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Tracing to Avoid Transmutation

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I. Introduction

All states have categories of property that are excluded, at least presumptively, from division in a divorce or from spousal claims (dower, curtesy, marital selection) at death. The separateness of such property requires proof by the person asserting the separateness that the property has indeed remained separate and can be identified either as the same property originally received or can be traced to such property.[1] In the absence of such identification and tracing, the property has been transformed (transmuted) into property that is subject to division in divorce or marital claim at death.

The purpose of this article is to explore the various methods or rules by which the requisite separateness can be proven (traced), and thus by negative implication what evidence will probably not be sufficient, resulting in a finding that the property has been transmuted into divisible property. The body of tracing law has developed generally in the western states which inherited community property concepts as part of their Spanish land grant, or French, status. Case law from those states presents a variety of evidentiary methods that may be used. These methods generally depend on the records available to trace old separate assets to current mixed or separate assets.

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[1] Common law states typically reject the community property concepts of source of funds and transmutation, applying instead common law theories of title and gift, and focusing on the time of acquisition rather than the source or method of acquisition. *See* Anthony v. Anthony, 514 A.2d 91 (Pa. Superior Ct. 1986); Harper v. Harper, 448 A.2d 916 (Md. App. 1982).

II. The Wisconsin Experience

Wisconsin is at the relative beginning of developing tracing law because it is the newest state to wrestle with the concepts that are common to community property states—separate and marital property, and the methods of distinguishing between the two. To the extent that the law evolves gradually, Wisconsin is at the inception of the process. Hence, its limited view of tracing and transmutation may be of a certain quasi-historical, almost anthropological, interest to other states.

A. *Direct Tracing*

Wisconsin courts have officially approved only one specific approach to tracing. The leading Wisconsin case to address the method of tracing separate property directly is an estate case decided under probate law, not under divorce law. *In re Estate of Lloyd*[2] takes a strict approach with tracing separate property and thus does suggest that Wisconsin will take a strict approach to tracing in the divorce context,[3] requiring detailed and comprehensive records of all transactions in and out of commingled accounts. The *Lloyd* court described the appropriate methodology for tracing separate property as follows:

> The first step . . . is to determine the particular property's classification at a particular time, such as on the date of marriage, the determination date, or the date the asset was acquired. *It is necessary to have records of each transaction from the time a particular asset is acquired until the marriage terminates*. If the challenger can trace the source of payment for the acquisition of an asset by a spouse during the marriage and after the determination date to nonmarital assets, the acquired asset is nonmarital. Similarly, if an asset is mixed, tracing to a nonmarital property source preserves the traced component's nonmarital property character.
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> Direct tracing constitutes *actual proof of the classification from the initial receipt of the funds to the point at issue.* Unless a unilateral statement is executed, *the spouse not only must record each deposit and each expenditure, but also must maintain a record of interest earned on individual property and predetermination date property*. That interest

[2] 487 N.W.2d 647 (Wis. Ct. App. 1992).

[3] *But see*, Gardner v. Gardner, 527 N.W.2d 701, 708 n.2 (Wis. Ct. App. 1994) ("*Lloyd* is limited to the application of [the Wisconsin Marital Property Act's] tracing of property after the death of a spouse.").

> is marital property. *If tracing proves impossible at any point in an asset's history, the asset is transformed to marital property*.[4]

B. *Proof Problems*

The reality is that this prescribed method of direct tracing may not be possible through no fault of the parties. Many banks no longer return or retain canceled checks. Checking account statements only show the date a check cleared the bank and the amount for which it was written. Critical to tracing is the use to which the check proceeds were put: Were separate or marital expenses paid? A bank statement alone tells little. Many business and personal records are lost, discarded, or destroyed over time. Accountants and banks merge, or may be bought by larger banks or accounting firms. The trail of even the most meticulous records may be lost to fire, flood, earthquake, or other force of nature.

Perhaps recognizing that ideal proof is not always possible, not all courts applying Wisconsin law have viewed the tracing requirements as narrowly as the *Lloyd* court. A court applied probate law to evaluate an attempt to trace certain assets to separate property in a bankruptcy proceeding. The judge in *In re Geise*[5] found that the wife had adequately traced certain commingled property to its separate roots, although the tracing was not nearly as detailed as *Lloyd* seems to require. In *Geise*, tracing was relatively straightforward because the spouses kept their finances separate and the marital portion of the property consisted largely of appreciation on separate property investments. Thus, the parties' practice of asset separation and reasonable, if not perfect, record maintenance prevailed.

III. Numerous Methods of Tracing are Sanctioned in the United States

Less stringent methods of tracing are accepted when direct tracing is literally impossible. These methods are fact-driven and based on the best records available.

Direct tracing is the simplest, most straightforward tracing method of proof. It is the evidentiary equivalent of connect-the-

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4 *Id.* at 653-54 (emphasis added and citation omitted).

5 132 B.R. 908 (Bankr. E.D. Wis. 1991).

dots. Detailed and comprehensive records of *all* transactions in the chain are required.[6] Each dot must be connected, and each link in the claim must be clearly shown. If tracing proves impossible at any stage, the burden of proof to establish separate property has not been met.[7]

Sometimes the best records that exist will leave gaps in the chain. Through no fault of the proponent of the separate property, each dot cannot be connected. A portrait by Rembrandt and a portrait by Cezanne are approached very differently by the artists. Nevertheless, both are recognizable portraits of a very real person. Neither would be the equivalent of a photograph. Less direct tracing methods can also create a very clear picture of the parties' financial life without necessarily providing a photograph of every detail. If Generally Accepted Accounting Principles (GAAP) can identify the separate portion of an asset to a reasonable degree of accounting certainty, that testimony should be sufficient to establish the separate nature of the property. Other tracing methods accepted when direct tracing is impossible seem to borrow from the principles of accounting.

Because financial accounts are intangible assets, one cannot really tell whether the five dollar bill deposited on Tuesday is the same five dollars received at the withdrawal machine the next day or a week later. Inventories have the same impossibility of precise identification. It may be literally impossible to determine whether the widget that cost $4.95 to make was sold to Jones, or the one Jones received was made a week later at a cost of $3.40. Yet the cost of goods sold has to be reported. Accountants have developed accepted rules to solve the problems of tracing tangible asset costs when assets of various costs have been commingled. These principles apply with equal logic to tracing intangible assets, *i.e.*, money in one or more accounts.

A. *The Family Expense Method*

The family expense method is a somewhat relaxed version of direct tracing. California is one state that permits this method.[8]

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[6] *See Lloyd*, 487 N.W.2d 647.

[7] *Id.*

[8] *See, e.g.*, In re Marriage of Braud, 53 Cal. Rptr. 2d 179, 195 (Cal. Ct. App. 1996); In re Marriage of Mix, 536 P.2d 479, 484 (Cal. 1975).

The concept of the family expense method is to adopt the rule that in a commingled account, family ("marital" or "community") money will be used to pay family expenses *before* separate money will be used for family expenses. Therefore, it is not necessary to document every deposit and every expenditure as it occurred; no running balance is required. All of the family money that went into the account, up to the date in question, is calculated. Then, all of the family expenses that were paid out of the account in the same time period are computed. If the family expenses are equal to, or greater than, the family income, what is left is separate. Hence, the remainder of the account at that date or the asset purchased on that date with the "leftover" separate money is separate property.

Practical application of this rule up to a specific point in time is relatively simple. Suppose that the identity of a bank account as separate or marital property is in dispute. The account contained $1,000 of separate money immediately before the marriage. Another $1,000 of family money was added thereafter. All of the family expenses to the date in question total $1,500. If $500 is left in the account, under the family expense doctrine, that $500 would be separate property. A unique aspect of the family expense doctrine is that is concentrates equally on proof of what the money was spent *for* and where the money came *from*.

This approach reflects common sense in the view of many clients. Clients who are the beneficiaries of trust funds often do not generate a great amount of earned income. To them, it is obvious that if their living expenses substantially exceed their earned income, then investments they make must have been made with separate property. In essence, they say "We didn't invest until after the mortgage, the grocer, the dentist, etc." Most families probably follow the same pattern by ensuring that living expenses are paid before money is saved or invested. The client's intuitive approach is basically an accurate summary of the family expense doctrine.

Suppose the family withdrawals do not exceed the family deposits. If the same $1,000 of family money is added to the same $1,000 of separate money, the account contains $2,000. Then assume only $750 is used for family expenses. This means the account has $1,250 in it, but only $250 of that is family money. The

separate money has contributed nothing to the family, so the family estate may feel it has not been fairly dealt with.

B. *The "Marital Assets Out First" Method*

The next tracing method takes the family expense doctrine a step further, but focuses more sharply on what kind of funds are in the account and has less interest in what those funds purchased. This method operates on the premise that marital money is spent first, regardless of the expenditure purpose. The "Marital Assets Out First" approach resembles Last-In-First-Out ("LIFO") and First-In-First-Out ("FIFO") methods of business cost accounting. This method assumes that the withdrawals from the commingled account during the marriage used marital funds *first*, no matter what was being purchased. Separate funds deposited into the account sink to the bottom. The separate funds stay on the bottom of the account until all marital funds have been spent; only then are separate funds used. If additional marital money is added, then the separate funds once again drop to the "bottom" of the account. If an account contained $1,000 in separate funds and $1,000 in marital funds, if $750 is used for family expenses and $250 is used for separate expenses, $1,000 of separate money would still remain in the account. The separate estate would be ahead $250 at the direct expense of the family estate. However, if the separate funds are invaded (*i.e.*, $1,250 is spent, so the separate estate is now $750), they are not replenished from any source except separate funds.

Hill v. Hill[9] is a good illustration of this method:

> Assume that the wife deposited $50 of separate funds into an account that already had $25 of community property. The $50 would sink to the bottom. If a $35 check were then drawn against the account, the remaining $40 would be the wife's separate property. Should another $20 of community monies be deposited and a $40 withdrawal made, then the separate funds of the wife would equal $20. Should that $20 be removed, then the wife's separate property would be depleted even though $100 of community funds was deposited thereafter.[10]

Part of the problem with the sinking fund concept is that it is possible for the person who puts in more money to end up with a lesser share of the account. Eventually, the separate money rises

[9] 971 S.W.2d 153 (Tex. App. 1998).
[10] *Id.* at 158 n.5.

to the top, but only when no community money is left in the account. Consequently, even though more community money may have gone into the account, the community may receive a lesser share of the residue. The unfairness resulting in certain cases may have contributed to equitable adjustments adopted in other tracing methods.

C. *The Total Recapitulation Method*

The total recapitulation method has examples in New Mexico, Idaho and Texas.[11] This tracing rule permits a spouse to show that a specific asset was purchased with separate funds by showing that marital expenses exceeded marital income *over the entire course of the marriage*. This rule is like a mirror—it reflects the separate property by a process of elimination. First, all of the marital deposits are calculated. Then, all of the marital expenses are calculated. If the marital expenses exceed the marital income, the recapitulation shows, by negative inference, that everything else was purchased with separate property because there was no other source of funds. From some clients' point of view, this method also has a certain logic.

D. *The Pro Rata Method*

The most flexible tracing methodology is the pro rata method. This can be used equally well for tracing an account that is commingled and for tracing an asset purchased from a commingled account.[12] The pro rata rule establishes the percentage of separate money in the account over the time period in question. It then compares the total separate money to the total money in the account. That percentage (or ratio) is then applied to the asset in question, or to the balance in the account, or to both. For example, if $5,000 was established as separate money, and the entire account contained $17,800, then the separate share ratio was $5,000/$17,800 or 28.09%. That fraction represents the ratio of separate-to-community interest in the account. That

11 *See* Zemke v. Zemke, 860 P.2d 756 (N.M. Ct. App. 1993); Weilmunster v. Weilmunster, 858 P.2d 766 (Idaho Ct. App. 1993); DePuy v. DePuy, 483 S.W.2d 883 (Ct. App. Tex. 1972).

12 *See* Duncan v. United States, 247 F.2d 845 (5th Cir. 1957).

fraction would also define the ownership ratio of an asset purchased during the time that account existed.

Suppose the asset acquired was 250 shares of stock. Then 28.09% of the shares are separate, or 70.2 shares. This pure mathematical computation creates an aura of fairness, and a promise of predictability. It is a method that a court could apply to divide *any* assets purchased from a commingled account.

IV. The Use of Expert Testimony

Tracing is a question of proof. Failure to meet the burden means the separate property has transmuted into martial property. How to carry the burden of proof (and persuasion) is crucial to all attorneys. Can the burden of proof be met without an expert witness? In some instances, the answer may be "yes." For example, special knowledge or training probably is not required to follow a specific amount of money which is "parked" in a joint account, then promptly used to purchase a specific asset.[13] In *Zirngibl v. Zirngibl*, the wife deposited separate gifted money into a joint account and used it to purchase the parties' home. The court said that the merger of the separate property with other funds used to purchase real estate creates only a rebuttal presumption of donative intent, *i.e.*, that the person depositing the funds intended to make a gift of them to the marital estate.

However, the passage of time and a large number of intervening transactions can quickly move tracing to the realm of expert witness testimony. Reviewing years of financial records and preparing a detailed analysis of what the records show are likely beyond the ability of a party to the action to establish persuasively.

Tracing testimony will be measured by the usual rules of evidence. Expert witnesses will be held to the same standard as expert witnesses in other cases. Accountants as experts will be entitled to rely on the same types of records and facts upon which they normally rely in the practice of their profession. They can be asked to express opinions to a reasonable degree of professional certainty.[14]

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13 477 N.W.2d 637 (Wis. Ct. App. 1991).

14 The Federal Rules of Evidence, or their counterparts in most states, provide the same parameters as Wisconsin for expert testimony:

Even the rules of the accounting profession for audits (the most stringent of accounting examinations of financial records) do not require that *each* expenditure of a corporation over the entire year be separately verified.[15] Accountants can provide an expert opinion, to a reasonable degree of accounting certainty, that the corporation spent or earned $X during the period of the audit. Shareholders rely on such opinions. Public investors rely on such opinions. The government relies on such opinions in Securities and Exchange Commission's required filings.

If an accountant has sufficient facts upon which to base a professional opinion that a specific portion of a commingled account actually came from separate property, he or she should be qualified to testify. Generally Accepted Accounting Principles (GAAP) or Generally Accepted Auditing Standards (GAAS) are the product of the American Institute of Certified Public Accountants. They are the tools used by forensic accountants to explain what might appear to a lay person to be "gaps" in direct tracing evidence. Because the results of GAAP and GAAS analysis are reliable enough for multimillion dollar corporate transactions, they should be sufficient to prove whether all, or a portion, of an asset is separate property,

V. Conclusion

Tracing in divorce or estate proceedings should not be treated differently than any other problem of lay and/or expert testimony. All of the tracing methods accepted by courts are designed to provide answers to what are essentially accounting questions. Expert witnesses traditionally make judgments and

> 7.02. If . . . technical or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert . . . may testify thereto in the form of opinion or otherwise.
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> Further, an expert is not necessarily constrained by the limits of otherwise admissible evidence. If the evidence relied upon is ". . . of a type reasonably relied upon by experts in a particular field . . . the facts or data need not be admissible as evidence." *See* §§ 7.02 and 7.03, Federal Rules of Evidence.

[15] The direct tracing method discussed at length in Wisconsin seems to require a more detailed, more comprehensive chain of proof than is required of an audit of a multinational corporation. The public policy reasons for this extraordinary demand in a civil case are unexplained.

express opinions consistent with the accepted thinking and methods in their profession. The business evaluator does a business evaluation. A real estate appraiser does a real estate appraisal, each based on the variety of methods accepted in their respective fields. Ultimately, the evaluator's or appraiser's opinion is based on what that professional learned from the various approaches each employed. Accountants doing tracing should be equally thorough. If direct tracing is impossible, then other reliable methods should be available. Perhaps several methods can be applied to the questioned account, just as business appraisers apply several methods to the same business. Particularly if several tracing methods yield substantially similar results, the conclusion as to the separate asset, or portion thereof, should be especially persuasive.