Community Property Interests in Separate Property Businesses in Washington

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TABLE OF CONTENTS

I. INTRODUCTION

Many of the rules of Washington community property law are well established.[1] However, Washington law is not so clear when a spouse works during marriage in his

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1. *See* Harry M. Cross, *The Community Property Law*, 61 WASH. L. REV. 13, 18 (1986).

or her separate property business.[2] The spouse's labor is community property, yet the business is separate property.[3] Generally speaking, income generated during marriage from the labor of a spouse is community property.[4] Property brought into the marriage or received as a gift, including inheritance, is separate property.[5] The difficulty arises upon death or dissolution of marriage, when the task becomes determining what constitutes community and separate property. While Washington law establishes that the business may have started out as separate property, Washington courts have failed to provide a cohesive analysis of the effect of years of community labor on the business.[6]

The often-recited Washington rule is that so long as the owner-spouse is adequately compensated, a separate property business retains its separate character and all income generated by the business, and any increase in value of that business, is separate property.[7] However, if the owner-spouse is undercompensated, then the business and its income become community property.[8] Because the business is either entirely separate or entirely community property, this rule is sometimes referred to as the "all-or-nothing" rule.[9]

This all-or-nothing rule is often cited by lawyers, judges, and commentators as the only applicable law in Washington.[10] When made, such articulations ignore an *ad hoc* body of Washington case law, including recent cases that cannot be reconciled with the all-or-nothing rule.[11] In some instances the all-or-nothing rule has been departed from because that rule is often inequitable.[12] This recognition of inequity has caused all of our sister states with similar rules to expressly abandon the all-or-nothing rule;[13] Washington should do the same.

The following will begin with an explanation of the two general rules which community property states apply to determine the character of income generated by

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2. *See* Hamlin v. Merlino, 272 P.2d 125, 128-29 (Wash. 1954).

3. *See* Elizabeth Barker Brandt, *Community Property Treatment of the Increase in Value of Separately Owned Business*, 27 IDAHO L. REV. 195, 197 (1990).

4. *Id.*

5. WASH. REV. CODE §§ 26.16.010, 26.16.020 (2002).

6. *See, e.g.*, *Hamlin*, 272 P.2d at 128-29.

7. *See* Pollock v. Pollock, 499 P.2d 231, 236 (Wash. Ct. App. 1972).

8. *See generally id.*

9. J. Thomas Oldham, *Separate Property Businesses That Increase in Value During Marriage*, 1990 WIS. L. REV. 585, 592-93 (1990).

10. *See generally Hamlin*, 272 P.2d at 129; Brandt, *supra* note 3, at 209.

11. *See generally* Koher v. Morgan, 968 P.2d 920 (Wash. Ct. App. 1998) (applying community property principles to a meretricious relationship case by analogy); Jacobs v. Hoitt, 205 P. 414, 416 (Wash. 1922).

12. *Cf. In re* Buchanan's Estate, 154 P. 129, 132 (Wash. 1916).

13. *See* Nathan R. Long, *Community Characterization of the Increased Value of Separately Owned Businesses*, 32 IDAHO L. REV. 731, 760-67 (1996).

separate property assets: the American Rule and the Civil Rule. This is followed by a discussion of commingling and the impact of the separate property business owner's compensation. Next, it will explore in detail the various approaches taken in the so-called American Rule and Civil Rule states. Finally, this article will conclude by scrutinizing Washington's supposedly strict adherence to the American Rule and argue for a more equitable approach.

II. INCOME FROM SEPARATE PROPERTY: THERE ARE TWO GENERAL RULES ADOPTED BY COMMUNITY PROPERTY STATES

There are nine community property states.[14] Each has chosen one of two general schemes for characterizing income generated during marriage by separate property assets.[15] Because this article discusses cases from other community property states, each foreign authority must be viewed against that state's chosen scheme.

Under the traditional Civil Rule, now the minority rule, all income generated during marriage from any source—including increases in the value of separate property—is community property.[16] Thus, under the Civil Rule, the community always has a claim to the increased value of a separately owned business, whether or not a spouse was employed in that business and whether or not the spouse was reasonably compensated.[17] Idaho, Texas, Louisiana, and Wisconsin follow the Civil Rule.[18]

By contrast, income generated during marriage by separate property remains separate property in states that adhere to the American Rule, i.e., the majority rule.[19] Consequently, in American Rule states the rents and profits of a separate business remain separate property *unless* converted to community property through some process.[20] One example of such a process would be the creation of a community interest when the community is undercompensated for the labor and industry contributed by a spouse.[21] The American Rule is the law in California, Arizona, New Mexico, Nevada, and Washington.[22]

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14. *Id.* at 731. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. *Id.*

15. *Id.* at 732.

16. *See id.* at 733.

17. *See id.* at 757.

18. *See, e.g.*, Long, *supra* note 13, at 757-58. The majority of the Civil Rule states do not apply the Civil Rule strictly. For instance, in Wisconsin, Louisiana, and Texas, a finding of undercompensation must be made before the court will consider awarding the increase in value of a separately owned business to the community. *Id.* at 757.

19. *Id.* at 736.

20. *Id.* at 758.

21. *Id.*

22. *Id.* at 759-61, 765.

Washington has adopted the American Rule at R.C.W. 26.16.010–020. Section 26.16.010 provides:

> Property and pecuniary rights owned by the husband before marriage and that acquired by him afterwards by gift, bequest, devise or descent, *with the rents, issues and profits thereof*, shall not be subject to the debts or contracts of his wife, and he may manage, lease, sell, convey, encumber or devise by will such property without the wife joining in such management, alienation or encumbrance, as fully and to the same effect as though he were unmarried.[23]

Although community property states theoretically divide into Civil Rule and American Rule states, the distinction blurs when courts allocate the increased value in a separate property business.[24] Courts in all community property states—Civil and American Rule states alike—have difficulties deciding what interest the community should have when one of the spouses works in his or her separate property business.[25]

Among the five American Rule states, only Washington still purports to faithfully adhere to the American Rule when deciding the nature and extent of a community interest in a separate property business.[26] Courts in all other American Rule states routinely decide and allocate between the separate and community property components of a separate property business.[27] Washington stands alone among American Rule states in not having expressly abandoned the all-or-nothing rule.[28]

One commentator has articulated the policy behind most states' abandonment of the American Rule's all-or-nothing approach as follows:

> Most courts and writers agree that the all or nothing approach is not a good rule. The all or nothing approach allocates all of the increase to one estate or the other; no allocation is possible between the estates. This is an unrealistic zero-sum analysis. Common sense suggests that it normally would be more appropriate to allocate the increase between the two estates. Also, the all or nothing approach created an inflexible rule for all businesses of the same type,

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23. WASH. REV. CODE § 26.16.010 (2002) (emphasis added). Section 26.16.020 is substantially similar, but refers to the wife instead of the husband. *Id.* § 26.16.020.

24. *See, e.g.*, Long, *supra* note 13, at 733.

25. *See id.* at 733-34.

26. *See, e.g., In re* Marriage of Lindemann, 960 P.2d 966, 973 n.29 (Wash. Ct. App. 1998) (quoting *In re* Marriage of Johnson, 625 P.2d 720, 721-22 n.1 (Wash. Ct. App. 1981)); *see also* Long, *supra* note 13, at 733-34. Like Washington, the other American Rule states also have statutory schemes under which increases in separate property remain separate property; case law in the other American Rule states has expressly adapted the rule to fit the realities of closely held businesses. *Id.* at 767.

27. Long, *supra* note 13, at 767.

28. *See id.* at 933-34.

> regardless of the economic circumstances existing during the marriage and the extent and value of the spouse's efforts.[29]

As discussed below, Washington's devotion to the American Rule has not been entirely unwavering.[30] Washington has yet to adopt an allocation approach.[31]

III. UNDERCOMPENSATION ALWAYS CONSTITUTES COMMINGLING, THEREBY TRANSFORMING A BUSINESS INTO COMMUNITY PROPERTY

There are many ways in which community and separate property can become commingled.[32] The most obvious type of commingling occurs when separate property and community property funds are deposited into and spent from a bank account such that the end balance can no longer be clearly traced to its sources.[33] When separate and community property become commingled, the entirety is presumed to be community property.[34] In *Estate of Carmack*, the Washington Supreme Court stated this rule as follows:

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29. Oldham, *supra* note 9, at 592-93.

30. *See, e.g.*, Koher v. Morgan, 968 P.2d 920, 922 (Wash. Ct. App. 1998).

31. *See, e.g., Marriage of Lindemann*, 960 P.2d at 971.

32. *See, e.g., In re* Marriage of Skarbek, 997 P.2d 447, 450 (Wash. Ct. App. 2000).

33. *See In re* Marriage of Pearson-Maines, 855 P.2d 1210, 1214 (Wash. Ct. App. 1993).

34. *Id.* This is one of several key presumptions that are applicable. First, any increase in the value of separate property is presumed to be separate property. *In re* Marriage of Elam, 650 P.2d 213, 216 (Wash. 1982). That presumption may be rebutted by "direct and positive evidence" that the increase is attributable to community funds or labor. *Id.* When funds are hopelessly commingled and cannot be separated, the funds are presumed to be community property. *Marriage of Skarbek*, 997 P.2d at 450. A spouse claiming the funds to be separate property bears the burden, by clear and convincing evidence, to trace the funds to a separate source. *Id.*

Courts may also employ an accounting method concerning an allegedly commingled account, under which community expenditures are deemed made from community funds, and separate expenditures are deemed made from separate funds. Josephson v. Josephson, 772 P.2d 1236, 1239-40 (Idaho Ct. App. 1989).

> When utilizing this accounting method, a court compares the aggregate community deposits and withdrawals for community expenditures. If the expenditures exceed the deposits, there is no community interest in the residual funds. If the deposits exceed the expenditures, the net amount reflects a community interest in any residual funds. In the event separate property is used for community expenditure, reimbursement may be sought from the community, unless a gift to the community was intended.

Id. This approach is similar to the approach accepted in Washington. "[I]f there are both separate and community funds and there are sufficient separate funds from which the payments can be made, then the payments will be presumed made from such separate funds." *Marriage of Pearson-Maines*, 855 P.2d at 1214-15 (quoting Pollock v. Pollock, 499 P.2d 231, 238 (Wash. Ct. App. 1972) (emphasis omitted)) (finding property insurance proceeds used to rebuild a destroyed separate property dwelling to be separate property when deposited in and withdrawn from commingled bank account).

> [W]here separate funds have been so commingled with the community funds as to make it impossible to trace the former, or tell which are separate and which are community funds, all funds or property into which they have been invested belong to the community.[35]

The way to overcome the community property presumption is to trace property to a separate property source.[36] This process has been explained as follows:

> The basic presumption that an asset acquired during marriage is community property can be overcome through use of the source doctrine, that is, by tracing to a separate property origin or source. ... If the links of the chain back to, or forward from, a separate property source can be clearly established, there will be separate property ownership of the disputed asset. However, if the character of one of the links is confused or uncertain, the basic community property presumption, in the form of the commingling doctrine or rule, breaks the chain. When this break occurs, the uncertain link will be found to be community in character and to be the origin or source with respect to any subsequent change in form.[37]

"[I]f the sources of the deposits can be traced and apportioned, and the use of withdrawals for separate or community purposes can be identified, the funds are not so commingled that the account itself becomes community property."[38] In that situation, the court will apportion between the community and separate estates.[39]

Commingling can occur other than in a bank account.[40] The reasonable value of the labor of a business owner is community property because the labor of a spouse is community property.[41] Consequently, commingling can occur by leaving community property in a separate property business.[42] This may happen when the owner does not draw a reasonable salary.[43] Accordingly, leaving community property in a business constitutes commingling and the business becomes community property.[44]

As an explanation for Washington's rule concerning undercompensation, cases often refer to the "rule of contemporaneous segregation."[45] In essence, the rule of

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35. 233 P. 942, 944-45 (Wash. 1925).

36. Cross, *supra* note 1, at 55-56.

37. *Id.*

38. *Marriage of Pearson-Maines*, 855 P.2d at 1214.

39. *See, e.g., id.* at 1213 n.3.

40. *See, e.g.*, Koher v. Morgan, 968 P.2d 920, 922 (Wash. Ct. App. 1998) (finding a commingling of profits due to undercompensation).

41. *See* Brandt, *supra* note 3, at 197.

42. *See, e.g., Koher*, 968 P.2d at 922.

43. *Id.*

44. Hamlin v. Merlino, 272 P.2d 125, 128 (Wash. 1954).

45. *In re* Marriage of Johnson, 625 P.2d 720, 722 n.1 (Wash. Ct. App. 1981).

contemporaneous segregation states that when there is difficulty ascertaining the extent to which community and separate sources have produced the resulting income, the community property presumption will apply unless there was a segregation at the time the income arose.[46] When the separate property asset is a business, courts employ the legal fiction that setting a reasonable salary for the participating spouse constitutes a sufficient segregation.[47] Consequently, the failure to pay a reasonable salary is analogized as a failure to contemporaneously segregate community and separate funds, leading to commingling within the business, and causing what had been a separate property business to be transformed into community property by virtue of the presumption.[48] All commingled funds, regardless of their source, become community property because they can no longer be traced or identified.[49]

However, when a spouse is adequately and timely compensated, the separate property business retains its separate character.[50] The late Professor Cross discussed this concept as follows:

> The commingling doctrine is applicable if income is comprised of both community property and separate property ingredients. Such a pattern frequently occurs when separate property is managed by a spouse to produce income. The fruits of a spouse's personal efforts are community property, but, by statute, rents, issues, and profits of separate property are separate property. Thus, if a spouse produces income by working with a separate asset, the resulting income will be partly community and partly separate unless the asset can be established to be sterile, that is, nonproductive.[51]

One of the logical fallacies of using undercompensation as the basis for determining whether a business asset should be characterized as community or

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46. *Id.*

47. *Id.*

48. *See, e.g.* Pollock v. Pollock, 499 P.2d 231, 236 (Wash. Ct. App. 1972).

49. *See In re* Marriage of Skarbek, 997 P.2d 447, 450 (Wash. Ct. App. 2000).

50. *E.g., In re* Estate of Herbert, 14 P.2d 6, 7-8 (Wash. 1932) (finding adequate compensation by sole shareholder of ice machine corporation).

51. Cross, *supra* note 1, at 57. One commentator described the competing principles of law as follows:

> When separate assets are combined with the services of a married person, competing principles of community property law come into play. On the one hand is the principle that the community estate is entitled to the benefit of the labor and enterprise of the spouses, and that all assets acquired during marriage are presumptively community property. On the other hand is the principle that each spouse is entitled to own and manage separate property, and that once an asset is shown to be separate property it is presumed that it remains separate property, as are the rents, issues and profits of the asset presumptively separate property.

Kenneth W. Weber, 19 WASHINGTON PRACTICE: FAMILY AND COMMUNITY PROPERTY LAW § 11.14 (1997).

separate property is that the inquiry ignores the nature of the contributions by the owner-spouse and the economics of the business from the time the marital community commences to the time it terminates.[52] Washington courts ordinarily do not attempt to make an analysis of the changing value of the business or the reasons for the change in value.[53] For example, if a business retained its value in a market of declining values solely due to extraordinary community labor contributed by the owner-spouse, that would not be considered so long as the owner-spouse is deemed to be adequately compensated. The all-or-nothing rule thereby can effectively disregard Washington's public policy that the fruits of a spouse's labor during marriage should be community property.[54]

IV. WHAT CONSTITUTES UNDERCOMPENSATION?

One of the problems with Washington's approach is that there are no hard rules to determine when a spouse has been adequately compensated.[55] The compensation received by the owner-spouse is certainly not itself determinative as to its adequacy.[56] In *Marriage of Stenshoel*,[57] the court noted in the determination of income for child support purposes[58] that the income of a shareholder of a close corporation may be partially reflected in its retained earnings.[59] The court placed the burden on the shareholder to justify the amount of corporate-retained earnings when determining the shareholder's income.[60] By placing the burden on the shareholder, the court recognized that the salary paid by a close corporation often does not reflect the full remuneration received by a shareholder-employee.[61]

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52. *See* Long, *supra* note 13, at 737-38.

53. *See, e.g., In re* Marriage of Elam, 650 P.2d 213, 216 (Wash. 1982).

54. *See* WASH. REV. CODE § 26.16.030 (2002).

55. *See* Hamlin v. Merlino, 272 P.2d 125, 128-29 (Wash. 1954).

56. Oldham, *supra* note 9, at 596.

57. 866 P.2d 635 (Wash. Ct. App. 1993).

58. The determination of income for purposes of child support is an exercise that is largely based on statutory law. *See* WASH. REV. CODE § 26.19.071 (2002).

59. *See Marriage of Stenshoel*, 866 P.2d at 639-40.

60. *Id.*

61. *See id.* at 640. This view has not been adopted in all community property states. In *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. App. 1987), the majority opinion in a three-judge panel of the Texas Court of Appeals held that the retained earnings in a separate property Subchapter-S corporation did not constitute community property, even though the community paid income taxes on those retained earnings. The Texas court relied on its rule that unless a corporation is a spouse's alter ego, a court on divorce could only award shares of stock and not corporate assets, and that a shareholder of an S-corporation has no greater rights over the corporate property than the shareholder of any other corporation. *Id.* at 343-44. However, two Justices dissented from the holding that retained earnings were separate property. Justice Sam Bass dissented, arguing that retained earnings on which taxes were paid by shareholders should be considered community property. *Id.* at 348.

Washington case law indicates that fairness of the salary depends largely on the earnings of the corporation during the time the salary was paid.[62] However, any dividend paid or enhanced stock value resulting from reinvested profits is separate property.[63]

When determining the adequacy of compensation, the focus would ordinarily be on salaries paid to employees for engaging in similar functions in comparable businesses.[64] The underlying assumption is that there exist similar businesses that compensate owner-employees in a similar fashion, making "adequate compensation" a determinable ballpark figure. The reality, of course, is that the compensation of executives varies widely, particularly in small businesses which often have unique market niches.[65] In other words, there can often be no agreement as to the appropriate compensation of an owner-spouse because the individual circumstances of the business, the person, and the person's contributions will always be unique. This is one reason why experts will often arrive at substantially different figures for a reasonable level of compensation.[66]

One important factor used to determine adequate compensation may be the time the owner-spouse devotes to the business.[67] The reasonable compensation for the spouse who works ten hours per week would presumably be less than the reasonable compensation for the spouse who works seventy hours per week.[68] However, the

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Justice D. Camille Dunn dissented insofar as she did not believe the husband met his burden of showing that the increased value of the corporation was not due to the husband's labor. *Id.* at 346. *Thomas* is probably an anomaly, and in any event does not appear to be the law in Washington.

62. Hamlin v. Merlino, 272 P. 125, 129 (Wash. 1954).

63. *In re* Marriage of Brooks, 756 P.2d 161, 164 (Wash. Ct. App. 1988). *Brooks* does not explain whether there is a meaningful distinction between sharing in the increased value of the corporation and setting a reasonable salary based on the profitability of the corporation. The *Brooks* holding that the increased value resulting from reinvested profits is separate property appears inconsistent with the subsequent *Stenshoel* holding that retained earnings may reflect the earnings of a spouse, *i.e.*, be community property. *See Marriage of Stenshoel*, 866 P.2d at 640. The cases could be harmonized, because *Stenshoel* limited itself to the retained earnings themselves, instead of the increased value of the company resulting from use of the retained earnings, and *Stenshoel* was focused on income instead of asset value because it is a child support case. *Id.* However, it logically follows that if community property retained earnings were reinvested into new property, that new property should be part community property. If the ratio between contributions could no longer be determined, there would be a commingling of funds and the presumption should apply that the property is community property.

64. *See id.* at 164.

65. *Cf. In re* Marriage of Zeigler, 849 P.2d 695, 698 (Wash. Ct. App. 1993) (two certified public accountants arriving at substantially disparate figures as to whether the husband had received fair compensation as the owner of an insurance agency).

66. *See id.* at 697.

67. Oldham, *supra* note 9, at 594.

68. *Id.*

matter can become more complicated when individual facts are considered.[69] For example, what is a reasonable level of compensation for the owner-spouse who spends five hours a week working at the business and another five hours a week at the golf course, the latter of which generates most of the sales in a highly profitable medium-sized business? Or, what is the reasonable compensation for the mostly-retired owner-spouse who during marriage implemented a business strategy that continues to keep profits high? Should the reasonable compensation be identical for two owner-managers who work identical hours in similar businesses with identical overheads, but where the profits substantially differ because one owner located his business on a street with better parking?

Some suggest that "an owner is always more concerned about the success of a business than a mere employee."[70] Consequently, they argue that "the community claim would be undervalued" if the reasonable compensation is "based upon what an employee would earn to perform the same function."[71] This argument may have less merit if the employee's compensation scheme includes a profit-sharing or performance bonus component.[72]

Another problem with the adequate compensation question is that the motivation of the owner-spouse in setting his or her salary may be difficult to determine.[73] In a California case, *Millington v. Millington,*[74] the court discussed the division of a sporting goods store that was started by the husband and his business partner shortly before his marriage.[75] During the marriage, the husband purchased his partner's interest, and the store succeeded due to the husband's management abilities.[76] The husband minimized draws from the business, believing the business to be his separate property and desiring to keep wealth within his separate estate at the expense of the community.[77] In arguing that the business was his separate property because he had been adequately compensated, the husband provided evidence that his income was adequate for a manager of a sporting goods store.[78] The court rejected the husband's argument as follows:

> One expert testified that $7,500 would be a reasonable salary for a manager as the business existed in 1964-1965. This testimony did not, however, necessarily

69. *Id.* at 595.
70. *Id.* at 594.
71. *Id.* at 594-95.
72. Oldham, *supra* note 9, at 594-95.
73. *See* Millington v. Millington, 67 Cal. Rptr. 128, 133-35 (Cal. Ct. App. 1968).
74. *Id.*
75. *Id.* at 132.
76. *Id.* at 133-34.
77. *Id.* 134-35.
78. *Millington*, 67 Cal. Rptr. at 136.

> mean that there should not be greater compensation to one who had brought the business up to its current volume from its more modest beginnings.[79]

The court held that it was not an abuse of discretion for the trial court to attribute the entire growth of the business to the personal efforts of the husband.[80] Further, the court held that the land on which the business was situated, purchased prior to the marriage, was community property because "the property was paid for out of the earnings of the business, attributable to [the husband's] efforts...."[81] *Millington* is an example of how difficult, arbitrary, and limiting a focus solely on adequate compensation can be and sets forth an equitable approach to the problem.

Determining whether a business should be characterized as separate or community property based on adequate compensation may conflict with another principle of Washington law. It is well-established that spouses owe a fiduciary duty to each other.[82] Washington spouses not only owe each other the highest fiduciary duties, but also the duty to manage and control community assets for the benefit of the community.[83] A possible conflict arises between a spouse's fiduciary duty to manage and control community assets for the benefit of the community and the spouse's status as owner of a separate property business. The principle that the compensation set by the owner-spouse need merely be "adequate" appears to be at odds with that same spouse's fiduciary duty to manage and control community assets for the benefit of the community. This logical fallacy of focusing on adequate compensation is discussed in a Texas case:

> During marriage, the law will not permit a spouse to devote 100% of his time, talent, and toil on his own behalf in the operation of a sole proprietorship or a partnership and then claim 47% of the benefits as separate property. This conduct does not become acceptable in the eyes of the law merely because the same spouse does the same act through a corporate vehicle of his own creation.[84]

The discussion continues:

> In this case, the community estate owns all the profits and earnings of the business regardless of whether the community receives some of the profit as salary because the laws of this State mandate that every dollar that either spouse earns is community property. The majority apparently finds solace in its

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79. *Id.* at 136.
80. *Id.* at 137.
81. *Id.*
82. *E.g.*, McCutcheon v. Brownfield, 467 P.2d 868, 874 (Wash. Ct. App. 1970).
83. Peters v. Skalman, 617 P.2d 448, 452 (Wash. Ct. App. 1980).
84. Vallone v. Vallone, 644 S.W.2d 455, 461 (Tex. 1982) (Sondock, J., dissenting).

> determination that the community received "adequate compensation." However, what is adequate compensation is not the issue and is irrelevant here. Most people would agree that $200,000 annual salary is adequate compensation for a successful basketball player, actress, or restauranteur. When these individuals actually earn $1,000,000 per year, the entire $1,000,000 belongs to the community estate, not just the amount an appellate court may deem "adequate compensation." The rule is not that a portion of the earnings found to be adequate compensation for labor belongs to the community estate. The rule always has been that earnings of a spouse—all of the earnings—are community property. The result in this case should be no different.[85]

Finally, there is also a question as to whether the reasonable compensation should be adjusted for inflation between the time the compensation should have been made and the time the community claim arises.[86] Community claims are ordinarily not adjusted for inflation.[87]

Thus, the focus on adequate compensation as the basis for determining whether there is a community interest may be myopic. At the least, the adequacy of compensation of the owner-spouse should not be considered in isolation of other factors.

V. KEEPING COMMUNITY AND SEPARATE FUNDS ON CORPORATE BOOKS CAN CONSTITUTE COMMINGLING

The reality of small business ownership is that the owner must generally finance the business.[88] Owners often self-finance companies by not withdrawing all profits that appear on the books, instead leaving those profits in the company for operations or expansion capital.[89] Also, owners of small businesses sometimes pay personal bills out of business accounts.[90] An honest businessperson should record such payments on the books of the business as if the funds were paid to or for the benefit of the owner, such as in the form of a draw. These types of payments make the analysis as to the separate or community character of business more confusing.

There are two Washington cases that discuss whether assets become commingled when community assets are placed or kept in corporate accounts. In *Estate of Dewey*,[91] the Washington Supreme Court respected the characterization of property

85. *Id.*
86. Oldham, *supra* note 9, at 596.
87. *Id.*
88. *See, e.g.*, Pollock v. Pollock, 499 P.2d 231, 236-37 (Wash. Ct. App. 1972).
89. *Cf. id.*
90. *See In re* Estate of Myers, 376 S.W.2d 219, 221 (Mo. 1964).
91. 124 P.2d 805 (Wash. 1942).

as entered in the corporate books.[92] The question was whether real property acquired during marriage belonged to the community or the husband's separate estate.[93] The funds used to acquire the property came from the husband's separate property corporation, where he was the sole shareholder and an employee.[94] The husband recorded a monthly salary on the corporate books but only drew funds when needed.[95] When he purchased the real property at issue, the husband drew an amount that exceeded the total of his accrued salary.[96] The court held that the excess drawn was separate property and allocated the interests in the real property between community and separate property based on the ratio between the accrued salary and the excess withdrawn.[97] The case contained no discussion as to whether or not Mr. Dewey was adequately compensated.

Thirty years later, the Washington Court of Appeals reached a different result in *Pollock v. Pollock*.[98] In *Pollock*, the husband managed his separate property during the marriage.[99] There had been no allocation for salary and the husband presented no evidence of what a reasonable salary might be.[100] The husband used the same bank accounts for business and personal expenditures, including household expenditures, and operating revenue deposits.[101] He did not attempt to trace the deposits and expenditures.[102] The court held that the accounts and all assets acquired therefrom must be deemed community property.[103]

The primary differences between *Dewey* and *Pollock* are that: (a) there was no contemporaneous segregation in *Pollock,* [104] (b) the contemporaneous segregation in *Dewey* occurred within the corporate account ledger as each accrued but unpaid paycheck was recorded against the appropriate accounts,[105] and (c) Mr. Pollock used the same bank accounts for personal and business purposes.[106] It is not clear whether after-the-fact journal entries made by bookkeepers qualify as the "contemporaneous"

92. *Id.* at 806.
93. *Id.*
94. *Id.*
95. *Id.*
96. *Estate of Dewey*, 124 P.2d at 806-07.
97. *Id.* at 807-08.
98. 499 P.2d 231 (Wash. 1972).
99. *Id.* at 236.
100. *Id.*
101. *Id.* at 237.
102. *Id.*
103. *Pollock*, 499 P.2d at 237-38.
104. *Id.* at 237.
105. *See In re* Estate of Dewey, 124 P.2d 805, 806 (Wash. 1942).
106. *Pollock*, 499 P.2d at 236.

segregation of assets.[107] Journal entries, especially adjusting entries, are arguably not contemporaneous.

A 1966 California case contains an excellent discussion on the issue of tracking the shareholder-employee's assets on the company books for a large close corporation. In *See v. See*,[108] the California Supreme Court had the opportunity to decide a case involving the president of family-owned See's Candies, Inc.[109] The president received an annual salary, much of which was credited to a general ledger account on the books of the corporation instead of being paid.[110] The corporation paid many of the president's expenses, debiting that account, and the president contributed funds to the corporation to maintain a credit balance in his general ledger account.[111] The *See* trial court held there had been no acquisition of property with community funds because the husband could prove that he paid more community expenses than he had community income.[112] The California Supreme Court rejected the trial court's theory, noting that this theory "would disrupt the California community property system . . . [by] transform[ing] a wife's interest in the community property from a 'present, existing and equal interest'... into an inchoate expectancy to be realized only if upon termination of the marriage the community income fortuitously exceeded community expenditures."[113] Although the court approved of the general rule that the separate character of property can be proved by showing that community income was exhausted by community expenses at the time, adequate and contemporaneous records were required, stating:

> If funds used for acquisitions during marriage cannot otherwise be traced to their source and the husband who has commingled property is unable to establish that there was a deficit in the community accounts when the assets were purchased, the presumption controls that property acquired by purchase during marriage is community property. The husband may protect his separate property by not commingling community and separate assets and income. Once he commingles, he assumes the burden of keeping records adequate to establish the balance of community income and expenditures at the time an asset is acquired with commingled property.[114]

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107. *Cf. Pollock*, 499 P.2d 231; *Estate of Dewey*, 124 P.2d 805.
108. 415 P.2d 776 (Cal. 1966).
109. *Id.* at 778.
110. *Id.* at 779.
111. *Id.*
112. *Id.*
113. *See*, 415 P.2d at 779 (quoting CAL. CIV. CODE § 161a (West 1997)).
114. *Id.* at 780.

In other words, *See* held that bookkeeping entries on a general ledger did not constitute either contemporaneous segregation or tracing sufficient to overcome the community property presumption.[115]

A recent unpublished Washington case is not far behind the California *See* holding.[116] *Marriage of Lukoskie*[117] discusses the burden on the manager of the community estate to provide proof if there is a question concerning management.[118] In *Lukoskie,* the husband borrowed funds during separation which he claimed were used to benefit the community business.[119] The husband testified that he properly accounted for the funds, but the testimony was insufficient to satisfy the court of appeals:

> While correct that there was no dispute as to the accuracy of the advances or debt totals, there was no testimony indicating how the borrowed funds were spent. [The husband] fails to understand the difference between his accounting practices and the necessary proof of the fact that the indebtedness was used for the community's benefit, net of the community revenue such as rents, salaries, and [the wife's] post-separation income, which he controlled. The trial court sought supporting documentation for the accounting, but it was not provided.[120]

The court specifically noted that "[i]t was within [the husband's] power as the manager of the community estate and all of its assets to verify the lines of credit and other spending and to prove that it was used for community benefit."[121]

VI. COMMINGLING WILL MAKE ALL OR PART OF A CORPORATION COMMUNITY PROPERTY

A. *Approaches Used in the American Rule States*

Under the American Rule, any commingling will invoke the presumption that property becomes community property.[122] Hence, when a spouse's personal services have been combined with that spouse's separate property unincorporated business,

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115. *See id.* at 779-80.

116. *See* Lukoskie v. Kim (*In re* Marriage of Lukoskie), No. 49544-5-I (Wash. Ct. App. Oct. 28, 2002). Please note that unpublished court of appeals decisions may not be cited in the Washington appellate courts. *See* R. APP. P. 10.4(h).

117. No. 49544-5-I.

118. *Id.* at *9-10.

119. *Id.* at *3.

120. *Id.* at *10 n.12.

121. *Id.* at *9-10.

122. *See* Oldham, *supra* note 9, at 622.

and there has been no contemporaneous segregation, all income and increase in value of the business will be considered community property.[123]

Invoking the community property presumption can create inequity if a separate property business had substantial value at the time of the marriage.[124] The effect of this common scenario is unpredictability for the litigants.[125] The party asserting that there has been commingling could face a court that is reluctant to hold that the entire business is now community property.[126] This reluctance has made its way into Washington case law.[127] "[W]hen the community property is inconsiderable in comparison with the separate property, the mass remains separate property."[128] But when the court holds there has been no commingling because the business was valuable at the time of marriage, the community goes uncompensated for the increased value of the business due to the labor of the owner-spouse during marriage—labor that is clearly community property.[129] It seems the only equitable solution to this dilemma is to do some sort of allocation between the community and separate estates. In other words, the solution is to abandon the all-or-nothing rule.

The other American Rule states have adopted one or both of two approaches to apportion between increases due to community labor and the separate property.[130] Both approaches originated in California.[131] First, with the *Pereira* approach,[132] the court allows a fair return on the capital investment of the separate property business and treats the balance as community earnings attributable to the spouse's efforts.[133] The other option is the *Van Camp* approach,[134] where the court determines the

123. Rowe v. Smith (*In re* Estate of Smith), 440 P.2d 179, 180-81 (Wash. 1968) (finding a sole proprietor's truck parts business to be community property).

124. *See, e.g., In re* Estate of Witte, 150 P.2d 595, 601 (Wash. 1944).

125. *See* Long, *supra* note 13, at 767.

126. *See, e.g., Estate of Witte*, 150 P.2d at 601.

127. *See, e.g., id.*

128. *Id.*

129. *Cf. In re* Estate of Herbert, 14 P.2d 6, 8 (Wash. 1932).

130. *See* Long, *supra* note 13, at 767.

131. *See* Millington v. Millington, 67 Cal. Rptr. 128, 135-36 (Cal. Ct. App. 1968) (explaining the approaches).

132. Pereira v. Pereira, 103 P. 488 (Cal. 1909) (applying the approach for the first time). In *Pereira,* the husband owned a successful cigar shop and saloon before marriage, which prospered further during the marriage largely as the result of the husband's personality and efforts. *Id.* at 490. The California Supreme Court held it was error to allocate the entire increase in value to the community, because the husband's separate estate was entitled at least "to the usual interest on a long investment well secured." *Id.* at 491.

133. *See In re* Marriage of Dekker, 21 Cal. Rptr. 2d 642, 648 (Cal. Ct. App. 1993).

134. Van Camp v. Van Camp, 199 P. 885 (Cal. Dist. Ct. App. 1921) (applying the approach for the first time). In *Van Camp,* the husband owned a large, successful, separate property seafood packing company from which he received an adequate salary. *Id.* at 886. The salary was sufficient such that another president of the company with similar skills could have been hired. *Id.* at 889.

reasonable value of the spouse's services in the business, allocates that as community property, and treats the remainder of the profits as separate property.[135] Courts apply whichever approach yields the most equitable result under the circumstances.[136] The ability to select between the *Pereira* and the *Van Camp* approaches gives the court valuable tools with which to make fair allocations between the community and separate estates in American Rule states.

The *Pereira* approach is usually applied when the increased value in the business is due primarily to the capital invested in the separate business itself.[137] Hence, under the *Pereira* approach, it is irrelevant whether or not a spouse is undercompensated.[138] The focus is on the reasonable rate of return for the increased value of the business.[139] In that sense, the *Pereira* rule bears a striking resemblance to the classic Civil Rule approach, where the entire increase in the value of the asset itself is deemed community property.[140] The primary difference is that the separate estate is allowed a reasonable rate of return in American Rule states that use *Pereira*.[141]

Among states that use *Pereira*, there is no agreement as to what constitutes a reasonable rate of return.[142] Some California decisions have used the legal rate of interest of seven percent.[143] Other courts have used the rate the community would pay to borrow that capital.[144] Some have used the "normal" growth rate for businesses of the type owned,[145] others employ a seemingly-arbitrary rate of return based on the presumed prevailing rate in a well-secured investment.[146] One commentator argues that the rate of return should probably contain both inflation adjustment and use of capital components, and possibly be compounded.[147]

Under the *Van Camp* approach,[148] the separate property business does not have to increase in value for part of the business to be allocated to the marital

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Under the *Van Camp* approach, the compensation that had been paid to the community is deducted from the reasonable value of services to determine the community's claim, if any. *See Marriage of Dekker*, 21 Cal. Rptr. 2d at 648.

135. *Marriage of Dekker*, 21 Cal. Rptr. 2d at 648.

136. *Id.*

137. *See* Long, *supra* note 13, at 760.

138. *See* Oldham, *supra* note 9, at 601.

139. *Cf.* Long, *supra* note 13, at 760.

140. *See id.* at 761.

141. *Cf. id.* at 760.

142. *Id.*

143. *See, e.g.*, Salton Bay Marina, Inc. v. Imperial Irrigation Dist., 218 Cal. Rptr. 839, 866 n.11 (Cal. Ct. App. 1985).

144. *See* Oldham, *supra* note 9, at 601.

145. *Id.*

146. *See* Gillespie v. Gillespie, 506 P.2d 775, 779 (N.M. 1973).

147. Oldham, *supra* note 9, at 603.

148. Van Camp v. Van Camp, 199 P. 885 (Cal. Dist. Ct. App. 1921).

community.[149] The focus under the *Van Camp* rule is the value of the services the community provides to the business.[150] After determining the value of the community services, the remainder is left as separate property.[151]

The *Van Camp* approach differs from Washington's "adequate compensation" rule in a significant way. Under *Van Camp,* the focus is not whether the community was adequately compensated, but what the fair value of the community services rendered by the community was.[152] While both rules look at the compensation of the owner-spouse, in *Van Camp,* the community only receives the amount that the owner-spouse *should have been paid.*[153] Under the classic American Rule, the entirety of the business is transformed to community property if a spouse has been undercompensated.[154] Moreover, the analysis shifts from looking at the adequacy of compensation that has been paid to the value of the labor that was rendered.[155]

All American Rule states except Washington use either the *Pereira* rule or the *Van Camp* rule, or both.[156] For instance, Arizona apportions profits from separately owned businesses where there has been a combination of separate property and community efforts.[157] Arizona's system can be described as follows:

> The rents and profits of separate property in Arizona will be in some measure allocated to the community estate. The increased value of a separately owned business will almost always be caused by both community labor and the natural increase of the separate property. The only conceivable way in which the owner of a separate business could avoid apportionment would be to fail to contribute any labor whatsoever to the business. Whether or not the owner spouse has received an adequate salary is not even an issue until after the court has decided that the increase should be apportioned and then only if the *Van Camp* approach

149. *See* Oldham, *supra* note 9, at 593.

150. *Id.*

151. *Id.*

152. *Id.*

153. *See* Long, *supra* note 13, at 760.

154. *See id.* at 758, 760, 766.

155. *See id.* at 760, 763, 766.

156. *See id.* at 767.

157. *See In re* Marriage of Cockrill, 601 P.2d 1334, 1336 (Ariz. 1979) (finding that separate property farm increased in value due to community labor). In *Cockrill,* the court created a presumption that any increase in value of separate property was due to the labor of a spouse, and therefore community property. *Id.* at 1336. The burden is on the spouse who claims the increase is separate property to prove that the increased value is due to the inherent value of the property itself and not the labor of a spouse. *Id.* The *Cockrill* court further held that the court could use any reasonable measure to apportion the increased value between the community and separate estates. *Id.* at 1338. Before Arizona adopted the apportionment rule in *Cockrill,* it used an all-or-nothing approach as to whether the increased value of a separate business was community or separate property. *See* Oldham, *supra* note 9, at 592.

is considered (which allocates the difference between what an adequate salary should have been and what was actually paid to the community).[158]

Similarly, Nevada apportions the increase in the value of separate property between the labor, skill, and industry of one or both spouses and the capital investment itself.[159] "Where both factors contribute to the increase in value of a business, that increase should be apportioned between separate and community property."[160] The Nevada court reached this conclusion by reasoning, "[t]he rule we announce today is necessary in order to prevent the inherent injustice of denying the owner of separate property a reasonable return on the investment merely because the increase in value results 'mainly' from the labor, skill, or industry of one or both spouses."[161] The *Johnson* court approved of both the *Pereira* and the *Van Camp* methods for apportioning increases in value, holding that the courts may apply whichever approach achieves "substantial justice between the parties."[162]

New Mexico likewise apportions between the community and separate estates. In *Gillespie v. Gillespie*,[163] the court applied the *Pereira* approach and concluded that an adequate return on investment for the husband's separate property partnership interest in a tile reselling company was the prime rate of interest plus two percent.[164] The increase in value beyond that rate of return was community property.[165] The New Mexico Supreme Court questioned its prior holding that the appropriate rate of interest to be applied should be the "usual interest on a long investment well secured," an equity investment in a business not being secured and having risk.[166] New Mexico's application of the *Pereira* rule does differ from the other states.[167] In New Mexico, the courts may not reach the apportionment question unless it is first determined that the business owner spouse was undercompensated.[168]

158. Long, *supra* note 13, at 762-63.

159. *See* Oldham, *supra* note 9, at 592 (explaining that like the other American Rule states, Nevada previously used the all-or-nothing rule that is still nominally the rule in Washington for businesses).

160. Johnson v. Johnson, 510 P.2d 625, 626 (Nev. 1973).

161. *Id.*

162. *Id.* at 626-27.

163. 506 P.2d 775 (N.M. 1973).

164. *See id.* at 778-79.

165. *Id.* at 781.

166. *Id.* at 779 (quoting Jones v. Jones, 356 P.2d 231, 234 (N.M. 1960)).

167. *See* Long, *supra* note 13, at 764.

168. *Id.*

B. *Approaches Used in Civil Law States*

The Civil Rule states sometimes use approaches that differ from either the *Pereira* or *Van Camp* methods or strict application of the Civil Rule.[169] Interestingly, in Louisiana, the community is entitled only to the enhanced value of a company when due to the undercompensation of a spouse for his or her labor.[170]

> A spouse should not be permitted to deprive the community of a spouse's earnings that would be community property when that community labor enhances or increases the value of the laboring spouse's separately owned property. If a claim exists because the laboring spouse was either uncompensated or undercompensated, the measure of reimbursement is one-half the increase attributable proportionately to the uncompensated labor of the spouse.[171]

Although Louisiana is a Civil Rule state by its Civil Code,[172] Louisiana's treatment of the increased value of a separate property business bears some similarity to the American Rule because it requires a showing of undercompensation before a community interest will be found in the increased value of the business.[173]

Idaho uses a similar variation with respect to retained earnings.[174] Idaho courts have viewed a corporation's retained earnings as community property.[175] Further, if the retained earnings of a partnership enhance the value of partnership assets that were subsequently transferred to a corporation, the community is also entitled to an interest in the stock of that corporation.[176] The burden is on the person who claims an asset to be community property to prove that the retained earnings enhanced the value of the business, which is essentially a separate property presumption.[177]

A more recent Idaho case states that one of the required inquiries when evaluating whether retained earnings are community property is whether the net earnings were retained for a reasonable business purpose or to defraud the

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169. *Id.* at 756.

170. *See id.* at 755.

171. Krielow v. Krielow, 635 So. 2d 180, 183 (La. 1994). This view appears to be an extension or refinement of the holding in *Abraham v. Abraham*, which held that if any substantial labor of either spouse contributes to the value of a separate business, the business will be considered to be community property. Abraham v. Abraham, 87 So. 2d 735, 738-39 (La. 1956).

172. *See* Long, *supra* note 13, at 755.

173. *See id.* at 756.

174. *See, e.g.*, Swope v. Swope, 739 P.2d 273, 282 (Idaho 1987). This case is sometimes referred to as *Swope I*. *See, e.g.*, Long, *supra* note 13.

175. *Swope*, 739 P.2d at 282.

176. *See* Long, *supra* note 13, at 746-47.

177. *See* Swope v. Swope, 834 P.2d 298, 298-99 (Idaho 1992). Accordingly, this case is referred to as *Swope II*. *See, e.g.*, Long, *supra* note 13.

community, and that the history of dividend distribution is relevant to that determination.[178] Hence, although Idaho is a Civil Rule state, it too does not strictly apply the Civil Rule when dealing with the increased value of a separate property business.[179]

VII. WASHINGTON'S HISTORIC APPLICATION OF THE AMERICAN RULE MAY NOT BE AS ABSOLUTE AS IS OFTEN ATTRIBUTED

Commentators tend to cite Washington as a state that has not wavered from the American Rule.[180] Although the American Rule is the law in Washington, its courts have in fact departed from the all-or-nothing rule when expedient to a desired outcome.[181] This *ad hoc* departure from the rule, coupled with the fact that all other American Rule states have adopted an allocation approach when squarely confronted with a case that presented good facts and that was well reasoned,[182] makes the outcome of a Washington case, particularly on appeal, less predictable.

Washington certainly purports to be a true American Rule state.[183] Hence, in *Walker v. Fowler*,[184] the status of property became fixed at the time of acquisition, with the portion of real property acquired with the wife's separate property retaining its separate character, and the portion acquired by community credit retaining its community character.[185]

Similarly, *Mumm v. Mumm*[186] strictly applied the American Rule.[187] One of the questions before the *Mumm* court was the characterization of a smoke shop in the Ballard neighborhood of Seattle.[188] In *Mumm,* the parties were married just less than five years.[189] The wife was employed the first three years of the marriage and received an inheritance which was deposited into the parties' joint bank account.[190] The husband had several businesses.[191] Three years into the marriage, they entered

178. Josephson v. Josephson, 772 P.2d 1236, 1242 (Idaho 1989).

179. *See, e.g., id.*

180. *See* Long, *supra* note 13, at 765-67.

181. *See id.*

182. *See id.* at 733-34.

183. *See, e.g., In re* Marriage of Lindemann, 960 P.2d 966, 973 n.29 (Wash. Ct. App. 1998) (quoting *In re* Marriage of Johnson, 625 P.2d 720, 721-22 n.1 (Wash. Ct. App. 1981)); *see also* Long, *supra* note 13, at 733-34.

184. 285 P. 649 (Wash. 1930).

185. *See id.* at 650.

186. 387 P.2d 547 (Wash. 1963).

187. *See id.* at 549.

188. *Id.*

189. *Id.* at 547.

190. *Id.*

191. *See Mumm,* 387 P.2d at 547.

into an agreement which provided "that as between themselves the property should be clearly separated and earmarked so as to eliminate community property claims...."[192] Under that agreement, all income, together with any assets acquired with that income, was the separate property of the spouse who earned it.[193] Additionally, the wife executed a quitclaim deed of her interest in the smoke shop in favor of the husband.[194] After the parties entered into the agreement, they continued to deposit all earnings and profits into joint accounts, to the point that the accounting expert of each party concluded that the funds in the accounts were commingled.[195] At trial, the wife testified she signed the quitclaim deed after the husband told her: "You'll either sign this quitclaim deed or I'll throw you and your belongings out on the street."[196] The trial court held that all the property of the parties was community property, including the smoke shop, notwithstanding the separate property agreement and quitclaim deed, reasoning that the separate property agreement had not been mutually observed by the parties and therefore had not changed the status of the community property.[197] While *Mumm* presented what may have been equities in favor of the trial court's conclusions, there was no indication that the trial court decided the case based on those equities.[198] *Mumm* was a case where the equities aligned with an application of the American Rule, which was then applied.[199]

When the equities cry for an allocation between the community and separate estates, Washington courts will sometimes make such an allocation.[200] In such a case, the court will try to ascertain whether the increased value of the business is the result of the labor of a spouse or the natural result of a separate property investment.[201] The relative contributing force to the profits is also taken into consideration.[202] In *In re Buchanan's Estate*,[203] the shares of a corporation were rendered community property through commingling during a ten-year marriage.[204] The *Buchanan* court reasoned:

> James Buchanan was at all times its active manager and one of its principal officers; and, while he received a salary, as appears from the books of the

192. *Id.* at 548.
193. *Id.*
194. *Id.* at 549.
195. *Id.*
196. *Mumm*, 387 P.2d at 549.
197. *Id.*
198. *Id.* The Supreme Court specifically noted that the trial court had not made a finding of fact that the wife had executed any of the documents she signed under duress. *Id.*
199. *See id.*
200. *See, e.g., In re* Buchanan's Estate, 154 P. 129, 132 (Wash. 1916).
201. *See id.*
202. *See id.*
203. *Id.*
204. *Id.*

> company, the growth of its business and the accumulation of its property were manifestly the result of his personal efforts apparently more than that of any one else, and in any event much more than the result of the small amount of capital invested at the beginning by himself and wife. He was manifestly more than a mere employé for wages or salary. His whole attitude and demeanor towards the business of the company points to his efforts in its management as being more for the purpose of making money as a part owner thereof than as being interested only in receiving wages or salary for his work as an employé.[205]

Another example of apportionment occurs in *Jacobs v. Hoitt*.[206] In *Jacobs*, the husband borrowed $5,300 from Jacobs prior to marriage.[207] Later that same year, he started a bakery business before marriage with loans from his mother.[208] He married a few months after opening the bakery, which became successful due to the labor and effort of both husband and wife.[209] The husband repaid his mother the following year, but did not repay the loan to Jacobs.[210] Jacobs took legal action against the husband and garnished the husband and wife's joint bank account, which contained profits from the bakery.[211] In reviewing whether the funds in the bank account were community property, and therefore not available for garnishment by a judgment creditor of the husband's separate estate, [212] the Washington Supreme Court noted that the profits in that account were not the product solely of the separate property bakery equipment, but also of community property labor:

> The complication arises in this case from the fact that the separate property did not produce in and of itself all of the profits which accrued to the business. These profits were increased by the labor and effort of the husband and wife, whose earnings after marriage of course constituted community property. *The difficulty here is to apportion those profits between the original separate property and the subsequent community earnings.*[213]

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205. *Id.* at 131. *But cf. In re* Estate of Dewey, 124 P.2d 805, 807-08 (Wash. 1942) (finding entry of a salary on the corporate books as sufficient to segregate between separate and community property).

206. 205 P. 414 (Wash. 1922).

207. *Id.* at 415.

208. *Id.*

209. *Id.*

210. *Id.*

211. *Jacobs*, 205 P. at 415.

212. At the time of the *Jacobs* decision, no portion of the community property could be chargeable for separate debts. That rule has now been modified. *Cf.* WASH. REV. CODE § 26.16.200 (2002).

213. *Jacobs*, 205 P. at 416 (emphasis added).

Having raised the question, the Washington Supreme Court departed from the American Rule to make an apportionment of the bakery between community and separate property.[214] The court initially noted that the funds in the bank account were commingled and therefore constituted community property.[215] The court then analyzed whether it could apportion the separate and community property parts of baking equipment, which cost $14,000—of which $8,000 had been invested prior to marriage and $6,000 after marriage.[216] The *Jacobs* court held that 8/14 of the equipment was separate property subject to execution to satisfy the judgment against the husband's separate estate.[217]

In *Frye v. Carmack* (*Estate of Carmack*),[218] the court noted that the community and separate property interests in real property could be segregated where the lot was the wife's separate property but the building on the lot was community property.[219] Of course, *Carmack* involved real property and not a business.[220] *Carmack* has been distinguished by several cases because the community and separate contributions to the real property could be easily distinguished.[221] Further, as the dissent in *Walker v. Fowler*[222] points out, the majority in that case reached the opposite result from *Carmack,* but without mentioning *Carmack.*[223] Nonetheless, it is not clear whether *Walker* overruled *Carmack sub silentio. Carmack* was cited as recently as 1993 by the Court of Appeals in *Marriage of Pearson-Maines,*[224] which further distinguished *Carmack* because "[t]he facts of *Carmack*, however, do not state with any specificity whether any effort was made to trace the separate proceeds through deposits and expenditures. The lack of factual analysis in *Carmack* precludes a conclusive analogy to the instant case."[225] It would appear that the court of appeals in *Pearson-Maines* believed that *Carmack* retained vitality or it would not have chosen to distinguish it.

In *Rowe v. Smith* (*In re Estate of Smith*),[226] the court held that a sole proprietorship truck parts business had become so commingled with the earnings of the husband during marriage, that the business was rendered community property.[227]

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214. *Id.*
215. *Id.*
216. *Id.*
217. *Id.*
218. 233 P. 942 (Wash. 1925).
219. *Id.* at 943.
220. *Id.*
221. *E.g.,* Finch v. Wiren (*In re* Estate of Finch), 89 P.2d 218, 221 (Wash. 1939); *In re* Estate of Gulstine, 6 P.2d 628, 631 (Wash. 1932).
222. 285 P. 649, 651 (Wash. 1930) (Beals, J., dissenting).
223. *See id.*
224. 855 P.2d 1210 (Wash. Ct. App. 1993).
225. *Id.* at 1215.
226. 440 P.2d 179 (Wash. 1968).
227. *Id.* at 181-82.

As part of its decision, the *Smith* court emphasized that the business was unincorporated.[228]

Another fissure in Washington's strict adherence to the American Rule appears in *Marriage of Brooks*.[229] In *Brooks*, the husband became a partner in his law firm almost two years before marriage.[230] He left that firm a few years later and reinvested his capital into another law firm.[231] The second firm incorporated and the bylaws excluded any value for goodwill as between partners.[232] The husband and wife then dissolved their marriage after fourteen years.[233] The trial court held that the husband's shares in the law firm were his separate property, but that his share of the goodwill in his firm was entirely community property.[234] After deciding that the trial court did not err in holding that the bylaws did not bind the wife,[235] the court of appeals affirmed the trial court.[236] The appellate court reasoned that the husband's shares were separate property because the interest in his prior law practice was acquired before marriage and the husband's salary fully compensated him.[237] The court also held that the husband's goodwill was community property, reasoning that his goodwill was *de minimis* at the time of the marriage.[238] Because the goodwill of a business, including a professional practice, is so closely linked to the business as a whole,[239] the *Brooks* holding is difficult to square as being anything other than an apportionment of a separate property business between community and separate estates. However, *Brooks* may be distinguished on grounds that it involved "professional goodwill," which the Washington courts distinguish from ordinary business goodwill.[240]

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228. *Id.* at 180-81. Although a distinction between an incorporated and an unincorporated business may be convenient, this would appear to be an artificial distinction. There are many corporations that have a single shareholder who may even be the sole employee of the corporation. If the corporation has made a Subchapter-S election, the corporation pays no income tax, instead passing its income through to its shareholder's individual income tax return. *See generally* Thomas v. Thomas, 738 S.W.2d 342 (Tex. App. 1987). It seems the value of a corporation could be equally enhanced by the labor of a shareholder as a sole proprietorship by the labor of its proprietor or a partnership by a partner.

229. 756 P.2d 161 (Wash. Ct. App. 1988).

230. *Id.* at 162.

231. *Id.*

232. *Id.*

233. *Id.*

234. *Marriage of Brooks*, 756 P.2d at 162.

235. *See id.* at 163.

236. *Id.* at 167.

237. *Id.* at 165.

238. *Id.*

239. *See In re* Marriage of Hall, 692 P.2d 175, 178 (Wash. 1984).

240. *See id.* at 178. The Washington Supreme Court's distinction between professional goodwill and ordinary business goodwill appears to have been created to ensure an equitable valuation of professional practices in situations where the practices cannot be sold, and hence might

More recently, the Washington Supreme Court approved of an allocation between separate and community property in *Marriage of Elam*.[241] *Elam* held that an increase in the value of separate property attributable to community labor by the husband is presumptively community property absent contemporaneous segregation.[242] Significantly, the community is entitled to a share of the inflationary increase in the value of separate property proportionate to the community contributions.[243]

Elam concerned the characterization of property interests in the wife's house.[244] However, the legal principle in *Elam* should apply with equal force to any separate property asset improved with community effort. It seems as though no meaningful distinction can be drawn between community improvements of separate real property and community efforts invested in any other separate asset (including a separate business), provided there is a reasonable basis for an allocation.

The *Elam* court calculated the community's interest in separate property.[245] The testimony was that the value of the house was $15,000 at the time of the marriage.[246] Subsequently, $5,500 of community contributions were made, for a total value of $20,500.[247] The court noted that of the $5,500, only 50% of that amount, or $2,750, could be considered the husband's share.[248] The court then used the fraction of $2,750/$20,500, which equals 13.4%, and applied that percentage to the increase in value at the time of dissolution.[249] The court held the husband's share was 13.4% of the increase in value plus $2,750.[250] Apparently, the court did not view the asset so hopelessly commingled that it could not apportion between the community and separate estates. It used an allocation formula that was a variation of the *Van Camp* approach.[251] Under *Elam,* there is clear Washington authority to allocate the increase

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not have marketable goodwill. *See id.* In reality, and particularly when considering the valuation methods approved in *Hall*, *see id.* at 179-80, there seems to be little, if any, difference between professional goodwill and the goodwill of any other business.

241. 650 P.2d 213, 216 (Wash. 1982).

242. *Id.*

243. *Id.*

244. *Id.* at 214.

245. *See id.* at 216.

246. *Marriage of Elam,* 650 P.2d at 216.

247. *Id.* The *Elam* court assumed there was no inflation or deflation in the value of the house and that there was a direct correspondence between the value of the labor and its effect on the market value of the house. *See id.*

248. *Id.*

249. *Id.*

250. *Id.*

251. *Compare Marriage of Elam,* 650 P.2d at 216, *with* Van Camp v. Van Camp, 199 P. 885, 888 (Cal. Dist. Ct. App. 1921).

in value of separate property due to community labor from the increase attributable to ordinary inflation.[252]

Elam can be viewed as an evolution of the viewpoint that an asset acquired with commingled funds will be community and separate property, and perhaps even corporate property, in the same proportion as the source of the funds used to acquire the asset. This approach would be consistent with the authority concerning purchases in land.[253] For instance, in *Heintz v. Brown*,[254] the court allocated between the community and separate interests based on the source of the funds with which the assets were acquired.[255] In *Heintz*, real property was acquired from the wife's separate funds and through loans.[256] The court characterized a portion of the property to be separate property, based on the proportion the separate property contribution bore to the whole of the purchase price.[257] The balance was deemed community property.[258] The significance of *Elam*, however, is that it placed a value on community labor, and not the funds used to acquire property, and then made an allocation between community and separate property based on the value of the labor.[259]

More recently, in *Koher v. Morgan*,[260] a meretricious relationship case, the business owner took an unreasonably low salary.[261] The business then acquired assets.[262] The *Koher* court held that "the community property-like status of the couple's investments became fixed when Koher acquired the assets with funds that included his actual earnings, his business profits, and earnings he had foregone."[263] Consequently, the *Koher* court found that all property acquired by the business after the assets became commingled due to undercompensation were community-like property, with the assets acquired prior to the relationship retaining its separate-like character.[264] It appears that the *Koher* decision walks a tightrope between the traditional all-or-nothing American Rule and an allocation under either the *Pereira* or

252. *Marriage of Elam*, 650 P.2d at 216.

253. *See* Heintz v. Brown, 90 P. 211, 212 (Wash. 1907).

254. *Id.* at 211.

255. *Id.* at 212.

256. *Id.* at 211.

257. *Id.* at 212.

258. *Heintz*, 90 P. at 212.

259. *In re* Marriage of Elam, 650 P.2d 213, 216 (Wash. 1982).

260. 968 P.2d 920 (Wash. Ct. App. 1998).

261. *Id.* at 921-22.

262. *Id.* at 922. There were actually two businesses that the owner ran as one business. Findings of Fact and Conclusions of Law, Morgan v. Koher, (San Juan County Super. Ct. Aug. 4, 1997) (No. 95-2-05210-1), at 2. According to the Findings of Fact and Conclusions of Law in the superior court file, one of the businesses was a corporation and the other a sole proprietorship. *Id.*

263. *Koher*, 98 P.2d at 922.

264. *Id.*

the *Van Camp* approach. In doing so, *Koher* adopted a third method of allocating part of a separate property business between the community and separate estates.[265]

Koher stands alone in its proposition. It can be reconciled with prior case law as maintaining the separate character of what is clearly separate, and merely treating as community property that which is commingled.[266] In a sense, it is a refinement of the "all-or-nothing" rule. Unlike *Elam*, which used a form of the *Van Camp* approach, the approach taken in *Koher* does not bear a resemblance to the approaches taken in other jurisdictions.[267]

Additionally, although the language of the *Koher* appellate opinion is broad, the findings and conclusions of the trial court show that the owner ran his sole proprietorship and his corporation as essentially one company.[268] Accordingly, it could be argued that the *Koher* facts effectively involved commingling in the husband's own accounts as a sole proprietor, instead of in the accounts of a separate entity. The counterargument is that the court of appeals decided *Koher* based on an undercompensation analysis. An undercompensation analysis is ordinarily applicable to the corporate/separate entity situation, rather than the sole proprietor situation.[269] A sole proprietor's income is the profit, and the sole proprietor receives money through draws; a sole proprietor is ordinarily not paid a salary.[270] Regardless, *Koher* remains as a significant recent case where the court, faced with an inequitable result when strictly applying the all-or-nothing rule, forged a different result.[271]

The precursor to the principle set forth in *Koher* can be found in the following dictum:

> A persuasive argument can be made that, where a husband owning a *large corporation* pays to the community a salary which is grossly unfair, such salary should be disregarded with the result that profits accruing partly from community labors and partly from natural increase of the separate property will be held to be commingled and community property.[272]

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265. *Id.* Interestingly, the *Koher* trial court applied a *Pereira* method in its written ruling, holding that Mr. Koher was entitled to a reasonable return on his original investment. Court's Mem. Opinion, Morgan v. Koher, (San Juan County Super. Ct. June 20, 1997) (No. 95-2-05210-1), at 108. The court of appeals decision does not discuss this reasoning by the trial court. *See Koher*, 968 P.2d at 922.

266. *See Koher*, 968 P.2d at 922-23.

267. *Compare id.* at 923, *with In re* Marriage of Elam, 650 P.2d 213, 216 (Wash. 1982).

268. *Cf.* Findings of Fact and Conclusions of Law, Morgan v. Koher, (San Juan County Super. Ct. Aug. 4, 1997) (No. 95-2-05210-1), at 2.

269. *E.g.*, Hamlin v. Merlino, 272 P.2d 125, 129 (Wash. 1954).

270. *See, e.g., Koher*, 968 P.2d at 921.

271. *Id.* at 922.

272. *Hamlin*, 272 P.2d at 129 (emphasis in original.) *Hamlin* held that where the value of a separate corporation increases, the entire increase is separate property so long as the owner-spouse is

As can be seen from this discussion, Washington's adherence to its orthodox principles of the American Rule has been less than faithful. However, the apparent result of Washington's failure to adopt either the *Pereira* or the *Van Camp* approaches, or another equitable method for apportioning community and separate property interests in separate businesses, or even to develop a framework for analyzing these problems, is that the owners and spouses of Washington separate property business have no predictable relief mechanism for dealing with cases that present special equities. As a consequence, the parties and trial courts are left with *ad hoc* and inconsistent decision-making abilities in this area.

In contrast, all other American Rule states that have adopted either or both of the *Pereira* and *Van Camp* approaches have provided courts with guidance for resolving these knotty issues that arise with some regularity in community property states. Thus, if Washington had adopted *Pereira*, the courts would not have to engage in the tortured mathematics of *Elam* or *Jacobs*. Similarly, if Washington adopted the *Van Camp* approach, the *Brooks* court would not have needed to reach the bizarre conclusion that shares of the business were separate property but its goodwill was community property.

VIII. CONCLUSION

The *Smith, Jacobs, Koher, Brooks, Carmack,* and *Elam* cases are all examples where Washington courts bent the American Rule and ordered an allocation between estates. These cases reflect *ad hoc* solutions to problems that arise if the American Rule is strictly applied. Due to the *ad hoc* approach of the Washington courts, Washington's law in this area is confusing. Unfortunately, Washington has neither developed a cohesive body of law nor much incisive reasoning in its case law to provide reliable guidance on how to deal with these cases. The resulting unpredictability of outcomes in future cases is a form of injustice. Washington courts should clarify the law of this area and adopt the more flexible rules of our sister states.

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adequately compensated. *Id.* at 129-30.