PLANNER BEWARE: A PECULIAR EXCEPTION TO TEXAS COMMUNITY PROPERTY RULES

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I. INTRODUCTION

So, you think you know Texas community property law? How about a quick illustration to test your knowledge of the basic rules? Suppose you invested in ten city lots before you married your spouse. Under Texas community property law, the lots would be characterized as your separate property because they were acquired prior to marriage.[1] During your marriage, you decide to sell one of the ten lots and invest the proceeds in a different asset, such as rural real estate. According to Texas community property law, the cash you receive from the sale of your city lot is your

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1. *See infra* Part II.A.

separate property, including any portion of the proceeds which represents an increase in the lot's value that occurred during your marriage.[2]

The same set of principles would apply if you decided to extract capital from an entity that is your separate property and invest the extracted capital in a different asset—right?[3] Not necessarily![4] Texas courts have held that a return of investment from a separate-property partnership interest is community property.[5] This peculiar departure from traditional Texas community property rules, as well as other alarming exceptions discussed in this article, requires careful planning by investors and business owners and their advisors.[6]

Estate, business, and asset protection planners alike should be aware of the exceptions and inconsistencies that exist in the treatment of partnership interests.[7] Whether a client is considering investing separate property in a partnership, making a distribution from a partnership, or giving a partnership interest to a child with the expectation that it will remain the child's separate property, the advisor should warn the client of the risks involved.[8] This article examines some curious deviations from traditional Texas community property rules that exist and discusses why these rules should apply consistently to partnership interests held as separate property.[9]

II. COMMUNITY PROPERTY VS. SEPARATE PROPERTY

A. General Rule

The following provides a brief review of some fundamental principles of Texas community property law.[10] In Texas, all of a spouse's real and personal property owned or claimed before marriage or acquired during marriage by gift, devise, or descent is the separate property of that spouse.[11] Generally, all other property owned by either spouse is community property.[12]

Texas courts have held that "[t]he character of property as separate or community is determined at the time of inception of title. Inception of title

2. *See infra* Part II.D.
3. *See infra* Part II.D.
4. *See infra* Parts II–III.
5. *See infra* Part IV.B.2.
6. *See infra* Parts III–IV.
7. *See infra* Part IV.
8. *See infra* Parts III–IV.
9. *See infra* Parts III–IV. This article pertains to interests in legitimate, properly operated partnerships validly formed under state law. This article does not address issues such as fraud on the community and alter-ego theory. *See* Zisblatt v. Zisblatt, 693 S.W.2d 944, 946 (Tex. App.—Fort Worth 1985, writ dism'd); Young v. Young, 168 S.W.3d 276, 280 (Tex. App.—Dallas 2005, no pet.) (affirming trial court's judgment that husband's corporation was alter ego for purposes of equitable estoppel).
10. *See* discussion *infra* notes 11–15 and accompanying text.
11. *See* TEX. CONST. art. XVI, § 15; TEX. FAM. CODE ANN. § 3.001 (West 2015).
12. *See* FAM. § 3.002.

occurs when a party first has a right of claim to the property by virtue of which title is finally vested."[13] If inception of title occurs before marriage, the law generally classifies the subject property as separate property.[14]

B. Income from Separate Property

All property other than property obtained before marriage or acquired by gift, devise, or descent is community property.[15] This includes "personal earnings" and "revenue from separate property" received during marriage.[16] Therefore, Texas law generally classifies income derived from a spouse's separate property as community property.[17] However, as discussed later, the timing of distributions of partnership earnings to a spouse who owns his or her partnership interest as separate property plays a huge role in the characterization of those distributions.[18]

C. Appreciation of Separate Property

Once it has been established that asset A is separate property, what happens if the value of asset A increases during the owner's marriage?[19] Does asset A retain its separate character in its entirety?[20] What is the character of the increase in the value of asset A that occurred during the marriage? Texas case law provides that separate property that appreciates in value remains entirely separate property, as to both its original value and the increase in value.[21] This principle is sometimes referred to as the "mule rule" due to the subject matter of its seminal case.[22] In contrast to the mule rule, which stands for the premise that the appreciation in value of separate property remains separate property, the "crop rule" represents the principle that in Texas, the income or "fruits" from separate property is community property.[23]

Often, the determining factor in characterization issues is whether an entity's increase in value is viewed as being the result of "income" that was

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13. Wierzchula v. Wierzchula, 623 S.W.2d 730, 731–32 (Tex. Civ. App.—Houston [1st Dist.] 1981, no writ) (citing Strong v. Garrett, 224 S.W.2d 471 (Tex. 1949)).

14. *Id.* at 732.

15. FAM. § 3.001.

16. *Id.* § 3.102. The terms "personal property" and "revenue from separate property" are not defined in the Family Code. *See id.*

17. *See id.*

18. *See infra* Part IV.B.3.

19. *See infra* Part II.C.

20. *See infra* Part II.

21. *See* Stringfellow v. Sorrell, 18 S.W. 689, 689 (Tex. 1891).

22. *See id.*

23. *See* De Blane v. Hugh Lynch & Co., 23 Tex. 25, 29 (1859).

allowed to accrue in an entity or "appreciation" of the entity itself.[24] As discussed below, a problem facing owners of separate-property partnership interests is the blurred line between income from the partnership and appreciation of the partnership.[25] What is the distinction between income and appreciation when an entity's increase in value is the result of undistributed profits that have been reinvested in the entity?[26]

D. Mutations of Separate Property

Returning to our example, what happens if the owner sells asset A for cash?[27] What is the character of the cash?[28] Or, what if the owner trades asset A for asset B?[29] What is the character of asset B?[30] Under the traceable mutation rule, "separate property [retains] its character through a series of exchanges so long as the party asserting separate ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to property that, because of its time and manner of acquisition, is separate in character."[31] Property acquired "in exchange for separate property becomes the separate property of the spouse who exchanged the property."[32] "Property established to be separate remains separate property regardless of the fact that it may undergo mutations or changes in form; its separate character is not altered by the sale, exchange, or substitution of the property."[33]

Now, imagine asset A is a partnership interest and the owner surrenders a portion of the partnership interest in exchange for a cash or property distribution from the partnership (such distribution may be described as return of capital, return of investment, liquidating distribution, partial redemption, etc.).[34] What is the character of the cash or property received by the owner in exchange for the partnership interest?[35] Arguably, the general rules applicable to any other asset should apply, and under the rules discussed above, the cash or property received in exchange for the

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24. *See* Thomas R. Andrews, *Income from Separate Property: Towards a Theoretical Foundation*, 56 LAW & CONTEMP. PROBS. 171, 179 (1993).

25. *See id.*

26. *See infra* Part IV.B.

27. *See supra* Part I.

28. *See supra* Part I.

29. *See supra* Part I.

30. *See supra* Part I.

31. Walton v. Johnson, 879 S.W.2d 942, 946 (Tex. App.—Tyler 1994, writ denied) (quoting Celso v. Celso, 864 S.W.2d 652, 654 (Tex. App.—Tyler 1993, no writ)).

32. Ridgell v. Ridgell, 960 S.W.2d 144, 148 (Tex. App.—Corpus Christi 1997, no pet.).

33. Barras v. Barras, 396 S.W.3d 154, 167 (Tex. App.—Houston [14th Dist.] 2013, pet. denied) (citing Harris v. Harris, 765 S.W.2d 798, 802–03 (Tex. App.—Houston [14th Dist.] 1989, writ denied)).

34. *See supra* Part I.

35. *See supra* notes 31–33.

partnership interest should be classified as separate property.[36] However, an exception to the rules discussed above appears to exist for partnership interests.[37]

III. TREATMENT OF SEPARATE-PROPERTY STOCK

A brief look at how Texas courts treat corporate stock held as separate property is instructive before examining the current view Texas courts hold toward partnership interests held as separate property.[38]

A. Application of the "Mule Rule" to Stock Held as Separate Property

Generally, the mule rule applies to any asset owned by a spouse.[39] For example, when one spouse owns stock in I.B.M., Xerox, or another corporation as separate property, any increase in the value of the stock is "deemed to be the separate property of the spouse owning the stock."[40] The law is settled that "an original issue of corporate stock, which was separate property when issued to the husband, retains its separate character, no matter how much it increases in value as a result of surplus accumulated out of the earnings of the corporation."[41] Any "increase in the value of separate-property stock remains separate property."[42]

This principle extends even to stock in a Subchapter S corporation holding retained earnings which have been allocated to the shareholder and reported on the shareholder's federal income tax return.[43]

Because courts have applied the mule rule to stock that has appreciated as a result of income being plowed back into the corporation (no pun intended) rather than distributed as dividends to stockholders, this concept should also apply to partnership interests.[44]

B. Distributions to Stockholders

A dividend paid by a corporation to its stockholder is generally characterized as community property, regardless of whether the stock is

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36. *See supra* notes 31–33.

37. *See infra* Part IV.A.

38. *See infra* Part III.A.

39. *See* Stringfellow v. Sorrell, 18 S.W. 689 (Tex. 1891).

40. Bell v. Bell, 504 S.W.2d 610, 611 (Tex. Civ. App.—Beaumont 1974, *rev'd on other grounds*, 513 S.W.2d 20, 21 (Tex. 1974)).

41. Scofield v. Weiss, 131 F.2d 631, 632 (1942). *See also* Johnson v. First Nat. Bank of Ft. Worth, 306 S.W.2d 927, 929 (Tex. Civ. App.—Fort Worth 1957, no writ) (holding that the increase in the value of stock from accumulated earnings is not community property).

42. Smith v. Smith, 22 S.W.3d 140, 150 (Tex. App.—Houston [14th Dist.] 2000, no pet.).

43. *See* Thomas v. Thomas, 738 S.W.2d 342, 343 (Tex. App.—Houston [1st Dist.] 1987, writ denied).

44. *See id.*

community property or separate property.[45] The treatment of other types of distributions made to stockholders is discussed next.[46]

1. Complete Liquidation of Corporation

In a divorce case involving the complete liquidation of a corporation that took place during marriage, distributions to a spouse who owned the corporation's stock as separate property were determined to be the spouse's separate property in accordance with the mule rule and the rule of mutation.[47] The court acknowledged that "[d]istributions received in exchange for the cancellation of stock upon the corporation's dissolution retain the character of the stock."[48] Therefore, "when a spouse owns separate -property stock in a dissolving corporation and receives distributions of liquidated assets, the distributions remain the stockholder's separate property."[49] The court recognized that the distribution included the corporation's retained earnings, which would typically be classified as community-property dividends upon distribution.[50] The court stated 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."[51]

2. Partial Liquidation of Corporation's Assets

In addition to distributions received by a shareholder upon the complete liquidation of a corporation, the mule rule and the rule of mutation have been applied to distributions made to a shareholder in partial liquidation of corporate assets.[52] In a fairly recent divorce case, a corporation distributed property to its shareholder who owned the stock as separate property.[53] The court applied the rule of mutation to the distributions, noting that "separate property that merely undergoes mutations or changes in form remains separate property."[54] The court classified the distributions as separate property in their entirety without addressing any component of

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45. *See* Bakken v. Bakken, 503 S.W.2d 315, 317 (Tex. Civ. App.—Dallas 1973, no writ).

46. *See infra* Part III.B.1.

47. *See* Legrand-Brock v. Brock, 246 S.W.3d 318, 321 (Tex. App.—Beaumont 2008, pet denied).

48. *Id.*

49. *Id.*

50. *See id*. at 322.

51. *Id.* The court also pointed out that this treatment mirrors the treatment under the Internal Revenue Code of liquidating distributions from a corporation. *Id.* at 322 n.5.

52. *See* Sanders v. Sanders, No. 02-08-00201-CV, 2010 WL 4056196, at *16 (Tex. App.—Fort Worth, Oct. 14, 2010, no pet.).

53. *Id.* at *1.

54. *Id.* at *16. In this case, the court placed much emphasis on the fact that the shareholder was the sole owner of the corporation and that the deed conveying the property from the corporation to the shareholder contained a recital which stated that the property was conveyed to the shareholder as his sole and separate property. *See id*. at *14, *16.

the distributions which may have been attributable to the corporation's increase in value (through retained earnings or otherwise) during the marriage.[55]

The treatment of separate-property stock differs significantly from the treatment of separate-property partnership interests, as discussed next.[56]

IV. TREATMENT OF SEPARATE-PROPERTY PARTNERSHIP INTEREST

A. Application of the "Mule Rule" to Partnership Interest Held as Separate Property

Courts have held that, "if a married partner contributes separate property [to a partnership], then his interest in the partnership is separate property to that extent, and any appreciation in its value as a result of general economic conditions . . . remains separate property."[57] As discussed earlier, because courts have applied the mule rule to stock that has appreciated as a result of earnings being retained in the corporation rather than distributed as dividends to stockholders, it follows that this concept should extend to partnership interests.[58]

B. Distributions to Partners

In theory, a distribution of profits made by a partnership to a partner should be characterized as community property.[59] However, in practice, there is not always a clear distinction between income from the partnership and appreciation of the partnership, the latter of which is often the result of reinvested earnings.[60] When a spouse owns a partnership interest as separate property, under what circumstances is a distribution from the partnership properly classified as income from separate property?[61] When is a distribution from the partnership properly classified as a mutation of appreciated separate property?[62] Any such distinction between income and appreciation due to reinvested earnings has been called "illusory" by experts

55. *See id.* at *14–16.
56. *See infra* Part IV.
57. Smoot v. Smoot, 568 S.W.2d 177, 180 (Tex. Civ. App.—Dallas 1978, no writ) (citing Norris v. Vaughan, 260 S.W.2d 676, 681 (Tex. 1953)).
58. *See supra* Part III.A.
59. *See supra* Part II.B.
60. *See supra* Parts II.B–C; *infra* Part IV.B.3.
61. *See infra* Part IV.B.3.
62. *See* Andrews, *supra* note 24, at 210–11.

in the field.[63] The treatment of partnership distributions by Texas courts is discussed next.[64]

1. Buyout of Withdrawn Partner's Interest

In *Harris v. Harris*, the husband owned a partnership interest as separate property.[65] The husband withdrew from the partnership during the marriage, and at the time of the divorce he was receiving monthly payments from the partnership as a buy-out of the value of his interest.[66] The court applied the mule rule and the rule of mutation to the husband's partnership interest and characterized the payments under the buy-out agreement as the husband's separate property, noting that "mutations and increases in separate property remain separate property."[67] Although the partner was successful in obtaining separate-property treatment for the entire amount that he received for the redemption of his partnership interest, this case cannot necessarily be extended to other similar situations.[68] The court pointed out that the wife may have been successful in pursuing a community-property claim on grounds that there was an income component included in the buy-out payments, but the wife failed to do so at trial.[69]

2. Non-liquidating Distribution of Partnership Property

In *Lifshutz v. Lifshutz*, the husband owned a partnership interest that was his separate property.[70] The court determined that, during the marriage, the partnership effected a constructive distribution of partnership assets to the husband, and held that the entire distribution was a "non liquidating community distribution" of property to the husband.[71] Curiously,

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63. *See id*. The problem has been described as follows: "[O]ur modern forms of wealth make [the distinction between income and appreciation] illusory. If a spouse decides to invest his separate property in a growth stock for its appreciation, he preserves the separate nature of that property. If, instead, he buys a bond for its interest, the bond generates community income. Moreover, with stocks the choice between interest and appreciation may not even be in the owner's hands. If the company decides to issue a dividend, it is community property. If the company declares no dividend and instead reinvests its profits in capital development, the stock appreciates in value and that appreciation remains separate property . . . . Furthermore, in the individual business, partnership, or closely-held corporation, the allocation between appreciation and income is in the hands of the managing spouse since he or she decides whether and how much to draw out of the business. . . . The nub of the problem is that appreciation and income are economically indistinguishable." *Id.* (quoting GRACE GANZ BLUMBERG, COMMUNITY PROPERTY IN CALIFORNIA 100 (1987)).

64. *See infra* Part IV.B.1.

65. *See* Harris v. Harris, 765 S.W.2d 798, 802–03 (Tex. App.—Houston [14th Dist.] 1989, writ denied).

66. *See id.* at 803.

67. *Id.*

68. *See id*.

69. *See id.* at 802, 805.

70. *See generally* Lifshutz v. Lifshutz, 199 S.W.3d 9 (Tex. App.—San Antonio 2006, pet. denied).

71. *Id.* at 24.

the court did not differentiate between the portion of the distribution that may have represented a return of the husband's investment in the partnership (i.e., the husband's separate property) and the portion that may have represented a distribution of income from the partnership (i.e., community property).[72] Instead, the court held that all distributions made from a partnership during marriage are community property, regardless of whether a distribution represents income from the partnership or a return of the partner's separate-property capital contribution to the partnership.[73] This phenomenon of separate property contributed by a partner to a partnership being re-characterized by courts as community property when it is later distributed from the partnership to the partner during marriage has been referred to by commentators as the inadvertent "conversion" of separate property to community property.[74]

The court in *Lifshutz* relied heavily on a broad interpretation of *Marshall v. Marshall* in holding that all distributions made from a partnership during marriage are community property.[75] However, it is important to note that in *Marshall* the partnership agreement provided for a guaranteed salary to be paid to the husband, and it stated that all other partnership distributions made to the husband consisted of the husband's share of partnership profits.[76] The court in *Marshall* expressly narrowed its holding to the specific situation that existed in that case—where the partnership agreement provided that all distributions constituted a share of the partner's profits.[77] The Texas Business Organizations Code provides that distributions from a partnership are governed by the written partnership agreement.[78] Is the holding in *Marshall* properly extended to cases where the partnership agreement characterizes partnership distributions differently from the partnership agreement in *Marshall*?[79]

The court in *Lifshutz* also relied on commentators' interpretations of *Marshall* from as far back as 1993 and 1997.[80] The court cited one commentator's assertion that the rule of mutation of separate property does not

72. *See id.*

73. *See id.* at 27.

74. *See* Paige Ben-Yaacov & Randall B. Wilhite, *Marital Property Issues in Drafting Planning Documents*, Texas Bar CLE, 26th Annual Estate Planning & Probate Drafting Course.

75. *See Lifshutz*, 199 S.W.3d at 26–27.

76. *See* Marshall v. Marshall, 735 S.W.2d 587, 593–95 (Tex. App.—Dallas 1987, writ ref'd n.r.e.).

77. *See id.* at 595. The court held as follows: "In this case, all monies disbursed by the partnership were made from current income. The partnership agreement provides that 'any and all distributions . . . of any kind or character over and above the salary here provided . . . shall be charged against any such distributee's share of the profits of the business.' *Under these facts*, we hold that all of the partnership distributions that Woody received were either salary under the partnership agreement or distributions of profits of the partnership." *Id.* (emphasis added).

78. *See* TEX. BUS. ORGS. CODE ANN. § 153.208(a) (West 2006).

79. *See Marshall*, 735 S.W.2d at 593–95.

80. *See Lifshutz*, 199 S.W.3d at 26–27.

apply at all to the characterization of a partnership distribution from a partner's capital account:

> To the extent that income distributions are made from the partnership, the distributions will be characterized as community property. Further, to the extent that distributions from the partnership include a return of the partner's separate capital contribution, the distribution will be characterized as community income because the partnership entity becomes the owner of the capital contribution.[81]

The court also cited another commentator's assertion that "when an individual partner contributes property into a partnership, the partner loses individual interest in the property and, since the partnership itself is the new owner, the property can no longer be classified as separate or community."[82]

It is the author's opinion that both of these assertions miss the mark. While it is true that the partnership becomes the new owner of the contributed property and the contributed property owned by the partnership loses its designation as separate or community property, this contributed property should not be the focus.[83] Instead, the asset that the partner received in exchange for his contribution of separate property to the partnership—the partnership interest—should be the subject of the mutation analysis.[84] When the focus properly shifts to the partnership interest that is owned by a spouse as his or her separate property, it is clear that the partnership interest should retain its separate-property character through any subsequent traceable mutation of the partnership interest, whether via sale, exchange, redemption, or other method. Rather than indiscriminately classifying all partnership distributions as community property, each distribution should be analyzed on a case-by-case basis to determine into which of the following categories it falls: (1) a distribution of partnership profits; or (2) a distribution of partnership assets to the partner in exchange for all or a portion of his or her separate-property partnership interest.[85] If it is a distribution of profits, it should be classified as community property.[86] However, if it is a distribution of assets in exchange for all or a portion of the partner's interest in the partnership (sometimes referred to as a redemption, liquidation, return of

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81. *See id.* at 26 (quoting Lisa H. Jamieson, *Marital Property Issues in the Modern Estate Plan*, 49 BAYLOR L. REV. 391, 402 (1997)).

82. *Id.* at 27 (quoting ALOYSIUS A. LEOPOLD, 38 TEX. PRAC.: MARITAL PROPERTY AND HOMESTEADS § 4.10 (1993)).

83. *See id*.

84. *See id*. at 26.

85. *See* Andrews, *supra* note 24, at 179. Of course, determining whether a distribution consists of partnership earnings or a return of investment in a partnership which has increased in value over time due to reinvestment of partnership earnings raises the problem of distinguishing between income and appreciation. *See id.*

86. *See supra* Part II.B.

investment, etc.), it should be treated as a traceable mutation of the separate-property partnership interest and classified as separate property.[87]

3. Distribution of Accumulated Partnership Profits—Timing Is Everything!

Perhaps just as concerning to the partner's spouse as the *Lifshutz* view is to the partner is the premise that partnership income can effectively be shielded from community property treatment as long as it is not distributed during the marriage.[88] It could be said that the *Lifshutz* holding allows for the potential inadvertent conversion of separate property to community property, while the holding of *Smith v. Grayson* allows for the manipulation of profits in a manner that prevents those profits from ever becoming part of the community estate.[89]

In *Smith v. Grayson*, the husband acquired a partnership interest prior to marriage.[90] While he was married, the partnership distributed some profits to the partners, but kept a portion of the profits within the partnership.[91] In the divorce proceeding, the husband claimed his partnership interest was his separate property.[92] However, the wife argued that the portion of the value of the husband's partnership interest that represented undistributed income was community property.[93] Ruling in favor of the husband, the court reasoned that "[p]artnership earnings are owned by the partnership prior to distribution to the partners and cannot be characterized as either separate or community property."[94]

In reaching its decision, the court referred to the earlier case *Cleaver v. Cleaver* which held that both "corporate management may invest company earnings in corporate assets rather than distributing those earnings to shareholders" and "[p]artnership management may withhold earnings."[95] The court pointed out that "[t]he partner's spouse has no interest in the assets of a partnership until they are actually distributed" and acknowledged that "a partnership can be an effective means of preserving the separate property character of assets contributed to the partnership and the undistributed income thereon."[96]

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87. *See supra* Part II.D.

88. *See Lifshutz*, 199 S.W.3d at 26; Jamieson, *supra* note 81, at 402.

89. *See* Smith v. Grayson, No. 03-10-00238-CV, 2011 WL 4924073, at *1 (Tex. App.—Austin Oct. 12, 2011, pet. dism'd) (mem. op.); *Lifshutz*, 199 S.W.3d at 26.

90. *Smith*, 2011 WL 4924073, at *1.

91. *Id.*

92. *Id.* at *2.

93. *Id.*

94. *Id.* at *6 (citing Cleaver v. Cleaver, 935 S.W.2d 491, 494 (Tex. App.—Tyler 1996, no writ)).

95. Cleaver v. Cleaver, 935 S.W.2d 491, 495 (Tex. App.—Tyler 1996, no writ) (citing Heilbron v. Stubblefield, 203 S.W.2d 986, 989 (Tex. Civ. App.—El Paso 1947, writ ref'd n.r.e.); Fain v. Fain, 93 S.W.2d 1226, 1229 (Tex. Civ. App.—Fort Worth 1936, writ dism'd)).

96. *Smith*, 2011 WL 4924073, at *6 (quoting Lifshutz v. Lifshutz, 199 S.W.3d 9, 26 (Tex. App.—San Antonio 2006, pet. denied)).

As discussed previously, income derived from separate property generally belongs to the community.[97] The partner's spouse may wonder how a partner's right to partnership profits is not intrinsically community property when other assets such as retirement plans, promissory notes, and life insurance policies are characterized as community property upon divorce even when no distributions or payments were made during marriage.[98] In contrast to other assets in which a spouse does not possess a present possessory interest, as long as partnership profits are not distributed to the partner during marriage, the partner's right to partnership profits is somehow immune from community characterization.[99] If the profits are distributed one day before the marriage is terminated, the distribution is characterized as community property—meaning that the partner's spouse has a one-half undivided interest in the profits.[100] If those same profits are distributed one day after the marriage terminates, the profits belong entirely to the partner.[101] Is it logical that the timing of the distribution is the sole factor that determines whether the partner's right to partnership profits will ultimately be classified as separate or community property?[102]

V. CONCLUSION

A review of case law in light of traditional Texas community property rules reveals puzzling inconsistencies in the treatment of partnership interests as compared to other types of property, such as corporate stock.[103] A spouse who intends to rely on the general rules regarding income derived from separate property, appreciation of separate property, and mutation of separate property may be surprised to find that the interpretation of the rules may vary where partnership interests are concerned.[104] In addition, straightforward application of the rules is not always possible due to the inability to distinguish between income from a separate-property entity and appreciation of a separate-property entity.[105]

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97. *See supra* Part II.B.

98. *See* TEX. BUS. ORGS. CODE ANN. § 1.002 (West 2015). Under Texas law, a "'[p]artnership interest' means a partner's interest in a partnership," including the right to receive distributions. *Id.* § 1.002(68). Distributions may consist of the partner's share of profits or return of capital. *See id.* §153.208(b). " [W]hen a partner becomes entitled to receive a distribution, the partner has with respect to the distribution the status of" a creditor of the partnership. *Id.* § 153.207.

99. *See id*. § 152.101.

100. *See id.*; Marshall v. Marshall, 735 S.W.2d 587, 594–95 (Tex. App.—Dallas 1987, writ ref'd n.r.e.).

101. *See Marshall*, 735 S.W.2d at 594–95.

102. *See generally* Lifshutz v. Lifshutz, 199 S.W.3d 9 (Tex. App.—San Antonio 2006, pet. denied).

103. *See supra* Parts IV.B.1–3.

104. *See supra* Part IV.A.

105. *See supra* Parts II.B–C.

A number of factors impact the treatment of transactions involving partnership interests.[106] Distributions made in complete redemption of a withdrawing partner's interest—including any component attributable to retained income—may be characterized entirely as separate property.[107] Distributions made in partial liquidation of a partnership's assets—including any component representing the partner's original separate-property capital contribution—may be classified entirely as community property.[108] Finally, the portion of a partner's share of partnership earnings that accumulate during marriage, which are generally treated as community property when distributed, can escape community property treatment altogether if distributions are simply delayed until after the marriage terminates.[109]

Without a doubt, this unpredictable treatment of partnership interests and departure from the usual rules that apply to marital property is a cause for concern among current and would-be owners of partnership interests and their advisors.[110] Until the existing inconsistencies are reconciled by lawmakers or clarified by the courts, practitioners should be familiar with these exceptions to traditional community property rules and assist clients with careful preparation for transactions involving partnership interests.[111]

106. *See supra* Parts IV.A–B.
107. *See supra* Part IV.B.2.
108. *See supra* Part IV.B.2.
109. *See supra* Part IV.
110. *See supra* Parts III–IV.
111. *See supra* Part IV.