BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
NEIL D. AND CAROLE C. ELZEY)

Appearances:

For Appellants: Carole C. Elzey, in pro. per..

For Respondent: Benjamin F. Miller
Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest to a proposed assessment of personal income tax and a late filing penalty against Carole C. Elzey, individually, in the total amount of $1,400.26 for the year 1964, and on the protest to a proposed assessment of personal income tax against Neil D. and Carole C. Elzey, jointly, in the amount of $129.95 for the year 1965. In this opinion the term "appellant" shall refer to Mrs. Elzey.

The question for decision is to what extent, if any, income earned in 1964 and 1965 by Michael V. Doherty, appellant's former husband, was community income taxable to appellant.

Appellant married Mr. Doherty in 1955 and they resided thereafter in California. In 1963 they separated and a suit for divorce was filed. After lengthy litigation, an interlocutory decree was entered on June 15, 1965, Matters litigated in the divorce court proceeding included determination of the community property and its division. Mr. Doherty had a $102,770 capital investment in a partnership, the J. V. Doherty Co., when he married appellant, During the marriage he received a salary from the partnership of between $5,000 and $12,000 a year. The court determined, however, that Mr. Doherty's yearly salary was inadequate compensation for his services to the partnership. It concluded, therefore, that a portion of his share of the undistributed partnership profits for the marital years was additional community property.

To determine the community portion of the undrawn profits, the court applied the rule of Pereira v. Pereira, 156 Cal. 1 [103 P. 488], that there should be allocated as separate property a reasonable return on a pre-marital investment, with the remainder of the profits classified as community income. It found that because of the nature of the business a 20 percent return each year [$20,554], was separate income from the investment. After examining a schedule of Mr. Doherty's partnership profits and withdrawals for the years 1955 through 1963, the court was then able to calculate the amount of his undrawn partnership profits.that represented income to the community.

Mr.. Doherty reported to respondent what he considered community income for 1964 and 1965 and paid tax on one-half thereof. On neither her 1964 return nor the joint 1965 return did appellant report any tax on income earned by Mr. Doherty prior to the decree. Respondent extended the divorce court's action to 1964 and 1965, concluding that in addition to all of Mr. Doherty's salary for 1964 and one-half for 1965, a portion of his share of the partnership profits for those two years was community income, one-half taxable to appellant. It also determined appellant was entitled to one-half of those itemized deductions of Mr. Doherty which represented

expenses of the community. Respondent then issued the proposed assessments that are the subject of this appeal.

Since the filing of this appeal, respondent, has conceded that the proposed assessments against appellant individually for 1964 and against her present husband and herself, jointly, for 1965 should be reduced to $489.78 and $54.14, respectively. It has further determined that the penalty for 1964 should be withdrawn.

As reduced by respondent, community income would be allocated to appellant as follows:

	1964	1965
1/2 Mr. Doherty's $10,000 salary	$ 5) 000	$2,500
1/2 Community share of J. V. Doherty Co. profits	$10,721	$3,632,
1/2 Community itemized deductions	($388)	($48)

* For one-half the year

Subsequent to the hearing on this matter, respondent. conceded that it used some erroneous figures and inconsistent theories in allocating the profits above, but claims such errors favored appellant.

Appellant maintains the parties stipulated during the divorce court proceedings that community property interests would be severed as of December 31, 1963. She relies on the fact that the amount of undrawn profits determined by the court to be community property was computed on the basis of profits from 1955 through 1963. She also argues that even if some of the.1964 and 1965 partnership income is community property, she neither knew the amount nor had use of it, except for the amount of monthly court -ordered temporary support for her children and herself during the litigation.

In resolving this appeal, we must review the applicable provisions in the California Civil Code. 1/

1/ All references are to Civil Code provisions in effect during the years on appeal. Since that time, the sections have been renumbered and, in many instances, there have been sub stantive changes.

Section 163 provided that all property owned by the husband before marriage, and that acquired afterwards by gift, bequest, devise, or descent, with the rents, issues and profits thereof, was his separate property. The relevant part of section 164 provided that all other personal property acquired during marriage by the husband was community property. Pursuant to the terms of section 169.2, a husband's earnings derived after an interlocutory judgment of divorce and while the parties were living separate and apart, were the separate property of the husband.

Section 161a defined the respective interests of husband and wife in community property, during continuance of the marriage, as "present, existing and equal interests. "It .is well settled that the wife's interest in community property under this provision is a vested property interest. (Cttinger v. Ottinger, 141 Cal. App. 2d 220, 225 [296 P. 2d 347].) She is therefore considered the owner of one-half of the community income and is liable for income tax on that amount. (United States v. Malcolm, 282 U . S. 792 [75 L. Ed. 714]; Poe v. Seaborn, 282 U . S. 101 [75 L. Ed. 239]; Gilmore v. United States, 290 F. 2d 942, rev'd and remanded on other grounds, 372 U . S. 39 [9 L. Ed. 2d 570].) Consequently, appellant was liable for tax on one-half of her former husband's earnings from services performed for the partnership up to the date on which the community character of those earnings was terminated by the interlocutory divorce decree. (Appeal of Beverly Bortin, Cal. St. Bd. of Equal., Aug. 1, 1966.)

It is true that the parties were entirely free by agreement to change the character of his future earnings to separate property. (Civ. Code, § 158; Van Dyke v. Commissioner, 120 F. 2d 945; Helvering v. Hickman, 70 F. 2d 985.) However, there is no proof in the record of any prior agreement between the parties severing community property interests as of December 31, 1963. It appears that the court, in determining the community portion of the undrawn profits on the basis of the partnership profit figures for January 1, 1955 through December 31, 1963, was merely making use of the information available at the time of the trial in 1964.

Respondent has conceded certain errors in its calculations. Accordingly, we must determine the amount of the community

earnings. Mr, Doherty's partnership profits for 1964 were $39,796. Using the court's approach for previous years, his -income from his 'separate investment was $20,554, leaving community profits of $19,242, of which appellant's taxable share was $9,621. This is less than respondent's calculation of $10,721, For 1965, his profits were $34,526. Profits attributable to the first five and one-half months of 1965 (to the date of the decree) would be $15,829. Income from his separate investment for this period would be $9,416, leaving community profits of $6,413, of which appellant's taxable share, was $3,207. This is less than $3,632, as computed by respondent. Furthermore, the salary which constituted community income in 1965 was $4,587 (the salary for the first 5 1/2 months), . Consequently, the amount representing appellant's community share was $2,294, not $2,500 as calculated by respondent, Therefore, respondent did not err in appellant's favor, and the amounts of... community income allocable to appellant should be reduced and tax liability computed in accordance with our calculations herein.

Appellant maintains the tax should be paid by her former husband because he had the use of most of the community income. It is true that section 18555 of the Revenue and Taxation Code provides that the spouse who controls the disposition of or who receives or spends community income, as well as the spouse who is taxable on such income, is liable for the payment of the taxes on such income. However, the language of this provision clearly does not purport to relieve appellant of her liability for the tax.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Neil D. and Carole C. Elzey

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest to a proposed assessment of personal income tax and a late filing penalty against Carole C. Elzey in the total amount of $1,400.26 for the year 1964, and on the protest to a proposed assessment of personal income tax against Neil D. and Carole C. Elzey, jointly, in the amount of $129.95 for the year 1965, be and the same is hereby modified to reflect respondent's concessions and to reflect the reduction in the amounts of community income allocable to Mrs. Elzey in accordance with the views expressed herein. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 1st day of August, 1974, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____. Member

ATTEST: _____ Secretary