By Richard B. Malamud

Separate Property Reimbursement of Joint Income Taxes

Couples must select the appropriate allocation formula

The process of characterizing a couple's property as separate or community property[1] inevitably leads to issues of reimbursement. One scenario seems to receive less scrutiny than others: Is the community entitled to reimbursement if community property has been used to pay the income tax liability on the income of one spouse's separate property?

As an example, A and B are married and have community income from salary[2] and separate income from dividends paid on stock that A inherited.[3] If the entire income tax liability is paid with community property funds, is A required to reimburse the community for the portion of the joint income tax obligation that resulted from the inclusion of the separate property dividend on the joint income tax return?

Richard B. Malamud is a professor in the department of accounting and law at California State University Dominguez Hills.

The answer to these questions is yes.[4] Common law and the California Family Code require a spouse to reimburse the community where the community has paid the income tax on a spouse's separate income—subject to the applicable statute of limitations. Spouses need to choose among a variety of methods that may be used to allocate the joint tax liability between the community and separate income.

The ability of the community to seek reimbursement for payments to a spouse's separate property does not depend on whether community funds are used to improve separate property or to pay expenses related to separate property. When a spouse uses community property to improve separate property, reimbursement is required[5] in order to prevent unjust enrichment[6] and to avoid constructive fraud.[7] The same rational applies if the community funds are used to pay a spouse's separate expenses[8] such as separate property taxes and assessments.[9]

Reimbursement is required for both improvements and expenses because if it were not, community funds could be consumed in conserving or improving one spouse's separate property, leaving the community—and, thus, the other spouse—with no assets.[10] Paying separate expenses with community funds is simply another form of commingling community and separate property, a situation that must be corrected by reimbursing the community.[11]

Courts requiring spouses to reimburse the community for its payment of separate expenses generally look to directly traceable separate expenses such as property taxes on separate property. However, the obligation to reimburse the community also applies to any separate obligation paid with community funds. Thus, a spouse is required to reimburse the community if community funds are used to pay the income taxes imposed on separate income.[12] Referring to the community payment of post-separation income tax—a separate debt—the court in *In re Marriage of Epstein* stated, "When a husband utilizes community funds to pay taxes relating to his separate property income he must reimburse the community...."[13] The same rule applies to pre-separation payments by the community.[14]

The annual community payment of the joint federal income tax obligation in circumstances where the joint tax return contains one spouse's separate income is a very common example of a pre-separation community payment of a separate debt. Courts have held that a couple should allocate the federal tax liability each year between community and separate income so that the community can be reimbursed for the amount of tax it paid that properly represents a separate debt.

Applying Statutes

The community's right to reimbursement appears to be covered by Family Code Sections 920 and 1101,[15] but the courts rarely cite statutory authority[16] when requiring the community to be reimbursed for the community's payment of the separate tax expense. Family Code Section 920, effective January 1, 1985, provides a right of reimbursement to the community when community funds are used to pay the separate debts of a spouse.[17] That right exists no matter which spouse applies the property to the satisfaction of the debt, and it

RICHARD EWING

applies to voluntary or involuntary payments, unless there is an express written waiver of reimbursement.[18] The term "debt" is broadly defined as an obligation incurred by a married person before or during marriage, whether based on contract, tort, or other grounds.[19]

Family Code Section 1101(a) requires reimbursement if community funds are used to pay a separate liability. Section 1101(a) provides that a spouse has a claim against the other spouse for a breach of fiduciary duty that results in an impairment to the undivided one-half interest in the community estate, "including...a single transaction or a pattern or series of transactions...."[20]

What's Fair Is Fair

If A and B (see pages 19 and 20) decide to use the relative income allocation formula, the allocations based on the marginal method and the average method are as follows:

Tax Allocation	Marginal Method	Average Method	Difference
Separate tax allocation	$2,800	$1,948	($852)
Community tax allocation	$16,683	$17,535	$852
Total Tax	$19,483	$19,483	$0

—R.B.M.

Family Code Section 1101 applies to the community payment of a separate debt because the failure of a spouse to reimburse the community impairs the other spouse's undivided one-half of the community. Failure to reimburse the community also provides the requisite breach of fiduciary duty.[21] Court decisions rendered before the enactment of Section 1101 frequently found a fiduciary breach of duty when a husband commingled community and separate assets,[22] when a husband unintentionally used community funds to discharge his separate indebtedness,[23] and even when the couple entered into a prenuptial agreement.[24] A right to reimbursement is inappropriate, however, if the spouses agree on an alternate plan or if the community payment was a gift.[25]

Relief is available for an aggrieved spouse if the failure to reimburse the community for its payment of separate income taxes has persisted for an extended period of time. Courts have held that the statute of limitations will not bar a cause of action for reimbursement.[26] These rulings are based on the theory that a wife "cannot be expected to treat her husband as a stranger."[27] For the same reason, an Oregon court held that laches cannot be used as a defense.[28] In California, even a 12-year delay did not constitute laches in circumstances where the plaintiff had a reasonable excuse for the delay and the defendant was not prejudiced.[29]

Unlike common law, Family Code Section 920 provides a specific three-year statute of limitations that requires the right to reimbursement to be exercised not later than the earlier of 1) the spouse having "actual knowledge" of the application of the property to the satisfaction of a separate debt, 2) a divorce proceeding, or 3) the death of a spouse. In marriages that have lasted for more than three years, the earliest date usually will be three years after actual knowledge. Apparently no case has inferred actual knowledge as the payment of the tax, the filing of the return, or the knowledge that there has been a failure to reimburse the community for the community payment of the separate tax. If the payment of the tax or the filing of the return constitute actual knowledge, then the three-year statute often will run before reimbursement is requested. If the community has paid a separate debt, most individuals will not have that knowledge until their lawyer or accountant informs them of the issue, usually at the time of a divorce or death.

Determining when actual knowledge exists under Family Code Section 920 is unnecessary if Family Code Section 1101 also applies, since Section 1101 provides that an action may be commenced upon the death of a spouse or in conjunction with an action for either legal separation or the dissolution of marriage—even if Section 1101's normal three-year limitations period has passed.[30]

Two factors should be considered before entering into protracted litigation involving retroactive reimbursement:

- The cost of hiring an expert to determine and prove the amount of the potential reimbursement.
- The likely recovery.

Calculating the Possibilities

In the context of tracing community and separate assets, "[w]hen discovery is substantially complete...the accountant, attorney, and client should take a step back and determine whether tracing will be cost-effective."[31] In most cases, these calculations will be expensive unless a couple maintains separate and community bank accounts and keeps detailed records identifying the source of all income and deductions.[32]

Many couples in which one spouse has separate income prepare their own tax returns. These couples are likely to pay the entire tax liability with community funds because they are unaware that they should allocate the tax into community and separate shares, or they may not know how to calculate the allocation. This lack of knowledge applies to some accountants as well. Some accountants may erroneously avoid the issue because they assume that a couple might not be willing to pay the full cost of calculating the tax allocation.[33]

If a spouse or a couple decides that it is cost-effective to allocate the joint income tax liability between the community and separate income, they must then determine *how* to allocate the liability. This is when the real fun begins, because the couple or their tax adviser must chose between the numerous formulas presented in articles and treatises. One treatise simply states that the tax should be allocated based on the parties' "separate income."[34] Another uses a formula allocation based on the ratio of the net tax each spouse would pay if separate returns were filed.[35]

In a handbook on prenuptial agreements, several alternative allocation formulas are proffered, including the relative income allocation formula[36] and the relative separate tax formula.[37] The book also provides a unique and simple formula in which the husband pays the remaining joint tax liability after the wife pays withholding tax on her salary (based on the withholding tables for one dependent) as well as estimated taxes on her separate property at the same rate her salary is taxed.[38]

Still another formula finds income taxes attributable to separate property computed separately, with a contribution made from the separate property.[39] Although this formula appears to contain a very simple solution to the problem, it presents numerous practical problems because almost all relevant terms are undefined. This is true for the other more complex formulas as well. For example, none of the formulas define "income" or "tax," and the term "parties" most likely should be read as community or separate property if the formulas are to work effectively.

A rather unique formula allocates back taxes to the spouse who is at fault. It provides that if one spouse failed to report income, any resulting tax liability should be paid by that spouse.[40] Although legally enforceable if agreed to by the parties, this formula is contrary to California law, which provides that, in general, each spouse is responsible for one-half of the tax on the community income.[41] Thus, in most cases, this formula should not be used, unless the parties agree or one spouse qualifies as "innocent."

An Easy-to-Use Formula

Couples whose circumstances do not require more specialized formulas should consider using the relative income allocation formula—an allocation formula based on the relationship of the separate and community income to the joint tax liability—simply because it is the most user-friendly. The relative income allocation formula can be interpreted using methods of calculation for either marginal or average income. Both are easy to use, assuming that there is no problem identifying each item of income as either separate or community.

The marginal income method allocates to the separate income the marginal tax rate paid on the joint income tax return, effectively taxing the separate income as if it were the last dollars earned. Thus the community should only pay the amount of tax it would have paid but for the addition of the separate income. The additional tax caused by the inclusion of the separate income, the marginal tax, is therefore allocated and reimbursed to the community.

For example, A and B are married and file a joint return for 1996 claiming the standard deduction. The couple has $90,000 of community income from salary and A has $10,000 of separate income from dividends on separate property. The 1996 federal income tax liability on the community income is $16,683. If the additional $10,000 separate income is included, the joint tax liability is $19,483. Under the marginal or "but for" method, the community should be reimbursed the additional $2,800 tax ($19,483 minus $16,683) resulting from the inclusion of the separate income.[42] This approach is used by many tax preparers because it is easy to calculate and it is always fair to the community.

Spouse A may object to the use of this method because it places the burden of the marginal tax rate, which is the higher tax rate, on A[43]—arguably overstating A's allocation and understating the community's share of the tax. However, the opposite approach—taxing the separate property as the first $10,000 of income and charging the additional marginal tax to the community generally—should not be used because it would charge $0 to the separate share and the entire tax of $19,483 ($19,483 minus $0) to the community, a substantial overcharge.

The average method avoids allocating either the separate or community share of the joint tax liability at the highest marginal tax rate by allocating the joint tax based on the ratio of the relative separate and community income.[44] Under the average method, both the community and separate income is taxed at the same tax rate, the couple's average tax rate. Under the average method, the joint income tax liability is allocated based upon relative community and separate income. Using A

LAURENCE H. MICHELSON
ATTORNEY SERVICE
$\$27^{00}$ PER SERVE
(Los Angeles County Only)
COURTHOUSE FILINGS:
LOS ANGELES COUNTY • SAN BERNARDINO
VENTURA • ANTELOPE VALLEY & MORE!*
*Please call for quotes on other areas and services
818/787-SERV (7378) • FAX 818/904-3444

DEPOSITIONS?
Text Search?
Images?
Video?
Integration on CD-ROM?

USED EFFECTIVELY IN COURT TRIALS SINCE 1994

The most powerful and cost-effective tool available for managing ALL of your discovery data. Synchronized deposition text to video; Full-text search; Hyperlinks to exhibits, documents and other images; Digital IssueBuilder™ outline organization; Instant access to animations, graphics and all other visual evidence via easy-to-use barcodes; Jukebox changer support for 7-2500 CD-ROMs; Fast and easy to learn and use. Re:Viewer™ Windows® software **now just $2,950.** CD production, service and support available nationwide. One call!

800-668-8889

VISIONARY
Information Systems
Incorporated

USC
UNIVERSITY OF SOUTHERN CALIFORNIA

UNIVERSITY OF SOUTHERN CALIFORNIA
LAW SCHOOL

2nd Annual Insurance Law Institute
"Insurance Coverage and Bad Faith"

Thursday and Friday, April 24-25, 1997
Sheraton Grande Hotel • Los Angeles

Insurance bad faith remains a constantly evolving area of law. Multi-million dollar bad faith verdicts against insurance companies are announced weekly. These same large punitive damage awards remain a touchstone for business interests and politicians bent on reforming tort laws nationwide. In the third party insurance context, the determination of the duty to defend is a critical decision with significant bad faith implications for the insurer. In the first party context, the numerous disasters and catastrophes during recent years have generated novel bad faith issues for both plaintiffs and defense. Moreover, bad faith issues are developing in many specialized areas of insurance law, such as medical and intellectual property coverage.

The 2nd Annual Insurance Law Institute offers cutting edge information and commentary from highly distinguished panelists. Topics to be discussed include:

- Bad Faith Strategies
- Punitive Damages
- Environmental Coverage
- Medical Insurance Issues
- Agency Issues
- Trial Techniques and Jury Selection
- Discovery Strategies
- Intellectual Property Claims
- Disability Claims
- Alternative Dispute Resolution

The USC Law School certifies that this activity has been approved for MCLE credit by the State Bar of California in the amount of approximately 14 hours.

FURTHER INFORMATION: (213) 740-2582

FDIC and Bank Workouts

Representation of debtors in the settlement and negotiated discounted payoff of their real estate debts with the FDIC and banks. We have negotiated discounted payoffs on notes of $140,000 to $74,000,000 and provided funding to effect payoffs up to $35,000,000. We have successfully settled 100% of our clients' cases and none of our clients have had to file bankruptcy. Our staff includes former high-ranking FDIC and bank workout officers. We handle negotiations, not legal work. We do not compete with the referring attorney.

Recent Negotiated Discounted Payoffs

- the payoff of a $74,000,000 debt (resort & hotel) for $48,000,000*
- the payoff of a $37,500,000 debt (retail) for $13,000,000*
- the payoff of a $5,500,000 debt (condos, ind., office) for $925,000*
- the payoff of a $1,800,000 debt (condos) for $520,000*
- the payoff of a $850,000 debt (apartments) for $323,000
- the payoff of a $805,000 debt (office) for $290,000*
- the payoff of a $701,000 debt (office) for $300,000
- the payoff of a $600,000debt (office) for $350,000
- the payoff of a $542,000 debt (marina) for $100,000*
- the payoff of a $309,000 debt (office leasehold) for $103,000*
- the payoff of a $272,000 debt (home) for $136,000
- the payoff of a $230,000 debt (apartments) for $85,000
- the payoff of a $140,000 debt (condos) for $27,000*
- the payoff of a $16,112,000 deficiency for $300,000
- the payoff of a $1,800,000 deficiency for $125,000*
- the payoff of a $300,000 deficiency for $50,000

Recent Fundings Provided for Discounted Payoffs

• We provided funding for the asterisked discounted payoffs sited above • We also recently provided funding for the following: • 2.6 million for a residential subdivision • 5 million for R & D and office • 7 million for R & D and office

Also, purchaser of performing or non-performing mortgage notes & Comm'l R.E. loan lender.

HICKS MANAGEMENT GROUP
Toll Free (888) 251-2767
www.hicksmgt.com

and B once again as an example, the joint tax liability of $19,483 on the $100,000 joint income would be allocated 90 percent to the community ($90,000 in community property salary) and 10 percent to A as the separate property owner spouse ($10,000 in separate property dividends).[45] A's allocated and reimbursable tax is $1,948, 10 percent of the total federal tax liability of $19,483. In most cases, the average method results in a relatively fair allocation between the community and separate income. (See "What's Fair Is Fair," page 18.)

Although one court accepted a gross income allocation method similar to the average method, it did not require that this method be used in all cases, nor did it state that such a method was the only acceptable method of allocation.[46] The case should not be used as authority for applying the average method because it did not discuss the reason why the average method was proper.[47]

In practice, the allocation formula selected will probably reflect the spouses' relative financial positions and bargaining power.[48] No one formula should be used for all situations. The proper approach will vary depending on all of the facts and circumstances of a given case.[49] ■

[1] *See* Susan Adler Channick, *What's in a Name: A Critical Look at California's System of Characterizing Marital Property*, 26 CAL. W. L. REV. 1 (1989-90); Carol S. Bruch, *The Definition and Division of Marital Property in California: Towards Parity and Simplification*, 3 HASTINGS L. REV. 769 (1982); Rick Sims, *Consequences of Depositing Separate Property in Joint Bank Accounts*, 54 CAL. ST. B.J. 452 (1979).

[2] FAM. CODE §760 defines community property, in part, as "all property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in this state...."

[3] FAM. CODE §770 defines separate property, in part, as:
(1) All property owned...before marriage.
(2) All property acquired...after the marriage by gift, bequest, devise, or descent.
(3) The rents, issues, and profits of the property described....

[4] In Texas, however, income from separate property is community property. TEX. FAM. CODE §5.01(a); Dawson-Austin v. Austin, 920 S.W. 2d 776 (Tex. Ct. App. 1996).

[5] Shaw v. Bernal, 163 Cal. 262, 271 (1912); Estate of Chandler, 112 Cal. App. 601, 604-05 (1931); William Q. de Funiak, *Improving Separate Property*, 9 HASTINGS L.J. 37 (1957-58); WILLIAM W. BASSETT, CAL. COMMUNITY PROPERTY LAW §6.62, at 485 (1994).

[6] *See* Marriage of Lucas, 27 Cal. 3d 808, 816 (1980); Estate of Maurice H. Honickman, 58 T.C. 132, 138-39 (1972) (a gift was presumed under Pa. law). *See also* Note, *The Division of the Family Residence Acquired with a Mixture of Separate and Community Funds*, 70 CAL. L. REV. 1263, 1279 (1982); Richard W. Bartke, *Yours, Mine and Ours-Separate Title and Community Property Funds*, 44 WASH. L. REV. 379 (1969).

[7] In re Marriage of Jafeman, 29 Cal. App. 3d 244, 256, 105 Cal. Rptr. 483, 491 (1972).

[8] HOGOBOOM & KING, CAL. PRAC. GUIDE: FAM. LAW, (8:522), at 8-129 (1996); WILLIAM W. BASSETT, *supra* note 5, at 485.

[9] Estate of Turner, 35 Cal. App. 2d 576, 579 (1939).

[10] *Id.* at 580.

[11] WITKIN, SUMMARY OF CAL. LAW, Community Property §85 (9th ed. 1990).

[12] In re Marriage of Epstein, 24 Cal. 3d 76, 89, 154 Cal. Rptr. 413 (1979). *See also* In re Marriage of Lee, 207 Cal. App. 3d 1260, 1264, 255 Cal. Rptr. 488, 490 (1989) (Epstein also applies to the payment of post-separation community obligations with separate funds—a situation now covered by FAM. CODE §2640).

[13] Epstein, 24 Cal. 3d at 89.

[14] In re Marriage of Frick, 181 Cal. App. 3d 997, 1015, 226 Cal. Rptr. 766, 775-76 (1986).

[15] Formerly CIV. CODE §§5120.210, 5125.1.

[16] In Epstein, 24 Cal. 3d 76, the court noted that post-separation earnings were separate property based on former CIV. CODE §5118. Epstein cites prior cases and holds that reimbursement is required without citing any statutory authority. *See* 24 Cal. 3d at 89.

[17] JOSEPH J. STEIN & JACK ZUCKERMAN, CALIFORNIA COMMUNITY PROPERTY WITH TAX ANALYSIS §4.05[1], at 4-19 (1996).

[18] FAM. CODE §920(a).

[19] FAM. CODE §902.

[20] FAM. CODE §1101(a). *See also* HOGOBOOM & KING, *supra* note 8, (8:612), at 8-147 (1996).

[21] FAM. Code §1101, effective Jan. 1, 1992, provides a high standard of care as the requisite duty. *See* Marriage of Reuling, 23 Cal. App. 4th 1428, 1439, 28 Cal. Rptr. 2d 726, 732 (1991); *see* HOGOBOOM & KING, *supra* note 8, (8:627), at 8-151.

[22] Thomson v. Thomson, 81 Cal. App. 678, 685 (1927).

[23] In re Marriage of Walter, 57 Cal. App. 3d 802, 806-07 (1976).

[24] Mergenthaler, 69 Cal. App. 2d at 529.

[25] *See* HOGOBOOM & KING, *supra* note 8, (8:846-7), at 8-201.

[26] Mergenthaler, 69 Cal. App. 2d 525. *See also* WITKIN, CAL. PROCEDURE (3d ed.), Actions, §469.

[27] Mergenthaler, 69 Cal. App. 2d at 529.

[28] Cary v. Cary, 159 Or. 578, 80 P. 2d 886 (1939).

[29] Huddleson v. Huddleson, 187 Cal. App. 3d 1564 (1987).

[30] FAM. CODE §1101(d)(2). It is interesting—even shocking—that if the initial three years has passed, a spouse seeking reimbursement is barred from court unless he or she sues for divorce or dies. What is the likely effect of this statute—the encouragement or discouragement of marriage?

[31] JACK ZUCKERMAN, ET AL., TRACING AND ITS APPLICATION IN FAMILY LAW MATTERS—1995 FAMILY LAW REFERENCE BOOK 5019.

[32] *See* In re Dawley, 17 Cal. 3d 342, 356 (1976). *Cf.* Ewell v. Comm., 1996-253 T.C. Memo.

[33] Preparing an allocation requires the accountant to identify all items of income as either community or separate, a task not otherwise required to prepare a tax return. The accountant also must prepare separate spreadsheets of manual calculations for each couple, since income tax preparation software does not yet allocate the joint tax between the community and separate shares.

[34] *See* HOGOBOOM & KING, *supra* note 8, (10:267), at 10-55.

[35] *Id.*, (10:267), at 10-155. *See* STUART B. WALTER, CAL. MARITAL TERMINATION SETTLEMENTS §8.11, at 249 (1971); Treas. Reg. §20.2053-6(f). Like the income allocation formula, this formula will not work unless the term "parties" refers to community and separate income. If there is separate property only, *see* Richard B. Malamud, *Allocation of the Joint Return Marriage Penalty and Bonus*, 15 VA. TAX REV. 489-550 (Winter 1996).

[36] GARY N. SKOLOFF, ET AL., DRAFTING PRENUPTIAL AGREEMENTS, [IV][H][1], at IV-83 (1995).

[37] *Id.*, [IV][H][2][f], at IV-93.

[38] *Id.*, [IV][2][a], at IV-89.

[39] *Id.*, [IV][H][5], at IV-97.

[40] LARRY RICE, THE COMPLETE GUIDE TO DIVORCE PRACTICE, FORMS & PROCEDURES FOR THE LAWYER 276 (1992).

[41] *See* In re Marriage of Hargrave, 36 Cal. App. 4th 1313, 1319, 43 Cal. Rptr. 2d 474 (1995) (holding that each spouse is liable for one-half of the tax on community income, even if one spouse is an innocent spouse).

[42] Alternatively, separate funds could be paid to the IRS as estimated tax or paid with the return in any year in which at least that amount is due with the return.

[43] The community thus receives the benefit of the graduated income tax rates, beginning at 15 percent; A's entire income is taxed at 28 percent.

[44] This method—although using gross income rather than net income—was approved in Hill v. Hill, 82 Cal. App. 2d 682, 698 (1947). *Cf.* Rev. Rul. 74-486, 1974-2 C.B. 56, which used taxable income as the basis for the allocation of state taxes. Although the examples use gross income because it makes the illustrations easier to follow, if a couple has adjustments to income or if they itemize, adjusted gross income or taxable income, rather than gross income, should be used, because they take into account both income and deductions.

[45] If the couple itemized their deductions, "income" should be relative taxable income, rather than gross income.

[46] Weinberg v. Weinberg, 67 Cal. 2d 557, 564, 63 Cal. Rptr. 13 (1967).

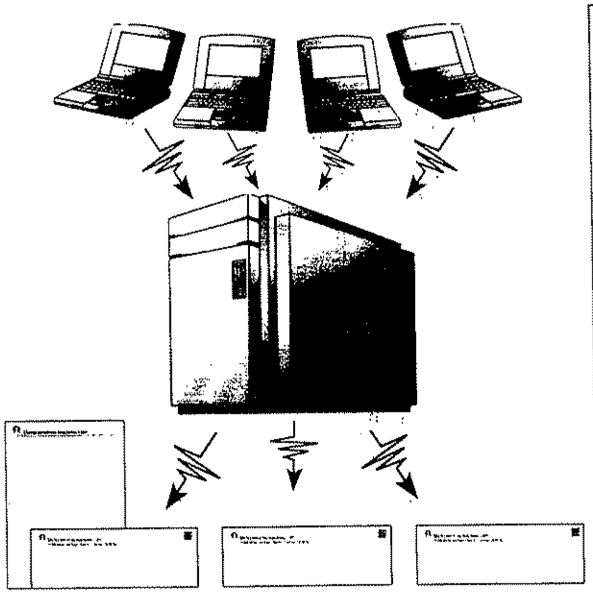
[47] *Id.*

[48] See WALTER, *supra* note 35, §8.7, at 248.

[49] *See, e.g.*, Beam v. Bank of America, 6 Cal. 3d 12, 98 Cal. Rptr. 137 (1971); Pereira v. Pereira, 156 Cal. 1 (1909); Van Camp v. Van Camp, 53 Cal. App. 17 (1921). *See also* Westbrook v. Comm., 74 T.C. 1357 (1979).

CRIMINAL DEFENSE ATTORNEYS

JAIL MAIL® IS PROFESSIONAL & EFFECTIVE!



JAIL MAIL® is highly effective legal advertising. Within 30 short days you can be on line with one of the most cost effective marketing concepts in the country. Using a powerful computer network, daily arrest information is compiled, sorted and selected for you based on your specific criteria. This information is merged into a letter, written by you on your letterhead, and sent to those recently arrested. Direct Mail benefits those who do not know how to find a lawyer giving you the opportunity to inform them of your qualifications. Our full service letter shop can mail letters for you daily.

LIMITED MARKETS AVAILABLE. CALL TODAY -

(800) 462-5245

United Reporting Publishing Corp. encourages responsible advertising and reminds all attorneys who advertise to strictly adhere to the Rules of Professional Conduct and to be mindful of the spirit of those rules.

UNITED REPORTING PUBLISHING CORP. 11255 Whiterock Road • Rancho Cordova, CA 95742