

## Characterization of Property Assets May Require Tracing

California is a community property state for division of marital assets during a divorce, and one spouse may have significant assets before marriage that are considered separate property. Separate property remains the property of the owner spouse for purposes of a divorce judgment. Community property is deemed property owned by both spouses and is often divided 50-50 in the divorce judgment. Therefore, whether property is separate, community, or quasi-community is an important issue in a marriage dissolution action.

In the recent case of *Marriage of Ciprari*, the trial court characterized a majority of the cash and securities held in commingled accounts as Husband's separate property. On appeal, the wife attacked a detailed tracing analysis performed by Husband's expert witness, upon which the trial court relied. The court of appeal concluded the tracing was valid and constitutes substantial evidence in support of the judgment.

The parties stipulated that Husband entered the marriage with over \$2 million of separate property. Of that amount, \$874,000 was held in two Wells Fargo Bank accounts. The trial court found the money held in the bank accounts was "essentially 'gifted' to the community," a finding neither party contested. In the absence of an agreement to the contrary, the use of separate property to meet community living expenses is a gift to the community.

On the date of the parties' marriage, Husband held the balance of his separate property of over \$1.1 million in a brokerage account at PaineWebber. In 1996, Husband received a \$244,000 bonus from his employer. Because the parties had married during 1995, the bonus was partly separate property and partly community property. Nevertheless, Husband deposited the entire amount in his PaineWebber brokerage account. This was the first time that community and separate funds became commingled in the account.

How much, if any, of that sum was Husband's separate property, and how much was community property, is known as a "characterization" issue. "Characterization" refers to the process of classifying property as separate, community, or quasi-community.

California Family Code, section 760, states the basic presumption that, except as otherwise provided by statute, all property acquired by a

married person during marriage, while domiciled in California, is community property. Each spouse has a “present, existing and equal” interest in the community property.

On the other hand, property acquired before marriage, or after separation, or at any time by gift, bequest, devise, or descent, is separate property. And the “rents, issues, and profits” of separate property are separate property, whether earned before, during, or after marriage. Except as otherwise provided by statute, neither spouse has any interest in the separate property of the other.

“Thus, there is a general presumption that property acquired during marriage by either spouse other than by gift or inheritance is community property, unless traceable to a separate property source. This is a rebuttable presumption affecting the burden of proof; hence it can be overcome by the party contesting community property status.

Since this general community property presumption is not a title presumption, virtually any credible evidence may be used to overcome it, including tracing the asset to a separate property source, showing an agreement or clear understanding between the parties regarding ownership status, and presenting evidence the item was acquired as a gift.

Of course, mere commingling of separate property and community property funds does not alter the status of the respective property interests, provided that the components of the commingled mass can be adequately traced to their separate property and community property sources. But if the separate property and community property interests have been commingled in such a manner that the respective contributions cannot be traced and identified, the entire commingled funds will be deemed community property pursuant to the general community property presumption of section 760.

The presumption that all property acquired by either spouse during the marriage is community property may be overcome. Whether or not the presumption is overcome is a question of fact for the trial court.

Where funds are paid from a commingled account, the presumption is that the funds are community funds. In order to overcome this presumption, a party must trace the funds expended to a separate

property source. This issue presents a question of fact for the trial court and its finding will be upheld if supported by substantial evidence.

There are the two primary methods of tracing under California law: direct tracing and exhaustion tracing.

“Direct tracing” can be used to demonstrate a spouse’s separate property was used to purchase an asset, even though the purchase is made with funds from a commingled account containing both separate and community property. It requires (a) documentary proof that sufficient separate property funds were available in the account at the time of purchase; and (b) proof that the spouse making the purchase intended to use separate, rather than community, funds.

“Exhaustion tracing” is sometimes also called “Recapitulation,” “Family expense,” “Family living expense,” or “Family income exhaustion” tracing. Whatever the name, it attempts to trace a payment or purchase from a commingled mass to separate property funds by process of elimination; *i.e.*, by showing that—because *all* community property funds were exhausted at the time the purchase or payment at issue was made—separate property funds necessarily must have been used. This approach presumes that available community property funds are used for family expenses before separate property funds are used for that purpose.

California law does not preclude trial courts from relying on any tracing method other than the two just described. Trial courts have the flexibility to consider any credible evidence and to evaluate alternative tracing methods to determine whether the proponent of the tracing carries his or her burden of proof. The tracing method may vary depending on the facts. Thus, trial courts are free to consider and credit reasonable, well- supported, and non-speculative expert testimony, when determining whether the proponent has successfully traced commingled assets to a separate property source.

Husband also invested in real estate, and a married person is free to invest his or her separate property. The fact that the husband purchased the property with his separate funds, as the trial court found, is not evidence of taking undue advantage of the wife, nor is it a breach of a fiduciary relationship which would invoke a presumption of fraud or undue influence. Wife did not cite evidence that would support

a conclusion that Husband mismanaged community funds. On the contrary, she concedes that Husband's investments were quite successful.

An apportionment of profits may be required when one spouse invests separate funds in real estate or securities, but not when the spouse expended only minimal effort and the other spouse introduced no evidence attributing a value to the services.

#### LESSONS:

1. Assets owned before marriage and acquired during marriage should be characterized as separate, community, or quasi-community property when acquired, and then care given in how they are handled.
2. To confirm the characterization of assets as separate, community, or quasi-community property, either a pre-nuptial agreement for assets owned before marriage, or a post-nuptial agreement for assets acquired during marriage should be used.
3. All agreements between spouses concerning their property should be in writing and signed by the spouses, preferably before a notary to guard against claims of forged signatures.