

Washington Law Review

Volume 22 | Number 1

2-1-1947

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Recommended Citation

F. A. LeSourd, *Community Property Status of Income from Business Involving Personal Services and Separate Capital*, 22 Wash. L. Rev. & St. B.J. 19 (1947).

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COMMUNITY PROPERTY STATUS OF INCOME FROM BUSINESS INVOLVING PERSONAL SERVICES AND SEPARATE CAPITAL

F. A. LeSourd*

I.

SCOPE OF PROBLEM

STILL uncertain in many community property states after a half century of litigation is the community or separate status of income derived by the husband or wife from a business involving personal services and separate capital.

Typical is John Jones, who owns a corner grocery store in Seattle, Washington. After becoming well established, he takes unto himself a wife—little knowing that he is also acquiring a community property and income tax headache. At the time of marriage, he has a substantial investment in inventory, receivables and equipment. The business continues after marriage, taking all his time. It is successful, and the income grows through the years. Is this income community or separate property?

Jones would have the same problem if he were operating any merchandising, brokerage, manufacturing or like business. And the answer to this question may have not only important property consequences under state laws but also substantial tax consequences under federal laws.

This problem applies in full force only in the states of Arizona, California, Nevada, New Mexico and Washington. In these states, the original community property system as established under the French and Spanish law, to the effect that rents, issues and profits of separate property belong to the community,¹ have been modified by statutes providing that rents, issues and profits of separate property are separate.² Idaho, Louisiana, Oklahoma and Texas have retained, in essence, the original community property system (although with modifications), and it follows in those states that income from

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¹ Fuller v. Ferguson, 26 Cal. 547 (1864).

² Arizona: ARIZ. CODE ANN. (1939) § 63-302; California: CAL. CIV. CODE §§ 162, 163; Nevada: NEV. COMP. STAT. (1929) § 3355; New Mexico: N. M. STAT. ANN. (1941) § 65-304 and 305; Washington: REM. REV. STAT. §§ 6390, 6891.

a business conducted after marriage belongs to the community even though the business is operated on separate capital of the husband.³

While the income arising from separate property in the states first named constitutes separate property, nevertheless, the income arising from the personal time or efforts of the husband or wife constitutes community property.⁴ Where the husband personally operates a business in which his separate capital is invested, the problem of determining the status of the income is, therefore, perplexing.

II.

HOW PROBLEM AROSE

To appreciate the underlying conflicts affecting this question, one may well examine the process by which these states abandoned the French and Spanish system of giving the community the income from separate property. The first of these states to set up its community property system was California. By Section 9 of the Act of 1850, the California Legislature followed the ancient community property system and provided that the rents and profits of separate property of either husband or wife should be deemed common property. But in 1860, in *George v. Ransom*,⁵ this statute was held unconstitutional insofar as the wife's separate property was concerned. The California Constitution provided that property owned by the wife before marriage and acquired by gift, devise or descent thereafter should be separate and the Supreme Court held that the framers of the Constitution must have had in mind the meaning of "separate property" at common law. Since at common

³ Idaho: IDAHO CODE ANN. (1932) § 31-907; Louisiana: LA. CIV. CODE Art. 2402; Oklahoma: Session Laws 1945, Title 32, §§ 1, 2, 3, p. 118. The original Oklahoma community property law of 1941 had included as separate property the increase of separate property. OKLA. STAT. (1941) Title 32, §§ 53, 54. This was repealed in 1945. Texas: TEX CONST. (1876) Art. XVI, § 15. *Frame v. Frame*, 120 Tex. 61, 36 S. W. (2d) 152, 73 A. L. R. 1512 (1931). However, in Texas, increase in value of separate property is separate. VERNON'S ANN. CIV. STAT. Arts. 4613, 4614. See long list of Texas cases cited in *O'Connor v. Comm.* (C. C. A. 5th, 1940) 110 F. (2d) 652. The problem discussed in this article could be applicable to such increase.

Some of these states have qualifications in the case of separate property of the wife. See statutes and decisions cited.

⁴ Arizona: *Garver v. Thoman*, 15 Ariz. 38, 135 Pac. 724 (1913), *Rundle v. Winters*, 38 Ariz. 239, 298 Pac. 929 (1931), *In re Torrey's Estate*, 54 Ariz. 369, 95 P. (2d) 990 (1939). California: *McDuff v. McDuff*, 32 Cal. App. 552, 191 Pac. 957 (1920), *Pereira v. Pereira*, 156 Cal. 1, 103 Pac. 488 (1909), *Estate of Gold*, 170 Cal. 621, 151 Pac. 12 (1915). Nevada: *Lake v. Lake*, 18 Nev. 361, 4 Pac. 711, 7 Pac. 74 (1884). See also *Barrett v. Franke*, 46 Nev. 170, 208 Pac. 435 (1922). New Mexico: *Katson v. Katson*, 43 N. M. 214, 89 P. (2d) 524 (1939). Washington: *Jacobs v. Hoitt*, 119 Wash. 283, 205 Pac. 414 (1922). *In re Hebert's Estate*, 169 Wash. 402, 14 P. (2d) 6 (1932). Federal: *Poe v. Seaborn*, 282 U. S. 101, 75 L. Ed. 239, 51 S. Ct. 58; *George W. VanVorst*, 7 T. C. 826 (1946).

⁵ 15 Cal. 322, 76 Am. Dec. 490 (1860)

law the wife was entitled to the income on her own separate property, since the framers of the Constitution were more familiar with common law, and since the purpose of adopting the community property system, as the Court states, was to protect the wife from the improvidence of the husband, the Court concludes the framers of the Constitution must have intended the profits from the wife's separate property to be separate.

That this decision applied only to separate property of the wife, and that the statute was constitutional as applied to the husband was indicated the next year by *Lewis v. Lewis*,⁶ where increase in separate livestock of the husband was held to belong to the community. Income from the wife's separate property was, therefore, separate and income from the husband's community. This contradictory treatment in California was ended in 1872 by the enactment of legislation making separate the income of the separate property of both husband and wife.⁷

The original Washington community property law passed in 1869⁸ did not directly set forth the status of rents, issues and profits of separate property. The amendatory act of 1871⁹ followed the French and Spanish system, and provided that the income from separate property should be common property. However, this was left out of the 1873 act¹⁰ and in 1879 the law was amended to adopt the California rule that income from separate property was separate.¹¹

Arizona's original community property law provided that the rents and profits of separate property should be community.¹² However, the Supreme Court of Arizona held, quoting from *George v. Ransom*, that a later act¹³ giving a married woman exclusive control of her separate property, gave to her as separate property the income from her separate property.¹⁴ Later, the legislature provided that the income from separate property of both husband and wife should be separate.¹⁵

Nevada and New Mexico adopted systems modeled primarily on the California law and with it the California construction that the rents, issues and profits of separate property are separate.

⁶ 18 Cal. 654 (1861)

⁷ CAL. CIV. CODE §§ 162, 163.

⁸ Wash. Session Laws 1869, p. 318.

⁹ Wash. Session Laws 1871, p. 67, § 2.

¹⁰ Wash. Session Laws 1873, p. 450.

¹¹ Wash. Session Laws 1879, p. 77, § 1.

¹² Arizona, Act of 1865, § 9.

¹³ Arizona, Act of 1871.

¹⁴ Charauleau v. Woffenden, 1 Ariz. 243, 25 Pac. 652 (1876)

¹⁵ ARIZ. CODE ANN. (1939) § 63-302.

The California doctrine as announced in *George v. Ransom* resulted in a hybrid community property system in these five states and brought into being the problem here discussed.¹⁶

III.

EARLY ATTEMPTS TO SOLVE PROBLEM

Fundamentally, it may properly be said that this hybrid system arose out of the desire to protect the rights of women that was basic in the psychology of the pioneer West. Not only did this Western psychology create this problem of segregation of community and separate income, but also it influenced the early attempts to solve the problem. In 1864, in *Lewis v. Johns*,¹⁷ the husband was farming the wife's separate land, and the question was whether the community was entitled to any part of the proceeds by reason of the husband's services. Stating that the Constitution and decisions of California afforded a shield to the separate property of the wife and the profit thereof, the court held that the husband cannot, by his act, acquire an interest in the wife's separate property or its increase. Also typical of these early decisions is *Dresendorff v. Hopkms*,¹⁸ where the wife ran a separately owned boarding house. The California court held that although personal labor was involved, nevertheless, personal labor would in some degree be involved in all rents, issues and profits of separate property and this was no reason to change the rule that the income was separate.

Similarly, the Supreme Court of Washington, in the period from 1895 to 1921 repeatedly held that the community derived no income by reason of the services of the spouses in a business based on separate capital.¹⁹

All this was very well in protecting the wife, but like so many other principles, it produced results which threatened to nullify the very objective sought to be obtained. Where the husband had separate property and devoted all his time to it, was the wife thereby to be deprived of any community income? An early case which was extreme on this point, *Lake v. Lake*, came to the Supreme Court of Nevada in 1884.²⁰ There the husband and wife both

¹⁶ DEFUNIAK, 1 PRINCIPLES OF COMMUNITY PROPERTY § 71, note 50, attributes this result to the view on the part of the court that the entire community property was subject to the separate debts of the husband, and a desire to protect the wife from the husband's creditors.

¹⁷ 24 Cal. 99, 85 Am. Dec. 49 (1864)

¹⁸ 28 Pac. 265, 95 Cal. 343 (1891)

¹⁹ *Leake v. Hayes*, 13 Wash. 213, 43 Pac. 48 (1895), *Brookman v. State Insurance Co.*, 18 Wash. 308, 51 Pac. 395 (1897), *Hester v. Stine*, 46 Wash. 469, 90 Pac. 594 (1907), *Merrick v. Appenzeller*, 115 Wash. 181, 196 Pac. 629 (1921)

²⁰ 18 Nev. 361, 4 Pac. 711 (1884), On rehearing reported as *Lake v. Bender*, 7 Pac. 74 (1885)

devoted full time to the operation of a hotel owned separately by the husband. Faithful to the letter of the rule that had been established, the court held that all of the income was the separate property of the husband. Thus the wife was deprived of not only the benefit of the husband's services but also the benefit of her own services.

In Washington, too, the theory of the early cases giving the wife separately all income from a business conducted on her separate capital, despite personal services rendered by her, caused the court in 1901 in *Austin v. Clifford*²¹ to hold that no community property arose from the business of the husband in buying and selling property where the capital was originally his separate property²²

Criticism was bound to follow this extension of *George v. Ransom*²³ achieving a result so contrary to the basic premise of protection of rights of women, still a vital psychology in the West in the first quarter of this century. In 1907, F. T. Post of the Washington bar attacked the *Austin* case on the ground that it enabled the husband to avoid accumulation of community property.²⁴ The courts, while continuing to give lip service to the old rule, began finding ways and means to give the community an interest in the profits from separate property where services were involved. The California Supreme Court permitted a creditor of the husband to reach a crop of barley raised on land leased by the wife.²⁵ The Supreme Court of Washington in 1904, citing Texas cases, gave the community a lien against separate real estate for the increase in value thereof resulting from the joint efforts of the spouses.²⁶ Even in the drastic case of *Lake v. Lake*²⁷ the Nevada court stated as dictum that if it were apparent that the profits came principally from the joint efforts of the husband and wife, they would be community. As early as 1892 the Washington court referred to the fact that the energy and skill of

²¹ 24 Wash. 172, 64 Pac. 155 (1901)

²² Cf. *Estate of Higgins*, 65 Cal. 407, 4 Pac. 389 (1884), *Bauer's Estate*, 79 Cal. 304, 21 Pac. 759 (1889); *Re Peppers Estate*, 158 Cal. 619, 112 Pac. 62, 31 L. R. A. (N. S.) 1092 (1910); *Lenninger v. Lenninger*, 167 Cal. 297, 139 Pac. 679 (1914); *Seeber v. Randall* (C. C. A. 9th, 1900) 102 Fed. 215.

²³ *Supra* note 5.

²⁴ PROCEEDINGS OF WASHINGTON STATE BAR ASSOCIATION, 1907.

²⁵ *Davis v. Green*, 122 Cal. 364, 55 Pac. 9 (1898) Cf. *Hester v. Stine*, 46 Wash. 469, 90 Pac. 594 (1907), where the Washington court refused to let a creditor of the husband reach a crop of barley on the wife's land because the wife conducted the farming herself and the husband was most of the time absent from the state.

²⁶ *Legg v. Legg*, 34 Wash. 132, 75 Pac. 130 (1904)

²⁷ *Supra* note 20.

a spouse was a contributing factor to the production of the income as support for an extension of the rights of the community ²⁸

During these early days there was much confusion and uncertainty caused, in the writer's opinion, by the fact that most of the judges were educated in the common law and had an imperfect understanding of the civil law background of community property. Slow to develop, for example, was a clear comprehension that the value of services of the spouses belonged to the community even where devoted to separate property ²⁹

IV

CALIFORNIA SOLUTION: THE PEREIRA FORMULA

In 1909 the divorce case of *Pereira v. Pereira*³⁰ came before the California courts. The husband there operated a saloon business. His original capital therein, \$15,500, had been separate property. The lower court, seeking as usual to protect the wife, held that all the income from the business was community property. Nevertheless, the Supreme Court of California stated that there should be an apportionment to be determined from all the circumstances of the case, and that the separate capital with which he had commenced business should have resulted in separate income at least to the extent of interest on a well secured loan, citing the West Virginia case of *Boggess v. Richards, Adm'r* ³¹

It is interesting that the first case in the community property states to attempt to segregate the income into part community and part separate relied on common law principles. *Boggess v. Richards, Adm'r* was a case where a husband in a common law state devoted his labor to his wife's property. The court said that equity would protect creditors of the husband from what was, in effect, a fraudulent conveyance and that the only way to ascertain how much of the profit was due to the labor of the husband was to deduct from the profit legal interest on the amount of capital invested.

California has, in the main, continued to follow the *Pereira* formula.³² However, the California courts have not applied the formula to cases involving management of separate property as distinguished from the conduct of an active business. Where the spouse spends full or part time buying, selling,

²⁸ *Yesler v. Hochstetler*, 4 Wash. 349, 30 Pac. 378 (1892)

²⁹ *cf. Lake v. Lake, supra* note 20; *Hester v. Stine*, 46 Wash. 489, 90 Pac. 594 (1907)

³⁰ 156 Cal. 1, 103 Pac. 488 (1909)

³¹ 39 W. Va. 576, 20 S. E. 599, 26 L. R. A. 537 (1894)

³² *Estate of Caswell*, 105 Cal. App. 475, 288 Pac. 102 (1930); *Estate of McCarthy*, 127 Cal. App. 80, 15 P. (2d) 223 (1932). *Cf. Estate of Gold*, 170 Cal. 621, 151 Pac. 12 (1915) where approval is dictum since all profits there were found

improving, renting or otherwise managing separate property, all income is separate.³³ And even in some cases where the *Pereira* formula would seem entirely applicable, the California courts have failed to apply it.³⁴

Arizona appears to hold that the income is all community or all separate, depending on whether services or separate capital is the principal factor.³⁵ The New Mexico court has suggested that the reasonable value of the services be given to the community and the balance of the income be set apart as separate property.³⁶

V

WASHINGTON SOLUTION: COMMINGLING

In Washington, the Supreme Court, without overruling its earlier decisions, has gone the entire way from its previous rule that all the income is separate to the present rule that all the income is community.³⁷ Only once in this progress of complete reversal did the court stop at the intermediate ground of apportionment of the income. This was in 1922 in *Jacobs v. Hoitt*.³⁸ *Pereira v. Pereira* and its formula were not mentioned and the Washington

to have resulted from services, i.e., gambling, and awarded to the community; *In re Fellow's Estate*, 108 Cal. App. 681, 289 Pac. 887 (1930), where approval is dictum since the court found that no definite separate capital had been established.

The *Pereira* formula has been both supported (14 CALIF. L. REV. 402) and criticized (Alvin E. Evans in 10 CALIF. L. REV. 271, 282) by California commentators.

³³ *In re Barnes Estate*, 128 Cal. App. 489, 17 P (2d) 1046 (1932), where this distinction is expressly made. Cf. *Cline v. Cline*, 4 Cal. App.(2d) 626, 41 P (2d) 588 (1935)

The distinction between managing a business and managing one's property is hard to follow in many cases. For example, see *Fuller v. Harwell*, 117 Cal. App. 280, 3 P.(2d) 592 (1931) where the wife under this doctrine was given all of the cattle and hogs in what appears to be a full scale livestock and dairy business commenced with her separate capital.

It is possible that this exception to *Pereira v. Pereira* has been abandoned in California. See *Witaschek v. Witaschek*, 56 Cal. App.(2d) 277, 132 P (2d) 600 (1942), where the Court of Appeal sustained an apportionment of profits arising from the husband's activities in managing his separate investments. The apportionment is not shown to have strictly followed the *Pereira* formula, however.

³⁴ *Gray v. Perlis*, 76 Cal. App. 511, 245 Pac. 221 (1926); *Seligman v. Seligman*, 85 Cal. App. 683, 259 Pac. 984 (1927); *Estate of Pepper*, 158 Cal. 619, 112 Pac. 62 (1910)

³⁵ *Rundle v. Winters*, 38 Ariz. 239, 298 Pac. 929 (1931); *In re Torrey's Estate*, 54 Ariz. 369, 95 P (2d) 990 (1939); cf. *Lincoln Fire Ins. Co. of N. Y. v. Barnes*, 53 Ariz. 264, 88 P.(2d) 533 (1939)

³⁶ *Katson v. Katson*, 43 N. M. 214, 89 P (2d) 524 (1939)

³⁷ Compare, for example, *In re Witte's Estate*, 21 Wn.(2d) 112, 150 P (2d) 595 (1944), with *Leake v. Hayes*, *Austin v. Clifford*; and *Hester v. Stine*, all *supra* notes 19 and 21.

³⁸ 119 Wash. 283, 205 Pac. 414 (1922)

court, with a method of apportionment not too clear in the opinion, sought to do equity in accordance with the facts of the case.

As enunciated clearly by the more recent decisions, the Washington court now holds that where personal services (which belong to the community) are devoted to a business involving separate capital, there has been a commingling unless the parties contemporaneously themselves segregate the income. The court further holds that community and separate income having been commingled, all the income belongs to the community³⁹ unless the community property is inconsiderable in comparison with the separate property, in which event it is all separate.⁴⁰ A further qualification has been made, that if withdrawals for community expenses exceed the value of the services rendered by the spouses, then the remainder is separate property⁴¹

VI.

NEITHER CALIFORNIA NOR WASHINGTON RULE IS EQUITABLE

Behind the adoption of the Washington rule appears to be the feeling that no practical basis of apportionment is available, and the court will not venture into such a speculative field. In reality, then, the Washington rule is an avoidance of the problem. One could argue in support of this rule on the ground that it gives more certainty were it not for the fact that it leaves entirely uncertain the question of when the community services are inconsiderable in comparison with the separate capital.

The Washington rule is basically not equitable. Where the community services are substantial and all income goes to the community, the spouse gets nothing for his contribution of separate capital. And where the court gives all income to the separate capital because the community services are small compared to the separate capital, the community gets nothing for the services rendered. A practical case with which the author is familiar is where a man in the business of buying and selling for his own account real estate and other investments is married. He devotes his full time to the business, but it might be said that the value of his services is small in comparison with the large amounts of separate capital which he had in the business at the time of marriage. Should the court so hold, and thus treat all income as separate, he

³⁹ *In re Buchanan's Estate*, 89 Wash. 172 154 Pac. 129 (1918); *Salisbury v. Meeker*, 152 Wash. 146, 277 Pac. 376 (1929); *E. I. DuPont de Nemours & Co., Inc. v. Garrison*, 13 Wn.(2d) 170, 124 P (2d) 939, 17 WASH. L. REV. 221 (1942); *In re Witte's Estate*, 21 Wn.(2d) 112, 150 P (2d) 595 (1944), cf. *In re Binge's Estate*, 5 Wn.(2d) 446, 105 P (2d) 689 (1940)

⁴⁰ *In re Witte's Estate*, *supra* note 39; cf. *In re Binge's Estate*, *supra* note 39.

⁴¹ *State ex rel. Van Moss v. Sailors*, 180 Wash. 269, 39 P (2d) 397 (1934) Also see note 60 *infra* for cases holding that when a salary is taken from the business the balance of income is separate.

could spend a lifetime devoting his full time to a very profitable business and never accumulate any community property. Conversely, if the court held that his services were substantial and that all income was community, he would be deprived entirely of any separate income from the large amount of separate property held by him at the time of marriage.

Nor is the California rule free from possible inequity. The *Pereira* case gives the separate property a return equal to interest on a long term debt, and the balance goes to the community. Where earnings are large, the community may get a return far exceeding the reasonable value of the services, while the separate property, which may be a substantial contributing cause of the large income, is left with nothing more than interest. On the other hand, if the income is small, all of it may go to the separate property as interest and the community services go unrewarded.

VII.

FEDERAL TAX FORMULA. G. C. M. 1030

The states, then, being in conflict on the status of income from a business involving community services and separate capital, how has the Federal Government treated it in administering its tax laws?

This question, of course, is of frequent and substantial importance with regard both to federal income and estate tax.⁴² On its solution depends the splitting of income or estate between husband and wife, thus achieving lower tax brackets.

As is to be expected on a point on which the state courts, themselves, are not in agreement, the rulings of the Bureau of Internal Revenue have not been entirely consistent. In the first formal ruling on the question, Solicitors Memorandum 3883,⁴³ the Solicitor of Internal Revenue in 1925 was asked to determine the status of earnings in Arizona of a husband who operated after marriage an automobile agency which he had started before marriage. The memorandum discusses the Arizona, California and Washington cases, but insofar as the Washington decisions are concerned, cites only the early cases (now apparently not followed), that the labor of a spouse on separate property did not give the community any interest in the proceeds. These Washington cases he rejected, adopting the rule of *Pereira v. Pereira*,⁴⁴ treating

⁴²The Federal Estate Tax importance of the question has been narrowed by the 1942 estate tax amendments. See *Fernandez v. Wiener*, 325 U. S. 1186, 90 L. Ed. Adv. Op. 147 (1945), 66 Sup. Ct. Adv. Op. 179. But the problem remains in determining source of funds under those amendments.

⁴³IV, 2 CUM. BULL. 125.

⁴⁴See note 30 *supra*.

as separate income interest on the separate capital and treating the balance of the income as belonging to the community

In 1927, possibly concerned over the large tax savings in the states involved, the Bureau of Internal Revenue reconsidered the matter. Reconsideration, however, was limited to Arizona and Washington. California remained under S. M. 3883 because of the specific decisions of her courts as to the method of apportionment. The reconsideration resulted in the issuance of General Counsel's Memorandum 1030,⁴⁵ stating that where the income was essentially attributable to the separate property it was separate; where it was essentially attributable to services of one of the spouses it was community; but where both were essential factors in producing the income an apportionment should be attempted, in accordance with what each in fact contributed to the success of the enterprise. A general method suggested was to segregate the income in the proportion which a fair return on the separate investment bears to the fair value of the personal services involved.

Of course this left the situation uncertain as far as Arizona and Washington were concerned and put them in a different position from California. Moreover, the formula suggested in G. C. M. 1030 was generally more favorable to the Bureau of Internal Revenue than that suggested in S. M. 3883, since the former allocated to separate property some of the income above the interest on the separate capital, while the latter gave to the community (and consequently permitted the division between husband and wife on income tax returns) all income above the usual interest on the separate capital. It is not, therefore, surprising that in 1931 there appeared G. C. M. 9825⁴⁶ ignoring the differences between California and Washington decisions and applying the more favorable (to the government) rule of G. C. M. 1030 to a California case. This made it appear that the formula of G. C. M. 1030 was the Bureau of Internal Revenue policy for all of the states dealt with by this article. G. C. M. 9825 also suggested that a fair return on separate capital under the formula of G. C. M. 1030 would be "usual interest" on the separate capital. Whether this meant legal interest or usual commercial rates of interest was not made clear. Determination of the reasonable value of husband's services, the other factor in the formula, was apparently left as a question of fact in each case.

There have been no further formal rulings since 1931 and subsequent Bureau of Internal Revenue policy is disclosed only in administrative settlements and positions taken in litigated cases. This policy has not been con-

⁴⁵ VI, 1 CUM. BULL. 26.

⁴⁶ X, 2 CUM. BULL. 146.

sistent. In some cases the Commissioner of Internal Revenue has argued for his formula⁴⁷ and in others, where it did not work out to the government's advantage, he has argued against it.⁴⁸ Also, the writer is unofficially advised that some cases in the State of Washington have been administratively settled on the basis of the Washington Supreme Court decisions, *viz*: giving all the income to the community.

The Tax Court has been much more consistent in following G. C. M. 1030 than has the Bureau itself, and the formula appears to be the settled policy of that court.⁴⁹ One exception was the case of *Lawrence Oliver*,⁵⁰ arising from California where the Tax Court followed the *Perera* case and gave the community all the income over and above usual interest on the separate capital investment. No mention is made of the several Tax Court decisions applying the different formula of G. C. M. 1030.

VIII.

CONFLICT OF FEDERAL AND STATE RULES: THE TODD CASE

In the very same year that the Tax Court in the *Oliver* case applied the California formula, the Circuit Court of Appeals for the Ninth Circuit in *Todd v. Commissioner of Internal Revenue*⁵¹ approved an earlier Tax Court ruling rejecting the California formula and applying the formula of G. C. M. 1030. Two of the three circuit court judges held that in spite of the California rule as enunciated in the *Perera* and other cases, to the effect that the community should receive all income above usual interest on separate capital, it was the duty of the Commissioner of Internal Revenue to determine from the facts of the case the amount of the return on the separate capital. The commissioner's method, they said, is a rational one, is supported by evidence, and the burden of showing error in the determination is on the taxpayer. One judge dissented on the ground that the commissioner's determination cannot block inquiry into legal defects of the commissioner's action. The case was finally remanded *per curiam* for further evidence and independent action by the Tax Court.

⁴⁷ J. Z. Todd, 3 T. C. 643 (1944), (remanded by C. C. A. 9th in 153 F.(2d) 553 (1945); see J. Z. Todd, 7 T. C. 399)

⁴⁸ Cecil Gray, T. C. Memo. Op. June 13, 1945 (Prentice Hall, T. C. Memo. Dec. 1945, ¶ 45, 236); Clara B. Parker, *Executrix*, 31 B. T. A. 644 (1934); cf. Lawrence Oliver, 4 T. C. 684 (1945)

⁴⁹ Cecil Gray, note 48 *supra*; J. Z. Todd, 3 T. C. 643 (1944) (remanded by C. C. A. 9th (1945) in 153 F.(2d) 553; see J. Z. Todd, 7 T. C. 399); Clara B. Parker, 31 B. T. A. 644; Paul F. Hill *et al.*, *exec.*, 24 B. T. A. 1144 (1931)

⁵⁰ 4 T. C. 684 (1945).

⁵¹ 153 F.(2d) 553 (1945).

On remand⁵² the Tax Court refused to depart from its original decision applying G. C. M. 1030 rather than California law. At the time of writing this article, the case is again before the Ninth Circuit on appeal from the Tax Court.

The importance of the *Todd* case is not limited to California. Washington, likewise, has a considerable stake in its outcome. The present Washington law that all of the income from a business involving community services and separate capital is community, unless segregated contemporaneously by the spouses themselves, has likewise been ignored by the Tax Court. In *Cecil Gray*,⁵³ the commissioner contended that substantially all of the income after marriage from a separately owned brokerage business was separate income. Taxpayer contended that under the applicable decisions of the Washington Supreme Court it was all community and as an alternative asked that a computation under G. C. M. 1030 should be made. The Tax Court declined to follow the Washington decisions and adopted the formula of G. C. M. 1030.

If the *Todd* case is finally decided as indicated by the views of the majority of the circuit court in the first hearing, it will appear that a method of apportionment of income between community and separate property can be adopted for federal tax purposes even though contrary to the laws and decisions of the state.

To support this contention, the Commissioner of Internal Revenue relies on the presumption of correctness attached to his determination of tax. The taxpayer has the burden of proving the commissioner's determination incorrect. The commissioner argues that the various state laws on the subject here discussed do not fix ownership of income from a business involving separate capital. The presumptions adopted by the states are, he says, merely procedural methods of determination and do not establish ownership of property so as to overcome the commissioner's determination.⁵⁴ The Washington cases, for example, say that the question of whether the income is community or separate is one of fact, and that where there is no clear way to segregate the income it will be treated as commingled and all be presumed to be community property. This is, it is argued, not a determination of ownership of income but simply disposition of a case because of lack of proof. If the matter is one of fact, not law, then the commissioner believes he can

⁵² *J. Z. Todd*, 7 T. C. 399.

⁵³ See note 48 *supra*.

⁵⁴ Nevertheless, where it was to his advantage, the commissioner has himself relied on the State presumption. *Estate of Emma Frye*, 44 B. T. A. 835 (1941)

require that taxpayer prove the proper segregation in order to overcome the commissioner's presumption of correctness.

This theory was apparently adopted by the Circuit Court of Appeals for the Ninth Circuit in *Shea v. Commissioner of Internal Revenue*⁵⁵ in 1936. Nevertheless, the Circuit Court of Appeals for the Fifth Circuit has repeatedly taken precisely the opposite view in cases coming up from Texas and Louisiana,⁵⁶ stating that the presumption that commingled property is community is so bound together with local property rights that the failure to apply it would result in serious interference with the local substantive law.⁵⁷ And the Tax Court has held to the same effect in at least two cases arising from the State of Washington.⁵⁸

One may expect that the Ninth Circuit will take a definite position on this question in the *Todd* case. Should that be in accordance with the opinion of the majority in the first *Todd* case and contrary to the Fifth Circuit decisions, ground for certiorari in the Supreme Court of the United States would exist to finally settle the question.⁵⁹ From the taxpayer's side of the question it can be contended that the Washington rule that no apportionment will be made and the California method of apportionment adopted in the *Perera* case are, in effect, final rules of law determining status of property, since they apply only where there has been a commingling and thus no factual segregation is possible. In reality, the state courts and the Tax Court are trying to adopt different legal formulas as to ownership of property. The question of segregation may be factual, as the courts have stated but where there are no facts the solution must be by legal principle governing ownership of property.

IX.

MISCELLANEOUS PROBLEMS

In certain situations there are inherent facts on which a segregation may

⁵⁵ 81 F.(2d) 937 (1936)

⁵⁶ *McFaddin v. Comm.* (C. C. A. 5th, 1945), 148 F.(2d) 570; *Howard v. U. S.* (C. C. A. 5th, 1942), 125 F.(2d) 986; *Stewart v. Comm.* (C. C. A. 5th, 1938), 95 F.(2d) 821.

⁵⁷ *Howard v. U. S.*, *supra* note 56.

⁵⁸ *Austin Leigh Claiborne et al., ex'rs*, 40 B. T. A. 722 (1939); *Thomas W. Costello*, T. C. Memo Dec., Jan. 27, 1945, found in 1945 Prentice Hall; T. C. Memo Dec. ¶ 45034.

⁵⁹ It is possible that the commissioner's position will be upheld insofar as suits for refund of tax in Federal District Courts are concerned, but denied as to proceedings before the Tax Court. This is because on refund suits, the taxpayer has the burden of proving the correct amount of tax, but before the Tax Court all that the taxpayer must prove is that the assessment is arbitrary. *Helvering v. Taylor*, 293 U. S. 507, 79 L. Ed. 623, 55 Sup. Ct. 287 (1935); *Forbes v. Hassett*, 124 F.(2d) 925 (C. C. A. 1st, 1942)

be made and state and federal courts concur in segregating on the basis of such facts. For example, if the spouse takes a salary from the business, this has been treated as a contemporaneous segregation of the value of the services, and the balance of the income is deemed separate.⁶⁰ In recognizing contemporaneous segregation by the parties the Tax Court has gone so far as to uphold an apportionment made in the income tax returns of the husband and wife.⁶¹

Attention is called to the fact that the present discussion goes only to unincorporated business—individual or partnerships. Where the husband or wife at the time of marriage own stock in a corporation—even if a wholly owned corporation to which the spouse devotes full time—the status of the income may be determined by entirely different legal principles. Services of the spouse to the corporation are presumably entirely paid by the salary drawn from the corporation⁶² and the separate status of the stock would seem properly to make all dividends separate property. However, in order to do equity in hardship cases, the courts have, at times, given the community an interest in the income from the corporation over and above the salary paid.⁶³

If the federal courts finally approve the action of the Tax Court in applying the formula of G. C. M. 1030, it will be important that taxpayers, in cases before the Tax Court or District Court, prove the factors necessary to the application of this formula. This involves establishing the reasonable value of the services of the spouse and the reasonable rate of interest on the separate capital.⁶⁴

Where income from a business involving separate capital is apportioned, difficult problems are often faced in the treatment of withdrawals from the

⁶⁰ *Shea v. Comm.*, 81 F.(2d) 937 (C. C. A. 9th, 1936); *Hugh B. Tinsling*, 7 T. C. 161 (1946), *George W. VanVorst*, 7 T. C. 826 (1946), *Anna L. Compton, exec.*, 11 B. T. A. 26; *Julius Shafer*, 2 B. T. A. 640; *Zimmerman v. Squire*, 57 F. Supp. 229 (W. D. Wash. 1944); *Van Camp v. Van Camp*, 53 Cal. App. 17, 199 Pac. 885 (1921) *Contra: Rucker v. Blair*, 32 F.(2d) 222 (C. C. A. 9th, 1929)

Taxpayers will note from this that if it be desired that the community receive a maximum amount of the income of an unincorporated business involving separate capital, the spouse should not receive an amount designated "salary" for his services.

⁶¹ *Anna L. Compton, exec.*, 11 B. T. A. 26 (1928)

⁶² *Gump v. Comm.*, 124 F.(2d) 540 (C. C. A. 9th, 1941), *In re Hebert's Estate*, 169 Wash. 402, 14 P.(2d) 6 (1932)

⁶³ *In re Buchanan's Estate*, 89 Wash. 172, 154 Pac. 129 (1916), *Guy C. Earl, Jr.*, 4 T. C. 768; *G. A. Axelson*, B. T. A. Memo Dec., April 7, 1942, found in Prentice Hall, B. T. A. Memo Dec., 1942, ¶ 42216.

⁶⁴ *F. A. Wilson*, B. T. A. Memo Op., Feb. 6, 1943, found in Prentice Hall 1943 Tax Court Memo Dec., ¶ 43085.

business. Are these withdrawals to be charged to the community or separate funds? The Supreme Court of Washington has quite uniformly held that it is to be presumed that separate debts are paid from separate funds and community debts from community funds.⁶⁵ On this point, in the case of *Cecil Gray*,⁶⁶ the Tax Court clearly erred, undoubtedly due to haste and inattention, in adding separate withdrawals to the separate capital rather than decreasing separate capital by the withdrawals made for separate purposes, which would seem to be the correct rule as stated in the Washington cases.

CONCLUSION

That difficult problems of segregation have resulted is not sufficient reason to regret the action of Arizona, California, Nevada, New Mexico and Washington in abandoning the historical system of community property by depriving the community of the income from separate property. Protection, primarily for the wife and secondarily for the husband, in their separate property was intended. This protection was deemed to be in the interests of public policy. However, as this article shows it has not been fully achieved. It can be achieved if solutions are found to the problem of segregation of community and separate income which will give the benefits intended by the legislature in making the change.

The Washington court, in refusing to make any segregation of income arising from a business involving community services and separate capital, fails to carry out the spirit of these sections of the Community Property Law. In fact, the effect of the Washington rule in most cases is to put Washington back on the historical system of community property where all income from separate property belongs to the community, despite the legislative command to the contrary. And by saying that all income will be separate if the community services are small as compared to the separate capital, the Washington court has opened up the possibility of a husband working actively and profitably for a lifetime without earning any community property, a result certainly contrary to the intention of the legislature.

The California apportionment formula more closely approximates the intent of the law but still it is subject to the charge of substantial inequity. Moreover, the cases holding that the services of a spouse in managing his or her separate property, as distinguished from the conduct of an active business, give rise to no community income whatever, bring about the same result

⁶⁵ *In re Finn's Estate*, 106 Wash. 137, 179 Pac. 103 (1919); *In re Binge's Estate*, 5 Wn.(2d) 448, 105 P.(2d) 689 (1940); *In re Woodburn's Estate*, 190 Wash. 141, 66 P.(2d) 1138 (1937); *Guye v. Guye*, 63 Wash. 340, 115 Pac. 731, 37 L. R. A. (n. s.) 188 (1911)

⁶⁶ See note 48 *supra*.

in California as is possible in Washington, *viz.* that the husband could work actively and profitably for a lifetime without receiving any community property. This result would seem entirely indefensible in light of the purposes sought to be obtained by the community property system.

The closest approach to achieving the intent of the law yet suggested is the apportionment formula of G. C. M. 1030, dividing the income according to the ratio of reasonable interest on the separate capital to the reasonable value of the community services. The state supreme courts might well give consideration to this formula.

No matter what the rule adopted, it is regrettable that these five states with similar laws intended to produce the same results, have not worked out a uniform method of treatment of this problem. But even though these state courts pursue their own separate paths, there would seem to be no warrant for the federal courts and the Bureau of Internal Revenue to disregard the state law on the subject. These state rules whether or not called "presumptions" have become settled laws of property governing ownership of income between the parties. They should be recognized for tax purposes just as the community property system itself is recognized.