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Equitable Distribution Update

NC Court of Appeals

I. Tenancy By the Entirety and the Marital Gift Presumption

S.L. 2013-103 amends the marital property presumption found in G.S. 50-20(b)(1) to specifically include property acquired as tenants by the entirety. As of October 1, 2013, the statute now provides:

> It is presumed that all property acquired after the date of marriage and before the date of separation is marital except property which is separate property under subdivision (2) of this subsection. *It is presumed that all real property creating a tenancy by the entirety acquired after the date of marriage and before the date of separation is marital property. Either* presumption may be rebutted by the greater weight of the evidence. (italics indicates language added by S.L. 2013-103).

Rebutting the Marital Property Presumption

While G.S. 50-20(b)(1) specifically states that the general marital property presumption is rebutted by showing the property falls within one of the categories of separate property listed in G.S 50-20(b)(2), the statute does not state specifically how the presumption regarding property titled as tenancy by the entirety is rebutted. However, case law regarding the marital property presumption and burdens of proof in classification indicate that a presumption that property is marital generally is rebutted by a showing that the property actually is separate property. *See Brackney v. Brackney*, 199 N.C. App. 375, 682 S.E.2d 401

(2009); *Finkle v. Finkle*, 162 N.C. App. 344, 590 S.E.2d 472 (2004); *Atkins v. Atkins*, 102 N.C. App. 199, 401 S.E.2d 784 (1991). Therefore, presumably, the new presumption in G.S. 50-20(b)(1) that property creating a tenancy by the entirety is marital can be rebutted by showing, by the greater weight of the evidence, that the real property was acquired in whole or in part with separate funds or in exchange for separate property. *See* G.S. 50-20(b)(2)(defining separate property).

However, case law provides that when property is titled as tenants by the entirety, there is a presumption that any separate property or separate funds used to acquire the property was gifted to the marriage and, according to G.S. 50-20(b)(2), gifts between spouses during the marriage are marital property unless a contrary intention is expressly stated in the conveyance. *McLean v. McLean*, 323 N.C. 543, 546, 374 S.E.2d 376, 378 (1988); *Romulus v. Romulus,* __ N.C. App. __, 715 S.E.2d 308 (2011); *Stone v. Stone,* 181 N.C. App. 688, 640 S.E.2d 826 (2007); *Walter v. Walter,* 149 N.C. App. 723, 561 S.E.2d 571 (2002); *Davis v. Sineath (Davis),* 129 N.C. App. 353, 498 S.E.2d 629 (1998); *McLeod v. McLeod*, 74 N.C. App. 144, 327 S.E.2d 910 (1985). The property is presumed marital even if one spouse subsequently dissolves the tenancy by the entirety by quitclaiming her interest in the property to the other spouse. *See Beroth v. Beroth,* 87 N.C. App. 93, 359 S.E.2d 512 (1987)(quitclaim executed before the date of separation); *Davis v. Davis*, 360 N.C. 518, 631 S.E.2d 114 (2006)(quitclaim executed after the date of separation). The rationale for the presumption is that the titling of the property as tenants by the entirety supplies the specific donative intent necessary to find a gift to the marital estate. *McLeod,* 74 N.C. App. at 156, 327 S.E.2d at 918. According to the Supreme Court, it is the nature of the conveyance itself which gives rise to the presumption of donative intent. *McLean v. McLean*, 323 N.C. 543, n. 1, 374 S.E.2d 376 (1988)("property is not simply titled jointly, but titled by the entireties, a unique form of ownership in which title is held by the marital entity.")

Rebutting the Marital Gift Presumption

Case law provides that the presumption of a gift to the marriage may be rebutted by evidence that the separate property was not gifted to the marriage, *McLean v. McLean*, 323 N.C. 543, 374 S.E.2d 376 (1988)(presence of donative intent at the time of transfer determines whether gift was made; motivation for making gift is not determinative; rebut presumption by proving no gift was intended); *Warren v. Warren,* 175 N.C.App. 509, 623 S.E.2d 800 (2006); *Loving v. Loving*, 118 N.C.App. 501, 455 S.E.2d 885 (1995); **or** by showing that while there was a gift between the spouses during the marriage, the intention that the property would remain separate property was expressly stated in the conveyance creating the tenancy by the entirety. [*Romulus v. Romulus,* __ N.C.App. __, 715 S.E.2d 308 (2011), citing G.S. 50-20(b)(2) and *McLeod*.]

Case law consistently has held that the presumption that the contribution of separate property to the acquisition of the property held as tenants by the entirety is a gift to the marriage can be rebutted only by clear, cogent and convincing evidence, s*ee e.g. Mclean; Warren; Loving*, but it appears that the 2013 amendment to G.S. 50-20(b)(1) is intended to change that burden of proof to greater weight of the evidence. There is some question about this however, given the fact that the statutory amendment references only the marital property presumption and does not reference the marital gift presumption. In *McLean,* the Supreme Court noted that the two presumptions are "distinct concepts."

Whether a party succeeds in rebutting the presumption is a matter left to the trial court's discretion for it is the trial court that must find the evidence convincing; *McLean*, 323 N.C. at 555, 374 S.E.2d at 383; *Romulus v. Romulus*, __ N.C. App. __, 715 S.E.2d 308 (2011), but the trial court's finding that a party successfully rebutted the presumption must be supported by competent evidence in the record or the classification of the property as separate will be overturned. *Walter v. Walter*, 149 N.C. App. 723, 561 S.E.2d 571 (2002) (when party did not provide supporting evidence in his brief and appellate court could find none in the record, residence classified as marital property); *Stone v. Stone,* 181 N.C. App. 688, 640 S.E.2d 826 (2007) (where trial court failed to classify as either separate or marital property the wife's contribution of her separate property to purchase the marital residence and funds provided by her mother for improvements thereto, and failed to conclude whether wife had rebutted the marital gift presumption, case remanded for a new distribution order).

An appellate court will review the exercise of discretion under an abuse of discretion standard. *Thompson v. Thompson,* 93 N.C. App. 229, 377 S.E.2d 767 (1989). There is no North Carolina appellate opinion affirming a trial court determination that the marital gift presumption was successfully rebutted.

It is the donor's, not the donee's, intent that is relevant. *Warren v. Warren,* 175 N.C. App. 509, 623 S.E.2d 800 (2006) (donee wife's testimony, that she did not believe that her husband had given her an interest in entireties property, irrelevant).

There is no rule that the marital gift presumption cannot, as a matter of law, be rebutted by testimony of the donor spouse alone. *Romulus v. Romulus,* __ N.C.App. __, 715 S.E.2d 308 (2011) (weight to give donor testimony is matter for trial court to determine). However, appellate courts repeatedly have upheld trial court determinations that testimony offered by the grantor spouse alone that no gift was intended was not sufficient to rebut the presumption of a gift in individual cases. *Warren v. Warren,* 175 N.C. App. 509, 623 S.E.2d 800 (2006); *Haywood v. Haywood*, 333 N.C. 342, 425 S.E.2d 696 (1993), *rev'g in part per curiam for reasons stated in dissenting opinion in* 106 N.C. App. 91, 415 S.E.2d 565 (1992) (Wynn, J., dissenting); *Thompson v. Thompson*, 93 N.C. App. 229, 377 S.E.2d 767 (1989); *Draughon v. Draughon*, 82 N.C. App. 738, 347 S.E.2d 871 (1986), *review denied*, 319 N.C. 103, 353 S.E.2d 107 (1987). The court of appeals reversed a trial court determination that the presumption had been rebutted where evidence used by trial court to support the separate classification of the property did not relate to husband's donative intent. *See Lawrence v. Lawrence,* 100 N.C. App. 1, 394 S.E.2d 267 (1990)(the trial court erred in classifying property held as tenancy by the entirety as separate property based on findings that separate funds were used to acquire the entirety property, the property was the "ancestral" property of the donor spouse, the donee spouse did not know the location of the property, and the donee spouse did not testify that the donor spouse intended to make a gift to the marital estate). In *McLean v. McLean*, 323 N.C. 543, fn. 3, 374 S.E.2d 376 (1988), the court noted that while testimony from donor that transfer was made to avoid federal tax consequences established why gift was made, it did not refute that gift was made.

II. Divisible Debt and Postseparation Payments

S.L. 2013-103 also amends the definition of divisible debt contained in G.S. 50-20(b)(4)(d). Effective October 1, 2013, divisible debt will include only "*passive* increases and *passive* decreases in marital debt and financing charges and interest related to marital debt" occurring after the date of separation. This amendment appears to be intended to exclude *active* increases and *active* decreases in marital debt from the definition of divisible property. In *Hay v. Hay*, 148 N.C. App. 649, 559 S.E.2d 268 (2002), the court of appeals held that the postseparation increase in the net value of marital real property caused by the fact that one party paid down the principal on the mortgage encumbering the property was not *passive* appreciation because it had been caused by the *action* of one party making postseparation payments. Based on *Hay*, the recent amendment to G.S. 50-20(b)(4)(d) appears to mean that decreases in marital debt caused by payments made by one spouse after the date of separation are no longer divisible property because they are active rather than passive decreases in marital debt. By providing that a postseparation decrease in marital debt caused by one party paying that debt is no longer divisible property which must be specifically classified, valued and distributed by the court along with marital property, courts presumably will return to addressing most postseparation debt payments only through 'consideration', the use of 'credits' and adjustments to the distribution of the marital estate.

Background.

Equitable distribution is the process of distributing *marital* property and *marital* debt between divorcing spouses. Subject to the narrow exception for a subcategory of marital property called divisible property discussed further below, if property and debt is not within the marital estate, a trial court has no authority to distribute the property or debt in equitable distribution. *See Chandler v. Chandler,* 108 N.C. App. 66, 422 S.E.2d 587 (1992); *Gum v. Gum*, 107 N.C. App. 734, 421 S.E.2d 788 (1992); *Truesdale v. Truesdale*, 89 N.C. App. 445, 366 S.E.2d 512 (1988). In North Carolina, the marital estate freezes on the date of separation. *Becker v. Becker*, 88 N.C. App. 606, 364 S.E.2d 175 (1988). This means that, again subject to the narrow exception of divisible property, a trial court is limited to distributing between the parties only that value of property and debt which existed on the date of separation. Before the creation of divisible property in 1997, *see* SL 1997-302 (discussed further below), numerous cases held that any change in the value of the marital estate occurring after the date of separation could be considered by the court only as a 'distribution factor.' *See e.g. Truesdale v. Truesdale*, 89 N.C. App. 445, 366 S.E.2d 512 (1988). This means the court could consider the changes in value when deciding whether to distribute the date of separation marital estate equally or unequally between the parties, but none of the value acquired or lost during separation actually could be distributed between the parties. *See Gum v. Gum*, 107 N.C. App. 734, 421 S.E.2d 788 (1992)(rather than distributing increased value, or income received after date of separation, court must consider its existence, consider to whose benefit it accrues, and then consider that benefit when deciding whether an equal distribution of the marital estate is equitable).

Similarly, the court of appeals has held that because marital debt is that debt incurred during the marriage for the joint benefit of the parties that was owed on the date of separation, *see Huguelet v. Huguelet*, 113 N.C. App. 533, 439 S.E.2d 208 (1994), new debt incurred after the date of separation is not marital debt and cannot be distributed by the trial court in the equitable distribution judgment. *See Warren v. Warren,* 175 NC App 509, 623 S.E.2d 800 (2006)(wife's draws on marital equity line after the date of separation created new debt rather than an increase in marital debt). Further, the court of appeals has held that marital debt must be distributed by the court at the date of separation value even if the debt is paid in full by the date of distribution. *Loving v. Loving,* 118 N.C. App. 501, 455 S.E.2d 855 (1995). The liabilities of each party on the date of distribution are distribution factors only. G.S. 50-20(c)(1).

Nevertheless, North Carolina appellate courts consistently have held that the trial court has broad discretion in determining how to address the postseparation decrease in marital debt caused by one party paying the debt and in determining how to address payments made by parties during separation which do not meet the definition of marital debt because they were not actually owed on the date of separation but were made to maintain or protect the marital estate. For example, in *Smith v. Smith,* 111 N.C. App. 460, 510 (1993), the court of appeals stated that "[d]etermination of the appropriate treatment of marital debts and postseparation payments towards those debts depends upon the particular facts of each case and is left to the discretion of the trial court." *Accord Walter v. Walter,* 149 N.C. App. 723 (2002) and *McNeely v. McNeely,* 195 N.C. App. 705, 673 S.E.2d 778 (2009). With this statement, the *Smith* court implicitly acknowledged that the appellate courts have allowed trial courts much more flexibility in addressing postseparation changes in the value of marital debt and postseparation payments related to the maintenance of marital property than it has allowed for other postseparation occurrences related to the marital estate.

The trial court's authority does not appear to be limited to addressing only that debt fitting the definition of marital debt as set forth in *Huguelet* mentioned above. While payments made after the date of separation on marital debts owed on the date of separation clearly are payments of marital debt, the court of appeals in *Smith* pointed out that payments made towards other "obligations flowing from marital property, such as mortgage payments and payment of property taxes, also have been treated by the Court as payments made towards a marital debt," even though technically some of those debts do not fit the definition of marital debt because they were not owed on the date of separation. *See also Bowman v. Bowman,* 96 N.C. App. 253, 385 S.E.2d 155 (1989)(taxes on jointly held property classified as marital debt even though not owed on date of separation).

According to *Smith* and other cases both before and after *Smith*, options of the trial court in dealing with all postseparation payments related to marital debt and related to the maintenance of the marital estate include "apportioning" the debts between the parties, "ordering one spouse to reimburse the other spouse for payments made towards the debts," considering postseparation payments "as a distribution factor," "crediting a spouse in an appropriate manner for postseparation payments made," or using an "actual credit" to account for the payments. The *Smith* court noted that the North Carolina Supreme Court also "impliedly approved the use of a credit as a means of taking into consideration postseparation payments made towards marital debts in *Weincek-Adams v. Adams,* 331 N.C. 688, 417 S.E.2d 449 (1992)." *See also Walter v. Walter, 149 N.C. App. 723 (2002); Wall v. Wall,* 140 N.C. App. 303 (2002); *Loving v. Loving,* 118 N.C. App. 501, 455 S.E.2d 885 (1995); *Truesdale v. Truesdale*, 89 N.C. App. 445, 366 S.E.2d 512 (1988)(approving use of adjustive credits); *Hendricks v. Hendricks,* 96 N.C. App. 462, 386 S.E.2d 84 (1989)(trial court can provide 'direct credits' to spouse making mortgage payments during separation when house awarded to other spouse in final distribution). *But cf. Miller v. Miller*, 97 N.C. App. 77, 387 S.E.2d 181(1990)(court held that postseparation payment of marital debt and debt associated with marital property must be addressed only as a distribution factor, just like all other postseparation changes to the marital estate. This means that if parties stipulate than an equal distribution is equitable, trial court cannot consider postseparation payments at all).

Divisible Property

In order to address perceived inequities associated with a trial court's inability to distribute postseparation changes in value of marital property or other postseparation occurrences regarding the marital estate, in 1997 the General Assembly amended the equitable distribution statute to create a subcategory of marital property called divisible property and to require that a court classify, value and distribute divisible property based on the date of *distribution* value of that property. This change required trial courts to specifically value and account for passive postseparation increases and decreases in the value of marital property, passive income earned from marital property, and new property acquired after separation but through the efforts of one or both parties before separation. G.S. 50-20(b)(4). It also required the trial court to value and account for increases in marital debt resulting from finance charges and interest accumulating between the date of separation and the date of distribution. *Id.* In 2002, the statute again was amended to include *decreases* in marital debt as a category of divisible property. S.L. 2002-159, sec. 92. In response to arguments such as that specifically rejected by the court of appeals in *Smith v. Smith,* 111 N.C. App. 460, 510 (1993), that trial courts should not be allowed to "only loosely consider" payments made by one party during separation, the 2002 amendment required trial courts to classify, value and specifically distribute all payments made by either party during separation which decreased marital debt.

The inclusion of decreases in marital debt within the category of divisible property increased the complexity of equitable distribution trials because parties could no longer simply provide evidence of the total amount a spouse paid during separation but instead were required to identify specifically how much of the total payments made actually caused a decrease in the amount owed on a marital debt on the date of separation. *See Peltzer v. Peltzer*, 732 S.E.2d 357 (N.C. App. 2012)(while trial courts must classify and value divisible debt, trial court is not required to place a value on or specifically distribute other postseparation payments made regarding the marital estate or maintenance of marital property). Despite this increased complexity in classification and valuation, the trial court's discretion in determining how to distribute the decrease between the parties in the final equitable distribution judgment remained unchanged. In other words, the amendment did not result in a requirement that a paying party receive dollar-for-dollar credit, or any credit for that matter, for postseparation reductions in marital debt. *See McNeely v. McNeely*, 195 N.C. App. 705, 673 S.E.2d 778 (2009); *Peltzer v. Peltzer*, 732 S.E.2d 357 (N.C. App., 2012); *Jones v. Jones, unpublished,* 193 N.C. App. 610, 670 S.E.2d 644 (2008)(court had discretion to credit wife for paying mortgage even though she had exclusive possession of the house during separation and was awarded house in distribution). Instead, the amendment required only that the equitable distribution judgment show exactly how the trial court valued the decrease in debt and how the court addressed it in the overall distribution. *See Bodie v. Bodie*, 727 S.E.2d 11 (N.C. App. 2012)(trial court erred in not classifying, valuing and distributing the divisible debt portion of postseparation payments made by husband before considering those payments in distribution or giving husband any type of credit for the payments).

<u>So where are we now?</u>

It is likely the 2013 amendment will apply to payments made on or after October 1, 2013 rather than to equitable distribution cases filed on or after that date. This is due to the fact that the court of appeals held that the amendment defining decreases in marital debt as divisible property applied to payments made by parties on or after the effective date of that statutory change, October 11, 2002. *Cooke v. Cooke,* 185 N.C. App. 101, 647 S.E.2d 662 (2008). This means that, as with the last amendment, both the old law and the new law will apply in some equitable distribution cases if the parties made payments both before and after October 1, 2013. *See Warren v. Warren,* 175 NC App 509, 623 S.E.2d 800 (2006)(postseparation payments made by husband reducing marital debt would be divisible debt but only to the extent the payments made after October 11, 2002).

While the trial court no longer will be required to specifically classify active reductions in marital debt, it is clear the court must give "some consideration" to postseparation payments from separate funds when those payments benefit the marital estate. *See Washburn v. Washburn, unpublished opinion,* (N.C. App. 2013)(trial court erred in failing to consider evidence presented by party regarding postseparation payments); *Bodie v. Bodie*, 727 S.E.2d 11 (N.C. App. 2012)(to decide whether to give credit for postseparation payments, court must consider source of the funds used to make the payments); *Williamson v. Williamson*, 719 S.E.2d 625 (N.C. App., 2011)(where trial court gave plaintiff 'credit' for paying defendant's personal expenses during separation, such as her phone bill, utility bill and water bill, case was remanded to trial court for findings as to how these payments benefited the marital estate); *but cf. Peltzer v. Peltzer*, 732 S.E.2d 357 (2012)(trial court did not err in considering fact that husband voluntarily paid wife's educational expenses from his separate funds after separation as a distribution factor). However, the type of consideration and the extent of the consideration will depend upon the particular circumstances of the case and will be within the discretion of the trial judge. *See e.g. Walter v. Walter,* 149 N.C App. 723 (2002)(when deciding whether and to what extent a paying party is entitled to credit in the final distribution, the trial court must consider postseparation payments made from non-marital or separate funds which benefited the marital estate but also must consider who had possession of the marital property during separation, who paid for or performed maintenance on marital property during separation, and who ultimately is awarded the property in the final distribution). *See also Peltzer v. Peltzer*, 732 S.E.2d 357 (2012)(trial court should consider how each party benefited from the payments when deciding whether and to what extent to credit the paying spouse).

Some appellate opinions indicate that if one party pays marital debt encumbering real property during separation and that property ultimately is distributed all or in part to the other party in the final distribution, the court must award the paying spouse credit or reimbursement for the amount paid. *See Loving v. Loving,* 118 N.C. App. 501, 455 S.E.2d 885 (1995); *Walter v. Walter,* 149 N.C. App. 723 (2002); *Hunt v. Hunt*, 85 N.C. App. 484, 355 S.E.2d 519 (1987). However, it is clear that if such payments are made by the paying spouse as spousal or child support, the paying spouse is not entitled to any consideration for those payments in equitable distribution. *Hill v. Hill*, 748 S.E.2d 352 (N.C. App., 2013); *Wirth v. Wirth*, 193 N.C. App. 657, 668 S.E.2d 603 (2008); *Wilkins v. Wilkins,* 111 N.C. App. 541, 432 S.E.2d 891 (1993)(G.S. 50-20(c) prohibits consideration of alimony and child support in equitable distribution).

<u>‘Credit’ v. distribution factor</u>

Now that trial courts are no longer required to go through the process of actually classifying postseparation payments, the task of the court will be limited to determining which of the options set forth in *Smith* and other appellate opinions such as *Walker* and *Loving* are appropriate under the particular circumstances of the case. Unfortunately, the appellate opinions do not define these various options or explain how they differ. What is clear is that trial courts must continue to distribute marital debt at the date of separation value between the spouses, and the court must continue to consider all distribution factors raised by the evidence in determining whether the marital and divisible estate should be divided equally or unequally between the parties. While not defined by case law, a 'credit' appears to be a method of dealing with the postseparation payments as part of the actual distribution of the marital estate (meaning the estate in existence on the date of separation), while other options involve adjusting the percentage allocation of the marital and divisible estates to each spouse due to consideration of the payments as distribution factors.

Distributing the date of separation value of a debt to one spouse gives a spouse 'dollar-for-dollar 'credit' for any postseparation payment made because the distribution reduces the net value of the marital property awarded to that spouse in the exact amount of the payments which reduced the debt. Similarly, if the trial court splits the date of separation value of the debt between the parties, the court is awarding only partial 'credit' to the party who made payments reducing the debt following separation. *See e.g. McNeely v. McNeely,* 195 N.C. App. 705, 673 S.E.2d 778 (2009). A trial court must be careful not to award 'double credit' to a spouse by assigning the marital debt to that spouse and then providing an additional type of 'credit' for payments made after separation. *See Smith v. Smith*, 111 N.C. App. 460, 511 (1993)(on remand trial court should reconsider treatment of mortgage payment were it was obvious court awarded double credit to paying spouse). For example, assigning the date of separation value of the marital debt to a spouse and then subtracting all payments made on that debt from a distributive award allocated to that spouse will result in a double credit for those payments.

This method of awarding 'credit' appears to be most appropriate method of accounting for payments which actually reduced marital debt that existed on the date of separation and therefor is included in the net value of the marital estate. The credits are awarded as the result of the actual distribution of the marital estate. Accounting for payments made during separation on debt *not* included in the date of separation value of the marital estate through the use of these types of credits will result in a judgment which distributes more than the net value of the marital estate and could result in confusion regarding whether a distribution is equal or unequal. If a court feels credit (as opposed to consideration as a distribution factor discussed below) is appropriate for a debt paid during separation, for example, amounts paid for property taxes or house maintenance costs accruing after the date of separation, the amount of those payments actually should be included within the total value of the marital estate – even though they were not actually owed on the date of separation – to make the math work out in distribution. The cases classifying these debts as 'marital' would support this method of accounting. *See Smith v. Smith*, 111 N.C. App. 460, 511 (1993), *Bowman v. Bowman,* 96 N.C. App. 253, 385 S.E.2d 155 (1989). Nevertheless, this seems awkward and could prove confusing in that there was no actual date of separation value for these debts. For this reason, it seems much more appropriate to deal with such payments as distribution factors only and adjust the allocation of the date of separation value of the marital estate as the court deems appropriate. *See Peltzer*. When payments are addressed as distribution factors only, the trial court is not required to place a specific value on the payments. *Peltzer*. While distribution factors can be considered only when the trial court has the option of making an unequal distribution, s*ee Miller v. Miller*, 97 N.C. App. 77, 387 S.E.2d 181(1990), as long as the parties do not stipulate that equal is equitable, the trial court is free to consider all distribution factors in deciding how to allocate the marital estate even if the court ultimately decides that an equal distribution is equitable.

Passive Increases and Passive Decreases in Marital Debt

Postseparation increases and decreases in marital debt and interest and finance charges related to marital debt *not* resulting from the actions of a spouse remain divisible property. Until this amendment, classification of divisible debt did not require consideration of whether the change in value of the debt was active or passive, so there is no case law to date discussing that distinction with regard to debt. In general, passive change means change resulting from external economic or other influences, such as inflation or market forces or other circumstances beyond the control of either party, *see O'Brien v. O'Brian*, 131 N.C. App. 411, 508 S.E.2d 300 (1999), *Brackney v. Brackney*, 199 N.C. App. 375, 682 S.E.2d 401 (2009), and active change means a change caused by the financial, managerial, or other contribution, effort or activity of one of the spouses. *See Ciobanu v. Ciobanu*, 104 N.C. App. 461, 409 S.E.2d 749 (1991) and *Brackney*. With regard to the burden of proof with divisible property, the court of appeals has stated that the party seeking to show property to be divisible bears the burden of showing the property fits within one of the categories in G.S. 50-20(b)(4). See *Walter v. Walter,* 149 N.C. App. 723, 728 n.2, 561 S.E.2d 571 (2002)(statement by court in a footnote)(except *cf. Wirth v. Wirth*, 193 N.C. App. 657, 668 S.E.2d 603 (2008), regarding postseparation changes in value of marital *property*, statute creates presumption that such changes are passive).

New debt incurred during separation is not marital debt and therefore not divisible debt. *See Warren v. Warren,* 175 NC App 509, 623 S.E.2d 800 (2006)(wife's draws on marital equity line after the date of separation created new debt rather than an increase in marital debt). Passive increases in marital debt – which remain divisible debt after the new amendment to G.S. 50-20(b)(4)(d) - will include interest and finance charges accruing after the date of separation not caused by the actions of either spouse. According to the burden of proof set forth in *Walter,* the party seeking to classify the interest and finance charges as divisible debt will need to prove the charges were not caused by the actions of either spouse. As finance charges frequently accrue as the result of penalties and late payments, there probably will be more disputes regarding whether actions of a spouse or both spouses during separation created the additional charges.

III. Defined Contribution Retirement Accounts, *i.e.* 401Ks

There is no recent statutory change dealing with retirement accounts in equitable distribution cases. However, the holding by the court of appeals regarding defined contribution plans in the case of *Watkins v. Watkins*, 746 S.E.2d 394 (N.C. App. 2013), is a significant development in the law. In that case, the court held that most defined contribution plans, such as 401Ks and IRAs, are not "pension, retirement, or other deferred compensation" plans within the meaning of G.S. 50-20.1.

While the equitable distribution statute does not define "pension, retirement, or other deferred compensation," in *Poore v. Poore*, 75 N.C. App. 414, 331 S.E.2d 266 (1985), the court held that the statute includes "any deferred compensation plan, whether structured as a pension, a profit sharing, or retirement plan." In *Fountain v. Fountain*, 148 N.C. App. 329, 559 S.E.2d 25 (2002), the court of appeals held that the definition was sufficiently broad to include vested and nonvested stock options granted to employees by employers as part of a compensation package, regardless of whether the options were exercisable by the employee spouse by the date of separation or not. *But cf., Ubertaccio v. Ubertaccio,* 359 N.C. 175, 604 S.E.2d 912 (2004), affirming and adopting concurring opinion by Judge Levinson in Court of Appeals, 161 N.C. App. 352, 588 S.E.2d 905 (2003)(clear intent of G.S. 50-20.1 to cover only those "other forms of deferred compensation" that are actually in the nature of pension and retirement benefits).

G.S. 50-20.1 governs the classification and distribution of pensions, retirement, and other deferred compensation plans. A trial court has limited options for distributing such plans and the options available depend upon whether a plan is vested or not vested. Classification of plans subject to G.S. 50-20.1 is determined by application of the 'coverture fraction' found in G.S. 50-20.1(d):

> "The award shall be determined using the proportion of time the marriage existed (up to the date of separation of the

> parties), simultaneously with the employment which earned the vested and nonvested pension, retirement, or other deferred compensation benefits, to the total amount of time of employment."

The coverture fraction conclusively determines the extent to which a pension, retirement or deferred compensation plan was acquired during the marriage and therefore is marital property. Applying the coverture fraction, if an employee spouse begins working at the job which earns her the pension, retirement or other deferred compensation during the marriage, the value of the pension or retirement account accumulated by the date of separation will be entirely marital. If however, for example, the employee spouse started working the job 5 years prior to marriage and continued working during the marriage for 5 more years until the date of separation, 5/10's or ½ of the date of separation value of the pension or retirement account will be marital. Because the statute provides that the award shall be determined using this fraction, a trial court cannot use a source of funds analysis to actually trace out the specific part of the date of separation value attributable to the spouse's employment before the date of marriage. *Robertson v. Robertson*, 167 N.C. App. 567, 605 S.E.2d 667 (2004); *Watkins*.

Retirement and deferred compensation plans fall within one of two categories. A plan is either a defined benefit plan or a defined contribution plan. A defined benefit plan is what is commonly thought of as a traditional pension. Future benefits are determined by the terms of the plan and are not based upon actual contributions by either the employer or the employee. While an employee generally makes contributions to a defined benefit retirement fund while working, the benefits eventually paid to the employee are determined using factors such as years of employment and amount of compensation rather than an amount contributed by the employee. *Cunningham v. Cunningham*, 171 N.C. App. 550, 615 S.E.2d 675 (2005); *Cochran v. Cochran*, 198 N.C. App. 224, 679 S.E.2d 469 (2009); *Bishop v. Bishop*, 113 N.C. App. 725, 440 S.E.2d 591 (1994). North Carolina Judicial Retirement and the North Carolina State Employees Retirement plan are defined benefit plans.

A defined contribution plan is a plan that provides an individual account for each employee participant. Contributions are made to the account by the employee and often also by the employer. Benefits eventually paid upon retirement are based solely on the amount accumulated in the employee's account. A defined contribution account has been described as "essentially an annuity funded by periodic contributions. At retirement the funds purchase an annuity for the rest of the employee's life or an actuarially reduced pension for the lives of the employee and spouse." *Seifert v. Seifert*, 82 N.C. App. 329, 346 S.E.2d 504 (1987). Perhaps the most common defined contribution plan is the 401k, the name reflecting the section of the Internal Revenue Code giving the fund a special tax status. The IRS defines a 401K plan as:

> …a qualified deferred compensation plan in which an employee can elect to have the employer contribute a portion of his or her cash wages to the plan on a pretax basis. Generally, these deferred wages (commonly referred to as elective contributions) are not subject to income tax withholding at the time of deferral, …
>
> Distributions from a 401(k) plan may qualify for optional lump-sum distribution treatment or rollover treatment as long as they meet the respective requirements. …
>
> Many 401(k) plans allow employees to make a hardship withdrawal because of immediate and heavy financial needs. Generally, hardship distributions from a 401(k) plan are limited to the amount of the employees' elective contributions only, and do not include any income earned on the deferred amounts. Hardship distributions are not treated as eligible rollover distributions.
>
> Distributions received before age 59½ are subject to an early distribution penalty of 10% additional tax unless an exception applies.

http://www.irs.gov/taxtopics/tc424.html. (IRS Topics Cite, Topic number 424).

Because a defined contribution plan is a specific fund to which contributions are made over time, it is possible to 'trace out' amounts contributed before the date of marriage. Nevertheless, the court of appeals held in *Robertson v. Robertson*, 167 N.C. App. 567, 605 S.E.2d 667 (2004), that the equitable distribution statute does not allow a defined contribution plan to be classified using the source of funds approach. If the plan is a "pension, retirement, or other deferred compensation" plan within the meaning of G.S. 50-20.1, the coverture fraction must be used to classify the marital portion of the plan. *See also Curtis v. Curtis, unpublished opinion*, 725 S.E.2d 474(2012)(specific holding in *Curtis* disapproved by *Watkins*).

In *Watkins,* the court of appeals held that a defined contribution plan such as a 401K may or may not be a form of deferred compensation within the meaning of and subject to the restrictions of G.S. 50-20.1. In that case, the trial court was required to classify two Investment Retirement Accounts (IRAs) opened by husband during the marriage and owned by him on the date of separation. One of the IRAs had been initially funded with a rollover from a defined benefit pension earned by husband through his employment both before and after the date of marriage. The other IRA was funded with a rollover from husband's 401K account containing contributions made while husband was employed both before and after the date of marriage. The husband made these rollovers because he was leaving the job he had held while the pension and 401K funds had been accumulating value. The trial court used a source of funds analysis to trace out the value in both IRAs attributable to the funds accumulated by husband before the date of marriage and classified that portion of both accounts as husband's separate property. On appeal, husband argued the trial court was required to use the coverture fraction to classify the IRAs but the court of appeals disagreed. According to the court, only that portion of an account that actually is '*deferred'* compensation, meaning an employee has no access to the funds in the account until retirement, falls within G.S. 50-20.1. The court explained:

> [When the equitable distribution statute originally was enacted in 1981], both defined contribution plans and defined benefit plans were thought of as vehicles for providing a "deferred compensation benefit," i.e., periodic payments to retired employees. Since the enactment of N.C. Gen.Stat. § 50–20.1, however, IRAs and 401(k) accounts have become more common methods for employees to fund retirement. Unlike the funds in a defined pension plan, the funds in an IRA do not represent a *deferred* compensation benefit because they belong to the employee and are accessible to the employee at any time.
>
> A 401(k) account is more complex in that a *portion* of the account may represent a *deferred* compensation benefit provided by the employer. An employee's 401(k) account typically consists of both employee contributions and employer contributions. The employee contributions, which can be withdrawn by the employee at any time, clearly do not represent a "deferred compensation benefit"; thus, N.C. Gen.Stat. § 50–20.1 does not apply to these contributions. Similarly, 401(k) plans which provide for immediate vesting of employer contributions do not provide "deferred compensation benefits," as there is no deferral of benefits under such plans. We note that there are certain 401(k) plans pursuant to which employer contributions vest over a designated period of time and that employer contributions in these instances might be construed as "deferred compensation benefits"; however, this precise question is not before us in the instant case, as there was no evidence presented at trial indicating that Defendant's 401(k) account—with which he funded his 401(k) Rollover IRA—consisted of any employer contributions which did not immediately vest at the time of contribution.

Watkins. Based upon this analysis, the court of appeals held that the trial court appropriately used the source of funds approach to classify the IRA funded by the 401K rollover but erred in using that approach to classify the IRA funded by the pension rollover. Because husband's pension clearly was a retirement account within the meaning of G.S. 50-20.1, the trial court was required to classify defendant's contribution to the initial funding of the IRA using the coverture fraction.

The *Watkins* court explained that application of the coverture fraction to all defined contribution plans:

> …"would lead to grossly inequitable results where, for example, significant amounts of property earned during the marriage could be treated as separate property, as the value of these accounts is largely, if not entirely, determined by contributions from the owner and *not* on the number of years of service to a particular company. For example, suppose that an individual opens an IRA and contributes a total of $6,000.00 to the account over a nine-year period. Assume that after these nine years the individual marries, and, because the spouse is a wage-earner, the individual is able to contribute $42,000.00 to the account during three years of marriage. If the parties separate after these three years and the trial court is required to apply the coverture ratio to the IRA, then only $12,000.00—or 25 percent of the $48,000.00 balance—would be considered marital property—since the individual was married only 25 percent of the time he funded the account, even though $42,000.00 of the account was funded by the individual's earnings during the marriage."

As a result of the *Watkins* decision, the challenge of the trial court will be to determine when the coverture fraction must be applied and when parties are free to classify by tracing out separate contributions. An account will be a retirement account subject to GS 50-20.1 only when the benefits are 'deferred', meaning not "accessible to the employee at any time." The *Watkins* opinion does not indicate what type of evidence was in the record in that case supporting the finding that husband had immediate access to the funds in the 401K account but did not have access to the funds in the pension account. The court of appeals simply stated that “[t]here [wa]s no evidence that any portion of this 401(k) plan included deferred compensation from an employer contribution.” The actual property owned on the date of separation and subject to equitable distribution in *Watkins* were two IRAs (Investment Retirement Accounts, one funded with the 401K and the other funded with the pension). The court of appeals makes the statement that all funds in all IRAs are immediately accessible to owners and therefore cannot be considered deferred compensation.

So what does it mean to have access to the funds? The court does not discuss this issue. However, the *Watkins* opinion does tell us at least three things. First, according to *Watkins,* an IRA (Individual Investment Account) is not deferred compensation except to the extent it is funded from an account that was a pension, retirement or other form of deferred compensation. While the court does not specifically say, presumably this is based upon the court’s assumption that funds in IRAs are immediately accessible by the owner of the account. Second, the fact an employee will incur significant tax penalties for withdrawal of funds before retirement will not affect the determination of whether an account is deferred compensation for the purpose of equitable distribution. Both the funds in the 401K and the funds in the IRAs in *Watkins* clearly would be subject to tax penalties if withdrawn by husband before retirement but the court nevertheless held that, without evidence indicating otherwise, the employee spouse had immediate access to the funds. *But cf. Robertson v. Robertson*, 167 N.C. App. 567, 605 S.E.2d 667 (2004)(trial court found that defined contribution profit sharing pension plan “would be difficult to liquate and would cause unfavorable tax consequences;” court of appeals held that trial court was requires to use the coverture fraction to classify this plan). Third, the ability to remove funds from an account to roll those funds over into another account upon termination of employment does not mean the funds are accessible to an employee. Both the 401K funds and the pension funds at issue in *Wadkins* were withdrawn by the husband during the marriage when his employment ended even though husband had not retired. This seems to indicate that pension funds such as the Judicial Retirement System and the State Employees Retirement fund, both of which allow plan participants to withdraw contributions upon leaving employment, will be considered deferred compensation for purposes of equitable distribution under the *Watkins* analysis.

The court in *Watkins* acknowledged that defined contribution plans such as 401Ks may contain both funds which an employee can access and funds which an employee cannot access, indicating there may be times when the coverture fraction must be applied to only part of the retirement account. Therefore, determination of the appropriate method of classification and distribution for any defined contribution plan will need to be made on a case by case basis.