Apportioning Business Profits
Generated by Spousal Labor and
Capital Owned Over Time by Shifting
Fractional Shares of the Separate and
Community/Marital Estates

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I. Introduction

This article addresses the proper classification of rents and profits
generated by applying during marriage spousal labor to capital that is
partly separate property of one spouse but also partly community or
marital property (or even partly separate property of the other spouse).
The article examines difficulties that arise when the fractional shares
of capital ownership fluctuate over the years. The focus is on problems
concerning apportionment of gains that arise in a state that adheres to
three majority positions on major issues of marital property law, in
both equitable distribution and community property states. The three
majority positions are:

1. The "source of funds" rule, under which one marital estate can
   "buy in" to a fractional share of title previously held solely by
   the other marital estate.¹ For example, husband brings to the
   marriage a sole proprietorship he is purchasing on an installment
   contract, and he pays off the debt with funds of the marital or

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community estate. It acquires an ownership interest in the business, not just a right of reimbursement.

2. The rule which classifies rents and profits generated from separate capital without application of any significant spousal labor as wholly separate property, rather than marital or community. If the capital is co-owned in fractional shares by the separate and marital/community estates, rents and profits are co-owned in the same proportion.

3. The rule that requires apportionment of rents and profits, arising when spousal labor has made separate capital productive, into separate and marital/community portions, as opposed to classifying these gains as 100 percent separate or community/marital (the "all or nothing approach to classification"). Apportionments usually are made by employing one of the formulae developed in community property states and known for the leading cases of Pereira v. Pereira and Van Camp v. Van Camp. The former selects a rate of return for capital to calculate the separate share, and the rest of the profits are marital or community. Van Camp

2. Although a substantial majority of buy-in cases have involved residences, not businesses, no state that recognizes buy-in doctrine when residences are at issue has held this rule cannot apply to businesses. In California, the buy-in theory is regularly applied to businesses, even when no real estate is involved. See Marriage of Frick, 226 Cal. Rptr. 766 (Cal. Ct. App. 1986) (restaurant corporation that owned no realty); In re Ball's Estate, 206 P.2d 1111 (Cal. Ct. App. 1949) (stock-bond portfolio).


4. In states that treat earnings of a separated spouse as separate property, the converse apportionment problem frequently arises during the period between separation and divorce: a spouse continues to work at, and continues applying "separate" labor to, a business consisting of marital or community capital assets. E.g., Marriage of Imperato, 119 Cal. Rptr. 590 (Cal. Ct. App. 1975).


6. See Jan Mark Adler, Arizona's All-or-Nothing Approach to the Classification of Gain from Separate Property: High Time for a Change, 20 Ariz. L. Rev. 597 (1978); Goderwis v. Goderwis, 780 S.W.2d 39 (Ky. 1989) (applying all-or-nothing approach where labor was chief contributing factor; no return on capital awarded).

7. 103 P. 488 (Cal. 1909).

8. 199 P. 885 (Cal. Ct. App. 1921). The Pereira and Van Camp formulae for apportionment are used, albeit seldom with cites to these California authorities, in equitable distribution states. See Oldham, supra note 3, ¶ 10.02, at 10-20; Turner, supra note 1, ¶ 5.22, at 246 (stating that Van Camp is employed in the great majority of apportionment cases from equitable distribution states, suggesting some courts may be unaware of the Pereira alternative).
fixes a fair salary for the labor provided by the marital or community estate and classifies the rest of the profits as separate. If a court determines labor is the chief contributing factor in producing the gain, it uses the formula most favorable to the marital/community estate: Pereira in a "big gain" situation, Van Camp if the gain is relatively small. If capital is the chief contributing factor, Van Camp will favor the separate estate in a big gain situation; Pereira when the gain is small.

The need to determine the fractional ownership interests in the capital of a business and in any accumulation of rents and profits from that business arises in three situations: (1) at divorce; (2) at the death of a spouse when a party other than the surviving spouse has a claim to the assets; and (3) upon the appearance, during marriage, of a creditor of one spouse who seeks to levy on such assets. In both (2) and (3), in noncommunity property states, the apportionment can be only into two types of property: the husband's separate property and the wife's separate property, because the concept of marital property is applied only at divorce. At divorce and in situations (2) and (3) in community

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It has recently been asserted that use of Pereira in a "big gain" situation is inconsistent with the majority rule that rents and profits of separate property are also separate. Nathan R. Long, Comment, Characterization of the Increased Value of Separately Owned Businesses, 32 Idaho L. Rev. 731 (1996). The writer fails to deal with the presumption that earnings during marriage are community/marital property. If a court must allocate $1 million worth of gain and determines $400,000 is a fair return for spousal labor and $400,000 is a fair return on capital, why should not the presumption favoring the community/marital property estate attach to the additional $200,000? Pereira effectively does so. It is use of Van Camp (which the Idaho writer says should be the only formula) in this situation that is problematic.

10. See Adler, supra note 6. For a "compromise" formula that combines Pereira and Van Camp, see Todd v. Commissioner, 153 F.2d 553 (9th Cir. 1945); Todd v. McColgan, 201 P.2d 414 (Cal. Ct. App. 1949); W. Brockelbank, The Community Property Law of Idaho 174-65 (1962) (algebraically stating this formula).

11. See Turner, supra note 1, § 5.09, at 147. Sometimes during marriage in community property states the classification must be made to determine if one spouse can convey or can encumber the assets without consent of the other or when tax liability of the spouses must be decided. See Reppy & Samuel, supra note 3.

12. Example: The wife inherits a farm during marriage and the husband alone manages it. The wife dies with a will leaving all her estate to sister, who urges that some of the farming profits on hand at the wife's death are a return on her separate capital and not just the fruit of the husband's labor producing (in the context of dissolution by death in an equitable distribution state) the husband's separate property. Sister's claim could also be asserted during marriage by a creditor of the wife who could reach the wife's separate property but not the husband's separate property.
property states, the apportionment can be into three types of shares: the husband’s separate property, the wife’s separate property, and community/marital property.

In equitable distribution states a marital property share of gains is necessarily calculated retroactively. That is, it cannot exist during the marriage, but is instead determined by applying an appropriate apportionment formula to assets on hand at divorce that can be traced to a business involving spousal labor applied to separate property capital.

If, as urged by this article, a state making an apportionment at divorce retroactively determines that a year-by-year accounting is required to take into account the changing nature of the capital of the business (e.g., the marital property share is increasing as marital property funds are used to reduce the purchase-money principal debt), Pereira can apply for certain years and Van Camp for others in classifying funds on hand. This is not inconsistent with the nonexistence of a marital property interest during the marriage but rather is an approach to make the retroactive apportionment as accurate as possible.

In community property states, on the other hand, because community interests do exist during the marriage, courts must classify earnings from the type of business we are considering in actions arising when the marriage is intact. I am aware of only one reported case on point, Tassi v. Tassi, from California. In that case, the husband brought to the marriage a separately owned wholesale meat business. During the marriage he made several gifts to his brother of cash, stocks, and bonds traceable to earnings from the business. After he died, the wife sued the donee for return of half the gifts on the ground they were community property and she had not consented, as required by California law. Applying Van Camp, the trial court found 73 percent of earnings from the business was husband’s separate property and 27 percent was community property. Thus, the wife recovered 13.5 percent of the gifts. The California Court of Appeals rejected wife’s claim that the community share should have been higher.

Neither the wife nor husband’s donee appealed from the trial court’s making an apportionment under Van Camp on the theory that Pereira-Van Camp allocations are made only at divorce and at death and not to answer problems arising during the marriage. Had such an argument been made, the appellate court might have had to decide whether an all-or-nothing rule is to be used instead of Pereira-Van Camp when an issue arises during marriage. I can see no reason why the court

would have adopted the all-or-nothing theory, which has no support in California. Moreover, if it did, on what basis would the earnings be 100 percent separate, as opposed to 100 percent community? Perhaps the court would ask whether labor or capital was the chief contributing factor. This is the first step in apportioning under Pereira-Van Camp and if the court, as in Tassi, finds it is capital, why would it not then apply Van Camp rather than classify all the earnings at issue as separate property? Or perhaps the presumption of community ownership of assets acquired during marriage—which applied to the items given away by husband—would have controlled.

In my opinion, the trial court was correct in Tassi, and one should expect all community property states that employ Pereira-Van Camp at divorce and death to follow Tassi and make an apportionment when the issue is management power during marriage, as in Tassi, or creditors' rights during the marriage.\(^{15}\)

In Tassi, it seems apparent that husband's meat business was unincorporated. Suppose instead, a wife brought to marriage an incorporated business worth $50,000 at the time. After ten years it was worth $1 million. If Pereira were to be applied, because her labor was the chief contributing factor causing substantial gain, the wife's separate property share would be $100,000 and the community share would be $900,000. Not in contemplation of divorce but because her brother lost all his assets in an earthquake, wife seeks to give all the stock to her brother. Can she do so without husband's consent in California?

Tassi could be distinguished on the ground that the court dealt with money and investments acquired during marriage that were presumptively community, while the shares of stock wife proposes to give away are assets owned by her before marriage. I am confident that California courts would not hold that the fact her business was incorporated enables her to defeat an interest of her spouse worth $450,000 (half the community claim under Pereira), and that Tassi would be followed in this situation. Form would not prevail over substance.

II. Factors Requiring Year-by-Year Apportionment

The presence of one of several possible factors make a total recapitulation apportionment inaccurate and should cause courts to make a year-by-year apportionment. In all reported cases involving apportionment of gains, with two exceptions, either a party has proven or the

\(^{15}\) That is, if Tassi arose today with the wife's judgment creditor levying execution on earnings from the meat business the husband had not given away to his brother, the creditor would be able to keep 27% of the funds levied on.
court has assumed that the ownership of the capital has been constant during the period when the profits to be apportioned arose. Usually the apportionment has been made with the court viewing the capital as being at all relevant times 100 percent the husband's separate property or the wife's separate property.

The best-known exception is Cord v. Neuhoff,16 where the Nevada Supreme Court took account of the ownership of a business' capital assets changing during one year following the marriage from 100 percent husband's separate property to partly community property. Cord held that once the capital was not 100 percent husband's separate property, but was partly community property in a fractional share that could grow or shrink over time, a year-by-year apportionment of gains had to be made. In the second exception case, from California,17 the court held that once the community estate acquired an interest in rental properties by taking over purchase-money mortgage payments, rentals were no longer all separate property but had to be properly prorated.

With no exceptions, the reported cases involving apportionment of gains look at the whole period of time—rather than assessing each year separately—to decide in the Pereira-Van Camp context: (1) whether the case is one of a big or little gain, and (2) whether labor or capital was the chief contributing factor to that gain. Then, if Pereira is chosen as the apportionment formula, one interest rate for return of capital is applied over the entire period of time to calculate a fair return on capital. If Van Camp is used, one sum is fixed as the fair total remuneration for spousal labor over the full period chosen for apportioning gains. Some cases hint that this is one unchanging annual salary. What all of the reported cases except Cord have failed to realize is that there are several potentially complicating factors that suggest a total recapitulation approach to apportionment will provide an inaccurate result which can be avoided by making a year-by-year accounting.

First, as in Cord itself, the ownership of capital may shift during one year from 100 percent separate property to a mix of separate property and community/marital property. In Cord, this occurred due to retention of some community earnings from labor in the business, which the court viewed as becoming part of the capital account. More commonly the ownership of the capital changes due to a shift to use of community/marital funds to reduce the purchase-money debt owed on business assets after initial payments were made with the separate property of a spouse. Another recognized mode of a buy-in is use of commu-

community/marital funds to erect improvements on realty theretofore owned 100 percent separately. A liquidating distribution earmarked as separate property would alter the separate property and community/marital shares of capital as well, if the community or marital estate had an interest in the business.

Goodwill is recognized at divorce by almost all states as property to be classified as separate property or community/marital property. It should follow that it is also property during the marriage and properly treated as part of the capital of the business. Goodwill is usually increasing over time, adding to the change of ownership of the capital assets. When a spouse, say wife, begins a professional service business, operates it for some years, and then marries, she brings to the marriage goodwill that is 100 percent wife’s separate property. During marriage it changes into community/marital property as her customers/clients rely more and more on her post-marriage services to them as a reason for returning to the business or professional office.

The second complicating factor involves the shifting of the prevailing interest rate. Although capital was at all times 100 percent separate property, evidence proves that the appropriate interest rate for applying Pereira—at all times the appropriate formula to apportion gains—was not constant during the marriage. For instance, the rate was especially high or low in one year when the gain was very large compared to other years.

18. See, e.g., Zimin v. Zimin, 837 P.2d 118 (Alaska 1992); Marriage of Sparks, 158 Cal. Rptr. 638 (Cal. Ct. App. 1979); Brandenburg v. Brandenburg, 617 S.W.2d 871 (Ky. 1981); Hall v. Hall, 462 A.2d 1179 (Me. 1983); Harper v. Harper, 448 A.2d 916 (Md. 1982). Turner, supra note 1, § 5.22, at 254. Recognition of a buy-in to a share of title through paying for improvements seems to have become the majority rule. Under most older cases, the remedy in this situation of one estate’s paying to improve property not solely owned by that estate was a right of reimbursement for the marital estate paying for the improvements, with no change in ownership of the land occurring. See William Q. DeFuniak & Michael J. Vaughn, Principles of Community Property § 73 (2d ed. 1971).


20. In a New Mexico case, the husband brought to the marriage in 1952 a tile business which had increased in value ninefold by divorce in 1971. Gillespie v. Gillespie, 506 P.2d 775 (N.M. 1973). The New Mexico Supreme Court affirmed use of a Pereira return on separate capital at the "prime rate prevailing during the marriage plus two percentage points." A 6.84% average prime plus two was applied over the nineteen years to make a total recapitulation. The husband had used community funds during marriage to pay off the remaining purchase money debt for the business, but New Mexico did not employ the majority buy-in remedy for this type of situation but instead gave the community reimbursement. Had the majority rule been used, a year-by-year apportionment would have been required, and the court would have used the actual prime-plus-two for each year of the calculation.
Third, capital ownership and Van Camp, as the proper formula, are constants, but the fair salary to be attributed to spousal labor fluctuates. For example, in a year of especially large gains the manager spouse was away from the business for many months.

Fourth, the proper apportionment formula changes from Pereira to Van Camp or vice versa as the business is operated during marriage. This shift in the applicable formula can arise out of change in conduct by the laboring spouse. For example, Wife, whose astute management has caused a rapid development of the business over several years, later goes into semi-retirement, but large gains continue to be reaped.\textsuperscript{21} The need to shift from Pereira to Van Camp or vice versa can also arise from a change in market conditions. Thus, even though spousal labor is continuously the chief contributing factor in the generation of business profits, product demand may vary greatly from year to year. In years of relatively "big" gain, community/marital labor is best rewarded by applying Pereira. In years of modest gain, Van Camp should be applied when labor is the chief contributing factor.\textsuperscript{22}

Fifth, the couple move themselves and the business operated by one or both of them from a community property state that uses "standard" Pereira-Van Camp to another state which has a different approach to apportionment of gains. The move could be from California, the creator of Pereira and Van Camp, to Texas. In Texas, all rents and profits from separate property are supposed to be community property,\textsuperscript{23} but this rule—having both statutory and constitutional foundation—is ignored by the courts when the separate property business is incorporated and gains arising in part from spousal labor during marriage are not distributed as dividends. In this situation, Texas acts like California in viewing the return on separate capital as also separate, but it always applies Van Camp to grant reimbursement to the community at the end of the marriage.\textsuperscript{24} Thus, if California would be using Pereira before

\textsuperscript{21} See Halderman v. Halderman, 21 Cal. Rptr. 75 (Cal. Ct. App. 1962) (the husband during the first 18 years of marriage was the driving force in building up his sole proprietorship pharmacy but then let his employees run day-to-day operations for two years). A case where the facts indicated a Van Camp to Pereira shift after about two years of the husband's laboring at a plumbing business is Stice v. Stice, 185 P.2d 402 (Cal. Ct. App. 1947). In Stice, the husband's father gave the husband, who had no experience in the type of business, a one-quarter partnership interest, which later increased to one-third. Soon, however, the husband became very skilled, so that his labor was the chief contributing factor in the growth of his partnership interest.

\textsuperscript{22} See generally supra note 10.

\textsuperscript{23} Tex. Fam. Code § 5.01(b) (West 1997); Arnold v. Leonard, 273 S.W. 799 (Tex. 1925).

\textsuperscript{24} Jensen v. Jensen, 665 S.W.2d 107 (Tex. 1984). Jensen applies an extreme version of Van Camp, as community dividends paid out, which can be all or largely a return on capital, were treated as part of the salary paid for community labor in deciding if an additional salary should be paid so that labor was fairly compensated.
the change of domicile, the Texas court in litigation years later must shift from a *Pereira* to a *Van Camp* approach in the year of change of domicile.

Sixth, after the capital has become a mix of separate property and community/marital property, the spouses separate. They live in a state where spouses cease accumulating community/marital property by labor after such a separation. Husband or wife continues working as before at the business, but now the labor contribution produces separate profits, and different versions of *Pereira* and *Van Camp* will be applicable.

I think it likely that one of these six factors will be present in a substantial majority of cases in which a court seeks to apportion gains into separate property and community/marital shares. In other words, total recapitulation accounting over the entire period of gain will be the exception. The "rule" will be an accounting on a year-by-year basis as in Nevada's *Cord* case, or at least an approach that breaks the accounting period into multi-year blocks, with a distinct apportionment approach for each. For example, if the only factor making total recapitulation improper is a shift after ten years of marriage from labor as the chief contributing factor to capital, there will be two blocks of time requiring separate calculations to apportion gains.

III. Problems in Calculating the Amount of "Buying-In" to a Share of Ownership of Capital

A. Events That Can Cause a "Buy-In" to Capital Ownership

In states that have adopted the source of funds rule for handling problems arising out of acquisition of capital by a mix of separate assets

25. At least this shift is required to decide cases that can arise during marriage involving management power, as in *Tassi*. See *supra* notes 14-16 and accompanying text. Under *Tassi*, during the California domicile, the community estate acquires a vested proprietary interest which the new domicile will take into account in dividing the property at divorce.

26. Change of domicile can introduce a wide array of complicating factors. For example, the move from California could be to an all-or-nothing state. Or it could be to an English common law state with the issue of apportionment of gains arising at termination of the marriage not by divorce but by death of a spouse. If both spouses worked at the business but not in such fashion that a 50-50 partnership could be implied, a return of the wife's separate property for her labor would have to be calculated plus a return for the husband's separate property. If *Pereira* were the appropriate formula (to reward labor in a "big gain" situation), a court would apparently have to calculate labor's share and then divide it pro rata, weighing the wife's contribution compared to the husband's on a percentage scale (e.g., the wife's labor was 60% of total labor, the husband's was 40%).

27. This is "reverse" *Pereira-Van Camp*, described *supra* at note 5.

and community/marital assets, the buy-in altering ownership of the capital can occur in at least six ways, with few states, if any, recognizing all six:

1. Capital contributions are made from one marital estate to a sole proprietorship or business operated by a partnership that was previously owned by a different marital estate, or co-owned by various marital estates. The contributions may be placed in a capital account or at once spent for business purposes, including the purchase of income-producing assets or to upgrade existing assets. This kind of capital contribution can also occur when a corporation owned by one marital estate issues stock upon payment made by a different marital estate.

2. Payments are made to reduce the purchase-money debt incurred to buy the business or incurred as part of an investment to expand the capital assets of the business or acquire newly issued corporate stock.\(^29\) The majority of these types of cases involves reduction of the purchase-money debt. Typically, this obligation was incurred by a party, say husband, before marriage. After marriage he uses community/marital funds to pay it off. The overwhelming majority of such decisions holds


There is a smattering of authority to the effect that there can be a buy-in only when the purchase-money debt is secured by mortgage or other security device encumbering the business assets being acquired. Thus, in a North Carolina case, the husband acquired corporate stock in the business where he worked with the marital property proceeds of an unsecured loan, which he repaid largely with his separate funds. King v. King, 434 S.E.2d 669 (N.C. Ct. App. 1993). The court refused to recognize that these payments obtained for the husband a separate property interest in the stock. Presumably the result would have been the same if the husband had provided nonbusiness property as security for the loan.

To deny a buy-in on such a technicality is to honor form over substance and let a mere fortuity control ownership rights. For example, the security for repayment of a loan taken out to obtain funds for new equipment at a manufacturing plant operated by the husband might be a mortgage on a cattle ranch the wife recently inherited, because the lender would agree to a lower interest rate if the unencumbered ranch, worth four times the face of the loan, were security rather than the business assets, already encumbered by first and second mortgages. In the case of the unsecured loan, the lender probably would, if the note fell into default, levy execution after judgment on the nonexempt portion of the business into which the loaned funds flowed. The only sensible rule is that payments on a purchase-money debt buy-in to title without regard to whether the loan is secured and the nature of any security provided. See William A. Reppy, Jr., Acquisitions with a Mix of Community and Separate Funds: Displacing California's Presumption of Gift by Recognizing Shared Ownership or a Right of Reimbursement, 31 Idaho L. Rev. 965, 1007 (1995); Estate of Ball, 206 P.2d 1111 (Cal. Ct. App. 1949) (purchase of stock portfolio with proceeds of unsecured loan); Schweizer v. Schweizer, 484 A.2d 267 (Md. 1984).
that the interest components of loan repayments do not buy-in to title, limiting the buy-in to the amount of principal reduction.\textsuperscript{30} Where, as is usually the case, loan payments are amortized, the earliest periodic payments are very largely comprised of interest and the buy-in is small. The final payments are almost all principal reduction with a very large buy-in component. Case law is sparse and inconsistent on the treatment of a refinancing loan taken out to capture a lower interest rate, but they always involve some sort of buy-in.\textsuperscript{31}

3. Business earnings that are in whole or in part community/marital property are not paid out as salary or dividends but retained in a capital account of the business, the capital of which had been exclusively the husband’s separate property or the wife’s separate property.\textsuperscript{32} This was the fact pattern in the Cord case from Nevada.\textsuperscript{33}

4. Funds from one marital estate are used to improve real property not owned solely by that estate. For example, community/marital funds might be employed to build a new commercial structure on land owned separately by husband or wife or by a busines entity of which one of them has a controlling ownership interest. This usually results in a proportional share buy-in\textsuperscript{34} and not ownership of the improvement itself as a distinct item of property.

5. Labor of a spouse is applied, not in day-to-day operations that generate profits, but to increase the value of the capital.\textsuperscript{35} For example,

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33. See supra note 17.


35. Turner, supra note 1, § 5.10, at 169 (citing Thomas v. Thomas, 377 S.E.2d 666 (Ga. 1989). See also Rosenfeld v. Rosenfeld, 597 So. 2d 835 (Fla. Dist. Ct. App. 1992) (remanded for determination whether spousal efforts enhanced value of the husband’s separate partnership). If the community/marital estate buys into a share of ownership of capital based on such a contribution of labor, it must not be double-counted. Thus, in applying the chief contributing factor test to choose Pereira or Van Camp as the apportionment formula, labor already rewarded via a capital buy-in must be disregarded, as it must be in calculating a fair salary if Van Camp is the selected apportionment formula.
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husband personally spends many hours installing fencing around land on which he will graze cattle in his beef-raising business.

6. One spouse makes a gift to the other of an interest in the business. In equitable distribution states this could be done by creating a co-tenancy where the business was previously owned solely by the donor spouse or by the donor’s renouncing an interest in an existing co-tenancy. In community property states, such a gift can arise out of separate to community property transmutation or transmutation whereby the donor spouse owning gives up his or her half community interest.\footnote{36}

\textbf{B. Assessment of Assets to Apportion Income}

Should the asset owned by the separate and community/marital estates be viewed, for purposes of apportioning income, as just the equity share or equity plus the share acquired through a loan not yet repaid? There is a split in authority on this point that could affect the outcome in cases under consideration: apportionment of gains over time when ownership of capital by the separate property and community/marital property estates fluctuates. To date the split appears in cases not involving Pereira/Van Camp apportionment, but rather division at divorce cases in which a court must calculate the amount of a buy-in occurring when funds of a marital estate not then the sole owner of the business are employed to reduce the principal owing on the purchase-money obligation. The majority rule treats only the equity in the property as property owned by a spouse or spouses. The theory is that the encumbered portion is not an asset to be divided at divorce. It will be assigned to the party ordered to pay the balance remaining on the purchase-money debt. The minority, led by California,\footnote{37} treats the encumbered portion of the asset as owned by the estate that extended its credit to make the initial acquisition.

An example can illustrate the two approaches. Husband pays $10,000 down and signs a note for $40,000 to buy a mechanic’s shop with equipment. He promptly marries. For five years community and marital funds are used to make note payments, reducing the principal debt by

\footnote{36. In several community property states, such transmutations can be made only with a formal writing. See, e.g., Estate of MacDonald, 794 P.2d 911 (Cal. 1990).

37. See Marriage of Moore, 618 P.2d 208 (Cal. 1980); Marriage of Marsden, 181 Cal. Rptr. 910 (Cal. Ct. App. 1982). Accord Malmquist v. Malmquist, 792 P.2d 372 (Nev. 1990). Some states have calculated the buy-in based on treating the encumbered portion as property capable of ownership by the separate property or community/marital property estates. See, e.g., Grant v. Zich, 477 A.2d 1163 (Md. 1984). Presumably these jurisdictions would also treat the encumbered portion as owned when making a Pereira-Van Camp apportionment.}
$5,000. To make the analysis less complicated, assume the shop is still worth $50,000. The majority rule would at this point view the asset as one-third community/marital property and two-thirds separate property (a $5,000 reduction of principal owing versus $10,000 paid to acquire the initial equity interest). The minority approach holds the community/marital property interest is one-tenth, as the separate property estate has contributed the full $10,000 in cash that created the initial equity and all $35,000 in loan proceeds that acquired the encumbered portion. Under this theory the community/marital payments over time buy-out the separate estate’s share of the asset consisting of the encumbered portion.

Although the majority rule treats the community/marital property estate more generously, the minority approach seems to make more economic sense. In some states only the husband’s separate property funds will be liable on the original purchase money note because it is a pre-marital debt. In equitable distribution states, if husband and wife are equal earners, only half of the total property that will be marital at divorce—husband’s earnings—are liable. If the lender on the note can reach all or part of the community property and that which will be marital, state law may nevertheless—because the debt is premarital—accord the community/marital estate a right of reimbursement for the amount of community/marital funds used to pay the lender voluntarily or seized by such creditor by levying execution on his or her judgment. If the husband’s separate property that will not be marital property is solely or primarily liable on the debt, the minority rule which treats that estate as owning the encumbered portion makes sense even when the issue is not apportionment of gains (which may have been entirely consumed) but solely division of the capital assets. In that context, if community/marital funds are liable on the note without right of reimbursement, some of the logic behind the minority rule is absent.

I predict that those states which have treated the encumbered portion of the business as unowned property in calculating a buy-in for purposes of dividing property at divorce without regard to which marital estate or estates are liable on the purchase-money debt will hold that this rule


39. Of course, if an anti-deficiency judgment statute applies, there is no personal liability at all.

40. ‘‘Marital property’’ here refers to property owned separately by spouses at the time the debt is due but which would be classified as marital property if there were a divorce.
cannot be used in making a *Pereira-Van Camp* apportionment of gains, for whatever reason. In this context logic compels treating the entire business as a single asset. In the above case of the machine shop, husband will be applying his labors not just to 15/50, the equity portion, of the shop and its equipment. He will use all of the assets. Perhaps majority rule theorists would respond to this observation that they view the encumbered portion as constructively owned in the same 1-2 fraction as the equity. But the husband’s separate property and community/marital property estates are not going to be liable on the purchase-money debt in a 1-2 ratio, so extending the fractional ownership in that manner to the encumbered portion is inconsistent with financial realities. The rule that views the encumbered portion as continuing—after use of community/marital property funds to retire some of the debt—to be owned by the separate estate initially furnishing the credit for the acquisition is proper in apportionment cases, and this article assumes all states will employ it.

**C. Dealing with Interest Component**

Should the interest component of periodic repayments of purchase-money debt buy-in to title? Although what seems to be the first buy-in case, from California in 1926, treated the full amount of contract-fordeed payments—which from a financing and taxation view contain an interest component—as buying into title, an interest buy-in was subsequently rejected by the California Supreme Court. The 1926 case has no following in other states, either. According to the leading California case, the interest components of the community/marital property payments reducing the purchase-money debt are ignored in determining the amount of buy-in because they are “expenses incurred to maintain the investment” in the profit-making venture.

The rule that the interest component of payments on the purchase money note do not buy-in to a share of ownership seems predicated

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42. Marriage of Moore, 618 P. 2d at 208.
43. Id. at 211. See Reppy, supra note 29, at 1044. Moore dealt with purchase of a residence, not a business, and stated its assumption that the spouses (i.e., the community/marital estate) were occupying it so that the interest payments received a return in the form of this benefit. This theory, transferred from the case of a house purchase to purchase of a business over time, is problematic. A *Pereira-Van Camp* apportionment will give the separate estate some return not enjoyed by it in the situation where the community/marital property estate (the spouses) gets all the use benefit of the residence. *Van Camp* can give the separate estate a very large share of the extensive earnings (equivalent to use value in the case of a residence).
on the following assumptions: (1) no *Pereira-Van Camp* calculation will be made until the community/marital estate has fully paid off the purchase-money debt, and (2) in making the apportionment of profits the community/marital fractional share existing when the debt is paid will relate back to the time of acquisition or the time when community/marital funds started to be used for payments on the purchase money obligation, usually the time of marriage.\(^\text{44}\)

However, it often happens that apportionment of gains must be made before the community/marital estate has completed paying the purchase-money debt. A divorce may intervene. The court now faces the problem that the community/marital estate has been paying interest for a future investment, the ultimate buy-in when the debt is fully paid, but will not get the benefit of that anticipated investment.\(^\text{45}\) If, as is likely, note payments were amortized, the early interest payments (which can approach 90 percent of the total of a monthly payment) are in effect paying for the right, exercisable well into the future, to make a large chunk of principal-reduction and consequent buy-in through the final amortized payments (which will correspondingly be close to 90 percent principal).

If the apportionment of gains is being made before the purchase-money debt that has been fully paid, it should be divided into two parts that can be called "rewarded interest" and "excess interest." Assuming note payments are made monthly, this requires a month-by-month calculation of the amount of buy-in due to principal reduction occurring with each payment along with the appropriate amount of interest for that buy-in. Thus, if the twenty-fourth payment made two

\(^{44}\) The latter date is used if the separate property estate is to get the benefit of pre-marriage appreciation as a buy-in to title. See infra text accompanying notes 56-60.

\(^{45}\) It may be argued that, in a case like the husband’s purchase of a machine shop discussed in text, the wife should understand when community/marital funds are used to make payments on the purchase price that the community/marital estate may not realize the full potential of a community/marital buy-in. This is because either her marriage may end by death or divorce before the purchase-money debt is fully repaid, or the husband may obtain separate property funds, as by inheritance, and shift from community/marital property to those funds to continue the payments on that debt. But happily married couples will not be thinking about termination of their marriage. Unless the husband has a benefactor-relative approaching death, the couple will not be thinking about an infusion of the husband’s separate property.

In community property states, because of the husband’s fiduciary duty as manager of the community estate, there is a genuine problem as to whether he properly can, by shifting to inherited separate property funds, cut off the investment potential arising out of use of community property funds to make payments on the purchase-money note if community property funds continue to be available after the inheritance. See generally *Reppy & Samuel*, supra note 3, at ch. 16.
years after the business was acquired, results in a $200 buy-in and the interest rate on the purchase money obligation is 8 percent, $16 worth of interest paid up to the time of apportionment is "rewarded interest" based on that month's buy-in. All of the interest paid with community/marital funds not so "rewarded" was paid for the opportunity to make a community/marital buy-in through a future payment. If the apportionment is made at the termination of the marriage by death or divorce, the opportunity of the community/marital estate to get the benefit of the future investment has expired, because the community/marital estate ends with the dissolution of the marriage.

When apportionment of gain is made in this situation, the excess interest should not be ignored, as it has been in California. The community/marital property estate seems at the very least entitled to reimbursement for the amount of excess interest. In the hypothetical case above of husband's pre-marriage purchase of a $50,000 machine shop, husband will be treated as owning the encumbered portion of the capital assets in making any apportionment and, thus, the community/marital property estate should be reimbursed with the husband's separate property funds.

Another solution is to treat the excess interest as buying-in to a share of title so that it gets a return of profits. In the hypothetical case above where, without considering excess interest and treating the encumbered portion as owned for apportionment purposes, the community/marital property share was $5,000 out of $50,000, assume excess interest was $10,000. Permitting it to buy-in to title for purposes of apportionment would change the denominator of the fractional shares from fifty to sixty, and the community/marital property fraction would be 15/60.

The prior discussion has focused on excess interest claims that entitle the community/marital property estate to a remedy such as reimbursement. But quite frequently the separate estate of the acquiring spouse will also be entitled to a remedy for excess interest. This claim arises when the separate estate has made note payments (containing an interest component) before a shift was made to the use of community/marital funds for such payments reducing the purchase-money obligation. The

46. See Reppy, supra note 29, at 1045. See also Herr v. Herr, 705 S.W.2d 619 (Mo. Ct. App. 1986) (stating generally that in an appropriate case interest that does not buy-in to title may be reimbursed).

47. Yet a third attempt to deal with the excess interest problem is employed in Nevada. It views the community/marital property as buying-in to title not based on the amount of principal-reduction it has paid but the amount of time during the repayment period it has made these payments compared to the time separate property was used. Malmquist v. Malmquist, 792 P.2d 372 (Nev. 1990). The Nevada approach is critically analyzed in Reppy, supra note 29, at 1051-53.
separate estate will have paid interest to keep alive the investment opportunity in completion of the contract, but due to the shift, often at the time of marriage, to use of community/marital property to complete the contract, separate property ceases to buy-in to ownership of the business. The affected separate property estate should be compensated for the lost opportunity. 48

In making year-by-year apportionments of gain—as this article suggests usually must be done—the problem of excess interest is most conveniently solved if reimbursement is the remedy for the marital estates that have paid excess interest. 49 Since the excess interest payments are made with an eye to an investment in future profits, reimbursement must include legal interest. When no interest is paid on reimbursement, the law treats the advance as an interest-free loan to the benefitted marital estate. That theory makes no sense in the context of buying the capital of a business.

D. Problems Related to Classifying Appreciation as Part of the Capital That Generates a Share of Gains

1. A Total Recapitulation Approach

All reported cases to date involving classification of appreciation of an asset over a period of time when buy-ins are occurring to alter the fractional shares of ownership have used a simplified, total-recapitulation approach from the standpoint of the time of litigation.

48. It cannot be fairly said that the pre-marriage debtor spouse, say the husband, has voluntarily waived the right to continue the husband’s separate property buy-in. It is likely that, not long after his marriage, the separate property he brought to the marriage has been spent or lost by commingling with community/marital property funds. Then only community/marital property funds, including a return for spousal labor in the business, may be available to make post-marriage note-payments. If state law makes it a condition of marriage that one without liquid separate property funds forfeits investment opportunities, the waiver seems involuntary (and to hold otherwise would raise an interesting question about unconstitutional conditions on the exercise of a fundamental, or at least important, right).

49. As illustrated in the text below, even without consideration of excess interest there is great complexity in making a year-by-year apportionment of gains. Complexities are increased if the remedy for payment of excess interest is not reimbursement (with legal interest) but a buy-in to a share of ownership. The buy-in for the separate estate of the acquiring spouse based on pre-marriage note payments should be a constant figure, but the community/marital buy-in arising from use of community/marital funds is not. The amount of excess interest paid by the community/marital estate increases at a decelerating rate year-by-year until half the purchase price has been paid. Then the excess interest paid by the community/marital property estate begins to decrease. Of course, the amount of buy-in for excess interest can be calculated on a year-by-year basis. If gains from the business are fluctuating greatly, the buy-in remedy would often be more fair in terms of lost investment possibilities then the simpler remedy of reimbursement with legal interest.
rather than a year-by-year calculation. But even in using the total recapitulation approach, which is much more convenient than a year-by-year analysis of appreciation, states have taken several different directions.

What the generally useful Turner treatise considers the best approach to classification of appreciation seeks simplicity frequently at the expense of serious unfairness. Turner poses a hypothetical like the one this article has discussed in which property is purchased by a spouse-to-be with a $10,000 separate property down payment and a $40,000 purchase-money note. Before any monthly payment is made, the acquiring party marries. He or she then uses community/marital funds for monthly payments on the debt. By the time of divorce the asset has increased in value to $65,000 and the purchase-money obligation has been reduced by $20,000 which was paid with community/marital funds. In dealing with the appreciation of $15,000, Turner’s recommended approach, followed in a handful of states, allocates the appreciation in a two-to-one ratio because separate funds have purchased one-third of the equity and community/marital monies two-thirds. The community/marital interest is worth $30,000–$20,000 buy-in via the principal component of note payments made with community/marital funds and $10,000 of appreciation.

This approach treats the 2/5 of the basic purchase price not yet paid for as unacquired property. But even if the marital estates were to be viewed as owning all the asset, not just the equity, Turner’s basic

50. Turner, supra note 1, § 5.10, at 165.

51. A variation of Turner’s basic approach employed in Maryland reduces the excess allocation to the community/marital property estate somewhat. Turner, supra note 1, § 5.10, at 165-66 (discussing Grant v. Zich, 477 A.2d 1163 (Md. 1984)). On the facts of Turner’s hypothetical, the separate property share is determined, under this precedent, by applying the two-to-one ratio (separate versus community/marital funds used to reduce purchase-money debt) to the full value of the property at the time of litigation ($65,000 compared to $45,000 under the Turner approach). This boosts the separate share from $15,000 to $21,667, reducing the community/marital property share by $6,667.

Yet another variation of Turner’s rule, which was employed in a 1978 Kentucky case, when applied to the hypothetical $50,000 acquisition, actually exacerbates the unfairness to the separate property estate. Robinson v. Robinson, 569 S.W.2d 178 (Ky. Ct. App. 1978). It determines the separate property share by comparing the down payment of $10,000 to the purchase price of $50,000 (and apparently would add to the $10,000 figure any subsequent reductions of principal owing made with separate property funds not present in the hypothetical being considered). This ratio of 20% is applied to the total value of the property at the time of litigation. Thus the separate property share is only $13,000 (1/5 of $65,000).

52. Illustrative cases following this model include Brandenburg v. Brandenburg, 617 S.W.2d 871 (Ky. 1981); Nardini v. Nardini, 414 N.W.2d 184 (Minn. 1987); Hill v. Hill, 747 S.W.2d 718 (Mo. Ct. App. 1988); Herr v. Herr, 705 S.W.2d 619 (Mo. Ct. App. 1986).
theory, because it takes a total recapitulation approach, disregards two variables: (1) the timing of the community/marital buy-ins, and (2) the timing of the appreciation. The simplified approach seems to assume that the community/marital buy-in proceeds at a constant rate, which is not true if note payments are amortized. It also assumes that the property appreciates in value at a constant rate, which would be unusual. Even if annual national inflation figures are used to calculate appreciation, there will be variations. But many business properties vary in value based on market forces peculiar to the type of business. Fluctuation in value—such as appreciation, perhaps followed even by a year of downturn in value—will often be more extreme than that seen in annual inflation data.

The total recapitulation approach to apportioning appreciation is particularly inapt if the mode of financing is even more unusual than monthly payments based on amortized or constant interest. Suppose that in Turner's hypothetical, the mode of repaying the purchase-money debt was interest only for ten years, then a $20,000 balloon payment of principal, followed by interest only for another ten years and another $20,000 balloon payment. Appreciation has been constant at 3 percent a year, and the classification of the asset is made soon after the first balloon payment was made using community/marital property funds. To give the community or marital estate any share of appreciation in this situation is illogical, as all the appreciation occurred before any community/marital property funds bought-in to title (because interest payments did not buy-in).

Another hypothetical, this with appreciation being the variable, further illustrates that the convenience of the total recapitulation method of classifying appreciation is surely outweighed by the illogic of its results. Suppose a case where, due to volatile economic conditions, the appreciation of an asset bought for $50,000 is a steadily rising 40 percent during the first two years of repayment on a purchase-money debt, and falling back to 30 percent before the court must make its property classification. Suppose further that a separate property down payment was $10,000, and the repayment period is twenty years. Interest payments, rather than being amortized, are based on the amount of debt owed when a periodic payment on the purchase-money obligation is made. The unamortized principal reduction is thus $2,000 per year.

53. An interesting question is whether the separate property estate, having enjoyed the 40% gain in appreciation in the first two years, must suffer all of the 10% drop that follows or whether the community/marital property estate, buying-in to title as the drop occurs, must take a negative position on the allocation-of-appreciation calculations by sharing in the 10% drop.
At the end of the first year of ownership, during which two-thirds of the ultimate appreciation of 30 percent occurs, community/marital funds have bought into 1/20 of the ownership of the asset. At the end of the second year, during which the other one-third of ultimate appreciation occurs, the community/marital property interest in the capital is one-tenth. Suppose divorce occurs at the end of the fifteenth year. At this point the community/marital estate has a $30,000 buy-in compared to the $10,000 interest separately owned due to the down payment. To find, as Turner would, that 75 percent of the $30,000 appreciation is owned by the community/marital estate because it owns three-fourths of the equity at the time the court makes its classification makes no sense.

If payments on the purchase money obligation are amortized, as they almost always will be, the community/marital buy-in at the end of the first year can be just as small and often even lower than in the case of unamortized payments.\textsuperscript{54} I continue to assume that courts making a \textit{Pereira-Van Camp} apportionment will treat the fractional part of the business encumbered by the purchase-money instrument—or proportionately equivalent to the unpaid debt if there is no security—as owned by the estate originally liable on the purchase-money instrument. In the case of the $50,000 acquisition under discussion, if appreciation is steady for ten years, rather than occurring in the first two years of ownership, the 10 percent appreciation after one year can exceed the community/marital property share of ownership at the end of that year arising out of use of community/marital property funds to reduce the purchase-money debt.\textsuperscript{55} Any approach to appreciation that gives one marital estate a substantially larger share of this type of gain during a year than that estate’s share of ownership based on prior contributions and contributions during that year is illogical. A party harmed by a total recapitulation approach to allocation of appreciation should have no difficulty demonstrating this fact to a court, when arguing for a year-by-year allocation of appreciation.

In sum, even if Turner’s approach is altered in a case where \textit{Pereira-Van Camp} apportionments will be made after the capital assets are

\textsuperscript{54} On a 30 year mortgage at 10% interest, the amortized payments for the first year reduce the principal by 5.56%. \textit{David Thorndike, Encyclopedia of Banking and Financial Tables} 5-179 (3d. ed. 1987).

\textsuperscript{55} Total recapitulation may achieve a rough justice if the classification is made after the purchase money debt is paid off. The early, small buy-ins will have had 20 years to share in appreciation; the last buy-ins, consisting primarily of principal payments, will have but a short time to participate in claiming a share appreciation. This rough justice notion assumes, however, a steady appreciation rate, which frequently contradicts the actual appreciation figures over time.
divided into separate property and community/marital property shares so as to treat all of the business—including the encumbered portion—as owned property, its total recapitulation feature requires that courts reject it. Total recapitulation will seldom allocate a fair share of appreciation to the marital estates. Total recapitulation treats recent community/marital property buy-ins (which can be substantial if made near the end of an amortized-pay off period) as having been made at the time of the separate property down payment. A year-by-year allocation of appreciation is necessary to take into account a nonsteady increase in the community/marital property share of ownership as well as fluctuations in the rate of appreciation.

2. Pre-Marital Appreciation

Pre-marital appreciation should be allocated to the appropriate separate property estate. Turner’s hypothetical case of the $50,000 acquisition eliminates a major problem often faced in buy-in cases by assuming that, immediately after the down payment was made with separate property funds, community/marital funds were used to make monthly payments on the purchase-money debt. That is, there was no period of time when ownership was entirely separate property, during which appreciation could occur. Suppose, however, the $10,000 down payment was made some years before marriage and the acquiring spouse used separate property funds to reduce the equity before marriage by $2,000 while the property increased by $5,000. At divorce some years later, the total appreciation is $15,000, and the purchase-money debt has been reduced by $18,000, which was paid with community/marital funds which were first used for monthly payments at the time of marriage.

All cases and other authorities that use a buy-in theory agree that the separate property estate has at least a $12,000 share of ownership (i.e., the down payment and the pre-marriage reduction of principal owning on the purchase-money obligation). In addition, a majority of the cases view the separate property estate as owning a share of the property worth of $17,000. If the separate property ownership is $17,000, the court is treating the separate property estate as having “captured” the pre-marriage appreciation, which should be treated as an ownership share if the court should have to make Pereira-Van

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56. Logically, under this “capture” theory, if after marriage the separate property estate continued to make note payments for some years before the spouses began using community/marital funds for such payments, the separate property estate would capture all the appreciation up to the time of this shift to use of community/marital funds that caused ownership to cease to be wholly separate property.
Camp apportionment gains. Turner asserts that the source of funds rule "logically" requires the pre-marriage appreciation be treated as part of the separate property contribution and he criticizes Maryland\textsuperscript{57} for not doing so.\textsuperscript{58}

In the hypothetical case above, where $5,000 of a total appreciation of $15,000 occurred before marriage, the separate estate's share of ownership would be calculated by Turner—in a context not involving Pereira-Van Camp apportionment—by treating only the equity portion of the "business as property owned by spouses. That could possibly mean that at the time the property comes before the court the separate property interest is 17/35 (48.6 percent). The denominator consists of the $17,000 separate property contribution plus $18,000 in reduction of the purchase-money debt due to expenditure of community/marital property funds.\textsuperscript{59} On this theory the separate property estate gets $4,860 of the unallocated $10,000 appreciation and the community/marital property estate gets $5,140. The $45,000 equity is thus shared $23,140 as community/marital property and $21,860 as separate property. A problem with this is the separate property estate gets to have its pre-marriage principal-reduction payments buy-in to title for purposes of allocating appreciation but the community/marital property does not get its post-marriage principal reduction payments similarly counted. This unfairness is inherent in a total recapitulation approach for dealing with appreciation but is avoided if a year-by-year analysis of the buy-in due to principal reduction is made, as urged by this article.

Turner's treatise suggests that thirty-five is not the proper denominator in the discussion above. Turner says that if appreciation appears in the numerator of the fraction, as pre-marriage appreciation does in the number seventeen, it must appear in the denominator so as to compare "appreciated separate interest value with total value."\textsuperscript{50} Since by "total

\textsuperscript{57} See supra note 52.
\textsuperscript{58} Turner, supra note 1, § 5.10, at 166.
\textsuperscript{59} The hypothetical set forth by Turner in his treatise had community/marital funds responsible for all the $20,000 of principal-reduction via note payments. The revised hypothetical has retained the $20,000 buy-in from principal reduction of the purchase-money debt but added the complexity that the first $2,000 of that reduction was paid with pre-marriage separate property funds. In forming the 17/35 fraction, I am extrapolating from Turner's two-to-one fraction in his original hypothetical that compared the total separate property and community/marital property contributions to the creation of an equity. Turner writes: "A percentage of ownership theory should logically define the source of funds fraction as the value of the separate interest on the date of marriage divided by the equity in the property on that date." Turner, supra note 2, § 5.10, at 166. Is not the "value" of the separate interest on the marriage the same as the equity on that date? The quoted sentence offers me no guidance. Should the final two words be changed to "the date of trial"?
\textsuperscript{60} Id.
value’’ Turner is referring to the value of the equity, not the whole property, the separate property fraction would be 17/45 or 37.8 percent. But if the community/marital property fraction is 28/45 (so that we arrive at 100 percent), we are crediting 100 percent of the post-marriage appreciation to the community/marital property estate (the figure twenty-eight is the $18,000 principal-reduction arising from use of community/marital funds plus the unallocated post-marriage appreciation). This is untenable. The very inquiry is how to allocate the $10,000 post-marriage appreciation, and to give it all initially to the community/marital property estate to increase the size of its fractional share to be used to finally allocate the $10,000 accords the community/marital property estate an illogical boost in its claim to a share of the $10,000 in appreciation.

If the community/marital property buy-in is constant (i.e., payments are not amortized), a formula can be devised to accurately assign out the $10,000 post-marriage appreciation as part of a total recapitulation analysis. If, as is likely, the buy-in of the community/marital property estate is through amortized payments, only a year-by-year accounting, taking into account the amortization tables, can accurately allocate the appreciation based on fractional ownership shares at the time the appreciation occurs.

In a 1986 case, California has tried to avoid the need to come up with a proper formula to solve this problem, or to use a year-by-year accounting to do so, by crediting the separate property with the $5,000 pre-marriage appreciation as a sort of reimbursement claim, while not allowing the separate property estate to claim any share of ownership based on pre-marriage appreciation. Thus, in the hypothetical under discussion, California’s Frick case allocates post-marriage appreciation by treating the asset actually worth $65,000 as worth only $60,000, since the pre-marriage $5,000 gain is handled through a reimbursement remedy. Under this approach it would seem that if after five years of equity-increasing community/marital payments, separate property once again was regularly used to reduce the purchase-money debt, this second “shift” is as much an occasion for calculating and converting into reimbursement claims the separate property and community/marital property shares of appreciation for the five-year period as was the initial shift, at marriage, from use of separate property to community/marital property funds to make note payments an occasion for converting separate property appreciation into a reimbursement claim.

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61. See Reppy, supra note 29, at 1009 (criticizing Marriage of Frick, 226 Cal. Rptr. 766 (Cal. Ct. App. 1986)).
Possibly, under the theory of Frick, if a court in California were to undertake a year-by-year approach rather than a total recapitulation analysis to allocate appreciation, it would still not treat any of the appreciation values as property that was involved in generating future appreciation. On the other hand, the unique California reimbursement approach may result from an effort to preserve total recapitulation accounting by eliminating one variable. This article demonstrates that in many situations a year-by-year accounting is essential if separate and community/marital interests are to be fairly calculated. If that step is taken in California, the apparent reason for Frick is absent and California should follow Turner's notion that appreciation from a prior period should be appropriately allocated as part of the process of classifying further appreciation.

IV. The Mechanics of a Year-by-Year Apportionment of Profits

A. Choosing the Appropriate Time Units for Apportionment

This article proposes a year-by-year analysis for apportionment of gains as the usual approach when factors are present precluding a total recapitulation approach employed in almost all the reported cases. There will be an occasional case where larger time chunks can be carved out. For example, wife brings to the marriage a business subject to no debts which retains in the business no earnings or a small amount of earnings that would be the wife's separate property under either Pereira or Van Camp. After five years, $200,000 of community/marital property funds are employed for a capital investment in wife's business that was previously all the wife's separate property. This change in capital structure precludes a total recapitulation accounting under a Pereira-Van Camp formula at sometime in the future. In dealing with gains generated after the community/marital property buy-in, the return on capital must be pro-rated between the wife's separate estate and the community/marital property estate.

Should a month-by-month calculation be used rather than year-by-year? It would be possible to fine-tune the apportionment in this way if the accountant for the business has preserved monthly data enabling buy-ins and apportionments of gain to be made on a per-month basis. But the gain in accuracy obtained from the inconvenience of increasing the calculations twelve-fold will seldom be worth the effort. I suggest courts demand the clearest evidence that a year-to-year calculation will be substantially inaccurate before using shorter periods.

That test will be met, however, in a few situations. Example one: a calendar-year accounting is to be made, and in the first year husband
and wife marry on May 3, requiring the first accounting period to be eight months instead of a full year. Example two: after many years of marriage wife causes the business to make a substantial partial-liquidation distribution of the wife’s separate capital funds in late June. This year should be broken into two six-month periods for apportioning gains.

The sample accounting below on a calendar-year basis brings in some, but by no means all, of the possible complicating factors. Since it is so very commonly encountered, the factor that probably causes the most difficulty—amortization of community/marital property payments that reduce the purchase-money debt incurred by a spouse’s separate estate—is dealt with in the hypothetical case.

B. Hypothetical: Three Years of Apportionment of Gains

1. Acquisition of the Business and Its Premarital Operation

Basic Facts: Five years before he marries wife, husband buys a business—consisting of real property, personality, and goodwill—for $500,000. The agreement of sale fairly values the goodwill at $50,000. Husband pays $100,000 down and signs a note for $400,000, payable over twenty years in amortized monthly payments at 10 percent interest. At all times the business pays husband a fair salary. In all years—except Year Three of marriage, as hypothesized below—husband’s labor is the chief contributing factor in the generation of the net gains of the business, all of which are reinvested in the business.

For five years the husband operates the business, increasing its goodwill to $100,000 and reducing the principal owing on the purchase-money debt (PMD) by $40,790. The interest components of these payments total $190,814.80. During these five years, some of the original equipment depreciates in value by $20,000. This is offset by inflationary gain in value of some personality and of the realty of $120,000, for a net gain of $100,000. Goodwill has increased by $50,000. Retained
earnings of $250,000 have gone into the capital accounts of the business over the five years, much in the form of additional and replacement equipment.

2. Apportioning Gains for Year One of Marriage

On January 1 of Year One, husband marries wife. He brings to the marriage a business worth $900,000 ($500,000 original value plus $100,000 inflationary gain, $50,000 goodwill, and $250,000 retained earnings).

At the time of the marriage an excess-interest sum should be calculated. Husband has bought in to capital at about the rate of $8,158 per year, producing an increase in equity of $40,790. Assume husband paid $8,158 of principal reduction at the end of each year. If interest were 10 percent on such sums, husband’s cost of financing the five years of buy-in would have been $12,237. All, or some portion, of the rest of the interest paid, $178,577.80, will be the amount of husband’s excess-interest claim to be later reimbursed with interest.

Turning now to apportionment of gains, for convenience changes in the ownership of the capital during any one year are temporarily disregarded—postponed for consideration until a calculation at the end of the Year One for purposes of allocating gains for the following year. In other words, capital values are “frozen” as they exist at the beginning of the year at issue.

At the end of Year One net business earnings for that year retained in the business are $150,000. This is a “big” gain (16.67 percent return on capital), and, with spousal labor as the chief contributing factor, the Pereira formula is applied to benefit the community/marital estate. Assume an appropriate Pereira interest rate is 10 percent which includes a return to offset the inflationary drop in the value of money. This rate

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67. In California, the sum of $100,000, the inflationary gain after offset for depreciated values of equipment, is not counted in valuing the capital asset husband brought to marriage under the strange Frick case. 226 Cal. Rptr. 766. It is unclear in California whether the increase in $50,000 goodwill is also not taken into account in valuing the business husband brought to marriage. It has been earned by husband’s labor and has not arisen due to market forces, so Frick can be distinguished.

68. The original $50,000 worth of goodwill has been retained but is included in the $500,000 initial purchase price. Total goodwill is $100,000 at the time of marriage.

69. An alternative approach is to treat the excess interest as buying-in to a share of capital for husband. See supra text accompanying note 48. Husband’s excess-interest claim is calculated on the assumption no separate property funds of husband will ever again be used to reduce principal owing on the marital property. If they are, a recalculation of excess interest will be required.

70. The alternative to such postponed consideration is a month-to-month rather than a year-by-year analysis.
allows the separate property estate to capture normal inflationary gain. So the $150,000 gain to be apportioned goes $90,000 to the husband’s separate property (10 percent return on the $900,000 capital value at the beginning of the year) and the balance, $60,000, to community/marital property. The $60,000 can be considered a return on labor above the “fair” salary paid to husband. Pereira was chosen as the apportionment formula in order to classify an especially big profit favorably to the community.

3. APPORTIONMENT FOR YEAR TWO

Capital values for Year Two apportionment are frozen at the end of Year One. Let us assume that accountants have calculated the value of the business as $1.15 million. The amount of the purchase money debt still unpaid is not subtracted because we have concluded the courts will treat the encumbered portion as much as the equity portion of the business as having played a part in generating profits.

The $900,000 business grew in Year One to $1,050,000 due to retained earnings that were apportioned under Pereira. Since the value at the beginning of Year Two is $1.15 million, there was in Year One a gain, in addition to the retained earnings of $100,000. The increase in goodwill of the business during Year One is, we learn, stated by accountants’ records to be $70,000. The balance of $30,000 falls into the category of “other” gain. Since husband has already received credit for an inflationary gain as part of his Pereira return on capital, this $30,000 should not be classified as inflationary or natural increase. When Pereira is the formula used such “other” gains can be viewed as excess return on labor which is owned by the community/marital property estate because Pereira puts a cap on the separate property return and lets the community/marital property share of gain “float.”

The community/marital property portion of the $1.15 million business consists of $60,000 retained earnings plus about $12,000 buy-in to ownership through PMD principal reduction in Year One. Although increased goodwill, which is the result of husband’s labors, in Year One was $60,000, there will also be some change in the classification.

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71. If special market forces caused the “natural” increase in value (i.e., not from labor) to exceed the national inflationary rate, husband must point this out to the court in seeking an unusually high Pereira interest rate for the year in question.

72. The $30,000 may possibly be gain due to market forces, but if husband failed to so prove in arguing for the highest appropriate interest rate for application of Pereira, the $30,000 can only be treated as more “other” gain captured by the community/marital property estate under Pereira.

73. According to Throndeki, supra note 54, at 5-178, the precise figure is $2,722.60 \times 4$, $11,890.40$. 
of the pre-marriage goodwill, as some of husband’s pre-marriage clients are now going to return to husband’s business because of satisfaction with his services in Year One. Let us assume that experts opine that the replacement of the pre-marriage goodwill of $100,000 will occur at the rate of 10 percent per year over ten years, or $10,000 during Year One. Accordingly, the community/marital portion of goodwill at the end of Year One is $70,000. The total community/marital property share of $1.15 million is $142,000 (12.3 percent). The separate property share of capital is 87.7 percent.

Let us assume that Year Two retained net earnings is $200,000, a “big” gain (over 17 percent of the total capital value of $1.15 million). Labor remains the chief contributing factor, so Pereira is the proper formula for apportionment. Because of recent inflationary creep, the Pereira interest rate for a return on capital now is fixed at 11 percent. The return on capital (.11 × $1.15 million) is $126,500, resulting in $73,500 as community/marital property as a reward for community/marital property labor not compensated by the salary paid. The $126,500 return on capital consists of $15,560 of community/marital property (based on the 12.3 percent of capital that is community/marital property), and the balance of $110,940 is the husband’s separate property. All such sums are retained in capital accounts of the business.

4. Apportionment for Year Three

Let us assume accountants report that the total value of the business, disregarding the purchase-money debt, is $1.5 million at the end of Year Two. This means there was a $350,000 increase in total value over the value at the end of Year One. Of this, $200,000 was retained earnings, the husband’s separate property share of which includes inflationary increase. Records reveal $60,000 is increase in goodwill, and $70,000 is accounted for by a storage building, constructed for that amount with use of community/marital property funds, on land that is

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74. See Reppy, supra note 19, at 187. The accountants for the business will not have made any attempt to quantify this type of change in the classification of goodwill, and expert testimony may be necessary.

75. This consists of goodwill worth $70,000, $60,000 of retained business profits plus $12,000 PMD principal reduction.

76. If, contrary to the prediction made by this article, a state were to treat the encumbered portion of the business as unowned when awarding a Pereira return on capital, the amount to be divided into the husband’s separate property and community/marital property shares is $802,000 ($1.15 million minus $347,210 owed on the purchase money debt at the end of Year One), and the community/marital share will be 17.7% rather than 12.3%. Treating the encumbered portion as unowned will almost always cause a more rapid increase of the fractional community/marital property interest in the business.
real property of the business. The jurisdiction treats an expenditure for such an improvement as buying-in to a share of ownership. The final $20,000 in gain fits into no identifiable category and is, thus, "other" gain. Since Pereira was employed to apportion gains in Year Two, the "other" classification results in a community/marital property increase in the business.

The community/marital property share of the $1.5 million business at the end of Year Two thus consists of the following:

1. $142,000—community/marital property value end of Year One
2. 73,500—community/marital property reward Year Two under Pereira for return on labor in excess of "fair" salary
3. 15,560—community/marital property Pereira return on capital Year Two
4. 60,000—added goodwill in Year Two
5. 10,000—replacement goodwill for Year Two
6. 70,000—storage building
7. 20,000—"other" gain

$391,060 = TOTAL COMMUNITY/MARITAL PROPERTY

This is 26 percent of the total capital for purposes of calculating a return on capital; the husband's separate property fraction is 74 percent.

Let us assume net profits retained in the business in Year Three were $220,000, a big 14.7 percent gain. Husband was ill during almost all of Year Three and performed little management functions, thus capital was the chief contributing factor. 77 Van Camp is the formula most favorable to capital in this situation. Since husband has been fairly paid for his limited efforts with salary and sick-leave benefits, the community/marital property estate has no claim based on labor for any of the $220,000. It is divided into return-of-capital shares, $57,200 (26 percent) going to the community/marital property estate and $162,800 to the husband's separate estate.

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77. Without support of any case law, Turner has proposed that in assessing whether community/marital property efforts have been adequately compensated, courts "might . . . attribute to top executives the actions of subordinates they select and control." Turner, supra note 1, § 5.21, at 252. On this theory, community/marital "labor" could be the chief contributing factor underlying business profits despite husband's absence, but I find Turner's notion dubious. A strong labor force is likely to remain with the business if it is sold, and for that reason may be treated as part of the capital of the business. Turner's theory would also greatly restrict application of Van Camp. In any event, for calculations here assume all the key employees were hired and primarily trained by husband before his marriage, which ought to negate the Turner hypothesis that their efforts are community/marital labor. Moreover, the physical assets of the business rather than employee labor could be the chief contributing factor if Year Three was marked by a surge of consumer interest in the product or service provided by the business that offset growth husband himself would have obtained by way of new clients had he been able to devote full efforts to the business.
5. Factors Not Dealt with in Above Calculations

The three years of apportionment of earnings calculated above deal with most, but by no means all, of the complicating factors that may be encountered. For example, there was no separate labor arising from separation of the spouses and no use of the husband’s separate property funds during some months to make purchase money debt payments. One can draw by analogy from the calculations here to deal with such issues.

The analogy is not as clear when the issue is how to deal with a year of net loss in business profits. There would seem to be two possible solutions. One would be to calculate negative interests—or temporary charges to be offset by net business profits next year or whenever the period of loss ends. This requires dividing the loss into the husband’s separate property and community/marital property shares. The chief contributing factor for the loss would have to be identified—perhaps market forces affecting the type of capital involved and poor management decisions by husband (which could have been made before marriage, in which case the husband’s separate estate would be charged as chief contributing factor). An easier approach would simply treat each estate as suffering a pro rata loss in its share of capital values during the unfortunate year. That is, the percentage of the husband’s separate property and community/marital property ownership interests would be carried forward and used as the basis for apportioning gain in the next year.

V. Conclusion

The year-to-year calculations suggested by this article are far more difficult to work out than are total recapitulations used to date in all but two of the reported cases. Yet that simplified approach cannot logically apply when the ownership interests in capital are shifting. Even if capital is at all times separate property, other factors will require a year-to-year apportionment. For example, fairness is not going to be achieved by a total recapitulation in a “big gain” case under Pereira if analysis shows spousal labor was the chief contributing factor in only two-thirds of the years included in the apportionment period, especially if some of the biggest gains were in Van Camp years.

Hopefully this article provides sufficient guidance so that, based on available accountants’ records, attorneys can in most cases do the calculations they consider appropriate in representing their clients without the need to hire experts.