

Conversion of Separate Property into Marital Property in Divorce: The Theory of Transmutation¹

By Robert J. Rufus, DBA, CPA, CVA, CFF, AFI,
and Laura S. Miller, MFE, CFA, AVA, AFI

It has been recognized by the courts that spouses should share in the economic fruits of their marriage. To that end, the first challenge of compiling a statement of marital assets (the marital estate) is identifying the “marital fruit.” Generally speaking, the marital estate includes all property accumulated and acquired during the marriage through the joint efforts of the parties.

Property classification, marital or separate, is significant because *only* marital assets are subject to distribution.

The classification of property is a mixed question of fact and law. The court must evaluate the facts and circumstances surrounding the acquisition of property (e.g., time of acquisition, nature of the transaction, titling, and source of funds) and, given the established facts, determine the proper classification with reference to all relevant rules of law.² This task is frequently complicated by arguments of transmutation, which address the *conversion* of separate property into marital property.

This article discusses the theory of transmutation and its related challenges. Our purpose is to (a) assist valuation practitioners in characterizing prop-

erty acquired during the marriage with non-marital resources, and (b) provide a framework for evaluating active appreciation (if any) of separate property during the marriage.³ To accomplish this purpose, we will:

1. Provide our working propositions and definitions.
2. Discuss the theory of transmutation, the burden of proof, and transmutation arguments.
3. Introduce common methods for analyzing the purported transmutation of separate property.
4. Present two cases to illustrate and test the proposed concepts.

PART 1: WORKING PROPOSITIONS AND DEFINITIONS

Our discussion builds upon the following working propositions and definitions.

- Marital property includes all property accumulated and acquired during the marriage (regardless of how

titled) through the joint efforts of the parties.

- Property acquired during the marriage is presumed to be marital unless it is shown to be separate.
- Separate property includes all property acquired by a spouse before the marriage or via bequest, descent, or gift during the marriage.
- Separate property exchanged for other separate property during the marriage remains separate property.
- Transmutation is the “change in the nature of something; in family law, the transformation of separate property into marital property, or marital property into separate property.”⁴
- The party claiming separate (or dual⁵) property status carries the initial burden of proof.
- Income derived from separate property is considered separate property.
- An increase in the value of separate property attributable to *active appreciation* or other contributions (efforts) of the marital estate is

1 Reprinted from *The American Journal of Family Law*, Summer 2012, pages 86–94, with permission from Aspen Publishers, Wolters Kluwer Law & Business, New York, NY (www.aspenpublishers.com). Original title: “What’s Mine is Yours, and What’s Yours is Mine...Until Divorce: Theory of Transmutation.”

2 This article is not intended to provide legal advice. Importantly, no two states operate under the same rules of law.

3 We do not address property acquired during the marriage with marital resources.

4 *Black’s Law Dictionary* (2009), 9th Edition, pg. 1638.

5 Some states recognize the dual nature of property acquired with both marital and separate funds. To distinguish between marital and separate contributions, the “source of funds” method (discussed herein) is commonly employed. Under this method, when both the marital and separate estates contribute assets toward the acquisition of property, each estate is entitled to an interest in the property in the ratio its contribution bears to the total investment in the property.

marital, while an increase in value attributable to *passive appreciation* is separate.

- Active appreciation of separate property refers to an increase in value as a result of financial or managerial contributions of one spouse to the separate property during the marriage.
- Passive appreciation of separate property refers to an increase in value as a result of changing economic conditions and other such circumstances beyond the control of either spouse.
- A spouse claiming an increase in value of separate property to be marital has the burden of proof, i.e., showing by a preponderance of the evidence that the increase in value is due to active appreciation or other contributions of the marital estate.
- Assets acquired subsequent to separation are not considered marital property, absent evidence that a spouse used marital property to obtain them.

PART 2: THEORY OF TRANSMUTATION

Transmutation, as defined above, is the conversion of separate property into marital property.⁶ It is not determined by statute, but rather is a theory developed through case law. This theory is based upon the *gift presumption*, i.e., the presumption that the owner of the separate property intended, via an affirmative act, to make a gift of that property to the marital estate. A gift is the “voluntary transfer of property to another without compensation,”⁷ and *donative*

intent is the “intent to surrender dominion and control over the gift that is being made.”⁸ The presumption that a gift was intended may be rebutted by competent evidence offered by the transferring spouse showing: (a) lack of intent to make a gift, or b) circumstances of fraud, coercion, or duress. If and when the presumption of gifting is rebutted, the court (the trier of fact) may classify the property as separate.

Burden of Proof. Understanding the requisite burden of proof, and how it shifts between the parties, is critical when assessing transmutation arguments.⁹ In family law (as in most civil litigation), the burden of proof is generally a preponderance of the evidence, which means “more likely than not.” In percentage terms, this signifies a 50 percent or greater probability that the facts sought to be established took place. In some jurisdictions (Ohio and Missouri, for example), the burden may be the higher standard of *clear and convincing evidence*. Unfortunately, there is no probability level that can be assigned to clear and convincing. It is more than a preponderance of the evidence and represents a measure of proof that “tilts the scales in the affirmative when weighed against the evidence of opposition,” producing a firm belief in the mind of the trier of fact as to the facts sought to be established.¹⁰

Classifying property involves a dual (shifting) burden of proof. The spouse claiming separate property status has the initial burden of proof. Once this spouse proves, generally via a preponderance of the evidence, that certain

property was acquired either before the marriage or during the marriage with separate property, the burden shifts to the other spouse to prove that the subject property (or some interest therein) is marital.

Common transmutation arguments. The most common transmutation arguments include the following:

Commingling. The most familiar argument is transmutation by commingling, where marital property is blended with separate property. The essence of this argument is that, when such blending occurs, the marital and separate assets lose their respective identities and become untraceable, i.e., inextricably combined.

Titling. The second most familiar argument is transmutation by titling. Although not definitive, property titled in joint names, regardless of how acquired, is presumed to be marital. A more difficult classification argument develops when property is enjoyed by both parties during the marriage but remains separately titled (see implied-in-fact gift discussion below).

Active appreciation. Another familiar argument is transmutation by active appreciation of separate property. As discussed above, active appreciation of separate property refers to an increase in value as a result of financial or managerial contributions (efforts) of one of the spouses to the separate property during the marriage. This argument often applies when a spouse operates a pre-marital business during the marriage.

Implied-in-fact gift and family use. Less common arguments include transmutation by implied-in-fact gift and transmutation by family use. Implied-in-fact means not directly expressed but “inferable from the facts.”¹¹ The implied-in-fact gift argument applies

6 In many states, the term *transmutation* is used interchangeably with the term *commingling*. For the purposes of our discussion, *commingling* refers only to situations in which separate property is blended with marital property.

7 *Black's Law Dictionary*, op. cit., pg. 757.

8 *Ibid.*, pg. 882.

9 Understanding the subject jurisdiction's legislative preference for the classification of property is also important.

10 See *Groenings v. Groenings* (2008). 277 S.W.3d 270. Court of Appeals of Missouri, Division Two.

11 *Black's Law Dictionary*, op. cit., pg. 823.

when the probability of the implication is so strong that a contrary intention cannot be inferred. In other words, transmutation by implied gift arguably occurs when a spouse's actions show an intention to give an asset to the marital estate. Several factors are commonly argued in establishing intent, including: (a) statements by the owner spouse, (b) family use of the property, (c) titling, (d) maintenance and management of the property, and (e) use of the non-owner spouse's credit to improve the property.¹² The family use argument is based on this same reasoning.

Agreement. A final argument for consideration is transmutation by agreement. This argument applies when a spouse, by agreement, transfers (transmutes) separate property to the marital estate. Importantly, such an agreement need not be written. Arguments surrounding oral agreements are driven by the nature of the transaction and surrounding circumstances.

A common situation involves deposits of separate funds into a marital (joint) account. The receiving spouse may argue there was an agreement (demonstrated by the deposit action) to convert the funds from separate to marital, constituting a gift with no agreement to repay. The transferring spouse, of course, claims separate property status, arguing that the separate funds can be traced (segregated) within the account (see discussion of tracing methods below). Once a transmutation has been effected, the ability to trace funds becomes irrelevant.

To clarify this issue, some jurisdictions (California is one) provide that a transmutation of separate property is

not valid unless made in writing with the express consent of the spouse whose interest in the property is adversely affected. Moreover, this declaration must contain language that explicitly acknowledges the change in characterization or ownership of the property.¹³

PART 3: REBUTTING TRANSMUTATION ARGUMENTS

As previously noted, the party seeking separate property status has the initial burden of proof. There is no requirement, however, that such proof (evidence) be unequivocal or undisputed. Our review of the relevant literature and case law identified several methods for rebutting transmutation arguments, including: tracing, lack of donative intent, source of funds, quantifying active and passive appreciation, and the consumption method.

Tracing. The commingling argument asserts that separate and marital assets have been inextricably combined. Tracing is used to rebut that argument. As the name implies, tracing is a process of identifying and segregating property. Support for this method is based on the working proposition, adopted in all states, that property acquired in exchange for separate property remains separate property. Although the law varies by jurisdiction, the following six tracing methods have (with one exception) been widely accepted.¹⁴

- **Transaction (item) method.** This method requires consideration and analysis of each individual transaction (deposit and withdrawal) within an account. It is the most rigor-

ous test and, of course, provides the best evidence.

- **Recapitulation (summary and value) method.** This method requires that all marital funds deposited and withdrawn be segregated and summarized. If the difference is positive (deposits exceed withdrawals), that amount is marital property. Conversely, if the difference is negative (withdrawals exceed deposits), the account balance is separate property.
- **Marital assets out first method.** This method characterizes all withdrawals from a commingled account as marital funds until the marital funds are exhausted, regardless of the withdrawal purpose.
- **Pro-rata method.** Under this method, which is common in dual property states, deposit percentages (marital v. separate) are calculated, and the balance is allocated accordingly.
- **Clearinghouse method (identical sum inference).** This method involves matching deposits and withdrawals. Specifically, marital (separate) deposits are matched with marital (separate) withdrawals. Applying this method requires that deposits and withdrawals be in specific amounts and separated by a short time.
- **Minimum sum balance method.** Although this method is identified in the literature, it is not widely accepted. It can be applied only in situations where the balance of the subject account never fell below its pre-marital balance. Due to this restrictive assumption, the applicability of this method is limited.

Lack of donative intent. Another method of rebutting transmutation arguments is demonstrating lack of donative intent. Although not definitive,

12 Conjecture alone is not an adequate basis for this argument. See *Allgood v. Allgood* (2011) 62 So. 3d 443. Court of Appeals of Mississippi.

13 See *Lund v. Lund* (2009). 174 Cal. App. 4th 40.
14 L. J. Harris (2004), "Tracing, Spousal Gifts, and Rebuttable Presumptions: Puzzles of Oregon Property Distribution Law," *Oregon Law Review*, 83, 1291-1329.

property titled jointly in the names of both spouses (regardless of how acquired) is presumed to be marital. Adding a spouse's name to the title of separate property is very strong evidence of intent to donate the property to the marital estate. Rebuttal arguments often focus on the purpose of the transfer (e.g., asset protection or contract requirements) and the circumstances surrounding the transfer (e.g., conditional transfer, lack of capacity, or duress). Any such rebuttal evidence must reflect the intent to maintain the property as separate and be strong enough to outweigh the counter-evidence of the affirmative act (change of title).

Source of funds. Some jurisdictions have adopted a "source of funds" theory of equitable distribution, which recognizes that some property—especially money—can have a dual classification: part marital and part separate. In such cases, the property will be classified (allocated) based on the sources of funds used to acquire/accumulate the property. Specifically, each party retains as separate property the amount he or she contributed plus any passive appreciation attributable thereto. This assumes that the asset spouse has presented sufficient evidence to rebut the marital property presumption. Moreover, this method is generally not applicable to separate property that has been transferred to joint title during the marriage.

Quantifying active and passive appreciation. A spouse who claims that an increase in value of separate property is marital has the initial burden of proof. The non-asset spouse must prove all three of the following:

- There has been an increase in the value of the separate asset (business) during the marriage.

- The asset spouse was an active participant and had the capacity (as an employee, officer, director, or stockholder, for example) to increase the value of the asset.
- The increase in value can be linked to the efforts of the asset spouse.¹⁵

Once marital effort and value have been established, the courts diverge on what percentage of the appreciation, if not all, is marital. The burden now shifts to the asset spouse to prove the amount of appreciation and to segregate the appreciation into active and passive components. The pre-marital component of value, of course, retains its separate property character.

Thus, the first challenge is determining the amount of any increase in value. This is commonly done by valuing the business at the date of marriage and again at the date of separation. Due to data constraints, the longer the duration of the marriage, the more complicated this seemingly straightforward process becomes. After the amount of the appreciation has been determined, the next challenge is explaining *why* the business increased in value—whether due to spousal contributions and/or efforts (active appreciation) or external factors (passive appreciation). No widely accepted criterion or standard has been identified for this challenge. Nonetheless, two approaches (from different perspectives) have been identified in the literature as authoritative, reasonable, and functional: the Pereira approach¹⁶ and the Van Camp approach.¹⁷ These approaches, although developed many years ago, continue to be cited. For ex-

ample, in *Trust Services of America, v. United States*,¹⁸ the court stated:

Once the court determines that at least some of the increment in value is community property..., it must calculate the exact amount of community property by either the Pereira method, which "allocate[s] a fair return on the [wife's separate property] investment [as separate income] and [allocates] any excess to the community property as arising from the [wife's] efforts"; or the Van Camp approach, which allocates as community property the reasonable value of the wife's services.

The three-step Pereira approach to quantifying active and passive appreciation focuses on the *passive* component. As previously noted, passive appreciation refers to an increase in value as a result of changing economic conditions and other such circumstances beyond the control of either spouse. The first step is determining the total appreciation of the separate property (business) during the marriage. The second step involves appreciating the date-of-marriage value using a reasonable rate of return. In the third step, the active appreciation component is determined by subtracting the calculated passive appreciation from the total appreciation. As one might expect, the most critical issue (aside from the date-of-marriage value) is the appropriate return on investment or growth rate. Various rates have been accepted by the courts, including (but not limited to) the industry growth rate, loan rate, investment rate, average market rate, and a fixed rate of return.

The Van Camp approach also involves three steps but focuses on the

¹⁵ See *Smith v. Smith* (1996). 197 W.Va. 505; 475 S.E.2d 881.

¹⁶ See *Pereira v. Pereira* (1909). 156 Cal. 1, 103 P. 488.

¹⁷ See *Van Camp v. Van Camp* (1921). 53 Cal. App. 17, 199 P. 885.

¹⁸ (1989). U.S. Court of Appeals, 9th Circuit. 885 F.2d 561.

active component of appreciation. As previously noted, active appreciation refers to an increase in value as a result of financial or managerial contributions (efforts) of one of the spouses to the separate property during the marriage. As with the Pereira approach, the first step in the Van Camp approach is determining the total appreciation of the separate property (business) during the marriage. The second step is determining the reasonable rate of compensation for the “complete” efforts performed by the spouse. The third and final step is a simple subtraction of the actual compensation received from the determined reasonable compensation, which identifies active appreciation.¹⁹ Again, the most critical issue (aside from the date-of-marriage value) is the appropriate rate of compensation for the efforts of the spouse during the marriage.

Although both of those approaches—Pereira and Van Camp—may seem simple, they involve substantial ambiguity. Both approaches require the assistance of a valuation expert to determine the total appreciation of the business during the marriage. As previously noted, this requires valuations at both the date of marriage and the date of separation. Any business valuation requires some degree of professional judgment, especially when performed many years after the fact (as in the case of a long-term marriage). Professional judgment is also required to determine the reasonable rate of return (in the Pereira approach) or the reasonable rate of compensation (in the Van Camp approach). Both of these factors have critical implications for the ultimate determination of the active appreciation component.

Unfortunately, there is no standard definition or proxy for the reason-

able rate of return. Rather, the courts have exercised discretion in choosing “whichever formula will effect substantial justice” based on the facts and circumstances of the specific case.²⁰ Although the reasonable rate of return in this context is a legal construct, it is akin to the *risk-adjusted* rate of return in finance. As previously noted, passive appreciation is intended to represent all factors outside the active spouse’s control. Arguably, a number of risk factors (e.g., equity market risk, industry risk, size, and company-specific attributes) are outside the active spouse’s control and should thus be considered in the passive growth rate.

Consumption method. The consumption method for rebutting transmutation arguments resembles the source of funds method, although it is applied to the marital estate as a whole rather than to a specific asset or account. This method is founded on indirect methods (e.g., the “net worth method”) used by the IRS to determine unreported income. The process involves a comprehensive analysis (from the date of marriage to the date of separation) of marital sources (inflows) and uses (outflows) of funds.

The first step in the consumption method is to identify all possible sources of marital funds. Examples of marital sources include the spouses’ employment income, earnings from marital assets, and funds received in exchange for marital assets. From this sum of marital sources, any marital uses (consumption) are then subtracted. If the former exceeds the latter, the excess is characterized as marital property that is available for investment. A reasonable rate of return is applied to track the growth

(passive appreciation) of this marital balance through the duration of the marriage. Each year, depending on the relative magnitudes of marital sources and uses, the marital balance may increase or decrease.

The consumption method (like the source of funds method) is most commonly used in dual property states. Although it is best applied when data is available on a periodic (usually annual) basis, it can also be applied to total marital sources and uses over the entire duration of the marriage. However, in this case, determining the passive appreciation component becomes more complicated. Moreover, when marital consumption cannot be supported with direct evidence, it can be estimated with statistical data for average consumer spending (e.g., the BLS Consumer Expenditure Survey).

Although these methods provide a framework for forming and evaluating transmutation arguments, their application in any given situation will most certainly be driven by the specific facts and circumstances. Regardless, the critical element is always *intent*.

PART 4. ILLUSTRATIVE CASES

In this section, we present two actual cases (the names are changed to protect the parties’ privacy) to demonstrate how the methodologies discussed above can be applied in practice. These cases are both based on actual engagements, which served as the impetus for our research and the writing of this article.

CASE: SMITH V. SMITH

Facts: Mr. and Mrs. Smith were married for 10 years. Mr. Smith is employed as an investment advisor, and Mrs. Smith is the general manager of a family-owned and -operated automobile

19 Cannot be less than zero.

20 See *Dekker v. Dekker* (1993). 17 Cal.App.4th at p. 853.

dealership. Mrs. Smith owns a majority interest (75 percent) in the dealership, an S corporation, which she acquired approximately two years before the marriage via a gift from her father. For gift tax purposes, the stock was valued at \$500,000, its book value.²¹ Her salary as the general manager is \$95,000 per year, with additional benefits including health insurance, retirement contributions, a country club membership, and the use of company cars (along with all related expenses) for herself and her spouse.

Each year all the dealership's earnings are paid out as distributions²² to the shareholders, who then loan the funds back to company. Essentially,

21 The company's book value does not include its intangible ("blue sky") value.

22 Distributions from an S corporation are based on stock ownership.

this practice serves to convert equity to debt. During the marriage, Mrs. Smith received annual distributions in the form of a check, which she deposited in her personal checking account. This account was in her name only, and she had sole signatory authority. Shortly after these deposits were made (generally within a few days), Mrs. Smith wrote checks back the dealership, for an amount slightly less than the distribution. These payments were classified as shareholder loans. Mrs. Smith's paychecks were also deposited in this same account, and it was used to fund her share of the marital expenses.

Analysis A: commingling. Mr. Smith's expert argued that marital funds (Mrs. Smith's salary) were commingled with separate funds (distributions from the dealership) in Mrs. Smith's checking ac-

count. Based on this commingling argument, he asserted that all funds deposited in this account became marital, including funds that were subsequently loaned to the dealership (approximate balance of \$1.5 million at the date of separation). In his testimony, Mr. Smith's expert described the marital and separate deposits on an annual basis, failing to discuss the timing of the individual transactions.

Mrs. Smith was then challenged with the burden of proof. Serving as Mrs. Smith's expert, we applied three tracing methods (transaction, clearinghouse, and minimum sum balance) to demonstrate how the separate funds (distributions from the dealership) flowed through the account. First, we demonstrated that the distributions occurred only once per year and remained in the account for short durations. Second, we demonstrated the fail-

Are You Walking A Tight Rope When Your Client Has "LITTLE" Or "NO" Goodwill But Has Equipment?

It's very likely that your next business valuation will reveal "little" or "no" goodwill; however, the business has machinery and equipment. Therein lies the value and you're first hurdle! How do you value the machinery and equipment?

Do you rely on the word of the owner? (How did the owner determine fair market value...*Does the owner really know?*) Do you rely on the depreciation schedule? (*Really?* Serves no purpose to determine fair market value!) Do you rely on book value? (Limited, does not reflect a defensible substantiated fair market value). Do you guess? (Surely not a professional like you!) Do you rely on the word of an auctioneer or dealer? (Auctioneers and Dealers sometimes may have a hidden agenda). ***ALL of these methods are inaccurate and filled with a tremendous amount of risk. Not to mention an unsubstantiated and skewed valuation.***

Isn't it time that you deliver a substantiated equipment value? Find out how you can reduce your risk of liability, expand your business, and deliver defensible equipment values that will hold up to scrutiny!

Toll Free (866) 632-2467
www.nebbi.org



TABLE 1: MR. SMITH'S COMPUTATION OF PASSIVE APPRECIATION

YEAR	BEGINNING VALUE (\$)	GROWTH (%)	GROWTH (\$)	CUMULATIVE VALUE (\$)
1	500,000	8.11	40,531	540,531
2	540,531	1.49	8,032	548,563
3	548,563	2.27	12,472	561,035
4	561,035	5.18	29,068	590,104
5	590,104	-2.97	(17,534)	572,570
6	572,570	0.46	2,615	575,185
7	575,185	4.52	25,997	601,182
8	601,182	3.43	20,592	621,774
9	621,774	-5.77	(35,889)	585,886
10	585,886	-15.60	(91,384)	494,502

TABLE 2: MR. SMITH'S COMPUTATION OF PASSIVE V. ACTIVE APPRECIATION

Business value at date of separation	\$3,000,000
Business value at date of marriage	(\$500,000)
Total appreciation in value	\$2,500,000
Passive appreciation	-0-
Active appreciation	\$2,500,000

ure of Mr. Smith's commingling argument by matching (identical sum inference) the deposits of the distributions with subsequent loan withdrawals. Third, we demonstrated that, during the short periods when separate funds were in the account, the account balance never fell below its initial (marital) balance. Finally, we showed that, during these short holding periods, more than 99 percent of the total account balance was attributable to separate funds. Based on this evidence, Mrs. Smith's attorney argued that her actions demonstrated no intent or agreement to gift her separate property to the marital estate, and it would be grossly inequitable to change the character of the separate property based on a short-term combination with a relatively negligible amount of marital property.

Resolution A: The Judge rejected Mr. Smith's commingling argument and ruled that Mrs. Smith's loans to the dealership constituted separate property.

Analysis B: active v. passive appreciation. Mr. Smith's expert next argued that the business had substantially appreciated in value during the marriage as a direct result of Mrs. Smith's efforts. The expert first determined that the increase in the value²³ of the business during the marriage was \$2.5 million. This amount was calculated by subtracting the initial gift value of \$500,000 from his valuation of the business at the date of separation, \$3 million (considering no marketability

²³ All references to value reflect a 75 percent ownership interest.

discount). The expert then employed the Pereira approach to determine the active appreciation component. As a proxy for a reasonable rate of return, the expert used the annual percentage change in new car sales, including negative growth for years 2008 and 2009 (-5.77 and -15.5975 percent, respectively). As illustrated in Tables 1 and 2, this strategy served to eliminate all passive appreciation, leading Mr. Smith's expert to conclude that all appreciation (\$2.5 million) was active.

Mrs. Smith was again challenged with the burden of proof. Serving as Mrs. Smith's expert, we first valued the dealership, as of the date of separation, at \$2 million (before a 30 percent marketability discount). We then estimated the value of the business, as of the date of marriage, at \$1.25 million. Because we were unable to complete a comprehensive valuation at this earlier date, we employed a "blue sky" multiple of five times the company's pre-tax income. Our objective was to provide a meaningful computation of the appreciation in value, including any intangible value. Given our date-of-separation value (\$2 million), we calculated the total amount of appreciation at \$750,000.

To identify any active appreciation component, we first considered the Van Camp approach, which requires the determination of a reasonable rate of compensation for the spouse's efforts. Based on market research, we concluded that reasonable compensation for Mrs. Smith's position was \$110,000 per year. Although this amount exceeded Mrs. Smith's base salary, when considering extraordinary benefits (including company cars and country club dues), her total compensation package was near the market level. Since Mrs. Smith had been adequately compensated for her active efforts, we found no active appreciation component.

TABLE 3: MRS. SMITH'S COMPUTATION OF PASSIVE APPRECIATION

YEAR	BEGINNING VALUE (\$)	RF RATE (%)	PASSIVE GROWTH (\$)	CUMULATIVE VALUE (\$)
2001	1,250,000	5.75	71,875	1,321,875
2002	1,321,875	4.84	63,979	1,385,854
2003	1,385,854	5.11	70,817	1,456,671
2004	1,456,671	4.84	70,503	1,527,174
2005	1,527,174	4.61	70,403	1,597,576
2006	1,597,576	4.91	78,441	1,676,017
2007	1,676,017	4.50	75,421	1,751,438
2008	1,751,438	3.03	53,069	1,804,507
2009	1,804,507	4.56	82,286	1,886,792
			636,792	

TABLE 4: MRS. SMITH'S COMPUTATION OF PASSIVE V. ACTIVE APPRECIATION

Business value at date of separation	\$2,000,000
Business value at date of marriage	(\$1,250,000)
Total appreciation in value	\$750,000
Passive appreciation	(\$636,792)
Active appreciation	\$113,208

To support this finding, we also used the Pereira approach, with two alternative reasonable rates of return—a risk-free rate (lower) and a brand-specific industry rate (higher). For the purpose of this discussion, we present our calculation using the lower rate. As illustrated in Table 3, we determined total passive appreciation during the marriage of \$636,000 with a cumulative passive (separate) value of \$1.9 million. As illustrated in Table 4, this indicates active appreciation of \$113,000.

Resolution B: The matter was settled after preliminary findings by the court, including the failure of Mr. Smith's expert to provide an "intellectually honest" date-of-marriage value for the business and his use of a flawed passive growth rate.

CASE: JACKSON V. JACKSON

Facts: Dr. and Mrs. Jackson were married for 24 years. Dr. Jackson is a retired surgeon, and Mrs. Jackson was not employed during the marriage. Dr. Jackson entered the marriage with substantial assets, including a medical practice, retirement savings, and various real estate and stocks that he inherited from his parents. During the marriage, Dr. Jackson sold some of his separate property and invested the proceeds in various investment accounts. These investment accounts, along with the remaining separate property, appreciated in value over the years. All assets were held in Dr. Jackson's sole name, with the exception of one investment account

and one of the parties' three residences.

Analysis: In this case, the parties agreed that all property jointly titled or used collectively by the family (e.g., the residences) had been effectively converted to marital property. Mrs. Jackson's attorney also proffered a commingling argument, suggesting that Dr. Jackson's employment earnings during the marriage had been inextricably combined with separate funds in the parties' various investment accounts. Although Dr. Jackson conceded the possibility of commingling in certain accounts, he asserted that most of the accounts had maintained their separate character (i.e., no deposits of marital earnings). However, due to the unavailability of financial data for all years during the marriage, we could not effectively apply a tracing method to rebut the commingling argument.

To assist Dr. Jackson in meeting his burden of proof, we prepared an analysis based on the consumption method. Specifically, for each year during the marriage, we determined Dr. Jackson's employment earnings from his income tax returns. From this marital source, we subtracted certain marital uses that could also be documented from the tax returns (e.g., retirement contributions, mortgage interest, and taxes). To estimate the remainder of the marital consumption, we used data from the BLS Consumer Expenditure Survey. Each year, the excess of marital sources over marital uses was assumed to be invested, earning an average market rate of return (using the S&P 500 as a proxy). The present value of this balance at the date of separation served as an estimate of the total marital estate. From this total, the values of the identified marital assets (transmuted property) were subtracted to determine the marital portion of the investment ac-

—Business Valuation—
the greatest growth opportunity in the financial profession

2012 Business Valuation and Certification Training Centers

Denver Aug 6–11
Washington, DC Aug 20–25
Boston Sept 10–15
San Diego Oct 1–6
Online Oct 2–Nov 1
Atlanta Oct 22–27
Chicago Oct 29–Nov 3
Philadelphia Nov 12–17
Fort Lauderdale Dec 3–8
Las Vegas Dec 10–15
Park City Jan 28–Feb 2, 2013

dates & locations subject to change

Visit www.theCTI.com—Call (800) 677-2009



counts. Thus the investment accounts were characterized as dual property.

Resolution: This matter was settled in mediation. The consumption method was effectively used to allocate property between separate and marital.

PROPERTY OWNER'S INTENT

As highlighted throughout this discussion, the most critical component of transmutation theory is evidence that the owner of the separate property *intended to make a gift* to the marital estate. All the methods described herein for rebutting transmutation arguments seek to challenge this gifting presumption. As noted, the applicability of the rebuttal methods in any given situation is driven by the jurisdiction, the requisite burden of proof, the specific facts and circumstances surrounding the transactions, and availability of necessary data.

Equitable distribution, which is followed in 47 of the 50 states, is the dominant rule in today's divorce courts. Importantly, equitable distribution does not mean equal distribution. Even if property is deemed by the court to be transmuted (converted to marital), equity can be achieved by altering the division between the parties. The case law indicates that most courts embrace the marital partnership theory, which holds that the marital unit only receives the benefit of the spouses' time, earnings, and effort *during the marriage*. Understanding this lay of the land, practitioners should focus their rebuttal arguments on grounds of equity, rather than technicalities of transactions. VE



Robert J. Rufus, DBA, CPA, CVA, CFE, AFI, is president and managing principal of Rufus & Rufus CPAs in Huntington, WV (www.rufusandrufus.com). He has more than 25 years of field experience as a forensic accountant, including more than 750 civil and criminal matters, ranging from IRS fraud investigations to business valuations in various industries. Rufus partnered with the University of Charleston to develop the Forensic Institute, whose programs include CPE seminars, specialized certifications, and a comprehensive executive master's degree.



Laura S. Miller, MFE, CFA, AVA, AFI, is a forensic analyst with Rufus & Rufus CPAs. She specializes in business valuations, quantitative methods, and calculating economic damages and has authored or coauthored more than 100 opinion reports.