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The Challenge of Apportionment

Donald B. King

THE CHALLENGE OF APPORTIONMENT

DONALD B. KING*

During the past half century, one of the most significant problems in the area of community property has been the apportionment of income or of an increase in value in situations involving the expenditure of community labor on separate property. Arising out of a conflict between fundamental community property concepts, this problem has served to perplex lawyers and judges alike. Confronted with the problem, courts have designed a number of systems of apportionment with wide-ranging consequences. Some of these systems, however, are inequitable, others are inflexible, and still others lack any definite criteria. Despite the efforts devoted toward solving this problem, it still remains surrounded by the ominous clouds of inequity and uncertainty.

In light of the diverse systems of apportionment and their varying results, a knowledge of the law in this area is of particular importance to the lawyer and his client. Likewise, the judge, in reaching a sound result, must have a thorough knowledge of the various facets of the problem and the various solutions which have been developed. In considering the challenges presented in this area, it is advisable to consider the underlying reasons for the basic problem, the various attempts of the courts to solve the problem, and the application of these systems. It is then possible to consider the various techniques for avoiding the problem and the development of a more equitable and satisfactory method of apportionment.

THE BASIC PROBLEM

The legal problem of apportionment is caused by the conflict between very fundamental concepts. One concept is embodied in the long established community property principle that the labor and skills of either spouse belong to the community.[1] The other concept is found

* Associate Professor of Law, Wayne State University; member of the Washington State Bar.

[1] This principle has long been a part of Spanish law and has remained in the community property systems in the United States. Since it is a well established principle only the primary sources and some of the more important authorities and cases are cited. Book 10, Title 4, Novisima Recopilacion. For commentaries on this law, see Matienzo, Gloss I, No. 6, Law 1; Llamas y Molina No. 3, Law 6 (Includes a statement by Palacios Rivios to this effect, and citations from Avendano and Azevedo). See also I DE FUNIAK, COMMUNITY PROPERTY, 66 (1943); MCKAY, COMMUNITY PROPERTY, 488 (1909); Rundle v. Winters, 38 Ariz. 239, 298 Pac. 929 (1931); Bayless v. Reed, 47 Cal. App. 139, 190 Pac. 211 (1920); *In re* Hebert's Estate, 169 Wash. 402,

in a principle which, although part of the law in the community property states of Arizona, California, Nevada, New Mexico and Washington, is a common law modification of an original Spanish principle. Under this principle the rents, issues and profits of separate property, as well as the increasing value, are separate.[2] These two principles are brought into play when community labor[3] and separate property are used together. The resulting income[4] is almost always due to both factors and a problem arises as to what part of the income is to be considered as separate property and what part as community property. This question is extremely difficult because it is impossible to determine precisely the contribution to income which each factor has made.

Wherever a division or distinction between community and separate property is necessary, the perplexing problem of apportionment arises. Thus it may arise in divorce,[5] estate,[6] tax,[7] creditor,[8] accounting,[9]

14 P.2d 6 (1932); Jacobs v. Hoitt, 119 Wash. 283, 205 Pac. 414 (1922). Translations of certain of the Spanish Laws and commentators may be found in II DEFUNIAK, COMMUNITY PROPERTY (1942); the Spanish Laws and commentators used here are from the translations in DEFUNIAK.

[2] While under the Spanish law the increase in value of separate property belonged to the separate property, the rents, issues, and profits belonged to the community. However, California, Arizona, Nevada, New Mexico, and Washington departed from the Spanish law and enacted statutes setting forth the principle that the rents, issues, and profits of separate property belong to the separate property owner. ARIZ. CODE ANN. §§ 25-213 (1959); CAL. CIV. CODE §§ 162, 163 (1954); NEV. COMP. LAWS § 123, 130 (1957); N.M. STAT. ANN. §§ 57-3-4 (1953); RCW 26.16.010, 26.16.020 (1951). These statutes, it appears, are a result of a misunderstanding of the community property system by men trained in the common law. In 1850, the California legislature followed the Spanish law and provided that the rents and profits of separate property belonged to the community (Cal. Act. of April, 1850, sec. 9). In 1860, this part of the statute was held unconstitutional when applied to the wife's separate property. George v. Ranson, 15 Cal. 322, 76 Am. Dec. 490 (1860). The court felt that the framers of the constitution were more familiar with the common law and that the profits of the wife's separate property should belong to her. They also thought that the community property system was adopted to protect the wife and their decision did not apply to the profits of the husband's separate property. The California legislature, wishing to put the husband and wife on an equal basis in this respect, enacted a statute providing that the rents and profits of all separate property are separate. The other states mentioned based their statutes concerning this subject on California's statute. See I DEFUNIAK, COMMUNITY PROPERTY, §§ 48, 50, 51, 52, 53 and 71 (1943).

[3] For easier reading in this article the term "labor" will include skill, judgment, talent, personality, and other such personal attributes.

[4] In this article the term "income" alone is used in situations which apply both to income and the increase in value of the separate property. The courts generally treat them as the same in dealing with this problem, and any distinction will be expressly indicated.

[5] Porter v. Porter, 67 Ariz. 273, 195 P.2d 132 (1948); Cone v. Cone, 131 Cal. App. 2d 424, 280 P.2d 871 (1955); Harrold v. Harrold, 43 Cal. 2d 77, 271 P.2d 489 (1954); Kenney v. Kenney, 128 Cal. App. 2d 128, 274 P.2d 951 (1954); Berry v. Berry, 117 Cal. App. 2d 624, 256 P.2d 646 (1953); Gudelj v. Gudelj, 41 Cal. 2d 202, 259 P.2d 656 (1953); Randolph v. Randolph, 118 Cal. App. 2d 584, 258 P.2d 547 (1953); Cozzi v. Cozzi, 81 Cal. App. 2d 229, 183 P.2d 739 (1947); Stice v. Stice, 81 Cal. App. 2d 792, 185 P.2d 402 (1947); Huber v. Huber, 27 Cal. 2d 784, 167 P.2d 708 (1946); Witaschek v. Witaschek, 56 Cal. App. 2d 277, 132 P.2d 600 (1942); Van Camp v.

recovery of gifts,[10] and quiet title[11] cases. A review of the cases, however, does not indicate that any different approach is applied by the courts because of the type of action in which the problem arises. Although it should be noted that any kind of property may be involved, the courts have sometimes based their systems of apportionment on the nature of the property involved and at other times they have applied different systems of apportionment to property of the same kind.[12] From a logical viewpoint, however, the type of property should not be controlling since the fundamental issue in each case is the same.

SYSTEMS OF APPORTIONMENT

In view of the cases dealing with apportionment, it can readily be seen that the courts have used a variety of systems. Courts of one state often refer to, and adopt, methods from other states. Furthermore, courts within a single state may utilize different formulae, and some courts have stated that they may utilize any system whatever. An analysis of the cases indicates the existence of the following described systems of apportionment:

Separate Property Gains System[13]—In some cases, all of the income has been considered as separate property. One of the reasons given for

Van Camp, 53 Cal. App. 17, 199 Pac. 885 (1921); Pereira v. Pereira, 156 Cal. 1, 103 Pac. 488 (1909); Campbell v. Campbell, 62 N.M. 330, 310 P.2d 266 (1957); Katson v. Katson, 43 N.M. 214, 89 P.2d 524 (1939).

[6] Lawson v. Ridgeway, 72 Ariz. 253, 233 P.2d 459 (1951); *In re* Torrey's Estate, 54 Ariz. 369, 95 P.2d 990 (1939); Logan v. Forster, 114 Cal. App. 2d 587, 250 P.2d 730 (1952); *In re* McCarthy's Estate, 127 Cal. App. 80, 15 P.2d 223 (1932); *In re* Gold's Estate, 170 Cal. 621, 151 Pac. 12 (1915); *In re* Pepper's Estate, 158 Cal. 619, 112 Pac. 62 (1910); *In re* Hebert's Estate, 169 Wash. 402, 14 P.2d 6 (1932); *In re* Buchanan's Estate, 89 Wash. 172, 154 Pac. 129 (1916).

[7] Todd v. McColgan, 89 Cal. App. 2d 509, 201 P.2d 414 (1949); Shea v. Comm'r, 81 F.2d 937 (9th Cir. 1936); J. Z. Todd v. Comm'r 3 T.C. 643 (1944), *remanded* 153 F.2d 553 (9th Cir. 1945). Although the distinction is not as important for federal tax purposes as it was before the joint return provision was enacted in 1948, it may still be important where certain state taxes are involved. See Todd v. McColgan, *supra.*

[8] Salisbury v. Meeker, 152 Wash. 146, 277 Pac. 376 (1929).

[9] Brown v. Harper, 116 Cal. App. 2d 48, 253 P.2d 95 (1953).

[10] Tassi v. Tassi, 160 Cal. App. 2d 680, 325 P.2d 872 (1958).

[11] Rundle v. Winters, 38 Ariz. 239, 298 Pac. 929 (1931); Dvorsky v. Balkum, 118 Cal. App. 364, 5 P.2d 19 (1931); Seligman v. Seligman, 85 Cal. App. 683, 259 Pac. 984 (1927).

[12] If the separate property is an incorporated business the courts are more inclined to give a salary to the community and the rest of the income to the separate property owner. See note 36 *infra.* If an "improvement" is made on separate property the courts may apply special rules. As is mentioned later, both of these distinctions are highly questionable from substantive, logical and policy viewpoints.

[13] *In re* Barnes Estate, 128 Cal. App. 489, 17 P.2d 1046 (1932); *In re* Pepper's Estate, 158 Cal. 619, 112 Pac. 62 (1910), recently overruled in California by *In re* Neilson's Estate, 371 P.2d 745, 749 (Cal. 1962); Diefendorff v. Hopkins, 95 Cal. 343, 28 Pac. 265 (1891); Lewis v. Johns, 24 Cal. 98, 85 Am. Dec. 49 (1864); Merrick v. Appenzeller, 115 Wash. 181, 196 Pac. 629 (1921); Hester v. Stine, 46 Wash. 469, 90 Pac. 594 (1907).

this result is that the principle of separate property would otherwise be completely undermined since some personal labor is involved in all rents, profits, and issues.[14] However, this assumption is not correct, as there is some income from separate property that may not require any labor on the part of either of the spouses. It has also been said that the legislature did not intend that a manager be hired for all of the separate property in order to keep the income from the community, when it enacted the statute that the income of separate property would itself be separate property.[15] However, the evidence indicates that the statutes were passed by men with common law backgrounds who apparently did not know that an alteration of the Spanish law would cause such difficulties.[16] Still another part of the argument for making the income separate is that it is impossible to determine what part comes from community labor and what part from the separate property, making it impossible, in turn, to apportion the profits.[17] Nevertheless, it has been amply shown that some reasonable apportionment, even if it is not precisely determined, is possible.

While this approach relieves the court of the difficult fact-finding task of determining the contribution of the community labor and of the separate property, it is undesirable because of its inequitable results. It gives to the separate property a gain which is earned in part by the community. If the husband is allowed to spend all his time working on his separate property, the community might never accumulate any community assets. The only satisfactory use of this system is in cases where the labor expended is so minute that the court should not consider it.[18] Just how minute the community labor must be in order for the court to disregard it and hold that all of the income is separate property is the catch in the proposition.

Community Gains System—The system of giving all of the income to the community has been used both where the separate property's contribution was very small in comparison with the community's contribution[19] and where the court felt that the separate business did not

[14] Diefendorff v. Hopkins, *supra* note 13.
[15] Katson v. Katson, 43 N.M. 214, 89 P.2d 524 (1939) (dictum).
[16] See note 2 *supra*.
[17] See *In re* Pepper's Estate, 158 Cal. 619, 112 Pac. 62 (1910), recently overruled in California by *In re* Neilson's Estate, 371 P.2d 745, 749 (Cal. 1962).
[18] In the case of *In re* Barne's Estate, 128 Cal. App. 489, 17 P.2d 1046 (1932), most of the income was due to the leasing of separate property and collecting of rents, and was held separate property. A small amount of farm labor, however, was also performed.
[19] *In re* Buchanan's Estate, 89 Wash. 172, 154 Pac. 129 (1916).

have within itself the potential power to produce income.[20] Also, it should be noted that the income will be presumed to be community property where the income is so confused and so commingled that it is impossible to separate it from other community assets and funds.[21] This, however, is a separate problem and where there is commingling the court need not concern itself with the problem of apportionment.[22] Other than in situations where the separate property's contribution is extremely minute, the system under consideration is not a satisfactory one since it would arbitrarily deprive the separate property of part of its contribution.

Principal Contributing Factor System[23]—Some courts have held that all of the income is either separate or community depending upon the principal contributing factor. The reason given by the courts for adopting this solution is that it is impossible to allocate or segregate the community labor element from the separate property element. One drawback is that it is often difficult to determine which factor contributes the most.[24] Frequently they are nearly equal and an exacting determination of fact is necessary. Obviously a slight percentage of of error will be of much greater consequence under this system than under any other.

The Salary System—The court may decide to allocate a salary to the community for its labor and give the balance to the separate property owner.[25] In cases where the spouse is receiving an agreed-upon salary

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[20] Salisbury v. Meeker, 152 Wash. 146, 277 Pac. 376 (1929).

[21] I DEFUNIAK, COMMUNITY PROPERTY, § 60, at 140-41 (1943).

[22] The court should utilize the theory of commingling where the income is mixed with the community funds and is not traceable, or where the facts are not clear as to the amount of separate property used for producing income. However, if these facts are clear and the income may be traced, the principle of commingling should not be applied. A contemporaneous segregation of the income itself should not be required in order to avoid the application of this principle, although the Washington Supreme Court has indicated that such a segregation may be necessary. See dictum in Hamlin v. Merlino, 44 Wn.2d 851, 272 P.2d 125 (1954).

[23] Lawson v. Ridgeway, 72 Ariz. 253, 233 P.2d 459 (1951); *In re* Torrey's Estate, 54 Ariz. 369, 95 P.2d 990 (1939); Rundle v. Winters, 38 Ariz. 239, 298 Pac. 929 (1931); Lake v. Bender, 18 Nev. 361, 7 Pac. 74 (1885). The *Lake* case is considerably weakened as a precedent since the court used this test as only one of several grounds on which to base its decision. Many courts have nevertheless cited it as a precedent.

[24] This is illustrated by the disagreement of the court in the *Lake* case, *supra*, note 23. If doubts exist, they are resolved in favor of the community. Barr v. Petzhold, 77 Ariz. 399, 273 P.2d 161 (1954).

[25] Shea v. Comm'r, 81 F.2d 937 (9th Cir. 1936); Lincoln Fire Ins. Co. v. Barnes, 53 Ariz. 264, 88 P.2d 533 (1939); Tassi v. Tassi, 160 Cal. App. 2d 680, 325 P.2d 872 (1958); Harrold v. Harrold, 43 Cal. 2d 77, 271 P.2d 489 (1954); Kenney v. Kenney, 128 Cal. App. 2d 128, 274 P.2d 951 (1954); Brown v. Harper, 116 Cal. App. 2d 48, 253 P.2d 95 (1953); Logan v. Forster, 114 Cal. App. 2d 587, 250 P.2d 730 (1952); Cozzi v. Cozzi, 81 Cal. App. 2d 229, 183 P.2d 739 (1947); Van Camp v. Van Camp,

from a business, the adoption of this view by the court may depend upon the amount of salary paid in comparison with the services rendered. This approach is often adopted where the salary has been a reasonable and adequate one. It should be pointed out, however, that the payment of a salary is not a necessary prerequisite for the application of this approach, and if the spouse is not receiving an agreed-upon salary the courts may set what they consider to be a fair equivalent,[26] or consider previous withdrawals as serving that purpose.[27] In some of the cases where the courts have used this approach, the income was largely due to factors other than the spouse's labor, such as an exclusive franchise,[28] population growth, or rising living standards.[29]

If the business is incorporated, there is a greater likelihood that the courts will use the salary approach.[30] A corporation may be viewed by the court as a separate entity whose "corporate veil" will not be pierced for the purposes of determining what part of the increased stock value or the dividends paid are due to the community's labor. In the leading case of *Van Camp v. Van Camp*,[31] the court said that it was impossible to determine what part of the income should be attributed to skill and and management and what part should be considered due to the investment of capital. It was felt that the corporate form of doing business lent itself to easy separability and permitted avoidance of the "impossible" apportionment problem.[32]

It has been argued in support of the salary system that the spouse owning the separate property could have hired another person to run the business.[33] In such a situation he would be entitled to all of the income. However, there is no more reason for indulging in this assump-

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53 Cal. App. 17, 199 Pac. 885 (1921); Katson v. Katson, 43 N.M. 214, 89 P.2d 524 (1939); Hamlin v. Merlino, 44 Wn.2d 851, 272 P.2d 125 (1954); *In re* Hebert's Estate, 169 Wash. 402, 14 P.2d 6 (1932).

[26] Kenney v. Kenney, *supra* note 25.

[27] Logan v. Forster, 114 Cal. App. 2d 587, 250 P.2d 730 (1952); Huber v. Huber, 27 Cal. 2d 784, 167 P.2d 708 (1946).

[28] Harrold v. Harrold, 43 Cal. App. 2d 77, 271 P.2d 489 (1954).

[29] Logan v. Forster, 114 Cal. App. 2d 587, 250 P.2d 730 (1952).

[30] Hamlin v. Merlino, 44 Wn.2d 851, 272 P.2d 125 (1954). An over-all study of the cases indicates this fact. See Harrold v. Harrold, 43 Cal. 2d 77, 271 P.2d 489 (1954); Kenney v. Kenney, 128 Cal. App. 2d 128, 274 P.2d 951 (1954); Logan v. Forster, 114 Cal. App. 2d 587, 250 P.2d 730 (1952); Van Camp v. Van Camp, 53 Cal. App. 17, 199 Pac. 885 (1921); Katson v. Katson, 43 N.M. 214, 89 P.2d 524 (1939); *In re* Hebert's Estate, 169 Wash. 402, 14 P.2d 6 (1932). But see *In re* Buchanan's Estate, 89 Wash. 172, 154 Pac. 129 (1916).

[31] 53 Cal. App. 17, 19 Pac. 885 (1921).

[32] Although the economic factors involved make the problem a difficult one, an apportionment more consistent with the contribution of each factor can be made. The courts often consider cases involving complex economic problems.

[33] Van Camp v. Van Camp, 53 Cal. App. 17, 199 Pac. 885 (1921).

tion than there is for speculating that the community, with its skill and labor, could have borrowed capital and merely have paid the interest. Indeed, in light of other areas of the law and public policy, it would seem that the community should be favored in the making of any hypothetical assumptions. Moreover, the spouse's skill and judgment might not be duplicated by an independent manager who might have been hired.

Where apportionment is required, the important determination is the amount the community has contributed in time and talent towards the profits, and such a determination should not be influenced by the legal form of incorporation. The salary system only reimburses the community for its labor and in effect does not allow it to share in the product. Unfortunately, some courts have seized upon this solution because it provides a ready-made method for dividing the income and avoids the difficult task of apportionment which a more equitable solution might entail.

The Interest System—The court may, on the other hand, allocate a reasonable interest payment to the separate property and give the remainder of the income to the community.[34] While a number of questions may arise concerning the interest rate to be used,[35] the courts have generally used seven per cent.[36] Other questions may arise as to when the interest should begin to accrue.[37] Further, it seems that the community should be permitted to show that the separate property earned less than the commercial or legal intrest which would normally be accorded to it.[38] The burden of showing this would fall upon the

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[34] Randolph v. Randolph, 118 Cal. App. 2d 584, 258 P.2d 547 (1953); *In re* McCarthy's Estate, 127 Cal. App. 80, 15 P.2d 223 (1932); McDuff v. McDuff, 48 Cal. App. 175, 191 Pac. 957 (1920); Pereira v. Pereira, 156 Cal. 1, 103 Pac. 488 (1909).

[35] A number of questions may be raised concerning the interest rate under this system. For example: should it be the legal rate or some commercial rate? If the venture is a very risky one, should the interest rate be higher? Does this mean that a commercial or an economic study must be made?

[36] Pereira v. Pereira, 156 Cal. 1, 103 Pac. 488 (1909). It is interesting to note that in Jones v. Jones 67 N.M. 414, 356 P.2d 231, 235 (1960), the appellate court rejected a division which gave the separate property owner approximately a 10 per cent rate on the grounds that there was no evidence to support it as "usual interest on an investment well secured."

[37] The court in *Pereira, supra* note 36, said that the interest should be figured from the date of marriage. Although this would be satisfactory in many cases, might it not be better if the interest were computed only during those years in which the property was productive? Otherwise, the interest might take a lion's share of the present income in situations where the separate property had been left idle over a long period of time and had only recently become productive because of the efforts of the community. Should interest be given for previous years during which the business lost money, and should it be cumulative? The courts have not yet faced these questions.

[38] Pereira v. Pereira, 156 Cal. 1, 103 Pac. 488 (1909).

spouse or community attempting to obtain the lower rate.[39] On the other hand, the separate property owner ought to be permitted to show that other factors should make the return to the separate property more than interest alone.[40] This solution, however, is just as defective as the salary system because the actual contribution of each factor is not considered.

Reasonable Rental System—The separate property owner may be given a reasonable rental, and the community may receive the rest of the income.[41] What is a reasonable rental can generally be determined by the rental value of similar property in the area.[42] Unfortunately, however, the rental may consume most of the income when profits are small and the community may not receive its fair share. Like the salary and interest systems, this one does not consider the actual contributions which the community labor and the separate property have made to the total product.

Reimbursement System—When the community has contributed to an improvement on the separate property it may be given a right to be reimbursed for its labor.[43] This system is inequitable because the community does not share in either the increased value or the income. It is interesting to note that the courts have not definitely stated the basis for valuing the community's labor.[44]

Mathematical Formulae System—It is also possible to use a mathematical formula for apportionment.[45] In *Todd v. Commissioner,* profits were allocated between the separate property and community labor in the ratio that an eight per cent return on the capital bears to the assumed reasonable salary.[46] If no apportionment has taken place for

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[39] *Ibid.*

[40] See *e.g.,* Logan v. Forster, 114 Cal. App. 2d 587, 250 P.2d 730 (1952).

[41] Laughlin v. Laughlin, 49 N.M. 20, 155 P.2d 1010 (1945); McElyea v. McElyea, 49 N.M. 322, 163 P.2d 635 (1945).

[42] Laughlin v. Laughlin, *supra* note 41.

[43] Strand v. Pekola, 18 Wn.2d 164, 138 P.2d 204 (1943); Horton v. Horton, 35 Ariz. 378, 278 Pac. 370 (1929).

[44] It is also interesting to note that where community funds are used for improvements on separate property, the courts may either apply the system under discussion or hold that the community receives the increased value or income. See Provost v. Provost, 102 Cal. App. 775, 283 Pac. 842 (1929); *In re* Carmack's Estate, 133 Wash. 374, 233 Pac. 942 (1925). They may also hold that a gift is being made where the husband improves the wife's separate property. See Dunn v. Mullan, 211 Cal. 583, 296 Pac. 604 (1931); Lombardi v. Lombardi, 44 Nev. 314, 195 Pac. 93 (1921).

[45] Todd v. McColgan, 89 Cal. App. 2d 509, 201 P.2d 414 (1949); J.Z. Todd v. Commissioner, 3 T.C. 643 (1944), *remanded* (statute), 153 F.2d 553 (9th Cir. 1945); Jacobs v. Hoitt, 119 Wash. 283, 205 Pac. 414 (1922).

[46] 153 F.2d 553 (9th Cir. 1945). The circuit court stated the formula as follows: "Eight percent of the average capital balance in each of these years is held the base

several years, the community is given a share in the capital and a share in the amount that it later earns.

If a formula is used there may still be a problem of applying it to the facts. Difficulty sometimes arises in determining the value of its component parts and an error in determining the value of such a part may be magnified by its effect on the result. Since a mathematical formula does not allow for unique factors or circumstances, an inequitable and unsatisfactory apportionment may ensue. Generally, however, a formula such as the one used in the *Todd* case, which takes into account both interest and salary, divides the income more fairly and equitably than the solutions previously considered. Such a mathematical formula may well lend stability and predictability to this uncertain area of the law.

Per Cent System—The court may apportion by estimating the percentage of the result that is due to the factor of labor and the percentage that is due to other, non-personal, factors.[47] An unfavorable feature of this system is that either the separate property owner or the community may be given an extremely low percentage or even none at all. This means that neither can rely upon being compensated for its contribution. Further, an error in per cent would destroy the hope of any anticipated compensation either by the community or by the separate property owner.

Another shortcoming is that these percentages are predicated on factors that cannot accurately be reduced to percentages. The contribution that labor makes, compared with non-personal factors such as location or a franchise, can only be roughly estimated, and the criteria to be used in arriving at such percentages are undefined. Though this system is flexible, the result lacks the desired degree of predictability.

Substantial Justice System—A court may decide to select whatever

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of the capital earnings. Salaries for services are found annually for the base of the community earnings. The two are added together and the percentage each base bares [*sic*] to the total constitute [*sic*] the proportions of the total income attributable to capital and to services." *Id.* at 555.

[47] In Berry v. Berry, 117 Cal. App. 2d 624, 256 Pac. 646 (1953), the court considered the fact that a large percentage of the increased value and profit was due to the increased demand for machine tools and manufacturing facilities following our entry into the war. In Jones v. Jones, 67 N.M. 414, 356 P.2d 231 (1960), the trial court attributed 50 per cent of the gain to the efforts of the separate property owner, 10 per cent to the other spouse's efforts (*i.e.*, 60 per cent to the community), and 40 per cent as gain on the separate property. However, the appellate court reversed this "arbitrary" finding and indicated that an "interest" theory or "some other proper theory" should be used.

system it believes will achieve "substantial justice" between the parties.[48] This technique gives the court sufficient flexibility to reach an equitable result, and affords protection to both the community and the separate property interests. However, there is no way of predicting the result and litigation concerning apportionment might tend to increase. Neither the community nor the separate property owner is assured of receiving any definite amount and the uncertainty created may outweigh the advantages of flexibility.

In view of these systems and their varying consequences, it is interesting to note that the Washington court has utilized several systems of apportionment. It has held, for example, that the separate property owner gets all of the income.[49] These cases are among the earlier ones in this area, and it is very unlikely that the court today would use this system. It has also held that the community receives all of the income on the basis that the separate business did not have within itself the potential power to produce income[50] and that the separate property's contribution was extremely small in comparison with that of the community.[51] In addition, there are holdings that the community is entitled to a reasonable salary or its equivalent and that the rest of the income passes to the separate property owner,[52] that a formula for apportionment is appropriate,[53] and that the community has consumed its share in living expenses resulting in no apportionment of the remaining amount.[54] It must be kept in mind that the income may become commingled with community funds and be considered community property, and that contemporaneous segregation of the income

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[48] In Logan v. Forster, 114 Cal. App. 2d 587, 250 P.2d 730, 738 (1952) and Tassi v. Tassi, 160 Cal. App. 2d 680, 325 P.2d 872, 879 (1958), the right was asserted, but the salary system was used. However, this wording could be used to argue that any system whatever could be invented and used by the courts. In Todd v. McColgan, 89 Cal. App. 2d 509, 201 P.2d 414 (1949) the court did not feel bound by existing systems and chose the mathematical formula system. The New Mexico courts have also indicated that they may use any system of apportionment. In Campbell v. Campbell, 62 N.M. 330, 310 P.2d 266, 286 (1957) the court stated that "[T]he method of division to be used depends upon what is best under all the proof. It is only when the actual value of the owner's efforts cannot be arrived at that resort may be had to more arbitrary proof of value, such as proof of the value of like services by others, prevailing rental values or interest rates upon investments."

[49] Merrick v. Appenzeller, 115 Wash. 181, 196 Pac. 629 (1921); Hester v. Stine, 46 Wash. 469, 90 Pac. 594 (1907).

[50] Salisbury v. Meeker, 152 Wash. 146, 277 Pac. 376 (1929).

[51] *In re* Buchanan's Estate, 89 Wash. 172, 154 Pac. 129 (1916).

[52] Hamlin v. Merlino, 44 Wn.2d 851, 272 P.2d 125 (1954); *In re* Hebert's Estate, 169 Wash. 402, 14 P.2d 6 (1932).

[53] Jacobs v. Hoitt, 119 Wash. 283, 205 Pac. 414 (1922).

[54] Toivonen v. Toivonen, 196 Wash. 636, 84 P.2d 128 (1938); Van Moss v. Sailors, 180 Wash. 269, 39 P.2d 397 (1934).

itself may be necessary to avoid such commingling.[55] Still other rules may apply if an improvement is involved. Further, there is little assurance that a court will use previously-applied systems. Since the basic problem is the same, courts frequently have utilized systems developed by the courts of other states.[56]

APPLICATION OF SYSTEMS

Several facts should be noted concerning the application of the systems of apportionment. The courts generally have not distinguished between apportionment at the end of a long period of time as contrasted with annual apportionment. The majority of cases, such as those concerning divorces or estates, arise out of situations where the income has not been apportioned annually. In such cases either the community or the separate property may already have consumed a portion or all of its share.

In some cases it has been held that the community's share was consumed by withdrawals for living expenses, and the courts have refused to make any apportionment of the amount remaining.[57] In order to hold that the community has consumed its share, however, it should first be ascertained what that share is. It may well be that only a portion of that share has been used,[58] and the community may be deprived of some of the amount to which it is entitled if there is no apportionment.

It might be asserted that the court should use the salary system because it would be equivalent to the consumption by the community for living expenses. While this might be true under some circumstances, there are a number of situations where this would not be so. The court

[55] See dictum in Hamlin v. Merlino, 44 Wn.2d 851, 272 P.2d 125 (1954).

[56] An interesting question arises as to what system a federal court should apply if it is confronted with a case involving the problem of apportionment. It would seem that under both the "substantive law" test and the "identity of result" test, the federal court should be the state system of apportionment. However, most states have more than one type of apportionment system. Which one should the federal court follow; or should a combination of these systems be used? In J. Z. Todd v. Commissioner, 3 T.C. 643 (1944), the federal court used a combination of several systems found in the state of California. Is this a following of the state law? It would seem that a combination of systems produces something novel and does not follow state law. If the state law is so indefinite as to which system should be used, does this lack of any definite state substantive law permit the federal court to use its own system? It is interesting to note that in a later case the theory used by the federal court was applied by the state court in a tax action by the Franchise Tax Commissioner of the State of California against Mr. Todd, *i.e.*, Todd v. McColgan, 89 Cal. App. 2d 509, 201 P.2d 414 (1949).

[57] Toivonen v. Toivonen, 196 Wash. 636, 84 P.2d 128 (1938); Van Moss v. Sailors, 180 Wash. 269, 39 P.2d 397 (1934).

[58] See Huber v. Huber, 27 Cal. 2d 784, 167 P.2d 708 (1946).

should not choose a particular system merely because there has been consumption, since this may be taken into account in connection with any of the systems.[59]

AVOIDING THE PROBLEM

The uncertainty and inequities in this area make it one of particular challenge for the lawyer. Essentially, the lawyer should be prepared to help his client attribute a separate or community character to the income that will withstand the test of litigation.

If the client wishes the income to be separate property, several things may be done. If the client is contemplating marriage and owns a business, it may be advisable to incorporate it prior to the wedding date. As previously mentioned, the courts have generally held that all of the corporate income, after deducting a salary, is separate property. It also would be advantageous to execute an antenuptial agreement concerning the separate property, the future income from it, and the time to be spent in managing it.

If the client is already married, it may still be advantageous for him to incorporate his business. Certain practices should be followed: the business should be carefully preserved as a corporate entity and kept separate from the clients personal affairs;[60] business should be conducted in the name of the corporation at all times and the community's credit should not be used to obtain loans for it; a fair and adequate salary should be paid for all of the services which the client contributes;[61] and the business should be staffed with adequate personnel so that the client may absent himself from it on personal matters.[62] Generally, any practices should be employed that tend to show that the corporation is not a sham, or that it is not set up solely for the purpose of keeping future income as separate property. While the

[59] The court should choose whichever formula it believes to be the most desirable, and then may allow for the consumption factor in reaching the final figures. It could do this by applying the system chosen to a total figure composed of the amount consumed plus the amount remaining to be apportioned. After it is determined what each would have received had there been no consumption, the amount consumed should be subtracted from the share calculated for the consuming element. Thus, where the community has consumed $50,000 in living expenses, and there is $100,000 remaining to be apportioned, the court should apply its apportionment formula to a figure of $150,000. Once the community's share of this figure is ascertained (for example $80,000) the $50,000 consumed by it should be substracted from this share figure ($80,000) and the remainder ($30,000) is the amount which the community should receive.

[60] Van Camp v. Van Camp, 53 Cal. App. 17, 199 Pac. 885 (1921); *In re* Hebert's Estate, 169 Wash. 402, 14 P.2d 6 (1932).

[61] *In re* Hebert's Estate, 169 Wash. 402, 14 P.2d 6 (1932).

[62] See Gilmore v. Gilmore, 45 Cal. 2d 142, 287 P.2d 769 (1955); Harrold v. Harrold, 43 Cal. 2d 77, 271 P.2d 489 (1954); Logan v. Forster, 114 Cal. App. 2d 587, 250 P.2d 730 (1952).

distinction between incorporated and unincorporated businesses is a dubious one from a policy and substantive viewpoint, nevertheless courts have seized upon it as a natural solution since it saves them from the task of apportionment. The lawyer should, however, see that his client takes some of the other precautions mentioned since the courts may someday refuse to recognize this distinction.

It is very important that the client keep a separate bank account for the business.[63] Otherwise some courts will hold that the commingling has made all the funds community property. Furthermore, since the character of the income changes in accordance with the intention of the parties, the client should not do or say anything which indicates an intention to treat the separate property income as community property.[64]

Generally, it is advisable to have a written contract between the husband and the wife setting forth the nature of the business and determining the status of future acquired property. Since this is a major subject in and of itself, this article does not purport to cover it. However, a few general principles may be mentioned. In Spanish law it was possible to make both antenuptial and post-nuptial contracts dealing with future earnings and gains.[65] These contracts are very carefully scrutinized by the courts, and anything which would tend to show duress, undue influence, or unfairness would make the contract unenforceable. This is an area in which a confidential relationship usually exists and steps to insure fairness should be taken. The wife should be adequately informed of the nature and consequences of the contract and it may even be advisable to provide her with her own attorney.[66]

In some circumstances, it may be more desirable for most of the proceeds of community labor on separate property to be community rather than separate property. The most advisable method is for the parties to enter into a written contract agreeing that the income and

[63] See dictum in Hamlin v. Merlino, 44 Wn.2d 851, 272 P.2d 125 (1954).

[64] Lawson v. Ridgeway, 72 Ariz. 253, 233 P.2d 459 (1951); Rundle v. Winters, 38 Ariz. 239, 298 Pac. 929 (1931).

[65] Fuero Juzgo, Book 4, Title 2, Law 17; Las Siete Partidas, Part 4. Title II, Law 24.

[66] See Hamlin v. Merlino, 44 Wn.2d 851, 272 P.2d 125 (1954). It should also be noted that, in some situations, the attorney may feel that the safest and most conservative method for keeping the income as separate property is to advise his client to expend no labor or skill upon the property. Indeed, he may advise his client to hire a manager for the separate property. This will prevent community labor from being expended and the principle that the income of separate property is separate will apply. However, the client may prefer to keep a close watch on his investment and may enjoy managing his own property.

the increase in value of the separate property belong to the community. The present value and nature of the separate property should be clearly defined. The parties also may desire to change the separate property itself into community property. Income from separate property may also become community property if there is commingling or a manifestation of intention to treat the income as property of the community.

Sound advice in this area can be especially valuable to the client in a monetary sense. For purposes of illustration, assume that the client has separate property worth $300,000 on which he expends his labor and skill. Business is extremely good and there is an annual income of $100,000. Under a system where the separate property receives interest, and the balance will pass to the community, the client will receive $21,000 ($300,000 capital x 7 per cent) and the community will receive $79,000. Under a system where the community is given a salary, (assume $10,000), the client will receive $90,000 and the community $10,000. If the income is given to the principal producing element, either the client or the community will receive the entire $100,000. If a formula similar to the one in the *Todd* case is used, the client will receive $70,588.24 and the rest will go to the community.[67] If a percentage system is employed, the amount may vary considerably depending upon the court's interpretation of the facts. If the court uses a criterion of "substantial justice," it would be impossible to predict the result. Irrespective of which system is used, the result will vary considerably, depending upon whether the court takes into account the fact that one element may already have consumed part or all of its share.[68]

SOLVING THE PROBLEM

Judges confronted with the problem of apportionment are challenged to utilize a system consistent with policies of equity and certainty.[69]

[67] Using 8 per cent for the interest part of the formula as in Todd v. McColgan, 89 Cal. App. 2d 509, 201 P.2d 414 (1949).

[68] The lawyer, in his role as a policy maker, may also want to consider the possibility of legislative reform in this area in order to prevent needless future litigation. However, any legislation prescribing a certain system might take away the flexibility which is needed by the courts to reach equitable results. Legislation to eliminate the conflict of basic principles would have to be very carefully drafted. Although the rents and profits of separate property belong to the community in Idaho, Louisiana, and Texas, the increase in value of separate property remains separate property and problems of distinguishing between profits from an increase in value and from ordinary income often arise.

[69] Unfortunately, a study of comparative areas of the law does not aid in the solution of this problem. While general equitable principles of pro-rating can be found, in such cases the courts are not confronted with the difficult factual problems of determining the contribution of each element.

Hence a knowledge of the fundamental issues, the various systems thus far created, and the merits of each system is essential. Not only is the judge faced with the prospect of choosing between existing systems, but in light of the entire history of the problem and the decisions governing it, he may choose to create a new system.

Although it is impossible to propose any system of apportionment which would be perfect, it is the opinion of the writer that a more equitable and satisfactory solution could be developed. It is suggested that the following proposal merits consideration: The community would be given a reasonable salary and the separate property would receive reasonable interest. While neither salary nor interest would represent an exact measure of contribution, each would be subject to practical determination by the court by resort to comparable commercial situations. This method would give adequate protection to both the community and the separate property interests and would give a high degree of predictability as to the amount each would receive. In cases where the facts may show that one or each should receive less than the amounts computed, the returns should be reduced accordingly. Such a reduction, however, would be made only where there was a clear showing that the "labor" or "capital" was considerably below the average of comparable commercial situations in quality or contribution to the income. If, in a rare case, there was an insufficient amount for both the salary and interest, each would be reduced proportionately. For policy purposes, the system might be modified to provide for a minimum salary for the community. If there was a surplus remaining after these amounts had been taken out, it would be divided between the two as the particular facts might dictate, but not according to any fixed ratio or percentage. Thus the court would consider any unique factors, such as extraordinary attributes of the personal labor, or the separate property, or external factors, in dividing the surplus. Likewise, if either the community or separate property has already consumed part or all of its share, this should be taken into account.

The suggested theory, of course, is similar in one aspect to the system which gives to the community a reasonable salary or its equivalent and in another to the formula which gives interest to the separate property. It also is similar to the one used in the *Todd* case, but differs in one very important and essential respect. Under the *Todd* formula, the total amount was apportioned by an inflexible ratio of the community salary to the interest of the separate property. This apportion-

ment is unsatisfactory because it does not take into account the factors which actually contributed to the income.[70]

While the suggested system appears to contain the better aspects of the theories it incorporates, several weaknesses remain. Although the separate property receives interest and the community is given a salary, each may not have actually contributed that much to the earnings. Only if this is very clear can either amount be reduced under the suggested system. Hence the system is ineffective in cutting down debatable contributions. However, this disadvantage is heavily outweighed by the positive qualities of both workability and predictability. Further, while the problem of determining the exact amount to be credited for interest and salary remains, any errors under the suggested system are not so serious as under some other method since both the community and the separate property owner will be guaranteed an approximate amount and will share in the surplus. Although the *Todd* formula tends to give such a result, an error in estimating interest or salary would be magnified since these factors are instrumental in setting the inflexible ratio upon which the surplus would be divided.

Another limitation of the suggested system is that the division of the surplus necessarily depends upon the court's interpretation of the facts. Hence it is impossible to predict precisely the amount that each will receive. Nevertheless, the court has an opportunity to look at the actual contributing factors in dividing the surplus and the disadvantage of absolute certainty is considerably outweighed by the advantage of having some flexibility.

CONCLUSION

The problem of apportionment, resulting from the conflict of basic legal principles and presenting complex factual determinations, is still an unsolved one. Courts have developed a number of diverse systems

[70] While it could be contended that the unique elements are accounted for when the interest and the salary are figured, there are several difficulties with such an argument. A population shift, franchise, location or anything that causes a sudden increased demand may be present. The salary and the interest on the capital are chiefly determined by supply and demand and do not reflect the income due to these unique factors. It might be said that the interest and salary in the formula used in Todd v. McColgan, 89 Cal. App. 2d 509, 201 P.2d 414 (1949), could be predetermined, so that the ratio gives the desired amounts of surplus to the community and separate property, in accordance with the contribution of labor, capital, and other elements. But to do this would be to decide first the percentage of the total which each of these should have and then make a formula to fit it that would give such a result. If this is done, the per cent system of apportionment alone could be utilized. Moreover, the very function of a formula is to determine the amount to be apportioned. This purpose cannot be fulfilled if the surplus amounts due each factor are computed first.

of apportionment with varying consequences. As a result, considerable inequity and uncertainty exist. Nevertheless, the lawyer may meet this challenge by advising his client to take certain precautions in order to avoid the problem. On the other hand, if a dispute has already arisen, the lawyer may best serve his client by having a thorough understanding of the problem and of the numerous systems which have been utilized by the courts. The courts can meet the challenge by continuing their long search for more equitable and satisfactory solutions.