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Benjamin H. Kizer

# COMMUNITY INTEREST IN COMMINGLED INCOME, DERIVED FROM PERSONAL SERVICE AND SEPARATE CAPITAL—ANOTHER VIEW

BENJAMIN H. KIZER*

THE LAWYERS of this state are deeply indebted to Mr. Francis A. LeSourd of the Seattle Bar for his thoughtful and scholarly analysis of "Community Property Status of Income from Business Involving Personal Service and Separate Capital."[1] This article gives special pleasure in that Mr. LeSourd has taken pains to go to the historic roots of the problem—in the Spanish law and in the early decisions of other states. However, I am not at peace with one of Mr. LeSourd's conclusions. I venture, therefore, to present an alternative to the view Mr. LeSourd has taken.

It will be remembered that our Supreme Court has held that where the income from community services in a substantial amount is inextricably commingled with income from separate capital, it treats the whole income resulting from the commingling as community income. but that where the income from such community services is not substantial, the income is regarded as belonging wholly to the separate estate. This rule Mr. LeSourd criticizes as "basically not equitable," and as an avoidance of the difficulties of the problem.

This commingling of substantial community income with separate income is of course the important aspect of the rule. There are few cases, and these of little moment, where the community contribution is so small that all the income is treated as separate. I shall speak, therefore, only of this greater commingling

Whether this rule is equitable or not depends, it would seem, on how we look at the relation of husband and wife, their property and their income. If we view this relation of the spouses as primarily a property relation, there is much to be said for Mr. LeSourd's view But if we look upon it as primarily a matrimonial relation, which the law protects with its presumptions because it views this matrimonial relation

*LL.B., University of Michigan, 1902, LL.D., Linfield College. Director UNRRA's China Office, 1944-46; Walker-Ames Professor, University of Washington, 1946-47, member of law firm of Graves, Kizer & Graves, Spokane.

[1] 22 WASH. L. REV. 19 (Feb., 1947).

as more important than the property of the spouses, then the view of our Supreme Court is soundly based.

Let us recall the precise language of our Court on this point. In the well-known case of *Yesler v. Hochstettler*,[2] our Supreme Court said:

> During the marriage relation the community property of the spouses is, and in the nature of things must be, the superior and controlling entity; its interests are paramount, and whatever tends to reduce its position must be exceptional.

Again in *Jacobs v. Hoitt*[3] our Court, in considering this problem of commingling, said:

> Its separate and community natures have become so confused that the court cannot apportion them, and the favor with which community property is regarded, and the presumptions in favor of it are such, etc.

These two paragraphs have been quoted by our Court over and over in support of its conclusions. To me, they are persuasive of a sound public policy that has its own equity That policy results in an interest in the accumulations for each of the spouses during the life of the community, to which each has contributed by his or her labor. This policy makes for sound matrimonial relations, and results in an estate for each when that relation is dissolved.

Furthermore, it is well to remember and give weight to the views of the statesmen and jurists who framed the rule of the Spanish law Their view was that, during the life of the matrimonial relation, all income, whether from community labor and property or from separate property, was community property This rule has roots that run deep into the past of community property law It grows out of a wise human experience, and is not lightly to be discarded.

Nor can I agree that the Washington rule is merely an avoidance of a difficult problem. Generally speaking, where the commingling of separate and community income has been complete as it was in the case of *In re Buchanan's Estate*[4], or in *E. I. DuPont de Nemours v. Garrison*[5] and in the many other cases that have helped to build up the rule in our Court, the problem is not merely difficult. It is utterly insoluble save by the use of presumptions or formulas. If we are not satisfied with the presumptions of the Spanish law or of our Court, we are

[2] 4 Wash. 349, 354, 30 Pac. 378 (1892).
[3] 119 Wash. 283, 287, 205 Pac. 414 (1922).
[4] 89 Wash. 172, 150 Pac. 129 (1916).
[5] 13 Wn.(2d) 170, 124 P.(2d) 939 (1942).

compelled to contrive an arbitrary formula. Such a formula is not a solution in any equitable sense. It merely cuts through the thicket of facts with a sword. It creates more inequities than it solves.

Furthermore, if the spouses wish to keep their separate estates free from commingling with their community estate, they have only to keep separate accounts, so that the earnings of their respective estates can be identified by the courts. In this time of heavy income taxes, accounts of all income must be kept by the managing spouse. It would impose little additional burden to separate the two classes of income and pay accordingly Such a separation of incomes would be given effect by our Court, because it would disclose the intent of the parties.

Conversely, where the spouses commingle the separate and community incomes as completely as they have done in the many cases referred to above, this continual process of commingling, of itself, raises a just inference that the parties intend to treat their incomes from all sources as community property For our Court, then, to reach such a conclusion is merely to give effect to the intent of the spouses.

What are the alternatives to the Washington rule? There are two presented by Mr. LeSourd. The first is found in *Periera v. Periera*[6] where in a divorce action in 1909, the California Court allowed the husband seven per cent per annum in simple interest on his separate estate, treating the substantial balance of the savings of the spouses as community property

Mr. LeSourd regards the *Periera* case as a step in the right direction, but as still falling short of doing justice to the equitable estate of the spouses. In his view, the nearest approach to an equitable rule is found in the General Counsel's Memorandum 9825, C. B. X-2, p. 146 (herein referred to as "GCM 9825"), used in the case of *Todd v. Com'r*[7]

If, out of solicitude for the increase of the separate estate of the spouse and in repudiation of the favor our Court has shown to the matrimonial relation, we conclude to depart from the Washington rule, this California rule, made concrete in the *Periera* case[8], has something to commend it; for, in a minority of cases, it might work out by coincidence a fairly equitable result.

But an analysis of the GCM 9825 method discloses that it is simply a slick formula, designed for the Commissioner of Internal Revenue, to create the maximum dislocation of income, that is, to throw prac-

[6] 156 Cal. 1, 103, Pac. 488 (1909).
[7] 153 F.(2d) 553 (C. C. A. 9, 1945).
[8] 156 Cal. 1, 103 Pac. 488 (1909).

tically all earnings during the life of the marital community into the separate estate of one spouse, thus creating the maximum of revenue for the government, and the minimum of estate for the other spouse. This formula reflects the well-known aversion of the Commissioner to the rules of community property

How well the application of the GCM 9825 formula succeeds in producing wholly lopsided results is well-illustrated by the Todd case, *supra*[9] Here, the separate estates of two brothers, invested in a lumber business, under the magic of this formula, increases in only six years from $144,000 to $292,000—more than doubled—while a net community estate for both brothers emerges of only $28,000.

On the face of it, one might suppose that the Commissioner was bighearted in letting so much as $14,000 apiece lodge in the two community estates. But a glimpse at the results for the third of these six years shows that the Commissioner knows what he is doing. In 1938, the business earned nearly $40,000, and each brother withdrew $10,400, surely not an extravagant allowance for annual living expenses in view of their earnings. But by the Bureau's formula, it resulted in the two community estates incurring a loss to their separate estates of $3,600, almost wiping out the small community estates of just under $6,000 earned in the two preceding years.

So it is clear that it took the bonanza years in the lumber business of 1940-41 to create even these small community estates of $14,000 apiece. A couple of bad years, and the inexorable eight per cent, compounded annually on the separate estates, will wipe out this $28,000 temporarily allowed to lodge in the two community estates.

It is plain then that the apportionment under GCM 9825 is a mere formula, and nothing more. It it no yardstick that measures the relative contributions of management and of capital earnings, save by its own artificial *ipse dixit*. In the *Todd* case, the earnings of the Todds' lumber business might be due overwhelmingly to the energy, thrift, and business wisdom of the Todds, or almost wholly to the general prosperity of the lumber business. The formula makes no inquiry It has no means of measuring these intangibles. It is as arbitrary as the Procrustean bed.

Furthermore, even as an arbitrary rule it has grave weaknesses. A managing spouse may fix a small salary for himself, merely because the business is undercapitalized and he is anxious to get ahead, yet

[9] 153 F.(2d) 553 (C. C. A. 9, 1945).

without any intent to increase his separate estate at the expense of the community estate. His spouse may loyally acquiesce in the penny-pinching this imposes on both. Nevertheless, under the GCM 9825 formula, the scale is unintentionally weighed heavily in favor of the separate estate.

Or, on the other hand, the spouses may prefer to treat themselves to a generous salary from the business so that they may live well or make other investments, again without reflecting on the consequences. This course, in its turn, tips the percentage of any overage of income in favor of their community estate. No one can say that such salary allocations work out equitable results in determining the proportions of community and separate earnings. But the GCM 9825 formula gives free play to such accidental determinations.

It should be remembered that the GCM 9825 formula has three prongs to its spear by which it draws away the lifeblood of all community labors and income: first is this seven or eight per cent interest compounded annually on the separate estate; second, if the profits in any given year exceed this high rate of interest, then the surplus is divided in the proportion that the amount of the interest on the separate estate bears to the salary of the managing spouse; third, the separate estate remains unimpaired by withdrawals of the spouses, since withdrawals in every case are presumed to be for community purposes, even though it results in running the community estate into debt to the separate estate.

This inevitably means that if one of the spouses is given a head start by a separate estate of $25,000 to $50,000, in a long life, with the usual ups and downs of earnings, the finish will see the separate estate absorb all of the lifetime earnings of the managing spouse, with no community estate whatever.

About the time this state entered the Union a young business man started in business at the time of his marriage with a capital of not more than $10,000. He died fifty-eight years later, leaving surviving him his wife and an estate of $750,000, all earned in his original business. Shortly before his death he drew his will in which he recited the growth of this fortune, and concluded that all of it was community property, and that the small nest egg with which the business had been started had little to do with the amassing of what seemed to him a large fortune.

Yet if we were to apply the three-pronged rule of GCM 9825, every dollar of that fortune would have been separate estate. Thus the surviving wife would have had nothing for her fifty-eight years of frugal living, save only what her deceased spouse might have seen fit to leave her by will, much diminished by the excessive inheritance taxes levied on this separate estate.

Such a rigorous rule as this works out results against the wife, when it is the husband who had a separate estate at marriage, which are much harsher than the common law It is little comfort to such a wife to be told that, if she had had the separate estate instead of her husband, she would have absorbed all the life's savings of the community, and her husband would have been left subject to her bounty

It is this test of many years' operation that discloses to the full the inequity and the fallacy of the GCM 9825 formula. It was born, not of any desire to work out equitable results, but only to create maximum returns in taxes, and to destroy as far as possible the community property rules that seek primarily the welfare of the community, not the enhancement of the estate of either spouse at the expense of the other.

From the Commissioner's standpoint, however, GCM 9825 has an Achilles' heel. In the *Todd* case counsel for petitioners apparently introduced no evidence as to the actual value of the services of the two partners, relying on the presumptions established by the Supreme Court of California in the *Pereira* case[10] and later cases. This they would seem to have been justified in doing in view of these California decisions, until the Ninth Circuit Court of Appeals said they were not so justified. Accordingly, two recent decisions of the Tax Court well illustrate the outflanking movement of counsel for petitioners by which the Commissioner of Internal Revenue has been restricted to the interest earned by invested separate capital, the whole of the balance of the earnings being treated as due to the energy and ability of the taxpayer, and therefore belonging to the community

In these cases the Tax Court has refused to permit the Commissioner to restrict the community's share in the earnings of the business to a meager salary The Tax Court has recognized the fact that, in many cases, the initiative and burden-bearing of a proprietor cannot be measured in terms of salary, but only in terms of the ups and downs of business profit.

[10] 156 Cal. 1, 103 Pac. 488 (1909).

Thus in *Lawrence Oliver v. Com'r*[11] counsel for petitioner introduced evidence showing that the taxpayer displayed great skill and energy in the upbuilding of his business, and that the profits therefrom were mainly attributable to the exercise of his personal qualities. Accordingly, the Tax Court apportioned seven per cent interest to the invested separate capital as its share of the annual net income of the business, and allocated all greater earnings—and these were quite considerable—to the community A similar result was reached in *Manning v. Com'r*[12] (March 12, 1947), although the taxpayer there conceded a rate of eight instead of seven per cent on his separate capital. Here the Tax Court showed its awareness of the inequitable results that may follow upon a general application of the rule of the *Todd* case.[13] The Tax Court pointed out that no evidence had been introduced by petitioners in that case to indicate that the allocations made by the Commissioner were unreasonable, and it further emphasized the fact that in the *Todd* case

> the partnership had a large capital investment in inventory because it was thought to be a good investment in view of ascending prices and the Commissioner and the Tax Court were warranted in inferring that there was a substantial gain in the capital value of the inventory as distinguished from earnings from new business obtained.

It is interesting to observe that the Tax Court itself has later found it necessary to supply a new and sounder ground for the decision of the *Todd* case. If the *Todd* case continues to be thus restricted to its specific facts, it may become merely a side track, not a main line case.

But there is one other aspect of the *Todd* case[14] that invites examination. In that case the Tax Court,[15] confronted with the California rule, first applied in its present form in the *Pereira* case[16] and later developed in the leading cases of *Estate of Gold*[17] and in the case of *In re McCarthy's Estate*,[18] declared that the determination of the Commissioner of Internal Revenue that the GCM formula 9825 is applicable, "effectually overcomes the ordinary presumptions of law,"

[11] 4 Tax Ct. 684 (1945).
[12] 8 Tax Ct. 440 (1947).
[13] 153 F.(2d) 553 (C. C. A. 9, 1945).
[14] *Id.*
[15] 3 Tax Ct. 643 (1944).
[16] 156 Cal. 1, 103 Pac. 488 (1909).
[17] 170 Cal. 621, 151 Pac. 12 (1915).
[18] 127 Cal. App. 80, 15 P.(2d) 223 (1932).

and thereupon departed from the California rule of ascertaining the fruits of commingled earnings and separate property income.

It is not questioned that the Commissioner's conclusions on issues of fact should have the weight given them by law But the substantive rules of law, established by the state courts in determining what is separate and what is community income, whether these rules grow out of presumptions or not, are necessarily as binding on the Commissioner of Internal Revenue as they are on the federal courts, if appropriate effect is to be given to the decision of the Supreme Court of the United States in the case of *Erie Railroad Co. v. Tompkins*.[19] In the late case of *Guaranty Trust Co. v. York*,[20] that Court has sardonically commented on the pain it gives federal judicial tribunals to follow the decisions of the state courts. Speaking for the Court, Mr. Justice Frankfurter there said:

> In overruling *Swift v. Tyson*, 16 Pet. 1, *Erie R. Co. v. Tompkins* did not merely overrule a venerable case. It overruled a particular way of looking at law which dominated the judicial process long after its inadequacies had been laid bare. Law was conceived as a "brooding omnipresence" of Reason, of which decisions were merely evidence and not themselves the controlling formulations. Accordingly, federal courts deemed themselves free to ascertain what Reason, and therefore Law, required wholly independent of authoritatively declared State law

In thus disregarding the California decisions on this point, it is obvious that the Commissioner of Internal Revenue has unregenerately given way to this same impulse to declare that "Reason and therefore Law" require him to reach decisions wholly different from the rules of law enunciated by the California Courts.

Nevertheless, on appeal of the *Todd* case to the U S. Circuit Court of Appeals for the Ninth Circuit,[21] the Tax Court's decision was affirmed in a two to one decision, Judge Stephens dissenting. The majority were careful not to repeat the statement of the Tax Court that the Commissioner was authorized to override the legal presumptions established by the California decisions, although the effect of its decision is to do just that.

However, the U S. Circuit Court of Appeals for the Fifth Circuit has several times given careful consideration to the weight to be given to such presumptions, and has reached a different conclusion. In its

[19] 304 U. S. 64 (1938).
[20] 326 U. S. 99, 101 (1945).
[21] 153 F.(2d) 553 (C. C. A. 9, 1945).

latest case, *McFaddin v. C.I.R.*,[22] after reviewing its earlier decisions on this point, it approvingly quotes from one of them, as follows:

> since the ultimate tax question here depends upon the ownership of funds on deposit, and since the law of Louisiana is controlling, the disputable presumptions above mentioned are so bound together with local property rights that the failure to apply them would result in serious interference with the local substantive law

True, the "disputable presumptions" there given effect arose out of statutes enacted by Louisiana and Texas. But such statutes declaring presumptions are no more weighty than a long line of judicial decisions, such as those of our Court that stem from *Yesler v. Hochstettler*[23] in the beginning years of our state court's existence, and given effect ever since.

It is to be hoped that when this matter is fully presented to the U S. Circuit Court of Appeals for the Ninth Circuit, as it manifestly was not presented in the *Todd case*,[24] it will be incumbent on that tribunal to give effect to this presumption of the Supreme Court of Washington, as a principle of local, substantive law If it should fail to do so, it is to be expected that certiorari will issue from the Supreme Court of the United States to determine the conflict between the two circuits.

I regret to have to differ from Mr. LeSourd in this one particular, for his article, taken as a whole, is most admirable. It deserves high praise for its thorough research and its analysis of the authorities. It is therefore a pleasure to agree heartily with his final paragraph, in which he states with persuasive logic that there is no warrant for the federal courts and the Bureau of Internal Revenue to disregard the state law on this subject. His closing paragraph would be more convincing, however, if he had stated the sound reasoning that supports the rule of our Supreme Court and the essential inequities of the formula, so ingeniously evolved by the Bureau of Internal Revenue in overcoming the effect of community property rules.

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22 148 F (2d) 570, 573 (C. C. A. 5, 1945).
23 4 Wash. 349, 30 Pac. 378 (1892).
24 153 F.(2d) 553 (C. C. A. 9, 1945).