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A Financial Perspective and Overview of Marital vs. Separate Property in Divorce

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In divorce, few issues carry more financial consequence than the identification, classification, valuation (where necessary), and division of property. This booklet provides a financial perspective on the analytical issues that commonly arise when distinguishing marital from separate property. It highlights the financial considerations that often inform these analyses, recognizing that the governing legal framework varies by jurisdiction and ultimately controls the characterization and division of property.

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PART I

Property Classification

Is an asset marital, separate, or some combination? What liabilities exist? Have separate assets been separately maintained or have they become commingled, transmuted, or enhanced by marital efforts? Must the assets and liabilities be evaluated at multiple dates – such as date of marriage, date of separation, date of petition/filing, date of trial, date of distribution, or the current date?

The list of questions and considerations extends beyond these. We acknowledge that states differ; this section is intended to be generally applicable across jurisdictions. Facts, circumstances, and state precedent are necessary starting points.

Although there are variations between states and jurisdictions, at a high level, the methodologies used to assess, analyze, and support these issues are commonly accepted and applied.

This section provides an overview of community property and equitable distribution states, highlights marital vs. separate property distinctions, and outlines practical forensic and valuation considerations in property tracing and marital estate division.

Community Property vs. Equitable Distribution

States generally follow either a community property or equitable distribution framework, which provides the foundation for how property is characterized and divided in divorce. From a financial perspective, many of the analytical tools used to classify, trace, and value assets are similar across jurisdictions, although the applicable law ultimately governs the decisions.

Marital vs. Separate Property

In divorce proceedings, property is generally classified as marital property (in some states, community property) or separate property. Although the categories themselves may sound relatively straightforward, disputes often arise when assets have changed over time through appreciation, marital contributions, or changes in ownership. These issues frequently require financial analysis to identify, trace, and evaluate in order to provide analyses and information that may assist the court in characterizing the property under the presiding law.

Marital Property

Marital property generally consists of assets acquired during the marriage through marital funds, marital efforts, or both and, subject to jurisdiction-specific exceptions, is ordinarily presumed to be marital or community property subject to division. Common examples include:

- Wages and employment income earned during marriage
- Retirement plan contributions made during marriage
- Real property acquired during marriage
- Investment or cash accounts funded with marital earnings
- Business interests formed or grown during marriage

Not all property classification issues are as straightforward as the examples above. One common area of financial or forensic analysis involves assets owned before the marriage that appreciate during the marriage. Depending on the facts and circumstances, governing law, and the source of appreciation, some or all of the increase in value may be subject to division as part of the marital estate. This issue commonly arises with closely held businesses, professional practices, real estate, and investment accounts. In these situations,

a financial expert is often asked to determine the value of the asset at the date of marriage and at the applicable valuation date(s), analyze the amount of appreciation, and evaluate the factors that contributed to that change in value. In some jurisdictions, the analysis may also require distinguishing between active and passive appreciation or evaluating changes occurring after the date of separation. In other jurisdictions, active vs. passive appreciation may be a non-issue due to presiding date for dissolution being current date. We wrote about this topic in a previous article, **The Importance of the Valuation Date in Divorce.**

Separate Property

Separate property generally refers to property attributable to one spouse rather than the marital estate. Examples of possible separate property include:

- Assets owned prior to marriage that retain separate characteristics through the marriage
- Items received individually by gift or inheritance (with the caveat that they retain separate characteristics through the marriage)
- Certain personal injury recoveries (excluding lost wages in many jurisdictions)
- Assets designated as separate by a valid prenuptial or postnuptial agreement
- Assets acquired during marriage with separate funds
- Distributions and subsequent uses from separate property (may vary by state and require supporting analysis)
- Property or assets acquired after the date of separation or date of filing (may vary by state and require supporting analysis)

However, separate property status is not self-executing. The burden of proof may fall on either (or both) parties depending on the jurisdiction, and, in some cases, litigation strategy. As an example, an asset titled in one spouse's name is indicia of ownership but not conclusive, just as jointly titled property is not necessarily marital property.

Forensic accountants are often engaged to evaluate the financial evidence underlying these classification questions. That analysis may involve reviewing account activity, identifying the source and use of funds, analyzing changes in value over time, and evaluating the available evidence.

Additionally, establishing and documenting the character of property often becomes more difficult over longer periods. Older account statements may be unavailable, funds may have been transferred through multiple institutions, or separate and marital funds may have been commingled in the same account. These factors can make tracing more difficult and increase the complexity of the financial analysis.



PART II

Valuation, Financial, and Forensic Considerations

In this section we take a closer look at the valuation, financial, and forensic issues that can complicate the analysis of marital vs. separate property: tracing assets over time, evaluating commingling or potential transmutation, identifying liabilities, and analyzing changes in value. The relevance and treatment of these issues vary depending on jurisdiction and the applicable legal framework.

Tracing

Tracing is the process of following an asset or funds from an identifiable source through subsequent transfers, transactions or changes. Tracing analyses can provide financial evidence relevant to determining marital vs. separate.

Commingling and Transmutation

The forensic analysis may become more complicated when separate and marital funds are commingled, such as when they are combined in the same account, or when events such as a change in title raise questions about whether property has been transmuted. The definitions and effects of these circumstances vary by jurisdiction. From the forensic accountant's perspective, a key question is whether the separate and marital components can still be identified and supported by the available financial records, particularly when the timeframe spans many years. A tracing analysis may be limited by unavailable or inaccessible statements, closed accounts, or other gaps in the financial records.

Typically, records relevant to a tracing analysis may include:

- Bank and brokerage statements;
- Canceled checks and wire transfers;
- Closing statements;
- Tax returns;
- Loan documents and applications; and
- Other relevant financial documents.

The financial expert may prepare a chronology of transactions, reconcile transfers between accounts, and identify the source and ultimate use of funds.

Transmutation may present a related issue. Property that began as separate may raise questions about whether its character changed during the marriage through retitling, transfers, or other actions. A financial expert can help identify those changes and review the available evidence. Whether those facts result in a change in the character of the property is a separate determination from the financial analysis.

Liabilities

Liabilities are also an important part of the financial analysis, as the marital estate is not determined by assets alone. Mortgages, lines of credit, business debt, tax obligations, shareholder loans, credit cards, and other liabilities may affect the net value of an asset or the overall marital estate.

The analysis surrounding liabilities may include:

- When the liability arose;
- What the borrowed funds were used for;
- The balances at the relevant valuation date(s); and
- Whether the liability is associated with a particular asset.

It is also important to determine whether a liability has already been reflected in the concluded value of another asset, such as a business, so that the liability is not inadvertently counted twice in the marital estate.

Personal and Enterprise Goodwill

For closely held businesses and professional practices, the topic of personal and enterprise goodwill may also be considered as it could impact the division the value to marital and/or separate.

Goodwill generally represents intangible value associated with a business beyond the identifiable tangible and intangible net assets. The analysis of personal vs. enterprise involves consideration of whether that residual value is attributable to the business, an individual, or some combination of the two.

Enterprise goodwill is generally associated with value that can remain with the business and be transferred independently of a particular owner. Personal goodwill, in contrast, is associated more directly with attributes that are unique to and inseparable from an individual. The distinction and allocation may affect the portion of business value included in the marital estate; however, the treatment of personal and enterprise goodwill varies by jurisdiction. We wrote in detail about this topic in a previous article, **Personal vs. Enterprise Goodwill: Issues to Consider in Divorce Valuations.**

Active and Passive Appreciation

When an asset characterized as separate property increases in value during the marriage, questions may arise not only about the amount of appreciation, but also about which factors caused the increase. Because the treatment of active and passive appreciation varies by jurisdiction, the financial expert should work with counsel to confirm and understand the applicable statutes and case law. Certain states exclude appreciation on separate property, while others may treat some or all of the appreciation during the marriage as marital. While Mercer Capital works nationally and internationally, we defer to counsel for the applicable framework on such complex matters.

If active vs. passive appreciation is relevant in your jurisdiction, active appreciation is generally associated with an increase in value attributable to the efforts or contributions of one or both spouses. Passive appreciation, on the other hand, is generally associated with external factors, such as market or industry conditions or the efforts of individuals other than the spouses. This is a complex analysis requiring specialized knowledge. For a more detailed discussion, see our prior article, **Active vs. Passive Appreciation of Closely Held Companies.**

The same concepts can apply to assets other than businesses. For example, changes in the value of real estate or investment accounts may be a result from personal contributions or improvements, general market appreciation, or a combination of both. Similarly, growth in an investment account may reflect additional contributions, investment returns, or both.

The Expert's Role

The scope of the financial expert's analysis will depend on the facts and circumstances of the matter, the jurisdiction, and the assignment. The expert does not provide legal conclusions but instead provides financial analysis to assist counsel and the trier of fact.

Financial, valuation, and forensic considerations often overlap. For example, evaluating a business interest may involve tracing funds invested in or distributed from the business, determining its value, and analyzing the factors that contributed to changes in that value. Similarly, when commingled funds are used to acquire another asset, the analysis may involve tracing the funds through the acquisition and evaluating the asset's subsequent appreciation.



PART III

Illustrative Examples

In Section I, we discussed the general distinction between marital and separate property.

In Section II, we examined the valuation, financial, and forensic issues that can complicate that distinction, including tracing, commingling, potential transmutation, liabilities, personal and enterprise goodwill, and active and passive appreciation.

In this section we apply these concepts through two examples which are hypothetical and simplified to illustrate the financial analysis that an expert may perform. The examples do not determine whether an asset or change in value is marital or separate. The applicable law, relevant dates, and facts of each matter govern counsel in that determination.

Example 1: Retirement Asset

Assume one spouse had $400,000 in a retirement account on the date of marriage. During the marriage, $120,000 was contributed through payroll deductions and the employer contributions totaled $60,000 during this same period. At the time of divorce, the account balance was $900,000 as of the relevant valuation date.

In this simplified illustration, the ending balance is attributed to four components: the $400,000 balance at the date of marriage, $220,000 of investment return estimated to that opening component, $180,000 of contributions made during the marriage, and $100,000 of investment return estimated from those later contributions.

Depending on the jurisdiction, the $400,000 balance may be considered a separate asset, or perhaps both the $400,000 balance and its growth are considered separate. That is where the expert's analysis provides support for determining what portion of the growth is separate. The return can be calculated through a number of reasonable methodologies, including tracing historical statements or applying a growth rate from a similar investment vehicle, like the S&P 500.

Example 1 :: Retirement Account

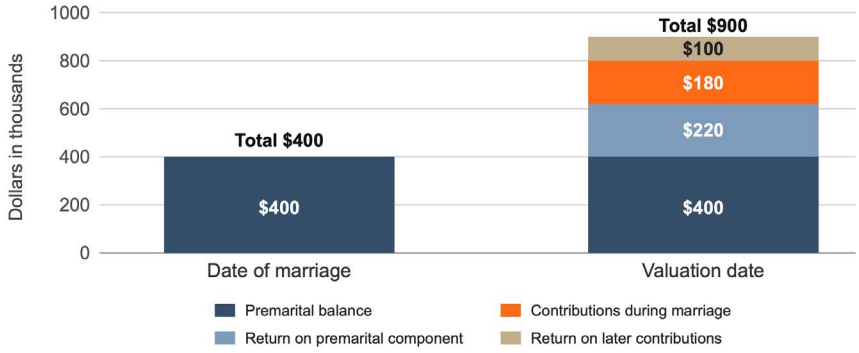


Figure 1:: Hypothetical financial components; the chart does not characterize any component as marital or separate property

Determining the Applicable Return

When complete statements are available, the financial expert can calculate the account's returns for a certain time period. This statement-based approach reflects the investment mix and performance of the actual account.

If statements are incomplete, the financial expert may consider a market-based return as an assumption.

Under either approach, plan statements, contribution histories, pay records, tax forms, and rollover documents support the tracing analysis. In the illustration, $620,000 of the ending balance consists of the premarital principal and its allocated return, while $280,000 consists of contributions made during the marriage and their allocated return. This is a supported financial tracing result and conclusion, not a legal characterization. Missing records or unresolved transfers may limit the analysis and require the financial expert to disclose assumptions or present a range of results.

Example 2: Business Interest

The following fact pattern is for illustrative purposes and meant to be simplified. Assume one spouse founded and owned a professional services firm as of the date the marriage. Assuming the valuation expert's scope includes a valuation as of the two relevant dates, date of marriage and date of divorce, the business had an equity value of $1.5 million at the date of marriage and $5.0 million at the divorce valuation date. Between the two relevant dates during the marriage, the business grew through expanded client relationships and service offerings, additional management and employees, and improved sales and earnings. The industry and economy also grew, and valuation multiples for comparable businesses increased.

For purposes of the illustration, the $3.5 million increase in value is analyzed and determined to consist of $2.1 million attributable to the owner-spouse's active efforts and $1.4 million attributable to passive factors, including efforts of third parties, industry growth, and market conditions.

Example 2 :: Business Interest



Figure 2:: Hypothetical allocation of the increase in business value; amounts shown in millions

This analysis requires much more than subtracting the opening value from the ending value. The two valuations should use consistent assumptions, methods, and standards of value. Changes in capital contributions, acquisitions, distributions, and changes in debt should also be considered. For further background, refer to a previous article we authored: **Active vs. Passive Appreciation of Closely Held Companies.**

Personal and Enterprise Goodwill vs. Active and Passive Appreciation

Active and passive analyses assist in the process of determining how and why value changed between two dates. Personal and enterprise goodwill analyses address how much of the ending value depends on the owner-spouse and how much can remain with the business without that individual. The analyses consider some similar attributes, but the categories do not map directly.

Active and Passive Appreciation	
Question	Why did value change?
Measures	Cause of appreciation over the period
Example	$2.1m active / $1.4m passive

Personal and Enterprise Goodwill	
Question	Where does goodwill reside?
Measures	Transferability at the valuation date
Example	Owner-dependent / business-dependent

Figure 3. Active and passive appreciation and personal and enterprise goodwill address different valuation questions

It is important to understand these analyses and characterizations, however, jurisdictions and case law differ in applicability of one or the other. In some jurisdictions, both active vs. passive appreciation and enterprise vs. personal goodwill may be appropriate considerations; at that point, the facts and circumstances are considered by the experts and legal team.

In our example, if client relationships are tied to the owner-spouse's reputation or continued involvement, personal goodwill may be present. Recurring contracts, documented processes, a recognized trade name, and a workforce that can serve clients without the owner-spouse may indicate enterprise goodwill. We discussed these considerations in **Personal vs. Enterprise Goodwill Issues to Consider in Divorce Valuations.**

Observations Across the Examples

Both examples begin with an asset owned before the marriage, but that fact does not complete the financial analysis. A well-supported analysis establishes the relevant dates and values, traces contributions and transfers, distinguishes activity-driven changes from investment or market performance, reconciles related debt and capital transactions, and discloses the methodology, assumptions, and limitations.

The analyses may overlap. Retirement account tracing must distinguish deposits from investment returns and follow funds through a rollover. The business analysis considers owner-spouse efforts, market conditions, goodwill, distributions, and debt. Addressing one issue without considering the others may produce an incomplete or internally inconsistent result.

Conclusion

Marital vs. separate property analyses often require more than identifying when an asset was acquired or whose name appears on the account or ownership documents. Financial records can establish the origin and movement of funds, quantify the components of a current balance or value, and explain the factors that contributed to appreciation. The financial expert organizes and analyzes that evidence to assist counsel and the court, while counsel applies the governing legal framework to the ultimate characterization of property.

About the Authors



Kathryn Burke, CPA, ABV, CFF is a Senior Financial Analyst with Mercer Capital. Kathryn has valuation experience in engagements related to corporate planning and reorganizations, financial reporting, fairness opinions, litigation support, employee stock ownership plans, mergers and acquisitions, and estate and gift tax planning and compliance matters. She also has forensics and litigation support experience for marital dissolution, economic damages, shareholder disputes, and general litigation. This includes experience in a wide range of industries.

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Karolina previously served on the AICPA Business Valuations Committee and is a current member of the American Academy of Matrimonial Lawyers Foundation's Forensic and Business Valuation Division. She frequently speaks to attorneys, accountants, and business professionals and is a contributing author to *Financial Valuation: Applications and Models, 5th Edition.*

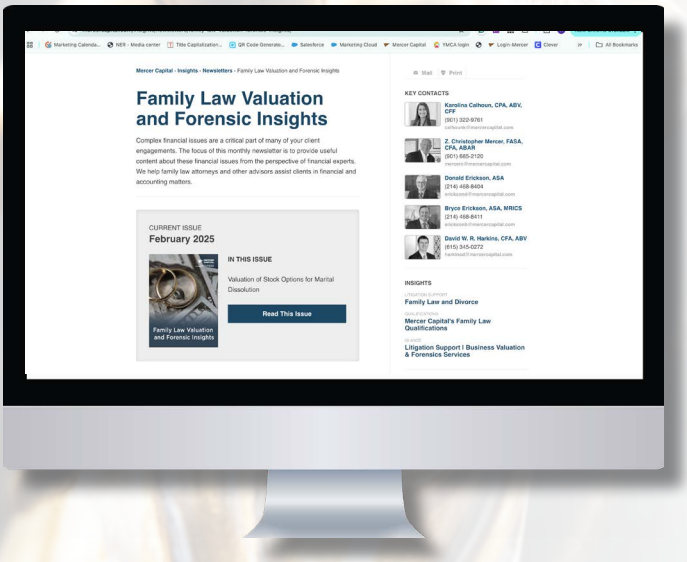
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Addressing Complex Financial & Valuation Issues

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