence, description, nature, custody, condition, location, and contents of documents and tangible things (including papers, books, accounts, drawings, graphs, charts, photographs, electronic or videotape recordings, data, and data compilations) that constitute or contain matters relevant to the subject matter of the action. *A person is required to produce a document or tangible thing that is within the person's possession, custody, or control.*

(Emphasis added). Tex. R. Civ. P. 192.3 Texas Rule of Civil Procedure 192.7(b) says:

> *Possession, custody, or control* of an item means that the person either has physical possession of the item or has a right to possession of the item that is equal or superior to the person who has physical possession of the item.

(Emphasis in the original).

In the case of *In re Kuntz*, 124 S.W.3d 179, 183-84 (Tex. 2003), the Supreme Court held that a former husband, who was an employee, lacked physical possession or the right to possess confidential information of his employer, and that the employer's records could not be obtained from the former husband. The Court cited two other cases:

> *In re Grand Jury Subpoena (Kent)*, 646 F.2d 963, 969 (5th Cir.1981) ("The [employee's] subpoena, if upheld, would be illegal because it would direct her to produce documents not in her possession, custody, or control. Because [employee] had mere access, her compliance with the subpoena would have required that she illegally take exclusive possession of [her employer's] documents and deliver them to the grand jury.") (emphasis in original); *Am. Maplan Corp. v. Heilmayr*, 203 F.R.D. 499, 501-02 (D. Kan. 2001) (denying motion to compel defendant, president

and minority shareholder of nonparty corporation, to produce nonparty corporation's documents in suit brought against defendant in his individual capacity).

O. SELF INCRIMINATION. An individual conducting business as a sole proprietor has a Fifth Amendment privilege against self incrimination; a corporation does not. *Braswell v. U.S.*, 487 U.S. 99, 108 S.Ct. 2284 (1988). It is unclear where partnerships and other hybrid entities fit in.

VI. VARIOUS MARITAL PROPERTY AND DIVORCE-RELATED ISSUES.

A. ACQUIRING AN OWNERSHIP INTEREST.

1. Formation Versus Acquisition of Interest. It is important to differentiate the date an entity is formed from the date the spouse acquires an interest in the entity. For example, a corporation is formed on the day the certificate of incorporation is issued by the Secretary of State, but shares in the corporation are acquired when capital is transferred to the corporation in exchange for the shares. A general partnership comes into existence upon an agreement between the partners, usually before any capital is contributed to the entity. A limited partnership can have a signed agreement and even paid-in-capital, but it does not come into existence until the certificate of limited partnership is filed with the Secretary of State.

2. Acquisition of Interest vs. Inception of Title. Ordinarily an asset is characterized as separate property or community property based on the circumstances existing when title is acquired. *Henry S. Miller Co. v. Evans*, 452 S.W.2d 426 (Tex. 1970). However, if title had its inception at an earlier time, the circumstances surrounding the inception of title will control character. *Smith v. Buss*, 135 Tex. 566, 144 S.W.2d 529, 532 (1940); *Winkle v. Winkle*, 951 S.W.2d 80, 88 (Tex. App.–Corpus Christi 1997, writ denied).

3. Subsidiary. Since corporations, partnerships and LLCs are entities, any subsidiary entities are owned by the entity and are not marital property. What happens when a spouse owns a separate property business and during marriage starts new businesses as subsidiaries of the separate property business? Retained earnings of the holding company can be used for this purpose, or the new businesses can be started with a loan from a third party to the company, sometimes backed by the spouse's personal guarantee. If wealth is created during marriage in this manner, does the other spouse have a claim? Clearly not a direct ownership claim. What about piercing the corporate veil?

B. INITIAL VERSUS SUBSEQUENT CAPITAL CONTRIBUTION.

1. Capital Contributed in Exchange for Ownership Interest. As stated in *Allen v. Allen*, 704 S.W.2d 600, 604 (Tex. App.–Fort Worth 1986, no writ):

> The approach of Texas courts in determining the separate or community character of a corporation formed during a marriage has been to require the parties to clearly trace the separate and community property assets that were contributed during the formation of the corporation. . . . Corporations organized during marriage and capitalized entirely with traceable separate property of one spouse are characterized as the separate property of that spouse.

Effect of Choice of Entities

(citations omitted).

Because corporate law used to require $1,000 in paid-in capital before a corporation could start into business, records from the start-up of a corporation usually reflect initial capital of $1,000. In many instances a transfer of $1,000 may not have actually occurred, or at least cannot be found after-the-fact. In *Allen*, a corporation formed during marriage was held to be community property because the wife could not overcome the presumption that the $1,000 initial capital was community property. In *Fazakerly v. Fazakerly*, 996 S.W.2d 260, 265 (Tex. App.–Eastland 1999, pet. denied), the wife secured a jury verdict that corporations started during marriage were her separate property, despite evidence that she capitalized the companies with $1,000 but could not produce the checks.

It should be recognized that in some instances parts of the purchase price for assets can be paid at different times without invoking community credit. In *Edsall v. Edsall*, 240 S.W.2d 424, 428 (Tex. Civ. App.–Eastland 1951, no writ), the husband purchased land, partly on community credit and partly in exchange for nineteen separate property cows. Eleven of the cows were delivered to the grantor at the time the deed was delivered, but eight cows were delivered two months later. The trial court held that the portion of the purchase price related to all of the cows was separate property, since the evidence showed that the buyer and seller intended for the balance of the purchase price to be paid from the buyer's separate estate.

2. Capital Contributed Without Acquiring More Ownership. When community assets are contributed to a separate property corporation or partnership at a time when no additional ownership interest is acquired, a claim for reimbursement may arise. Can this be approached as an economic contribution claim for a capital improvement?

3. Using Community Credit for Business Loans. What happens when a business entity buys an asset using borrowed funds, and the loan is personally guaranteed by a spouse? The entity, not the spouse, acquired the asset, so the asset cannot be marital property. *Faulkner v. Faulkner*, 582 S.W.2d 639 (Tex. Civ. App.–Dallas 1979, no writ) (husband was co-maker of loan whereby corporation built land on property owned by husband's father; no community ownership because no property was acquired by husband). What if a corporate debt is refinanced with a loan using a spouse's personal guarantee? According to Justice Camille Hutson-Dunn, in a concurring opinion in *Thomas v. Thomas*, 738 S.W.2d 342, 346 (Tex. App.–Houston [14th Dist.] 1987), the community estate should have a reimbursement claim. In *Thomas*, a corporation borrowed money to buy land and build a building. The debt was later refinanced, and the husband and wife personally guaranteed the new debt. Justice Hutson-Dunn wrote:

> Neither the parties' research nor ours has revealed a Texas case deciding the question of whether the community has a right to reimbursement for the use of its credit to secure a loan to refinance the husband's separate property debts. However, I am not willing to state, at this time, that this new reimbursement theory is without merit. I would analogize this situation to cases where separate debts are discharged with community funds. *See Villarreal v. Villarreal*, 618 S.W.2d 99 (Tex. Civ. App.–Corpus Christi 1981, no writ); *Hawkins v. Hawkins*, 612 S.W.2d 683 (Tex. Civ. App.–El Paso

> 1981, no writ). However, there is an important difference between the case before us and cases involving the discharge of a separate debt with community funds. When a debt is discharged, the cost to the community is obvious, but when a separate property debt is refinanced with the community acting as a guarantor, the cost to the community is not so readily ascertainable. In the latter situation, expert testimony would be required on the percentage risk undertaken by the community, and a dollar value would have to be assigned to that risk.

Id. at 346.

C. RETAINED EARNINGS. An increase in the value of a separate property business is separate property. *Jensen v. Jensen*, 665 S.W.2d 107, 109 (Tex. 1984). Part of the increase in value of an entity could be retained earnings. What if the entity is a pass-through entity, like a partnership or S-Corporation, where the tax liability for the retained earnings shows up on the spouse's personal tax return, and where the liability may have been paid using community property? Does that give the community estate a claim to the undistributed income? In *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. App.–Houston [1st Dist.] 1987, writ denied), the court held that retained earnings inside as S-Corporation are an asset of the business and therefore are not community property.

D. MUTATIONS OF OWNERSHIP INTEREST. Under the applicable statutes, an ownership interest in a business is traceable through mergers, conversions, and stock swaps, which are all mutations of the original business interest. What happens if, instead of a merger or conversion, the business reorganization involves the owner of a separate property corporation founding a limited partnership and then transferring all the corporation's assets to the limited partnership? Is that a mutation, or is it instead a distribution from the corporation that makes all the assets community property? Should the form of the business reorganization change the character of the new business?

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

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

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

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

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

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

E. TRACING INSIDE AN ENTITY. For both corporations and partnerships, the assets of the entity do not belong to a spouse and are therefore neither separate nor community property. That being so, ordinary tracing of separate and community property is not sensible. However, where the entity veil is pierced, the separateness of the entity is disregarded, so tracing would be appropriate. Also, premarital agreements can contain their own rules about tracing that might alter the ordinary marital property rules of tracing. A constructive trust claim against property transferred to an entity would seem to require tracing of the assets conveyed to the entity in fraud of the other spouse's rights. Tracing of separate and community assets is somewhat different from tracing profits and capital. Many businesses routinely distinguish profits from capital, and in some instances they are required to do so. There should be no impediment to proving that a distribution from an entity can be traced to capital and not profits, although the legal conclusion to be drawn from that fact may be subject to debate.

Bader v. Cox, 701 S.W.2d 677 (Tex. App.–Dallas 1986, writ ref'd n.r.e.), is a good example of tracing profits inside an entity. In *Bader v. Cox*, a partner in a law firm died with several contingent-fee cases pending. Under TUPA, death caused a "dissolution" of the partnership. *Id.* at 680-81; *see also* TUPA § 29 ("The dissolution of a partnership is the change in the relation of the parties caused by any partner ceasing to be associated in the carrying on . . . of the business"). The partner's widow sought "redemption" of her husband's partnership interest, including the profits attributable to the use of his right in the partnership property. *Id.* at 681. The trial court held that the pending contingent-fee cases could not be considered partnership property because the partnership used a cash basis accounting system, all of the partnership's ascertainable profits had already been credited to the decedent's capital account, and any profits derived from those cases in the future could not be attributable to work performed prior to the partner's death. *Id.* The Dallas

Court of Appeals reversed, holding that the pending contingent-fee cases were partnership property at the times of dissolution. *Id.* The court said that the widow's claim to these profits must be determined by taking the total amount of profits received from these cases after dissolution (i.e. her husband's death), and subtracting the profits attributable to the post-dissolution skill, time, efforts and diligence of the remaining partners. *Id.* at 684. Thus, it was necessary to trace inside the partnership to determine the fees derived from contingent fee contracts of the law firm in existence when the husband died, and allocating to the surviving partners the portion of the profits attributable to their efforts in completing the cases.

F. PIERCING THE ENTITY. A number of cases permit the spouse of a shareholder to "pierce the corporate veil" and claim as community property assets that belong to the corporation. This is sometimes called "reverse piercing," because the third party claimant is reaching corporate assets through the shareholder, and not reaching the shareholder through the corporation. The Pattern Jury Charges recognize such a claim in TEXAS PATTERN JURY CHARGES (FAMILY) PJC 205.1-205.4 (2008). The court in *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 517 (Tex. App.–San Antonio 2001, pet. denied), says that the injury from improper use of the corporation must damage the community estate "beyond that which might be remedied by a claim for reimbursement." In *Robbins v. Robbins*, 727 S.W.2d 743 (Tex. App.–Eastland 1987, no writ), the spouse used the alter ego theory to impress community property character on the corporate stock–a possible misconception of how the doctrine works.

Note that alter ego is just one of several bases to pierce the corporate veil, along with arguments that the corporate form has been:

1. used as a sham to perpetrate a fraud;
2. resorted to as a means of evading an existing legal obligation;
3. employed to achieve or perpetrate a monopoly;
4. used to circumvent a statute; or
5. relied on as a protection of crime or to justify wrong.

See Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986); TEXAS PATTERN JURY CHARGES (FAMILY) 205.2 (2008).

In *Young v. Young*, 168 S.W.3d 276, 281 (Tex. App.–Dallas 2005, no pet.), the court said:

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

The *Young* court said this about the remedy:

> In a divorce case, a finding of alter ego sufficient to justify piercing the corporate veil requires: (1) unity between the separate property corporation and the spouse such that the separateness has ceased to exist; and (2) the spouse's improper use of the corporation damaged the community estate beyond that which

might be remedied by a claim for reimbursement.

Id. at 281-82.

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

As mentioned in section III.A.5 *supra*, TBCA arts. 2.21A(1) & (2) require contract creditors to prove actual fraud, not just constructive fraud, to pierce the corporate veil. Additionally, TBCA art. 2.21A(3) has eliminated piercing the corporate veil for any "obligation of the corporation" based on "failure of the corporation to observe any corporate formality." Note that a spouse asserting a reverse piercing claim is usually not a contract creditor, and there is no appellate opinion addressing whether a piercing claim of a spouse in a divorce is an "obligation of the corporation" for purposes of Article 2.21A(3).

G. DISTRIBUTIONS OF PROFITS AND CAPITAL.

Distributions of Profits. All cash dividends paid by a corporation to married shareholders are community property. *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). In this sense, however, dividends are distributions made from earnings and profits. If the distributions are not made from earnings and profits, do they have the same character as the ownership interest?

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. Under the *Marshall* case, distributions of profits from a partnership to a married partner were held to be community income. *Marshall v. Marshall*, 735 S.W.2d 587, 594-95 (Tex. App.–Dallas 1987, writ ref'd n.r.e.). Would the result be different if all profits had already been distributed? What if the business had operated

at a loss during the entire marriage? Or from the inception of the businesses, so that there were no current earnings and no retained earnings?

Distributions of Capital. Some lawyers and forensic CPAs take the position that a business entity cannot make a capital distribution other than in complete liquidation of the entity; any other distributions they say are community property. Others argue that it is within the power of the board of directors, or the partners, to distribute capital instead of current income or retained income. Coupled with the position that a distribution of capital has the same character as the ownership interest it comes from, this reasoning leads to the conclusion that even a distribution of capital from an ongoing business with current or retained earnings to a spouse owning separate property shares or a separate property interest is received as separate property.

On a corporate balance sheet, retained earnings (sometimes referred to as earned surplus) represents corporate earnings that have not been distributed to owners. When all profits have been distributed, and earned surplus is zero, it can be argued that any further distributions to the owner are by necessity from paid-in capital, and thus constitute a return of capital.

In a partnership, there is no equity account that reflects either paid-in capital or undistributed profits per se. Paid-in capital for each partner must be reconstructed from records showing how much capital each partner has contributed since becoming involved with the partnership, and the net of profits and losses charged to that partner's capital account, less any distributions to the partner.

TRLPA mentions distributions of capital from a limited partnership. TRLPA provides that "distributions that are a return of capital shall be made on the basis of the agreed value . . . ." TRLPA § 5.04. TRLPA has the following definition for "return of capital":

> "unless otherwise provided in a written partnership agreement, any distribution to a partner to the extent that the partner's capital account, immediately after the distribution, is less than the amount of that partner's contribution to the partnership as reduced by prior distributions that were a return of capital."

TRLPA § 1.02(13). That description of a return of capital can be altered by written partnership agreement. So it is clear that a limited partnership can distribute capital as opposed to profits. The issue is not whether capital can be distributed. The issue is really whether capital distributed to the owner of a separate property limited partnership is received as separate property by that owner.

See "liquidation" in section VII.I *infra.*

[Comments by PLF:]

> Corporations. Distributions of profits from a separate property corporation are community property. Such distributions are usually in the form of dividends paid to a spouse-shareholder. What about the return of capital from an corporation? Questions arise as to what constitutes a dividend from a corporation. Dividends are the distribution of current or accumulated earnings to the shareholders of a corporation pro rata based on the number of shares owned. Black's Law Dictionary 331 (6th ed., abridged ed.,

Effect of Choice of Entities

West 1995); Glenn A. Welsch and Charles T. Zlatkovich, *Intermediate Accounting* 759 (8th ed. 1989). For financial reporting purposes, a dividend payment requires a credit to the account representing the item distributed to the shareholder (for example, cash, and a debit to retained earnings). Four dates are relevant in accounting for dividends: 1) date of declaration; 2) date of record; 3) ex-dividend date; and 4) date of payment. For cash or property dividends, the declaration date is important because courts have held that the formal declaration of the dividend by the entity's board of directors constitutes an enforceable contract between the corporation and the stockholders. In the case of stock dividends, a corporation has a right to revoke the dividend declared up to the date of issuance.

Complete and partial liquidations from corporations are discussed *infra*.

Partnerships. For purposes of characterization, income from separate property is community property, including the income from a separate property partnership interest. Some forensic accountants have interpreted the *Marshall* case, discussed *supra*, in a broad way to support a position that *any and all* distributions from a partnership are community property, not just distributions of income or profit of the entity. What if the distributions exceed the actual earnings of the partnership or actually constitute a return of the capital of the entity? Forensic accountants may account for the profits or earnings of the partnership and separate them from capital. It is then possible to attribute the partnership's income and profit to certain distributions, call them community, attribute distributions in excess of such earnings to capital, and call them separate property? This is especially applicable when the partnership agreement itself provides for distributions that are a return of capital to the partners. Questions may arise as to the treatment of the undistributed income, which is property of the entity and not of a marital estate. Is the entity's income cumulative and is the community estate entitled to have previously-undistributed cumulative earnings deemed to be community property whenever a distribution occurs? Should the treatment of assets received in dissolution of a partnership differ for a corporate liquidation or redemption of a shareholder's interest?

The exhaustion-of-capital approach was endorsed in the following quotation taken from *Brooks v. Brooks*, 612 S.W.2d 233, 237 (Tex. Civ. App.–Waco 1981, no writ), where the trial court awarded reimbursement to the husband's separate estate for the use of capital of a separate property corporation to pay family living expenses and to acquire personal assets:

> In summary, here was a corporation which was a going concern and wholly owned by Appellee Mr. Brooks at the time he married Appellant Mrs. Brooks, worth $63,266.00 at the time of the marriage; during the six years of marriage the parties drew $166,575.00 out of the corporation for living expenses and the acquisition of a sizeable community estate, thereby spending during such six year period not only all the corporation earned during the marriage, but also depleting the corpus of

> the corporation by $48,020.88. The right of reimbursement is an equitable doctrine. To us it seems fair and equitable under this record for the trial court to reimburse Appellee Mr. Brooks for this capital depletion, particularly where it is undisputed that the community estate acquired by the parties substantially exceeds the amounts reimbursed to Appellee.

Id. at 237.

Phantom Income. With a pass-through entity (like a Sub-S corporation, a partnership or an entity that elects to be taxed like a partnership), earnings of the business will be passed through to the owners to be reported on their personal tax returns. If the earnings are retained inside the entity, then there will be no actual income received to use to pay the income tax due on the "phantom income." If the spouse's interest in the pass-through entity is separate property, then the value of the separate estate will increase by the amount of that undistributed income, even though the community estate is liable for the tax on the undistributed income. In Texas, the existing case authority says that the undistributed earnings are not community property. *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. Civ. App.–Houston [1st Dist.] 1987, writ denied). If community money is used to pay the tax on the phantom income, reimbursement is in order. What if the entity distributes just enough earnings to the spouse to pay the tax on the phantom income? The distributions are presumptively community property, and if they are used to pay the tax on the phantom income it can be argued that reimbursement is still due for using community money to pay a separate debt–even though the entity actually paid the tax on the phantom income by distributing out the tax payment to the owners. One way to fix this problem is a written waiver of reimbursement. However, there is no statutory authority for post-marital waiver of reimbursement claims. Can the waiver be repudiated prior to divorce because it constitutes an agreement incident to divorce, under Tex. Fam. Code § 7.006(a)? Another way to avoid such a reimbursement claim is to partition the distribution so that it is received as separate property, so that separate cash is paying the tax on the phantom income.

Phantom income can also be a concern for a non-partner spouse who receives an assignee's interest in a partnership after divorce. Will there be phantom income? Does the partnership agreement *require* the partnership to distribute enough money to pay the phantom tax? If such a provision does exist, at the time of divorce, can it be amended later despite opposition from the assignee spouse?

H. IRC SECTION 1041. Historically, where the entire community property interest of both spouses in an asset (including a business) was awarded to just one spouse in the divorce, there was a risk of capital gain recognition on the part of the spouse whose interest was conveyed. This problem was resolved in 1984 when Congress amended the Internal Revenue Code and added Section 1041, which essentially defers capital gain recognition on interpousal transfers incident to divorce. Now under Section 1041, "[n]o gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)– (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce." IRC § 1041. Instead the transfer is treated as a gift for tax purposes, which means the spouse receiving the asset takes the asset at the transferor's tax basis. *See* Cheyanna L. Jaffke, *Stock Redemptions in the Marital Corporation: What Happens When the Love Is*

Gone?, 54 RUTGERS L. REV. 487 (2002) ("Jaffke"). The application of Section 1041 to the redemption of a spouse's interest in a business is discussed in section VI.I *infra*.

[Comments by PLF:] Geoff Poll wrote about Section 1041 in a paper presented to the Advanced Family Law Course in 2004, dealing with tax issues, and in particular "Stock Redemptions Incident to Divorce–Closely Held Family Corporation."

Divorcing individuals faced with the prospect of dividing a closely-held family corporation often found themselves subject to income tax consequences that were at worst unintended and at best difficult to predict. In the past, most tax cases examining these transactions were complex and lacked clear directives on what steps parties should undertake in order to achieve their desired tax results. Now, there is guidance from the IRS on this issue in the form of a new regulation under Treas. Reg. § 1.1041-2(c).

IRC § 1041 is the code section that provides the basic framework allowing spouses to divide the marital estate without current income tax consequences. It essentially allows the parties to assign potential income tax gains or losses to each other by picking and choosing which assets to transfer in the divorce. In deciding how to divide up marital assets, the parties can potentially achieve tax savings where the individuals will be in different tax brackets after divorce. IRC § 1041(a) provides that no gain or loss is recognized on property transfers between spouses or former spouses incident to divorce or separation (the "non-recognition rule"). *Id.* The transfer is "incident to divorce" if the transfer occurs within one year after the date on which the marriage ceases, or is related to the cessation of marriage. IRC § 1041(c). A transfer subject to IRC § 1041(a) is treated similarly to a gift for income tax purposes – the receiving party takes a carryover basis in the property received and the gain, if any, is recognized when the recipient ultimately disposes of the asset. If a transaction falls within the scope of IRC §1041, then the non-recognition rule's application is mandatory, even if the parties intended to engage in a bona fide sale and to create a current income tax consequence.

Section 1041 does not apply to assignments of income. Section 1041 recognition extends to the transfer of partnership interests as well, despite the presence in the partnership of so-called "hot assets."

I. REDEMPTION OF INTEREST. A good definition of a stock redemption could not be found in Texas case law, AMERICAN JURISPRUDENCE succinctly describes what constitutes a redemption for tax purposes:

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

33A AM. JUR.2d ¶ 4952, *Stock redemption defined.*

Effect of Choice of Entities

Marital Property Issues. It would seem that a stock redemption would be a simple case of mutation. However, redemptions can present a problem in the marital property context. Consider the following hypothetical:

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

[Comment by PLF:] An interesting marital property issue that can arise in connection with a corporation is the situation where, say, Husband's interest (100 shares of stock) is his separate property. Assuming that there are other shareholders of the corporation, a redemption of the stock of any one of the shareholders will effectively increase the percentage interest of the remaining shareholders, including the Husband. The husband's percentage interest in the corporation will have increased, and yet the number of separate shares of the Husband has not changed and would still be considered his separate property. Though this treatment may at first seem harsh to the community estate, the value of what the Husband had immediately prior to and after the redemption may be effectively the same, since the redeemed shareholder has received cash in redemption of his interest.

Tax Considerations. [Comments by PLF:] A redemption of an interest in a business entity is treated for accounting and tax purposes as a sale or exchange of the interest. Whether the sale is treated for tax purposes as a sale of a capital asset providing capital gain treatment, or as a transaction subject to ordinary income rules depends on technical tax issues. However, the cash/assets received by an interest owner in complete redemption of the interest should be the same character as the underlying interest.

If an interest is owned by both the Husband and Wife, the interest of one of them may be redeemed by the corporation if the stock is awarded to that spouse in the divorce and subsequently the redemption occurs. If this is done under the auspices of IRC Section 1041, capital gain on the transaction can be deferred. This process has been the subject of IRS litigation in *Arnes v. United States*, 981 F.2d 456, 458 (9th Cir. 1992).

In *Arnes v. United States,* 981 F2d 456 (9th Cir. 1992), *affg*. 91-1 USTC ¶50,207 (W.D Wash. 1991) *(Arnes I),* the spouses wholly-owned corporation operated a McDonald's franchise. McDonald's Corporation informed the husband that its rules precluded joint ownership of the corporation after divorce. The spouses agreed that the corporation would redeem Mrs. Arnes' shares. This agreement was incorporated into the divorce decree and Mr. Arnes guaranteed the corporation's obligation to pay Mrs.

Arnes. Mrs. Arnes paid tax on the capital gains arising out of the redemption, but later sued for a refund arguing that Sec 1041 protected her from taxation on the distribution. The crux of Mrs. Arnes' argument was that her transfer of shares to the corporation, which was required by the divorce instrument, was a transfer "on behalf of" Mr. Arnes. The District Court agreed, finding the transfer "benefitted" him and the Court of Appeals affirmed. The story did not end here. Perhaps because *Arnes I* was decided in favor of Mrs. Arnes, the government pursued Mr. Arnes on the theory that he had received a constructive dividend when the corporation redeemed Mrs. Arnes' shares. Mr. Arnes liability was decided in *Arnes v. Commissioner,* 102 TC 522 (1994) *(Arnes II),* a case that was appealed to the Ninth Circuit. The majority opinion in the Tax Court's case found that the legal issue was different from that in *Arnes I*, and because of the different legal issue, the court did not have to follow the decision in *Arnes I.* The majority on the Tax Court held that Mr. Arnes did not have a primary and unconditional obligation to buy his ex-wife's stock since he had merely guaranteed the corporation's payment and, therefore, he was not taxable on the transaction. Because *Arnes II* did not apply the holding of *Arnes I*, both Mr. And Mrs. Arnes escaped tax on the redemption of her shares, despite the bailout of cash from the corporation. The government was clearly whipsawed in the two decisions. In the intervening years the waters were muddied with a number of court decisions which grappled with the redemption on account of divorce question. This lead to the issuance of additional Treasury Regulations under Sec 1041 which, in effect, say that in these transactions someone must pay tax.

The redemption upon divorce issue is discussed further in Jaffke, at 503-526. The applicable IRS Regulation is on-line at: <http://edocket.access.gpo.gov/cfr_2005/aprqtr/26cfr1.1041-2.htm> (last checked 7/14/08).

J. LIQUIDATION. *See* Section III.A.10(d) *supra*.

1. Complete Liquidation. There is case authority that liquidating distributions from a corporation that is ceasing to do business are received by the owning spouse with the same character as his/her interest in the business. Thus, separate property stock begets a separate property liquidating distribution. *Legrand-Brock v. Brock*, 246 S.W.3d 318, 322-24 (Tex. App.--Beaumont 2008, pet. denied).

2. Partial Liquidation. A controversy exists today as to whether a business entity, like a corporation or a partnership, can make a partial liquidating distribution that has the same character as the spouse's ownership interest in the entity. The TBCA recognizes that a corporation may distribute a "payment . . . in liquidation of all *or a portion of* its assets." [Emphasis added] TBCA art. 1.02A(13). [Emphasis added]. This seems to recognize a partial liquidation by corporations. The court of appeals in *Legrand-Brock v. Brock*, 246 S.W.3d 318, 322 (Tex. App.--Beaumont 2008, pet denied), suggests this same theory based on the following quotation:

A liquidating distribution includes a

Effect of Choice of Entities

> 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.")

(emphasis added) *Ibid.* at 322. One federal court, ruling in a tax case, wrote of corporate dividends:

> The Code generally treats corporate distributions (or dividends) out of earnings and profits as ordinary income to the shareholder taxpayer. But if a corporation pays a dividend which exceeds its earnings and profits (as measured by § 316(a)), the Code treats that portion of the dividend as a nontaxable return of capital to the shareholder taxpayer to the extent of the taxpayer's basis in the securities, and as a capital gain to the taxpayer once the taxpayer's basis is exhausted.

Mazzocchi Bus Co., Inc. v. C.I.R., 14 F.3d 923, 927 (3rd Cir. 1994).

The *Brock* court quoted Black's Law Dictionary for the following definition: "a 'liquidation dividend' is defined as '[a] dividend paid to a dissolving corporation's shareholders, [usually] from the capital of the corporation, upon the decision to suspend all or part of its business operations.' Black Law's Dictionary 513 (8th ed. 2004)." *Brock II*, at 321 n. 3.

As part of the Uniform Principal and Income Act, applicable to trusts, TPC § 116.151 makes the following statement: "Money is received in partial liquidation: (1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or (2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt."

[Comments by PLF:] A transaction which is in liquidation of an interest in a closely-held business entity may also be treated as a sale or exchange in the same fashion as the redemption of an interest. If the interest being liquidated is a complete liquidation, it should be treated as a sale or exchange of the underlying interest. Some may wish to allocate a portion of the distribution to the earnings or profits of the entity with the remainder to capital.

In the *Brock* case discussed above, the liquidation and dissolution of the husband's separate property corporate entity was treated by the husband's forensic accountant as a sale of his stock and a mutation of his separate property stock. The wife's forensic accountant treated the distribution as community, under the theory that the "liquidating dividend" is simply a dividend, and urged that dividends from separate property are community. Alternatively, she asserted that retained earnings, when distributed, were community property, even if received in a liquidating distribution. The Internal Revenue Service uses such terms as "liquidating

distributions" and "liquidating dividends," but the tax use of the term "dividend" should not be determinative as to the character of the distribution in the absence of an independent analysis. Generally, tax treatment does not have a bearing on characterization rules. (In *Marshall*, the court looked to the parties' tax return to determine if the husband reported the oil & gas revenues as salary, as suggested by the partnership agreement.) In *Brock*, had the husband simply sold his shares to a third party, there would be no question that the proceeds were a mutation of the underlying stock.

The *Brock* decision did not credit the community estate with any of the corporation's previously-undistributed earnings. Although some forensic experts may advocate that dividends are appropriate to the extent of the earnings, this is not the treatment afforded the sale of stocks in the public market (i.e., no dividend income is ascribed to the sale of the stock). If the stock is separate property, the proceeds on sale of the stock are likewise separate property.

The question can be asked: how should a "spin off" be treated? *See* section V.I *supra*. Is a spin off from a separate property business a partial liquidation, having the same character as the ownership interest in the parent company, or is it a distribution of capital (and if so, what is the character?), or is it income from separate property that is community property?

3. Tax Aspects of Complete and Partial Liquidations. [Entire subsection by PLF:]

Much of the following discussion comes from the Bureau of National Affairs, U.S. Income Portfolios, 700-3rd: Choice of Entity. Thanks to Geoffrey Poll, CPA, JD with Ferguson Camp Poll for his tax expertise in reviewing these comments.

(1) Taxation of Complete Liquidation to Shareholders

In the complete liquidation of a corporation, the shareholders might receive cash, property, or both from the corporation. Generally a complete corporate liquidation is a taxable event. Some of the property received may be subject to liabilities. The basic income tax rule in this context is that a shareholder is treated as having exchanged stock for the net amount received in the corporate liquidation. If assets are received subject to liabilities, the amount received is the net value, after the reduction for the associated debt. If property is received in kind, the value received by the shareholder in that liquidation transaction includes the net fair market value of that property distributed. A liquidating distribution ordinarily results in capital gain (or capital loss) treatment to the recipient shareholder. This results because the shareholders are treated as selling their shares back to the corporation for receipt of the liquidating distribution. The gain or loss amount is measured by reference to the difference between the amount realized and the shareholder's adjusted basis for the stock canceled in the liquidation. This was the procedure used in *Brock*, *supra*.

The rules for measuring dividend distribution treatment for corporate distributions to shareholders for tax

purposes are not applicable to complete liquidation payments. The amount of the E&P account of the liquidating corporation is not relevant, therefore, in determining the characterization of the amounts received by the shareholders receiving complete corporate liquidation distributions. The E&P account of the corporation disappears with the termination of the existence of the corporation.

(1) Taxation of Partial Liquidating Distributions to Shareholders

Distributions in redemption of stock that qualify as a partial liquidation of the corporation will result in sale or exchange treatment to the selling shareholder. A redemption of stock is treated as a partial liquidation if it is in redemption of stock held by a noncorporate shareholder and is made pursuant to a plan and occurs within the tax year in which the plan is adopted or within the succeeding tax year, and is not essentially equivalent to a dividend at the corporate level. Noncorporate shareholders include individuals, partnerships, estates, and trusts. If the requirements are met, the distribution can be made to a sole shareholder, pro rata to all shareholders, or non-pro rata to one or more shareholders.

K. RECEIVERSHIPS. There is a potential for some tension to exist with regard to the divorce court's authority under the Texas Family Code to appoint a receiver in connection with a divorce and the Civil Practice and Remedies Code provisions regarding receivers, and the entity laws governing appointment of receivers for entities, and the law regarding charging orders as the method of collecting claims against owners of partnerships and LLCs.

Texas Civil Practices and Remedies Code Section 64.001 authorizes the appointment of a receiver "(3) in an action between partners or others jointly owning or interested in any property or fund, " . . . "(5) for a corporation that is insolvent, is in imminent danger of insolvency, has been dissolved, or has forfeited its corporate rights; or (6) in any other case in which a receiver may be appointed under the rules of equity."

Section 64.002 cryptically states:

> Persons Not Entitled to Appointment
>
> (a) A court may not appoint a receiver for a corporation, partnership, or individual on the petition of the same corporation, partnership, or individual.
>
> (b) A court may appoint a receiver for a corporation on the petition of one or more stockholders of the corporation.
>
> (c) This section does not prohibit:
>
> (1) appointment of a receiver for a partnership in an action arising between partners; or
>
> (2) appointment of a receiver over all or part of the marital estate in a suit filed under Title 1 or 5, Family Code.

TBCA Section 7.07A plainly states:

> No receiver shall be appointed for any corporation to which this Act applies or for any of its assets or for its business except as provided for

> and on the conditions set forth in this Act.

TBCA § 7.07A. Family Code section 6.502, entitled "Temporary Injunction & Other Temporary Orders," gives the court in a divorce the power of "appointing a receiver for the preservation and protection of the property of the parties. . . ." Tex. Fam. Code § 6.502(a)(5). Courts have construed this section to extend only to the spouses and not third parties. *Mallou v. Payne & Vendig*, 750 S.W.2d 251, 255 (Tex. App.–Dallas 1988, writ denied) (regarding receivers); *Commonwealth Mortgage Corporation v. Wadkins*, 709 S.W.2d 679, 680 (Tex. App.–Houston [14th Dist.] 1985, no writ) (corporation was not a "party" as contemplated by the Family Code). Case law recognizes the court's right to appoint a receiver to liquidate community property pursuant to the divorce decree. *Nelson v. Nelson*, 193 S.W.3d 624, 629 (Tex. App.–Eastland 2006, no pet.); *Young v. Young*, 765 S.W.2d 440, 444 (Tex. App.–Dallas 1988, no writ) (authority to appoint receiver in decree of divorce is Family Code provision on dividing the community estate, not Civil Practice and Remedies Code provisions regarding receivers). Texas Rule of Civil Procedure 695a permits a court in a divorce to waive the requirement of a bond upon appointing a receiver. How these powers of a divorce interface with the venue provisions of the TBCA regarding receivers deserves some attention. *See* section III.A.f *supra*.

Rusk v. Rusk, 5 S.W.3d 299, 306 (Tex. App.–Houston [14th Dist.] 1999, pet. denied), held that a court cannot, in a divorce decree, appoint a receiver over separate property. Remember that the partnership law says that a partner's management rights cannot be community property. That suggests that appointing a receiver in a divorce to exercise control over a spouse's interest in a partnership might not be appropriate.

It should be noted that appointing a receiver over community property shares is not exactly the same as appointed a receiver for a corporation. However, if the community property shares constitute a controlling interest in a corporation which has other shareholders, turning de facto control of a corporation over to a receiver appointed in a divorce may be expected to draw an intervention by the corporation or the other shareholders in the divorce.

The whole issue of appointing a receiver where the normal remedy of a creditor against an owner is a charging order, like with partnerships and limited liability companies, requires a lot of thought.

L. CO-OWNERSHIP AFTER DIVORCE. In some divorces one possible outcome is to leave spouses as co-owners of a business. This can perpetuate the problems that broke up the marriage well into the future. If control is equalized, an impasse in management of the entity can create legal problems that may ultimately require more litigation. One spouse may have control while the other does not, raising issues of fiduciary duties, owed to minority owners, as well as the potential for exploitation of power countered by shareholders derivative actions or suits for oppressive conduct or for conspiracy or breach of fiduciary duty.

Directors and officers of a corporation owe a fiduciary duty to the corporation regarding corporate matters. *International Bankers' Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). However, "[u]nder the 'business

Effect of Choice of Entities

judgment' rule, alleged unwise, inexpedient, negligent or imprudent decisions or conduct will not sustain a suit against the management of a corporation. . . ." The case of *Cleaver v. Cleaver*, 935 S.W.2d 491, 495-96 (Tex. App.–Tyler 1996, writ den'd), speaks to the problems of a minority shareholder:

> A claim that corporate dividends have been suppressed implies a breach of duty by the management to the corporation itself, not to the shareholders. . . . It is established that corporate management may invest company earnings in corporate assets rather than distributing those earnings to shareholders. . . .The Texas Business Corporation Act does not empower even stockholders to participate in, or control, the management of the corporations; that is the province of the managing board. . . . Under the "business judgment" rule, alleged unwise, inexpedient, negligent or imprudent decisions or conduct will not sustain a suit against the management of a corporation by the shareholders.

[citations omitted] *Id.* at 495-96. Generally speaking, an officer of a corporation owes a fiduciary duty to the shareholders collectively (that is, to the corporation itself), but he does not have a fiduciary relationship with individual shareholders, unless there is some contractual or other special relationship apart from the corporate relationship. *Faour v. Faour*, 789 S.W.2d 620, 621-22 (Tex. App.–Texarkana 1990, writ denied). However, as noted in *Redmon v. Griffith*, 202 S.W.3d 225, 236 (Tex. App.–Tyler 2006, pet. denied):

> Appellate courts have also recognized an individual cause of action for "shareholder oppression" or "oppressive conduct." . . . Oppressive conduct has been defined as follows:
>
> 1. [M]ajority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; or
>
> 2. [B]urdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely.

(Citations omitted). However--

> Courts must exercise caution in determining what shows oppressive conduct. . . . The minority shareholder's reasonable expectations must be balanced against the corporation's need to exercise its business judgment and run its business efficiently. . . . Therefore, despite the existence of the minority-majority fiduciary duty, a corporation's officers and directors are still afforded a rather broad latitude in conducting corporate affairs.

Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.–Houston [1st Dist.] 1999, pet. denied) (citations omitted).

And what is the remedy for shareholder oppression? In *Patton v. Nicholas*, 154 Tex. 385, 279 S.W.2d 848 (1955), an injunction was issued against the majority shareholder

who maliciously suppressed dividends. In *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App.–Houston [1st Dist.] 1988, writ denied), the court ordered a buy-out of the minority shareholder to remedy oppression. In *Duncan v. Lichtenberger*, 671 S.W.2d 948 (Tex. App.–Fort Worth 1984, writ ref'd n.r.e.), the minority shareholders were given reimbursement of their monetary contribution to the corporation where they were completely excluded from management of the business. How suppression of distributions can translate to partnerships is unclear, considering that a transferee of a partnership interest has no "right to compel distributions by the partnership." *See* section III.B.2, *Partnership Interest*, *supra*.

Problems can be even more acute for co-ownership of a partnership after divorce, because of the prospect of phantom income. The management of a partnership can retain earnings without distributing them, even though the income on those earnings appears on the other ex-spouse's personal tax return. *Cleaver v. Cleaver*, 935 S.W.2d 491, 495 (Tex. App.–Tyler 1996, writ denied); *see Thomas v. Thomas*, 738 S.W.2d 342 (Tex. App.–Houston [1st Dist.] 1987, writ denied (involving an S-Corporation). Partners owe each other a fiduciary duty, and "[a] managing partner . . . owe[s] to his copartners one of the highest fiduciary duties recognized in the law." *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976). Usually a partner can bring a suit against another partner for breach of this duty. However, if the other spouse has only a transferee/assignee's interest in the partnership, which has no management rights, one wonders how to reconcile the normal right of a partner to sue with the language in the partnership statutes indicating that a divorce court can award the non-partner spouse only an transferee's or assignee's interest, with no management rights.

For all of these reasons, perpetuating former spouses' co-ownership of a business after a divorce is usually a very bad idea.

VII. VALUATION ISSUES. There are different valuation approaches for corporations, partnerships, and sole proprietorships. A controlling interest in a corporation can carry a control premium. As to partnerships, according to the TRPA, management rights of a partner cannot be community property. Therefore even a controlling interest in a community property partnership is really a non-controlling interest for valuation purposes, which requires a discount for lack of control. It is hard to ascribe entity goodwill to a sole proprietorship; easier for an entity.

A. MEASURES OF VALUE (THE LEGAL PERSPECTIVE). There are two main measures of value used in the world of business entities: "fair value" and "fair market value." In the legal field, "fair value" is usually taken to mean the value of a partial ownership interest in a business, without adding a premium for control or subtracting a discount for lack of control, lack of liquidity, blockage discount, or effect of the sale of the partial interest. In the legal field, "fair market value" is usually taken to involve the "willing buyer-willing seller" analysis. This distinction has become complicated because in 2006 the accounting profession stopped using "fair market value" and started using "fair value" to mean "fair market value." So, the new terminology used in accounting standards and accounting literature may cause some confusion among lawyers.

Fair Market Value. "Generally, the value to be accorded community property in a divorce

Effect of Choice of Entities

proceeding is 'market value.'" *Ricks v. Ricks*, 169 S.W.3d 523, 527 (Tex. App.–Dallas 2005, no pet.), citing *R.V.K. v. L.L.K*, 103 S.W.3d 612, 618 (Tex. App.–San Antonio 2003, no pet.) (en banc).

Many Texas courts have the following definition of "fair market value":

> 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.

Wendlandt v. Wendlandt, 596 S.W.2d 323, 325 (Tex. Civ. App.–Houston [1st Dist.] 1980, no writ) (quoted in *Ricks v. Ricks*, 169 S.W.3d 523, 527 (Tex. App.–Dallas 2005, no pet.)); *see also City of Pearland v. Alexander*, 483 S.W.2d 244, 247 (Tex. 1972).

Fair Value. The term "fair value" is used in TBCA art. 5.12 in connection with a shareholder's right under TBCA art. 5.11 to dissent from a plan of merger, sale of all or substantially all assets, or plan of exchange. The dissenting shareholder is entitled to receive the fair value of his shares "excluding any appreciation or depreciation in anticipation of the proposed action." TBCA art. 5.12A(1)(a). The TBCA says this about fair value:

> In computing the fair value of the shares under this article, consideration must be given to the value of the corporation as a going concern without including in the computation of value any control premium, any minority discount, or any discount for lack of marketability. If the corporation has different classes or series of shares, the relative rights and preferences of and limitations placed on the class or series of shares, other than relative voting rights, held by the dissenting shareholder must be taken into account in the computation of value.

TBCA art. 5.12A(1)(a).

An important question that has received inadequate attention is whether a community property minority interest in an entity should be valued at fair value rather than fair market value.

Value for Tax Purposes. The family lawyer should be cautious of values reflected in tax returns. Values in tax returns are usually reflected at the adjusted tax basis, which does not purport to be fair market value.

B. MEASURES OF VALUE (THE ACCOUNTING PERSPECTIVE). [Entire subsection contributed by PLF:] Measures of value, usually referred to as "standards of value" in valuation literature, define the type of value being sought in a valuation. The standards of value may include:

- Fair market value
- Investment value
- Intrinsic value
- Fair value

On September 15, 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. The stated purpose of the Statement was to improve the consistency and comparability in fair value measurements and disclosures about *fair value* measurement. The standard applies to statements that are

Effect of Choice of Entities

issued in accordance with GAAP and is effective generally for reporting years 2007 and beyond. Although the term has been changed from “fair market value” to “fair value,” the definition of fair value sounds much more like fair market value than the concept of fair value used in corporate law situations where you must exclude the discounts normally associated with valuing a partial or minority interest.

The definition of “fair value” in SFAS 157 is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” This definition approximates “fair market value” definition without actually adopting with specific differences including price and market participants. It presents a hierarchy that prioritizes inputs to valuation techniques into (level ranges) from quoted prices in active markets to values which use projections for discounted cash flow analyses.

Fair market value is defined in the *International Glossary of Business Terms* as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetically willing and able buyer and able seller, acting at arm’s length in an open and unrestricted market when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." This definition comports with that found in Revenue Ruling 59-60, which is the classic “willing buyer-seller” definition.

A Word About Tax Basis and Book Value. Accountants record transactions on the cost or historical basis. We refer to that as "book value." Tax basis is the term used to record transactions (including asset acquisitions) at their cost, so tax basis and book value may be the same, or at least based on a similar construct. But tax basis and book value are seldom really the "value" of an asset except when it is first recorded in historical terms which may be fair market value at that time. For example, a depreciable piece of equipment has its original cost, that likely was fair market value when purchased, but is reduced over time by depreciation which affects both tax basis and book value, i.e. cost less depreciation to date. Care should be taken in reviewing tax returns and balance sheets to take into consideration whether the assets are recorded as tax basis or book value, and not fair market value.

Revenue Ruling 59-60 was issued as an explanation of guidelines to follow in the valuation of stock of closely-held corporations for purposes of determining the appropriate gross estate for estate tax purposes. It outlines the approach, methods and factors to be considered in valuing businesses where a market quotation is not available or does not result in fair market value. The use of Revenue Ruling 59-60 ("RR 59-60") has been broadened in the tax area for income taxes, partnerships and other business entities. Moreover, business valuation professionals use RR59-60 when preparing their valuations outside the tax area. In addition, its "factors to be considered" have become the foundation (especially at a time when virtually no other foundation existed) for business

valuation. It is in RR 59-60 that "book value" be considered in the analysis for each valuation: the book value of the stock and the financial condition of the business. In this case, while book value should be considered, it is only a consideration in performing the valuation.

C. TANGIBLE VERSUS INTANGIBLE ASSETS. [Comments by PLF:] Tangible assets are assets that "physically" exist, such as cash, investments, inventory, real property, accounts receivable, prepaid assets, and fixed assets. Intangible assets are assets that don't always physically exist, although they may be evidenced by some tangible document. The value of an intangible asset is dependant on the rights their possession confers on the owner. The Internal Revenue Code § 197 defines the intangible value of a business to include:

1. goodwill;
2. going concern value;
3. any of the following intangible items:
   a. workforce in place, including its composition and terms and conditions (contractual or otherwise) of its employment;
   b. business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers);
   c. any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item;
   d. any customer-based intangible;
   e. any supplier-based intangible; and
   f. any other similar item;
4. any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof;
5. any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof; and
6. any franchise, trademark, or trade name.

IRC § 197.

D. VALUING "PASS THROUGH" ENTITIES. [Entire subsection by PLF:] The conventional wisdom with respect to calculating and deducting income taxes on a business as a cost of doing business, is that this is a necessary deduction in arriving at net income and net cash flow. Furthermore, and importantly, the build-up method of calculating discount rates relies on the statistics developed and published by Ibbotson Associates in STOCKS, BONDS AND INFLATION, VALUATION EDITION. Ibbotson says that their returns are *after-tax returns* in the marketplace and should be applied to *after-tax cash flows*. How, then, should this data be applied to "tax-free" or pass-through entities? (Keep in mind that such a discussion assumes a controlling interest since a non-controlling interest holder cannot control whether to distribute cash.) Pass-through entities such as S-Corporations and partnerships do not pay taxes at the entity level. But if Ibbotson data is used is there a mismatch of the marketplace returns and the subject entity that is tax free? The IRS's position, successfully defended in recent estate tax court cases, is that a pass-through entity should not have a deduction for the hypothetical taxes it

would have paid had it been a C-Corporation. The effect of not deducting taxes in the pass-through entity is to make it more valuable than a C-Corporation. Some appraisers argue that the "hypothetical" buyer is likely to be a C-Corporation and would pay taxes. "Not so fast," says the IRS in its estate tax controversies. To support its case that C-Corporations aren't treated unfairly, the IRS published data that shows that many C-Corporations actually pay relatively little income taxes. Their 2002-03data shows that 68.5% of entities pay no tax at all, while an additional 25.3% of corporations pay less than $10,000 in income taxes. The argument, then, is that nearly 94% of entities pay little or no tax. This data supports the IRS's argument that C-Corporations are no different than a tax-free pass-through entity, as neither pay tax.

The *Heck* and *Gross* cases put at the forefront for valuation professionals the question of tax effecting the earnings stream and hence value. Factors have been developed that should be considered in determining the value of pass-through entities. See James R. Hitchner's publication FINANCIAL VALUATION APPLICATIONS AND MODELS (2d ed. 2006, John Wiley and Sons).

These factors or questions should be considered by the valuation professional in valuing the pass-through entity interests:

1. Who is the most likely pool of buyers?
2. Could the buyer elect "for free" on his/her own? (That is, filing a S election is a virtually "free" exercise - perhaps only a modest fee.)
3. What degree of control will the buyer have, and would others make the S election anyway?
4. What is the possibility that the S election will be broken?
5. Will a buyer of a company in this industry *pay* for a corporate entity form that affords tax-advantaged distributions?
6. What is the expected distribution level?
7. What is the opportunity to build up retained net income?
8. What is the likely holding period?
9. What is the opportunity for § 338(h)(10) election (now and in the future)?
10. Is there an opportunity to step up the basis of the underlying assets?
11. What is the date of S election and is there an opportunity to avoid built-in gains tax?
12. What is the capital structure of the company, and how does the fac that it is an S-Corporation affect its ability to obtain capital?

E. GOODWILL. The issue of goodwill in a divorce raises issues from both legal and business valuation perspectives.

1. The Legal Aspect of Goodwill.

a. The Legal Definition of Goodwill. The classic American legal definition of goodwill was given by Justice Story in his treatise on partnership law:

> the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it

> receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.

Story, COMMENTARIES ON THE LAW OF PARTNERSHIP § 99 (1841). This definition was cited by the U.S. Supreme Court in *Metropolitan Nat. Bank v. St. Louis Dispatch Co.*, 49 U.S. 436, 446, 13 S.Ct. 944, 948 (1893).

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

The U.S. Supreme Court more recently said this about goodwill:

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

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

The U.S. Court of Claims once wrote this about goodwill:

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

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

Other federal courts have described goodwill: *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1248 (5th Cir. 1973) (the "ongoing expectation that customers would utilize [a company's] services in the future"), *cert. denied*, 414 U.S. 1129 (1974); *Grace Bros., Inc. v. Commissioner*, 173 F.2d 170, 175-76 (9th Cir. 1949) ("the sum total of those imponderable qualities which attract the customer of a business–what brings patronage to the business"); *Dodge Bros., Inc. v. United States*, 118 F.2d 95, 101 (4th Cir. 1941) ("reasonable expectancy of preference in the race of competition"); *Ithaca Industries*, 97 T.C. 253 (slip op. at 17-18), 1991 WL 151392 (1991) ("While goodwill and going-concern value are often referred to conjunctively, technically going-concern value is the ability of a business to generate income without

interruption, even though there has been a change in ownership; and goodwill is a 'preexisting' business relationship, based on a continuous course of dealing, which may be expected to continue indefinitely"), *aff'd*, *Ithaca Industries, Inc. v. Commissioner*, 17 F.3d 684 (4th Cir. 1992).

In *Canterbury v. Commissioner*, 99 T.C. 223, 247 (1999), the Tax Court wrote: "The essence of goodwill is a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely. Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 233 (1975). Goodwill is characterized as 'the expectancy of continued patronage, for whatever reason.' *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir.1962), affg. 35 T.C. 720 (1961); *see Philip Morris, Inc. v. Commissioner*, 96 T.C. 606, 634 (1991), *affd.* 970 F.2d 897 (2d Cir., June 25, 1992)."

Rev. Rul. 59-60, § 4.02(f), 1959-1 C.B. 237, 241 states: "In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets."

b. Goodwill in Texas Commercial Cases. "A distinction can be drawn between the goodwill that attaches to a professional person because of confidence in the skill and ability of the individual and the goodwill of a trade or business that arises from its location or its well established and well recognized name." *Swinnea v. ERI Consulting Engineers, Inc.*, 236 S.W.3d 825, 837 (Tex. App.–Tyler 2007, pet. filed). The Texas Supreme Court addressed personal goodwill in the dissolution of a medical partnership under TUPA in *Salinas v. Rafati*, 948 S.W.2d 286 (Tex. 1997). The Court zeroed-out a $1,428,000 jury verdict for an expelled partner, holding that the recovery consisted entirely of personal goodwill of the two remaining partners who continued in business as a new partnership, and that that personal goodwill was not an asset of the partnership to be divided.

c. Goodwill in a Texas Divorce. The Texas Supreme Court wrote of goodwill in a Texas divorce:

> [I]t cannot be said that the accrued good will in the medical practice of Dr. Nail was an earned or vested property right at the time of the divorce or that it qualifies as property subject to division by decree of the court. It did not possess value or constitute an asset separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in event of his death, or retirement, or disablement, as well as in event of the sale of his practice or the loss of his patients, whatever the cause.

Nail v. Nail, 486 S.W.2d 761, 764 (Tex.

Effect of Choice of Entities

1972). This case is widely viewed as a comment on "personal goodwill," as distinguished from entity goodwill or enterprise goodwill.

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

> "Good will" is sometimes difficult to define. In a personal service enterprise such as that of a professional person or firm, there is a difference in what it means as applied to "John Doe" and as applied to "The Doe Corporation" or "The Doe Company". If "John Doe" builds up a reputation for service it is personal to him. If "The Doe Company" builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business but the sale of such business naturally involves the right to continue in business as "The Doe Company". The "good will" built up by the company would continue for a time and would last while the new management, performing the same personal services, would at least have the opportunity to justify confidence in such management while it attempted to retain the "good will" of customer clients of the former operators. At least the opportunity to have time to try to preserve the "good will" already existent and to use it as an entrance into the identical field of operations in a personal service type of business would be present where the name of the business is a company name as distinguished from the name of an individual. Therein does it have value, plus the value of the opportunity to justify confidence in the new management by the customer/clients of the predecessor owner(s). It is as applied to the foregoing that we consider Emergency Medicine to possess what we treat as "good will" as part of its worth and value under the circumstances of this case, and therefore an asset which would have value to some extent apart from John's person as a professional practitioner.

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

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

Salinas, at 291.

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

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

> that may be divided as community property.

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

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

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

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

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

2. The Accounting/Tax Concept of Goodwill. Self-created goodwill is not reflected in the accounting records of a business, since it is not recognized as an asset for accounting purposes. However, goodwill obtained through acquisition of another business is reflected in the accounting records and, since July 21, 2001, that goodwill must be tested for impairment at least annually, and its value must be reduced on the books if it has lost value. FASB No. 141. For tax purposes, goodwill purchased in a business acquisition is amortized over 15 years. IRC § 197.

[Comments by PLF:]

> *The Accounting Concept of Goodwill.* Goodwill is included among the list of intangible assets. From an accounting and financial reporting stand-point, goodwill is recorded on the books and records only when it is "purchased" goodwill, not when it is self-created. If the company is required to report their statements on a GAAP basis, an annual test is performed to test the impairment, if any, of the goodwill recorded by the

company, pursuant to FASB 157, discussed *supra*.

3. The Business Valuation Concept of Goodwill. [Comments by PLF] Assuming that the goodwill is not purchased and does not appear on a balance sheet, the goodwill must be valued in order that the enterprise value reflect all assets held. Goodwill is often described in valuation terms as the ability of an enterprise to earn in excess of the earnings that would be available based on only its tangible assets. Elements of earnings that may be attributable to goodwill are: (a) the capital investment that is required for a competitor to build or rebuild the company; (b) the critical function that employees have in the successful operation of the business compared to the employer/owner; (c) the uniqueness of the management skills that are necessary for the establishment of a competing business; and (d) the linkage of the name of the entity to the name of the employer/owner. The valuation approach used is one that is based on investment rate return principles, such as an earnings or income approach.

F. RESTRICTIONS ON TRANSFERS OF OWNERSHIP INTERESTS.

1. The Legal Perspective. Many entities involve stock transfer agreements, or buy-sell agreements. These agreements can apply to any business entity. Some agreements give the other owners or the business itself the right to buy a departing owner's ownership for fair value or fair market value or some other contractually-prescribed price. The difference between the value undiscounted and the value discounted can be significant. A buy-sell agreement that provides for a purchase at fair value will often result in a sales price that is higher than fair market value, leading the non-owning spouse to urge that the buy-sell provision is binding in the event of divorce–the opposite of the usual position.

A split in the Courts of Appeal has left conflicting opinions on the effect of buy-sell agreements on the value of the community estate's interest in a divorce. *Compare Finn v. Finn*, 658 S.W.2d 735 (Tex. App.–Dallas 1983, writ ref'd n.r.e.) (law firm's commercial goodwill was not divisible upon divorce because the partnership agreement did not provide any compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide any mechanism to realize the value of the firm's goodwill), *with Keith v. Keith*, 763 S.W.2d 950 (Tex. App.–Fort Worth 1989, no writ) (the formula set forth in the partnership agreement with respect to death or withdrawal of the partner is not necessarily determinative of a spouse's interest in the ongoing partnership as of the time of trial in a divorce).

The issue was addressed in the case of *R.V.K. v. L.L.K.*, 103 S.W.3d 612 (Tex. App.–San Antonio 2003, no pet.) (en banc), which is discussed here in some detail because the court issued three opinions. The case concerned the valuation of a medical practice and whether the court should follow *Finn* or *Keith* in determining whether a buy/sell agreement controls the valuation of stock. *Id* at 617. The San Antonio Court of Appeals, in a plurality opinion, ducked the question of whether to follow *Keith* or *Finn* because the divorce had not triggered the buy/sell agreement. *Id*. at 618. The plurality opinion reversed and remanded because the trial court failed to consider the buy/sell agreement to be a significant restriction on the marketability of the stock. *Id* at 619. The plurality felt that the

only expert to testify in the case had overvalued the medical practice. Thus, for the plurality, the buy-sell agreement did not determine value, but it affected value.

Chief Justice Lopez wrote an opinion that was both concurring and dissenting. The Chief Justice agreed with the dissent that the Court should address *Finn* or *Keith*, and further agreed that the Court should follow *Keith*. *Id.* at 619. Chief Justice Lopez concurred that the case should be remanded– but because the court had valued the medical practice too low. "I do not believe it was appropriate for the trial judge to select a thirty percent minority discount absent expert testimony that a minority discount should apply and what that minority discount should be for the particular entity." *Id.* at 621.

The dissenting opinion authored by Justice Marion (a Board Certified family lawyer), joined by Justice Stone, would have affirmed the trial court ruling. The dissent stated that the Court should follow *Keith* and "hold that the value of R.V.K.'s interest should be based on the present value of the entities as ongoing businesses, which would include such factors as limitations associated with the buy/sell agreement and consideration of commercial goodwill." *Id*. The dissent narrowly framed the issue stating "The only issue on appeal is whether the formula in the buy/sell agreement controlled valuation of the parties interest in the medical practice group." *Id.* at 622. The dissent believed that the trial court had properly applied a thirty percent minority discount to the value of the husband's interest in the medical group.

2. The Practical Perspective. Buy-sell agreements are usually designed to accomplish one or both of the following purposes: they give existing owners the right to control who will become new owners of interests in the business; and they set the price at which the other owners, or the business itself, can buy a departing owner's interest in the business.

If the goal is to control who may become a new owner of the business, the agreement usually contains a "right of first refusal," requiring departing owners to offer the ownership interest to current owners, and alternatively to the business itself. Only if there are no takers can the departing owner sell his/her interest to an outsider. In some family businesses, only direct descendants of certain progenitor(s) are allowed to own interests. The typical agreement provides for the entity to buy the interest in the business if that interest ends up in the hands of the spouse as a result of divorce, or in the hands of an heir in the event of the owner's death. The way most of these clauses are written, the divorce-related trigger will not apply unless the spouse actually ends up with an ownership interest in the entity after the divorce.

The other feature of most buy-sell agreements is a price-setting mechanism to determine how much another current owner, or the business, must pay to buy the departing owner's share of the business. Sometimes the price to exercise the "right of first refusal" is nothing more than the right to match any offer the departing owner may have received for his interest. This would by definition set the exercise price at fair market value. Some agreements set a formula to calculate the exercise price, such as book value or a multiple of earnings, or some other formula. This exercise price would usually not be fair market value, and it could be higher or lower than fair market value. A third approach to setting an exercise price is agreeing on one, two or three appraisers to value the business,

or the departing owner's share of the business. An interesting appraisal mechanism was used by Lone Star Technologies, Inc., as reported in Keith Sharfman, *Contractual Valuation Mechanisms and Corporate Law*, 2 VA. L.& BUS. REV. 53, 67 (2007) ("Sharfman"). If one party to the joint venture terminates the joint venture, the other party can buy the departing owner's interest at a price determined as follows: each side hires an appraiser, and their valuations are averaged; if the average is within 20% of the lower appraisal, it is binding; otherwise, a third appraiser is hired by the joint venture's external auditor, and the party's appraisal that is closest to the neutral appraisal becomes binding.

Like any contract, a valuation mechanism may be susceptible to different interpretations, which could take litigation to resolve. Also having the buy-sell agreement specify detail of what must be considered in arriving at a calculation may invite litigation over the accuracy of the underlying information or whether the accountant or appraiser followed the instructions set out in the agreement. And there is an argument, depending on state law, that contractual valuation mechanisms may be inherently subject to judicial review. Sharfman, at 69-77.

VIII. 10,000 FOOT VIEW OF THE COUNTRYSIDE. For those who have completed this journey with the authors, where does that leave us?

We have seen an astounding acceleration in the rate of change in business entity law. Partnerships have been around for 4,000 years, corporations for 2,000 years, and historically, the fundamental features have changed slowly. Texas' first corporation statute remained in effect for more than 100 years before it was replaced. Texas first limited partnership agreement was in effect for 109 years before it was replaced. The Uniform Partnership Act was not amended for 79 years. The Uniform Limited Partnership Act was not amended for 60 years. Texas adopted the Uniform Partnership Act 47 years after it was promulgated. The first LLC statute was enacted in 1987. Now LLC statutes extend across America.

Historically, the key distinction between a corporation and a partnership was the "entity nature": corporations were an entity, partnerships were not. Thus, corporations continued in existence despite a change in ownership, but partnerships did not. Also, shareholders were immune from entity debt while partners were not. Finally corporations were managed by employees instead of owners and partnerships were managed by the owners. Under current entity law, these distinctions have faded. Partnerships now have continuity of life despite a change in ownership; partners now can, with a few precautions, be immune from partnership debts. A corporation can be managed by its owners; limited partnerships can be run by one partner, sometimes itself an entity, without significant participation from owners who are limited partners.

New entities blur the distinction even more. A limited liability partnership can now make the general partners of a general partnership immune from entity debts that do not directly involve them. An LLC can be the general partner of a limited partnership and thus all owners will be immune from partnership debt.

On the tax side, one key aspect of partnerships was pass-through taxation, which resulted from lack of entity status. Now, a partnership is an entity but is taxed as if it is not.

Effect of Choice of Entities

In the absence of clear-cut legal precedents, lawyers and CPAs are turning to entity law and entity accounting concepts and tax concepts to help find solutions to marital property problems. Accounting and tax reporting seem to have influenced the entity-related divorce rulings decided by some appellate courts in recent years, while other courts have rejected a connection between taxation and marital property law. Corporate accounting and partnership accounting are similar but different, and neither fit very well with marital property concepts. Entity law does not mesh well with marital property concepts developed in simpler times. And reliance on partnership law can be confounded by some of the complex and idiosyncratic terms of partnership agreements.

With all this mix, it is good to apply a little common sense to evaluating entity transactions, so that long-standing tenets of what is separate and what is community property are not subverted by coincidental or unintended consequences of a business transaction, or an estate plan.