



# Forensic Accounting Today

Newsletter of Ron J. Anfuso, CPA/ABV, An Accountancy Corp.

Ron J. Anfuso, CPA, ABV, CFF, CDFA, FABFA\*  
28441 Highridge Road, Suite 110 • Rolling Hills Estates, CA 90274  
Phone: (310) 378-6606 • E-mail: rja@anfusocpa.com  
Website: www.anfusocpa.com • Blog: blog.anfusocpa.com



Issue 54  
Serving all of California

## Ron's Corner

When a case cannot achieve an equitable apportionment via either the Pereira or Van Camp approach, the forensic accountant needs to embrace a hybrid strategy that makes appropriate use of both methods. Such a process requires the forensic accountant to possess thorough knowledge and considerable experience in apportionment to think creatively enough to formulate a logical solution that will be clearly understood by counsel and accepted by the Judge. In such cases, forensic accountants should consider the Capital - Labor Apportionment Model (CLAM).

In this issue of *Forensic Accounting Today*, I present aspects of the initial case in which the CLAM method was accepted by the Tax Court. Moreover, I also share with you the step-by-step process of CLAM and provide you a link to the calculations of an actual case.

(<https://www.anfusocpa.com/wp-content/uploads/CLAM-2.pdf>)

If you have questions about apportionment or other forensic accounting issues, I welcome you to contact me.

Ron

## The Use of a "Hybrid" Formula in Apportionment: Todd et al v. Commissioner of Internal Revenue

Presented by Ron J. Anfuso, CPA, ABV, CFF, CDFA, FABFA

### Background

*Although the Todd case was not a family law matter, it can apply to apportionment in family law cases when a hybrid approach may prove more effective than limiting the method to Pereira or Van Camp alone. In this case, the Commissioner of Internal Revenue used what we today call the Capital Labor Apportionment Model (CLAM).*

Partners R.E. Brotherton and Aaron Turner had been married and living with their wives before the California community property law went into effect in 1927. They were partners in the buying and selling of lumber products, such as doors, frames and sash in a business called Western Door and Sash.

The parties agreed that on January 1, 1936, they had invested \$144,000 as their separate property and that at least that amount of money remained in their business in 1940 and 1941, the tax years in question.

The dispute between the parties and Internal Revenue concerned the portion of their income in 1940 and 1941 that was attributable to capital and the amount arising from the taxpayer's management of their business. All income from capital contributed by the husbands was taxable to the husbands as separate property, plus one-half of the income from managing the business.

The commissioner found that from 1936 through 1939, a considerable portion of the increased capital came from leaving in the business the money product of the capital, as well as a portion from the managerial activities of the taxpayers.

The taxpayers contended that the Commissioner and the Tax Court mistakenly refused to hold that the limit of the separate capital investment for 1940 and "1942" {1941} was the same as it was on January 1, 1936. The court however, stated that the income from the separate property left in the business remained separate property and thereafter was entitled to its share of the income.



### Do You Need a Financial Expert to Speak?

To discuss your group's needs, call Ron today!

Continued on page 2

# Capital - Labor Apportionment (CLAM) Model Steps

Determine and calculate the following steps for each year of the marriage:

- A) State the value of the business at the beginning period
- B) Determine the rate of return
- C) Calculate the return on average capital (Capital factor:  $A \times B$ )
- D) Determine the reasonable compensation for labor (Labor factor)
- E) Calculate the total allocation base (Capital plus labor:  $C + D$ )
- F) Calculate the percent of annual income allocation base attributable to capital ( $C/E$ )
- G) Calculate the percent of annual income allocation base attributable to labor ( $D/E$ )
- H) State the increase or decrease in value
- I) Calculate the annual income allocated to capital ( $F \times H$ )
- J) Determine the annual income allocated to labor ( $G \times H$ )
- K) Calculate the net annual separate income from capital ( $H - J$ )
- L) List the beginning separate capital (Prior year's M)
- M) Calculate the separate capital ( $K + L$ )
- N) List the beginning community property (prior year's O)
- O) Calculate the ending community capital ( $J + N$ )
- P) Calculate the ending total account balance ( $M + O$ )

## The Ruling

California rule of property states that when a spouse has an investment in a business at the time of marriage that he or she continues to conduct during the marriage, the investment continues to be his or her separate property. What portion of the subsequent profits is separate or community income is determined by the facts of the case. Whatever arises from the use of the capital by the community is separate property, and whatever results from personal activity, ability or capacity of the spouse is community property. Where the separate capital investment of the spouse is definitely determined in the amount as of the date of marriage, the income attributable to that is interest thereon at a rate not to exceed the legal maximum interest rate unless the case facts show it is entitled to a greater return.

Under Federal income tax law, the Commissioner of Internal Revenue's duty is to determine from *the facts of the case* the amount of return on the taxpayer's capital. The Commissioner determined that the product of the capital was not only greater than 7% (which was the legal limit rate), but more than 8%. It also appeared that the war in Europe was causing continual increases in lumber costs and the value of inventories.

The appeals court ruled that the Commissioner's method of allocation of the separate capital of the business was constantly increasing. Eight percent of the average capital balance in each of those years was held as the base for capital earnings. Annual salaries for services were calculated as the base for community earnings. The two were added together and the percentage of each base bore to the total constituted proportions of the total income attributable to capital and services.

Beginning in 1936, when the capital on January 1 was \$144,360, the average capital for the year was computed at \$151,908. The 8% was computed at \$12,158. This was added to the \$10,000 salary, making a total of \$22,158. The percentage of income attributable to capital earnings was 55% and the managerial earnings were the remaining 45%. Fifty-five percent of the 1936 partnership income of \$26,990 was calculated at \$14,809 and attributable to capital earnings. This was left in the business and added to the partnership capital of 1937.

Forty-five percent of \$26,990 was calculated at \$12,818 and attributable to community earnings. However, all was not left in the business — \$11,763 was taken out as personal expenses that, under California law, was presumed taken from community income. (*Cal. Family Code* §760)

Pursuing this method for the succeeding years, the Commissioner and the Tax Court found the partner's separate capital of the partnership in 1940 increased to \$242,380 and that the community had left in the business, above withdrawals of living expenses, \$13,904.

The Commissioner and Tax Court fixed the taxes and deficiencies for each of the partners based on the total partnership income of \$46,204. This was reached by applying the above formula of the shares of the 8% on capital added to an increased salary factor of \$15,000.

The Appeals Court ruled in favor of the Commissioner and the formula he applied, which produced a deficiency against the taxpayers.

\* For an explanation of these titles, please visit our website or request a copy of Issue 3 of *Forensic Accounting Today*.  
Copyright © 2020 Ron J. Anfusio, CPA, ABV, CFF, CDEA,  
FABEA. All Rights Reserved.