8 T.C. 537 (1947)

In community property states, income from a business started before marriage is allocated between separate property (return on invested capital) and community property (compensation for the owner's services).

Summary

Ashley Manning, residing in California, contested a tax deficiency, arguing the IRS incorrectly apportioned income from his piano business between his separate capital and community property after his marriage. The Tax Court held that 8% of the business's income attributable to Manning's separate capital was indeed separate property. However, the income exceeding that 8% was attributable to Manning's personal services and was therefore community property, aligning with California community property law and the precedent set in *Lawrence Oliver*.

Facts

Ashley Manning owned and operated a successful piano business before marrying in 1939. He continued to operate the business after his marriage. The business's profits were generated by Manning's invested capital and his skills and efforts. Manning and his wife filed separate tax returns, allocating business income based on an 8% return on capital and treating the remaining income as community property earned through Manning's services.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Manning's income tax for 1941, reallocating a larger portion of the business income as Manning's separate property. Manning challenged this adjustment in the Tax Court. The Tax Court reviewed the Commissioner's allocation and the evidence presented by Manning regarding the source of the business's income.

Issue(s)

Whether the Commissioner properly allocated income from Manning's business between his separate capital and community property, considering California community property law.

Holding

No, because the court determined that the income should be apportioned between the capital invested and Manning's services. The apportionment to capital should be an amount equal to 8% of the capital, and the remainder of the income should be apportioned to Manning's services and considered community income.

Court's Reasoning

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The Tax Court relied on California community property law, which dictates that income from separate property remains separate, while income from a spouse's labor during marriage is community property. The court cited *Pereira v. Pereira*, stating that profits from a business partly attributable to separate capital and partly to personal services must be apportioned accordingly. Applying this principle, the court determined, based on the facts, that 8% was a fair return on Manning's invested capital, and the remaining income was attributable to his personal services. The court distinguished *Clara B. Parker, Executrix* and *J. Z. Todd*, noting that in those cases, the taxpayers failed to provide sufficient evidence to challenge the Commissioner's allocations, whereas Manning presented compelling evidence demonstrating the primary role of his skills and efforts in generating the business's income. The court also emphasized testimony about Manning's unique contributions to the business, which supported the allocation primarily to personal services.

Practical Implications

Manning v. Commissioner provides a practical framework for apportioning business income in community property states when a business owner brings separate capital into the marriage. This case highlights the importance of substantiating the contributions of personal services versus capital investment. Taxpayers in similar situations should meticulously document their labor and management activities to support a claim that a significant portion of business income is attributable to community effort rather than separate capital. Later cases often cite *Manning* and *Oliver* together when addressing the allocation of business income between separate and community property. The case also demonstrates that a "reasonable rate of return" on capital is not a fixed number, but is a factual question to be determined based on evidence presented.

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