

## The Source of Funds Rule – Equitably Classifying Separate and Marital Property

by Judge Michael D. Lyon

Most district court judges and family law lawyers have handled a case similar to the following example: Wife has a house with a mortgage when the parties are married; the title stays in her name and the parties pay on the mortgage with marital funds. How, then, at the time of the divorce is the equity or value in the house divided? More specifically, how is Wife's separate interest protected while assuring that the marital contribution to the value of the home is respected? The salient objective of this article is to share with the bar and bench the source of funds rule, a tool which provides an equitable and systematic method of classifying separate and marital property.<sup>1</sup>

### 1. UTAH LAW ON THE CLASSIFICATION OF PROPERTY

The analysis of a property division incident to a divorce begins with section 30-3-5 of the Utah Code, which ostensibly gives a trial court broad power to equitably divide all property owned by the parties, regardless of when or how it was acquired: "When a decree of divorce is rendered, the court may include in it equitable orders relating to the children, property, debts or obligations, and parties." U.C.A. § 30-3-5 (1997). Indeed, facially it creates an *all property system*: namely, that all property owned by the parties may be equitably apportioned between them, regardless of ownership or whenever acquired.

Historically, the Utah Supreme Court was reluctant to go beyond the broad language of the statute and provide hard and fast rules for property division, holding instead that a grant of broad discretion to the trial court would better ensure an equitable result. Consequently, the Utah high court found no abuse of discretion when premarital property, or separate gifts and inheritance, were liberally divided between the divorcing parties. See *Newmeyer v. Newmeyer*, 745 P.2d 1276 (Utah 1987); *Bushell v. Bushell*, 649 P.2d 85 (Utah 1982); *Dubois v. Dubois*, 504 P.2d 1380 (1973). Likewise, it affirmed trial courts on the other end of the spectrum who concluded that each party should, in general, receive the real and personal

property he or she brought into the marriage. See *Preston v. Preston*, 646 P.2d 705 (Utah 1982); *Georgedes v. Georgedes*, 627 P.2d 44 (Utah 1981); *Jespersion v. Jespersen*, 610 P.2d 326 (Utah 1980); *Humphreys v. Humphreys*, 520 P.2d 193 (Utah 1974).

In the past decade our appellate courts have recognized the value of adopting and consistently applying some general rules and have created an analytical framework for the treatment and division of separate and marital property. In *Mortensen v. Mortensen*, 760 P.2d 304 (Utah 1988), Justice Howe articulated what has become the general rule in the division of separate or inherited property.

[T]rial courts making "equitable" property division pursuant to section 30-3-5 should, in accordance with the rule prevailing in most other jurisdictions and with the division made in many of our own cases, generally award property acquired by one spouse by gift and inheritance during the marriage (or property acquired in exchange thereof) to that spouse, together with any appreciation or enhancement of its value, unless (1) the

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other spouse has by his or her efforts or expense contributed to the enhancement, maintenance, or protection of that property, thereby acquiring an equitable interest in it, or (2) the property has been consumed or its identity lost through commingling or exchanges or where the acquiring spouse has made a gift of an interest therein to the other spouse.

*Id.* at 308 (citations omitted).

*Mortensen* is a seminal decision because it not only provides a more definite statement upon which practitioners and trial courts can rely, it shifts the analysis in Utah from an *all property system to a modified dual classification system*, where property is first categorized as either separate or marital and then, presumptively, the separate property is given to the owner spouse and the marital property is divided equitably. The presumption that separate property is given to the owner spouse may be rebutted, however, if there are just and equitable reasons to do otherwise. Thus, the dual classification system that is absolute in some states is a *modified* system in Utah because equity might require the trial court to invade separate property in fashioning an equitable result.

Since *Mortensen*, apparently in the interest of promoting more predictability and encouraging more consistent results, the Utah Court of Appeals has restricted a trial court's ability to divide separate property between the parties to situations involving "extraordinary circumstances," *Burt v. Burt*, 799 P.2d 1166 (Utah App. 1990), or "unique circumstances," *Walters v. Walters*, 812 P.2d 64 (Utah App. 1991). The court of appeals has been more proactive in monitoring the trial court's divisions, emphasizing that property division should be done in a "fair, systematic fashion." *Hall v. Hall*, 858 P.2d 1018 (Utah App. 1993). Specifically, the court of appeals requires detailed findings as to the classification of property before it is divided. See *Haumont v. Haumont*, 793 P.2d 421 (Utah App. 1990) (remanded for findings as to the source of the disputed properties); *Rappleye v. Rappleye*, 855 P.2d 260 (Utah App. 1993) (similar result); *Burt v. Burt*, 799 P.2d 1166 (Utah App. 1990) (similar result). Thus, it is critical for trial courts and lawyers representing divorcing litigants to be conversant with a consistent approach for classifying and dividing separate property.

*"Classification of property as either separate or marital must focus on when and how the property was acquired."*

## 2. THE SOURCE OF FUNDS RULE

### A. Importance of Equitable Classification

This current emphasis on property classification highlights a hole in Utah case law. Although Utah law is now fairly clear as to the analysis a trial court and litigants must follow once property has been classified, there have not been any Utah cases that have clearly defined *how* to determine if an asset is marital or separate property. The source of funds rule therefore fits cleanly and logically into the backdrop of existing Utah law because it is purely a rule of classification that provides a definition of marital property. Indeed, as discussed in more detail below, although Utah has not formally adopted the source of funds as a method of classification, many Utah cases apply source of funds principles. I recommend to the reader Brett R. Turner's treatise, *Equitable Distribution of Property*, from which came many of the ideas and formulas used in this article.

Classification of property as either separate or marital must focus on when and how the property was *acquired*. The theory of the source of funds rule begins with the premise that property is acquired by the parties when its real economic value is created. For example, a party may hold legal title to a house upon purchase, but will actually only "acquire" equity in the property as the mortgage is reduced or paid off.

Thus, in the opening example, although Wife holds title to the house upon marriage, if the actual value of the home is created during the marriage through marital mortgage payments, the source of funds rule would define the home as marital property because its value was acquired during the marriage.

The above example also illustrates that the acquisition of an asset may be a continuing process of making payments for the acquired property and, at the time of the divorce, there may be both a separate and a marital component in the value of the property. (This example is not to be confused with a situation where a separate asset has been commingled with marital assets or has been gifted to the marital estate such that the asset has lost its separate classification. When a separate asset is commingled, it should be classified as marital property and divided between the parties. *Mortensen*, 760 P.2d at 308.) Consider these further details to the above example: Wife owns a house with a fair market value of \$100,000 at the time of the marriage and at that time the house carries an \$80,000 mortgage. The house remains in her separate name and the parties use marital funds to pay down the mortgage. At the time of the divorce, the

fair market value is still \$100,000 but the mortgage is now \$60,000. A trial court using the source of funds approach would classify \$20,000 of the \$40,000 of acquired value in the home as separate property and the remaining \$20,000 as marital property.

Obviously, a practitioner or a trial judge will rarely be faced with dividing property that has not either appreciated or depreciated in value. Typically, the trial judge and the litigants are faced with the difficult proposition of classifying appreciation caused by forces outside the parties' control, such as inflation or market forces. I have found in several cases I have decided, that it is in these situations that the source of funds rule and accompanying formulas are most helpful. The source of funds rule dictates that this kind of appreciation be given the same character as the underlying asset. Accordingly, if the asset has been acquired by separate funds, all of the appreciation is separate. Likewise, if the asset has been acquired with separate and marital funds, which is the typical situation, the appreciation is allocated between the marital and separate estates proportionally.

Brett R. Turner, *Equitable Distribution of Property* 163 (2d ed. 1994). Giving appreciation the same classification as the asset that produced the appreciation is supported by a line of Utah cases. See *Mortensen*, 760 P.2d at 308 (holding that separate property should be awarded to the owner spouse "together with any appreciation or enhancement of its value"); *Dunn v. Dunn*, 802 P.2d 1314 (Utah App. 1990) (affirming award to plaintiff of retirement benefits accumulated prior to marriage, together with all interest attributable to those premarital contributions); *Preston v. Preston*, 646 P.2d 705 (Utah 1982) (remanding to the trial court for an award to defendant of separate property together with the proportion of appreciation in value attributable thereto).

Although allocating appreciation proportionally may force members of the bar and bench from their comfort zones to perform mathematical exercises, I believe failure to award a litigant who has separate funds in an asset a proportionate share of the appreciation of the asset is not only inequitable, but constitutes plain error. When a separate interest in property is simply returned at the end of a marriage without any attributable interest, the property has inequitably been used as an interest-free loan. Absent compelling equitable reasons to the contrary, no one could argue persuasively that this approach

should be adopted, and yet litigants routinely bypass a more complicated analysis by simply backing out the separate interest, giving it to the owner spouse, and then dividing the remaining property equally.

The facts and outcome of *Hall v. Hall*, 858 P.2d 1018 (Utah App. 1993), illustrate the inequities of this routine approach. In *Hall*, the trial court found that the wife had contributed \$21,000 into a marital home, and so it divided the equity in the home equally and then took \$21,000 out of the husband's marital share and gave it to the wife. The court of appeals held that, in order for an allocation of property to be done in "a fair, systematic fashion," the trial court should first classify property as separate or marital, then award the wife her separate contribution (absent "extraordinary circumstances"), and then divide the marital equity in the home equally between the parties.

Following these instructions, if the trial court found no extraordinary circumstances on remand, the wife's initial investment of \$21,000 was returned to her without a proportionate share of

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the interest. Her \$21,000 investment in the home was therefore treated as an interest-free loan to the marriage. Mr. Turner, in commenting on the *Hall* case, points out that had the value of the home dropped, it would clearly have been improper for the court to reimburse petitioner for her separate

contributions, leaving the marital estate to bear the entire loss. "If the separate estate must share the loss, however, it is only fair to allow it to share the gain. When marital and separate contributions are made to a single asset, the respective marital and separate interests should be treated as percentages and not as absolute amounts." Turner, *supra*, at 388, app. A.

I believe that given the court of appeals' preference for a systematic, fair approach, had the wife objected to the trial court's failure to provide more than mere reimbursement of the separate investment, the court of appeals would have approved awarding the wife a proportionate share of the interest. However, since the parties did not raise the amount of reimbursement on appeal, the court of appeals appropriately did not address the issue. Clearly, then, to ensure that a spouse's separate property is fully and equitably restored with a proportionate share of the interest, it is essential for practitioners and trial court judges to understand and consistently apply the sometimes difficult source of funds formulas.<sup>2</sup>

## B. The Source of Funds Formulas

As stated above, when a property's appreciation is caused by forces outside the parties' control, such as inflation or market forces, the appreciation should be given the same classification as the underlying property. If, therefore, the parties have contributed to the property \$10,000 in separate funds and \$20,000 in marital funds, the appreciation should be classified proportionally, or one-third as separate and two-thirds as marital. In Mr. Turner's mathematical formulas, this translates as follows:

*Value* (or net equity) = separate contributions + marital contributions + appreciation

*Marital interest* = value(marital contributions/total contributions)

*Separate interest* = value(separate contributions/total contributions)

Application of the formula is clearer through use of our example, with additional details: Wife owns a house with a fair market value of \$100,000 at the time of the marriage and at the time of the marriage the house carries an \$80,000 mortgage. The house remains in her separate name and the parties use marital funds to pay down the mortgage. At the time of the divorce, the fair market value has increased to \$160,000, due to market forces, and the mortgage is now \$40,000. The numbers would plug into the formulas as follows:

*Value* (or net equity) = separate contributions + marital contributions + appreciation

*separate contributions* = FMV at marriage - mortgage at marriage  
= \$100,000 - \$80,000 = \$20,000

*marital contributions* = Mortgage at marriage - mortgage at divorce  
= \$80,000 - \$40,000 = \$40,000

*Value* = \$20,000 + \$40,000 + \$60,000 = \$120,000 in net equity

*separate interest* = value(sep. contribution/total contribution)

*separate interest* = \$120,000(\$20,000/\$60,000)  
= \$40,000

*marital interest* = value(mar. contribution/total contribution)

*marital interest* = \$120,000(\$40,000/\$60,000)  
= \$80,000

Therefore, under the source of funds rule, the \$120,000 of equity is classified \$40,000 as Wife's separate interest and \$80,000 as marital interest. Wife would therefore be entitled,

absent extraordinary circumstances, to \$80,000 in equity (\$40,000 separate interest plus one-half of the marital interest). She receives back her separate contribution of \$20,000 plus the portion of appreciation that is attributable thereto; she receives a return on her investment. Typically, if the court determines a division of property should be consistent with this classification, the home is either sold or awarded to the owner spouse, who also assumes responsibility for the mortgage payments and must pay her former spouse his equity. In our example, Wife would receive the home, worth \$160,000, assume payments on the \$40,000 mortgage, and be forced to buy out Husband's \$40,000 of equity. Thus, even though she is awarded the home, she receives no more than her share of the equity.

The above example assumes all of the appreciation on the home is a result of market forces or inflation. When, however, appreciation results from specific contributions of marital funds or efforts, the resulting appreciation assumes the character of the funds or efforts. Turner, *supra*, at 162. This classification of appreciation from capital improvements is in accordance with Utah case law that when a spouse has by his or her efforts and expense contributed to the enhancement, maintenance, or protection of the property, he or she has acquired an equitable interest in it. *Mortensen*, 760 P.2d at 308.

To illustrate how a court could classify appreciation that may be in part due to capital improvements, assume this final variation of my example: Wife owns a house with a fair market value of \$100,000 and an \$80,000 mortgage at the time of the marriage. The house remains in her separate name, and the parties pay down the mortgage using marital funds and, using \$20,000 of marital funds, finish off the basement. At the time of the divorce, the fair market value of the house has increased to \$160,000 and the mortgage is \$40,000. I believe that the most equitable approach is to add the value of the marital funds expended on the home, or \$20,000, to the amount of marital contributions and the amount of total contributions, as shown below:

*Value* (or net equity) = separate contributions + marital contributions + appreciation

*separate contributions* = FMV at marriage - mortgage at marriage  
= \$100,000 - \$80,000 = \$20,000

*marital contributions* = [Mortgage at marriage - mortgage at divorce] + marital funds spent on capital improvements  
= [\$80,000 - \$40,000] + \$20,000  
= \$60,000

$Value = \$20,000 + \$60,000 + \$40,000 = \$120,000$  in net equity

$separate\ interest = value(sep.\ contribution/total\ contribution)$

$separate\ interest = \$120,000(\$20,000/\$80,000) = \$30,000$

$marital\ interest = value(mar.\ contribution/total\ contribution)$

$marital\ interest = \$120,000(\$60,000/\$80,000) = \$90,000$

Therefore Wife would be entitled (absent extraordinary equitable circumstances) to \$30,000 as a separate interest in the home and the \$90,000 marital interest would be divided equally between the parties.<sup>3</sup> It should be noted that there may be times when evidence is presented as to the amount of appreciation directly resulting from the improvement. When a trial court is presented with this kind of evidence, it seems equitable that the appreciation resulting directly from the capital improvement be backed out of the total appreciation and classified as marital. The remaining appreciation should then be apportioned between the separate and marital contributions using the formulas and, because the appreciation due to the capital improvement has already been allocated, the marital funds spent on the capital improvement should not be included in either the numerator (marital contributions) or the denominator (total contributions) of the working fractions.

### C. Evidence

As is illustrated by *Hall*, appellate courts cannot rule on the appropriateness of allocating appreciation proportionally through the source of funds rule without detailed findings from the trial court judge. Similarly a trial court cannot properly apply the source of funds formulas if the litigants do not present detailed evidence as to the value of the property. To ensure litigants do provide the necessary data, I use a pretrial order, specifically advising the parties that the allocation of separate property seems to be at issue, and that the parties should be prepared to present evidence as to the following:

1. The home's fair market value and mortgage amount at the time of the trial;
2. The amount of the parties' marital contribution to the equity (or the amount the parties have paid on the mortgage during the marriage and, separately, any capital contributions); and

3. The amount of the premarital equity interest in the home.<sup>4</sup>

### 3. CONCLUSION

David S. Dolowitz, in the April 1998 edition of the *Utah Bar Journal*, criticizes the appellate courts for, among other things, being inconsistent and sometime inequitable in their treatment of appreciation on separate property. David S. Dolowitz, *The Conundrum of Gifted, Inherited and Premarital Property in Divorce*, 11 Utah B. J. 3 at 16 (1998). His comments may well indicate the growing level of frustration among members of the bar who are left without definite, equitable guidance in this area.

I have found the source of funds rule to be practical in its direction as to the classification of separate and marital property, and equitable in its result. By focusing the inquiry narrowly on the value of the property and when that property was acquired and by providing formulas that may be consistently applied, its adoption would help eliminate some of the apparent frustration among members of the bench and bar by providing clear direction, thereby fostering more negotiated settlements and ensuring more uniform, equitable trial court decisions. Members of the bench and bar should move beyond occasional application of source of funds principles to wholesale adoption of the source of funds rule. Mr. Turner notes that, "[e]quitable distribution decisions defining the time at which property is acquired fall into two classes: those which adopt the source of funds rule, and those which avoid the issue." Turner, *supra*, at 354, app. A.

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<sup>1</sup>"Property" is not defined in the Utah Code. "Separate property" as used in this article includes all property either owned by one spouse prior to marriage, or received by a spouse individually by gift or inheritance during marriage.

<sup>2</sup>At least two other recent court of appeals' cases have had similar inequitable results: *Schaumberg v. Schaumberg*, 875 P.2d 598 (Utah App. 1994) (affirming division of appreciation on real property equally when separate funds used as down payment and marital funds used to augment the asset); *Moon v. Moon*, 790 P.2d 52 (Utah App. 1990) (affirming division of value of marital home equally, after value of land given as separate gift to husband is backed out).

<sup>3</sup>There may be situations, such as when a capital improvement is made right before the divorce, when it is more equitable to apply the source of funds formula annually, thus distributing the yearly appreciation according to the contributions made up to that point. Other jurisdictions applying the formulas have held, however, that in the typical case such an approach is unnecessarily time-consuming and tedious. Turner, *Equitable Distribution of Property* (Supp. 1997).

<sup>4</sup>This amount can be readily ascertained by knowing the fair market value of the property and the mortgage amount at the time of the marriage. If necessary, a qualified appraiser can extrapolate the fair market value of the home on the date of the marriage.