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Equitable Distribution Update: Tenancy by the Entirety, Postseparation Payment of Debt, and Defined Contribution Retirement Accounts

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The law relating to equitable distribution in North Carolina is constantly evolving, and in 2013 there were three especially significant developments, each relating to issues likely to arise in virtually every equitable distribution case litigated in the state, that is, the classification of jointly held real estate, the classification and distribution of payments of marital debt made by one or both spouses during the period of separation, and the classification and distribution of retirement planning accounts such as an IRA or a 401(k) account.

This bulletin discusses these recent developments, two of them the result of legislative action, the third the result of an opinion by the North Carolina Court of Appeals.

Tenancy by the Entirety and the Marital Gift Presumption

It is not uncommon during a marriage for one spouse to transfer title to real property held in his or her individual name to title held as tenants by the entirety or to use separate funds to acquire real property titled in tenancy by the entirety. There are many reasons why a spouse may decide to do this, not the least of which is the desire to protect the real property or the funds from the creditors of an individual spouse. Nevertheless, many spouses claim to be surprised when, upon separation, they find that this transfer of title caused the property to become marital property subject to distribution by a court in an equitable distribution proceeding. Since long before the adoption of equitable distribution, the common law in North Carolina has presumed that a transfer of title by one spouse to tenancy by the entirety is a gift to the marriage.[1] As discussed further below, this marital gift presumption carried over into the law of equitable distribution, providing that such a transfer causes separate property to become marital property subject to distribution by the court unless the transferring spouse can show by clear, cogent, and convincing evidence that no gift actually was made or that, while a gift was made, an express statement was made at the time of conveyance indicating that the intent of the donor spouse was that the property remain separate property.

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1. *See* Mims v. Mims, 305 N.C. 41, 286 S.E.2d 779 (1982).

As of this writing, there has not been a single appellate opinion in North Carolina concluding that evidence introduced in an equitable distribution trial was sufficient to rebut this marital gift presumption, and there has been no appellate opinion affirming a trial court determination in an equitable distribution case that the presumption had been rebutted. Effective October 1, 2013, the North Carolina General Assembly enacted S.L. 2013-103 titled "AN ACT AMENDING THE DEFINITION OF MARITAL PROPERTY TO PROVIDE THAT ENTIRETIES PROPERTY IS SUBJECT TO THE SAME BURDEN OF PROOF IN REBUTTING THE PRESUMPTION AS ALL PROPERTY CLASSIFIED AS MARITAL." Based on the title to the act, the apparent intent of this statutory amendment is to modify the marital gift presumption by providing that the burden of proof required to rebut the presumption is the greater weight of the evidence rather than the clear, cogent, and convincing standard required by case law.[2]

S.L. 2013-103 amends Section 50-20(b)(1) of the North Carolina General Statutes (hereinafter G.S.), the section of the equitable distribution statute defining marital property and codifying the marital property presumption. As of October 1, 2013, the statute provides as follows (new language indicated by italics):

> 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.[3]

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2. There is some question as to whether it is the intent of this statutory amendment to change the burden of proof required to rebut the marital *gift* presumption because the legislation actually amends only the section of the equitable distribution statute addressing the marital *property* presumption and leaves unchanged Section 50-20(b)(2) of the North Carolina General Statutes (hereinafter G.S.), the section of the statute specifically addressing the classification of gifts between spouses. The relationship between these two presumptions is discussed in more detail below, but the North Carolina Supreme Court has stated clearly that the marital *property* presumption and the marital *gift* presumption are "distinct concepts." McLean v. McLean, 323 N.C. 543, 546, 374 S.E.2d 376, 378 (1988). However, rules of statutory construction provide, one, that the title to an act is evidence of the legislative intent behind a piece of legislation (*see* State v. Anthony, 351 N.C. 611, 617, 528 S.E.2d 321, 324 (2000) (courts "shall consider the title of an Act as a legislative declaration of the tenor and object of the Act."); and Smith Chapel Baptist Church v. City of Durham, 350 N.C. 805, 812, 517 S.E.2d 874, 879 (1999) (title of an Act should be considered in ascertaining the intent of the legislation)) and, two, that legislation must be interpreted to give the new law some effect (*see* State v. Humphries, 210 N.C. 406, 410, 186 S.E.2d 473, 476 (1936) ("language used in statute must, if possible, be construed to give the statute some force and effect."); Abell v. Nash Cnty. Bd. of Educ., 71 N.C. App. 48, 51, 312 S.E.2d 502, 505 (1984) (court of appeals "will not adopt a construction of a statute which would effectively render it meaningless")). In this situation, the title to the act clearly references the burden of proof, and an alternative purpose for this statutory amendment is not apparent.

3. The legislation states only that the act is effective October 1, 2013. Legislation clarifying an existing statute rather than changing the law generally applies both to cases pending on the effective date of the amendment as well as cases filed on or after the effective date. Ray v. Dep't of Transp., 366 N.C. 1, 727 S.E.2d 675 (2012). Given that the apparent purpose of S.L. 2013-103 is to clarify the application of the marital property presumption previously codified in the existing statute as it relates to the marital gift presumption, and inasmuch as the act does not change the law relating to the classification of property held as tenant by the entirety, it is likely that the amendment applies to equitable distribution

Rebutting the Marital *Property* Presumption

The amendment clarifies that real property acquired as tenants by the entirety is presumed to be marital property, as is all other property acquired by either or both spouses during the marriage and before the date of separation. While G.S. 50-20(b)(1) specifically states that the general marital property presumption is rebutted by showing that 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.[4] Therefore, it seems obvious that the new presumption in G.S. 50-20(b)(1) that property creating a tenancy by the entirety is marital is 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.[5] If neither party is able to prove by the greater weight of the evidence that the tenancy by the entirety property was acquired in exchange for separate property, the newly amended statute makes it clear that the property will be classified as marital.

However, if a spouse can show by the greater weight of the evidence that the real property held as tenants by the entirety was acquired in exchange for separate property, will the real property be classified as separate property? The answer to that question appears still to be "no" because the spouse seeking a separate classification has another presumption to rebut before the property can be classified as separate. As stated above, case law has long held 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 a gift from the donor spouse to the marriage.[6] And, according to G.S. 50-20(b)(2) (the section of the equitable distribution statute defining separate property and not affected by the recent amendment), gifts between spouses during the marriage are marital property unless a contrary intention is expressly stated in the conveyance.[7] Once separate property is titled as a tenancy by the entirety, the real property is presumed marital even if one spouse subsequently dissolves the tenancy by the entirety by quitclaiming his or her interest in the property to the other spouse.[8] The rationale for the marital gift presumption is

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cases pending on the effective date of the amendment as well as those filed on or after the effective date. *See, e.g., Ray,* 366 N.C. 1, 727 S.E.2d 675 (where amendment clarified statutory application of public duty doctrine, the amendment applied to pending cases even though amendment changed the interpretation of the doctrine that had been adopted by the appellate court).

4. *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).

5. *See* G.S. 50-20(b)(2) (defining separate property).

6. S.L. 2013-103 does not appear to abrogate the marital gift presumption altogether even though the apparent purpose of the legislation is to modify the burden of proof required to rebut that common law presumption. The language of the act makes no reference to the gift presumption, and no change was made to the section of the statute addressing gifts between spouses.

7. *McLean*, 323 N.C. 543, 374 S.E.2d 376; Romulus v. Romulus, 215 N.C. App. 495, 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, 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).

8. *See* Beroth v. Beroth, 87 N.C. App. 93, 359 S.E.2d 512 (1987) (quitclaim deed executed before date of separation); Davis v. Davis, 360 N.C. 518, 631 S.E.2d 114 (2006) (quitclaim deed executed after date of separation).

that the act of titling separate property as tenants by the entirety supplies the specific donative intent necessary to find a gift to the marital estate.[9] According to the North Carolina Supreme Court, it is the nature of the conveyance itself which gives rise to the presumption of donative intent because "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."[10]

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[11] *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.[12]

Case law also 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.[13] As discussed above, the 2013 amendment to G.S. 50-20(b)(1) apparently intends to change this burden of proof to the greater weight of the evidence. While the burden of proof now may be lower, the marital gift presumption still must be rebutted by the party seeking to have the real property classified as all or part separate property. This means the party must show either that no gift actually was made or that a gift was made but an express statement also was made at the time of the conveyance indicating that the intent of the spouse making the conveyance was that the property would remain separate property.[14]

The supreme court clarified in *McLean v. McLean*[15] that determining whether a gift was made requires the court to determine whether the conveying spouse intended to make a gift to the marriage at the time of the transfer; the *reason* for the gift is not relevant to the determination. In that case, the former spouse testified that the property was transferred to a tenancy by the entirety because of the desire on the part of the transferring spouse to avoid federal tax consequences. The court held that while that testimony established why the gift was made, it did not refute at all that a gift was made. Arguably, the reason there are no appellate opinions in North Carolina illustrating a situation where the marital gift presumption successfully was rebutted is that most transfers are made under circumstances very similar to the circumstances in *McLean*; spouses have many reasons for making such transfers, but the transfers are in fact gifts. The spouse executing the conveyance has the intent at the time of transfer to cause title to vest in

9. *McLeod*, 74 N.C. App. at 156, 327 S.E.2d at 918.

10. *McLean*, 323 N.C. at 543 n.1, 374 S.E.2d at 376 n.1

11. *McLean*, 323 N.C. 543, 374 S.E.2d 376 (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).

12. *Romulus,* 215 N.C. App. at 503–04, 715 S.E.2d at 314–15 (citing G.S. 50-20(b)(2) and *McLeod*).

13. *See, e.g.*, *McLean*, 323 N.C. 543, 374 S.E.2d 376; *Warren*, 175 N.C. App. 509, 623 S.E.2d 800; *Loving*, 118 N.C. App. 501, 455 S.E.2d 885.

14. There is only one appellate opinion to date interpreting the "express statement" language in G.S. 50-20(b)(2). In *Friend-Novorska v. Novorska*, 131 N.C. App. 508, 507 S.E.2d 900 (1998), the court discussed the meaning of the statute in the context of the classification of an investment account, holding that a statement made a year before the transfer was not made at the time of the conveyance.

15. 323 N.C. at 543 n.3, 374 S.E.2d at 376 n.3.

the marital estate for no consideration.[16] The fact that the transferring spouse did not intend for the property to become marital property for purposes of equitable distribution should have no impact on the classification of the property as marital in a subsequent equitable distribution proceeding, unless the transferring spouse also made the express statement at the time of the conveyance that the property was intended to remain separate property.

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 sufficient,[17] 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.[18] An appellate court will review the exercise of discretion under an abuse of discretion standard.[19] It is the donor's, not the donee's, intent that is relevant.[20]

There is no rule that the marital gift presumption cannot, as a matter of law, be rebutted by testimony of the donor spouse alone.[21] 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.[22] The court of appeals reversed a trial court determination that the presumption had been rebutted where evidence used by the trial court to support the separate classification of the property did not relate to the husband's donative intent.[23]

So Where Are We Now?

The 2013 amendment to G.S. 50-20(b)(1) makes it clear that all tenancy by the entirety real property owned on the date of separation is presumed to be marital property. That presumption can be rebutted by the greater weight of the evidence that the property was acquired in

16. "A gift is a voluntary transfer of property by one to another without consideration therefore." Milner v. Littlejohn, 126 N.C. App. 184, 187, 484 S.E.2d 453, 456 (1997). The court also stated that a gift is established by showing the donor's intent to transfer title and actual delivery or constructive delivery of the deed.

17. *McLean*, 323 N.C. at 555, 374 S.E.2d at 383; *Romulus*, 215 N.C. App. at ___, 715 S.E.2d at 322.

18. 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 new distribution order).

19. Thompson v. Thompson, 93 N.C. App. 229, 377 S.E.2d 767 (1989).

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

21. *Romulus*, 215 N.C. App. at ___, 715 S.E.2d at 322 (weight to give donor testimony is matter for trial court to determine).

22. *Warren*, 175 N.C. App. 509, 623 S.E.2d 800; 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*, 93 N.C. App. 229, 377 S.E.2d 767; 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).

23. *See* Lawrence v. Lawrence, 100 N.C. App. 1, 394 S.E.2d 267 (1990) (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).

exchange for separate real property or separate funds. In addition, however, the party seeking to have the real property classified in whole or in part as separate property also has the burden of proving that the separate property was not gifted to the marriage or, if the property was gifted to the marriage, that an express statement was made at the time of the conveyance that the separate property would remain separate. While the burden of proof on that issue probably is lower based on the statutory amendment, it seems doubtful that the presumption will be rebutted successfully with any greater frequency than in the past because most transfers of separate property to tenancy by the entirety are gifts and most transfers do not contain the specific statement required by G.S. 50-20(b)(2) to rebut the gift presumption.

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 includes only "*passive* increases and *passive* decreases in marital debt and financing charges and interest related to marital debt" occurring after the date of separation. The intent of the amendment appears to be to exclude active increases and active decreases in marital debt from the definition of divisible property. In *Hay v. Hay*,[24] 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 debt which must be specifically classified, valued, and distributed by the court along with marital property, the legislation appears to return the law to what is was before the last amendment to the statute in 2002, meaning that trial courts again will address postseparation debt payments as individual judges deem appropriate based on all circumstances in a specific case.

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 are not within the marital estate, a trial court has no authority to distribute the property or debt through equitable distribution.[25] In North Carolina, the marital estate freezes on the date of separation.[26] 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 S.L. 1997-302, discussed further below), numerous cases held that any change in the value of the marital estate occurring after

24. 148 N.C. App. 649, 559 S.E.2d 268 (2002).

25. *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).

26. Becker v. Becker, 88 N.C. App. 606, 364 S.E.2d 175 (1988).

the date of separation could be considered by the court only as a "distribution factor."[27] This means that 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.[28]

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,[29] 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.[30] 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.[31] The liabilities of each party on the date of distribution are distribution factors only.[32]

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 as well as in determining how to address payments made by parties during separation on debts that do not meet the definition of marital debt because they were not owed on the date of separation but were made to maintain or protect the marital estate during separation. For example, in *Smith v. Smith*,[33] 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."[34] 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 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 v. Huguelet* (cited in note 29). 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 toward 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.[35]

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27. *See, e.g., Truesdale*, 89 N.C. App. 445, 366 S.E.2d 512.

28. *See Gum*, 107 N.C. App. 734, 421 S.E.2d 788 (rather than distribute 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).

29. *See* Huguelet v. Huguelet, 113 N.C. App. 533, 439 S.E.2d 208 (1994).

30. *See Warren*, 175 N.C. App. 509, 623 S.E.2d 800 (wife's draws on marital equity line after date of separation created new debt rather than an increase in marital debt).

31. Loving v. Loving, 118 N.C. App. 501, 455 S.E.2d 855 (1995).

32. G.S. 50-20(c)(1).

33. 111 N.C. App. 460, 510, 433 S.E.2d 196, 226 (1993).

34. *Smith*, 111 N.C. App. at 510, 433 S.E.2d at 226, *accord,* Walter v. Walter, 149 N.C. App. 723, 561 S.E.2d 571 (2002); *and* McNeely v. McNeely, 195 N.C. App. 705, 673 S.E.2d 778 (2009).

35. *Smith*, 111 N.C. App. at 510, 433 S.E.2d at 226. *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 both marital debt and 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)."[36]

Divisible Property

In order to address perceived inequities associated with a trial court's inability to distribute postseparation changes in the 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.[37] 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.[38] In 2002 the statute again was amended to include *decreases* in marital debt as a category of divisible property.[39] In response to arguments such as that specifically rejected by the court of appeals in *Smith*,[40] 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 that decreased marital debt made by either party during separation.

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

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36. *Smith*, 111 N.C. App. at 510, 433 S.E.2d at 226. *See also Walter*, 149 N.C. App. 723, 561 S.E.2d 571 (treated payments as distribution factor); Wall v. Wall, 140 N.C. App. 303, 536 S.E.2d 647 (2002) (treated payments as distribution factor but gave them very little weight; okay to award no credit); *Loving*, 118 N.C. App. 501, 455 S.E.2d 885 (treated payments as distribution factor); 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 distribution factor, just like all other postseparation changes to the marital estate; this means that if parties stipulate that an equal distribution is equitable, trial court cannot consider postseparation payments at all). *Accord* Haywood v. Haywood, 106 N.C. App. 91, 415 S.E.2d 565 (1992); Fox v. Fox, 103 N.C. App. 13, 404 S.E.2d 354 (1991).

37. G.S. 50-20(b)(4).

38. G.S. 50-20(b)(4).

39. S.L. 2002-159, sec. 92.

40. 111 N.C. App. at 507, 433 S.E.2d at 224.

owed on a marital debt on the date of separation.[41] 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.[42] 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.[43]

So Where Are We Now?

It is likely that 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.[44] This means that, as with the previous 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.[45]

While the trial court no longer will be required to specifically classify active reductions in marital debt, it is clear that the court must give "some consideration" to postseparation payments from separate funds when those payments benefit the marital estate.[46] However, the type of consideration and the extent of the consideration will depend on the particular circumstances of the case and will be within the discretion of the trial judge.[47]

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41. *See* Peltzer v. Peltzer, 732 S.E.2d 357 (N.C. Ct. 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).

42. *See McNeely*, 195 N.C. App. 705, 673 S.E.2d 778 (trial court had discretion to determine how to distribute divisible debt); *Peltzer*, 732 S.E.2d 357 (same); Jones v. Jones (unpublished opinion), 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).

43. *See* Bodie v. Bodie, 727 S.E.2d 11 (N.C. Ct. 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 payments).

44. Cooke v. Cooke, 185 N.C. App. 101, 647 S.E.2d 662 (2008).

45. *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 were made after October 11, 2002).

46. *See* Washburn v. Washburn (unpublished opinion), 749 S.E.2d 111(N.C. Ct. App., filed Aug. 6, 2013) (trial court erred in failing to consider evidence presented by party regarding postseparation payments); *Bodie*, 727 S.E.2d 11 (to decide whether to give credit for postseparation payments, court must consider source of funds used to make payments); Williamson v. Williamson, 719 S.E.2d 625 (N.C. Ct. 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); *Peltzer*, 732 S.E.2d 357 (trial court did not err in considering as a distribution factor fact that husband voluntarily paid wife's educational expenses from his separate funds after separation).

47. *See, e.g.,* Walter v. Walter, 149 N.C App. 723, 561 S.E.2d 571 (2002) (when deciding whether and to what extent a paying party is entitled to credit in the final distribution, trial court must consider postseparation payments made from non-marital or separate funds that benefited the marital estate but also who

Some appellate opinions indicate that if during separation one party pays marital debt encumbering real property and that real 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.[48] 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.[49]

"Credit" versus Distribution Factor

Now that trial courts are no longer required to go through the process of actually classifying postseparation payments, the court's task will be limited to determining which of the options set forth in *Smith* and other appellate opinions, such as *Walter v. Walter*[50] and *Loving v. Loving*,[51] are appropriate under the particular circumstances of the case. As laid out above, *Smith* states that options available to the trial court 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. Unfortunately, the appellate opinions do not define these various options or explain how they differ. For example, while many opinions use the word "credit" when discussing postseparation payment of marital debt, there is no appellate opinion explaining what it means to give a party a credit.

What is clear is that trial courts must continue to distribute marital debt at the date-of-separation value between the spouses, distribute divisible debt at the date-of-distribution value, and make findings about and 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. Distribution factors are those factors listed in G.S. 50-20(c), which the trial court must consider when determining whether the marital and divisible property should be distributed equally or unequally between the parties. Distribution factors do not change the total value of the marital or divisible estate; they simply inform the trial court's decision as to whether one spouse should receive more than half of the total value of the marital and divisible estate. There are fourteen factors listed in G.S. 50-20(c). Factor (c)(11a) requires that the court consider "acts of either party to maintain, preserve, develop, or expand" marital or divisible property during separation. A party's actions in paying marital debt encumbering a marital asset clearly would be an act "maintaining" or "preserving" marital property and should be considered as a distribution factor. The payment of a marital debt also "expands" the net value of the marital estate, regardless of whether the debt encumbers any particular marital asset. G.S. 50-20(c)(11a) also

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had possession of 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*, 732 S.E.2d 357 (trial court should consider how each party benefited from payments when deciding whether and to what extent to credit paying spouse).

48. *See* Loving v. Loving, 118 N.C. App. 501, 455 S.E.2d 885 (1995); *Walter*, 149 N.C. App. 723, 561 S.E.2d 571; Hunt v. Hunt, 85 N.C. App. 484, 355 S.E.2d 519 (1987).

49. Hill v. Hill, 748 S.E.2d 352 (N.C. Ct. 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).

50. 149 N.C App. 723, 561 S.E.2d 571 (2002).

51. 118 N.C. App. 501, 455 S.E.2d 885 (1995).

lists acts of either party "to waste, neglect, devalue or convert" marital property as a distribution factor, meaning that the trial court also must consider one party's failure to pay marital debt as a factor in distribution if that failure to pay results in a reduction in the value of marital or divisible property. In addition, factor (c)(12) requires that the trial court consider "any other factor which the court finds to be just and proper." According to appellate opinions, this "catch-all" factor allows the court to consider any conduct by a spouse that affects the value of the marital and divisible estate.[52] The payment of marital and divisible debt after the date of separation should be considered pursuant to this factor as well.[53]

So what does it mean to consider the postseparation payment of debt as a distribution factor? It means simply that, for example, if one spouse pays the mortgage on the marital residence during separation but the marital residence ultimately is distributed to the other spouse, the trial court may or may not decide it is equitable to award the paying spouse more than one-half the value of the marital estate because the payments made during separation caused the residence to have a higher net value at the date of distribution than it had on the date of separation and the nonpaying spouse actually is receiving more value than is reflected in the marital estate. At least three appellate opinions have held that consideration of postseparation debt payments as a distribution factor in a case is the only appropriate method of accounting for postseparation payments.[54] In addition, the court in *Miller v. Miller*[55] held that a trial court erred in considering postseparation payments at all when the parties stipulated that an equal distribution was equitable. According to the court in that case, because distribution factors are not considered by the trial court at all if the trial court does not have the option of an unequal division, a trial court has no need to hear evidence about such factors as the postseparation payment of debt.

It is much more difficult to determine what is meant by the word "credit" in the context of addressing postseparation payment of debt or, to be more precise, whether it means any one specific thing. A review of the appellate cases using the word "credit" in this context indicates that there probably is no legal definition of the term; rather, it seems to refer more generally to a trial court's chosen method of accounting for the payments made by one spouse in an individual case.

In one sense, "credit" can mean simply treating the debt as a distribution factor; the trial court can consider the fact that one party made payments during separation and credit that person by awarding him or her more of the marital estate. A credit also 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). A spouse necessarily will receive a dollar-for-dollar credit for any payment made during separation on a marital debt if that debt is distributed to that spouse at its date-of-separation value.

For example, if the date-of-separation value of the mortgage on the marital residence is $100,000, that debt is listed as a negative asset of the marital estate. If the former wife pays $50,000 of that mortgage during separation, the trial court can give her complete credit for that payment by assigning to her at least $50,000 of the total $100,000 marital debt. That assignment

52. *See, e.g.,* Plummer v. Plummer, 198 N.C. App. 538, 680 S.E.2d 746 (2009).

53. *See* Haywood v. Haywood, 106 N.C. App. 91, 415 S.E.2d 565 (1992) (payments should be considered under factors (11a) and (12)); Fox v. Fox, 103 N.C. App. 13, 404 S.E.2d 354 (1991) (same).

54. *See Haywood*, 106 N.C. App. 91, 415 S.E.2d 565; *Fox*, 103 N.C. App. 13, 404 S.E.2d 354; *and* Miller v. Miller, 97 N.C. App. 77, 387 S.E.2d 181 (1990).

55. 97 N.C. App. 77, 387 S.E.2d 181 (1990).

will decrease the net value of her share of the estate in the exact amount she paid on the debt, allowing the trial court the opportunity to award more marital property to her. In other words, awarding the debt to her reduces her equity by the exact amount she paid during separation. If the distribution is equal, this means that the wife will receive additional marital assets to make up for the reduction caused by the allocation of the debt to her.[56]

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.[57] A trial court must be careful not to award double credit to a spouse unintentionally by assigning the marital debt to that spouse and then providing an additional type of credit for payments made after separation.[58] For example, assigning the date-of-separation value of the marital debt to a spouse who made payments on that debt after separation but then "crediting" the paying spouse for those payments by subtracting all payments made on that debt from a distributive award allocated to the other spouse will result in a double credit to the paying spouse for those payments.

While the trial court must take care not to award double credit unintentionally, there may be circumstances where crediting appropriately will be reflected both in the allocation of the marital debt between the parties and in the trial court's consideration of distribution factors. A court may distribute all or part of the marital debt as negative assets to one party but still decide that an unequal division of the total estate is equitable based on the fact that one spouse "maintained" the marital estate during separation by paying marital debt or debt related to marital property.

Divisible Debt: 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. This means that the trial court must continue to classify, value, and specifically account for the distribution of all passive changes in the value of marital debt which occur during separation.[59] Until this amendment, classification of divisible debt did not require consideration of whether the change in the 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,[60] whereas active change means a change caused by the financial,

56. *See, e.g.,* Weincek-Adams v. Adams, 331 N.C. 688, 417 S.E.2d 449 (1992) (trial court awarded entire marital tax debt to former husband rather than split it between former spouses because trial court wanted to "credit" former husband for paying debt off during separation; allocation of that negative asset to husband allowed trial court to award him entire value of the marital home as part of an equal distribution).

57. *See, e.g.,* McNeely v. McNeely, 195 N.C. App. 705, 673 S.E.2d 778 (2009).

58. *See* Smith v. Smith, 111 N.C. App. 460, 511–12, 433 S.E.2d 196, 227 (1993) (on remand trial court should reconsider treatment of mortgage payment where it was obvious that court awarded double credit to paying spouse).

59. G.S. 50-20(b)(4)(d).

60. *See* O'Brien v. O'Brien, 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).

managerial, or other contribution, effort, or activity of one of the spouses.[61] 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 that the property fits within one of the categories in G.S. 50-20(b)(4).[62]

New debt incurred during separation is not marital debt and therefore not divisible debt.[63] 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*,[64] the party seeking to classify the interest and finance charges as divisible debt will need to prove that the charges were not the result of actions taken by either spouse. Because finance charges frequently accrue as the result of penalties and late payments, more disputes probably will arise over whether actions of a spouse or both spouses during separation created the additional charges.

Passive decreases in marital debt may include situations where debt is forgiven or "written-off" by a creditor during separation. However, if the trial court is convinced that the actions of one spouse caused the debt forgiveness to occur, the reduction will not be classified as divisible debt.

Defined Contribution Retirement Accounts

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*[65] is a significant development in the law. In that case the court held that most defined contribution plans, such as 401(k) plans and IRAs, are not "pension, retirement, or other deferred compensation" plans within the meaning of G.S. 50-20.1 and therefore are not subject to the classification and distribution restrictions contained in that statute.

While the equitable distribution statute does not define "pension, retirement, or other deferred compensation," in *Poore v. Poore*[66] the court of appeals held that the statute includes "any deferred compensation plan, whether structured as a pension, a profit sharing, or retirement plan." In *Fountain v. Fountain*,[67] the court of appeals held that the definition was sufficiently broad to include vested and non-vested stock options granted to employees by employers

61. *See* Ciobanu v. Ciobanu, 104 N.C. App. 461, 409 S.E.2d 749 (1991) *and Brackney*, 199 N.C. App. 375, 682 S.E.2d 401.

62. *See* Walter v. Walter, 149 N.C. App. 723, 728 n.2, 561 S.E.2d 571, n.2 (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).

63. *See* Warren v. Warren, 175 N.C. App. 509, 623 S.E.2d 800 (2006) (wife's draws on marital equity line after date of separation created new debt rather than an increase in marital debt).

64. 149 N.C App. 723, 561 S.E.2d 571 (2002).

65. 746 S.E.2d 394 (N.C. Ct. App. 2013).

66. 75 N.C. App. 414, 331 S.E.2d 266 (1985).

67. 148 N.C. App. 329, 559 S.E.2d 25 (2002).

as part of a compensation package, regardless of whether or not the options were exercisable by the employee spouse by the date of separation.[68]

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 available options depend on 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 as laid out 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 deferred compensation benefit, 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 through which a pension, retirement, or other deferred compensation is earned 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 at the job five years prior to the marriage and continued working during the marriage for five more years until the date of separation, five-tenths or one-half of the date-of-separation value of the pension or retirement account will be marital. Because the statute provides that the award is to be determined using this fraction, a trial court cannot use a source-of-funds analysis to trace out the actual portion of the date-of-separation value attributable to the spouse's employment before the date of marriage.[69]

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 on 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 upon retirement are determined using such factors as years of employment and amount of compensation rather than the amount contributed by the employee.[70] Both the North Carolina Consolidated Judicial Retirement System and the North Carolina Teachers' and 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

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68. *But cf.* Ubertaccio v. Ubertaccio, 359 N.C. 175, 604 S.E.2d 912 (2004), *aff'g & adopting concurring opinion by Judge Levinson in court of appeals*, 161 N.C. App. 352, 363, 588 S.E.2d 905, 912 (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).

69. Robertson v. Robertson, 167 N.C. App. 567, 605 S.E.2d 667 (2004); *Watkins*, 746 S.E.2d 394.

70. 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).

rest of the employee's life or an actuarially reduced pension for the lives of the employee and spouse."[71] Perhaps the most common defined contribution plan is the 401(k), the name reflecting the section of the Internal Revenue Code giving the fund a special tax status. The IRS defines a 401(k) 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 pre-tax 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.[72]

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*,[73] 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.[74]

In *Watkins*, the court of appeals held that the term "deferred compensation" has a different meaning in the context of an equitable distribution proceeding than it does in the context of tax law. According to the *Watkins* court, a defined contribution plan, such as a 401(k), 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 *Watkins*, the trial court was required to classify two "Investment Retirement Accounts" (IRAs) opened by the husband during the marriage and owned by him on the date of separation. One of the IRAs had been funded initially with a rollover from a defined benefit pension earned by the husband through his employment both before and after the date of marriage. This IRA is referred to as the "pension IRA." The other IRA was funded with a rollover from the husband's 401(k) account containing contributions made while he was employed both before and after the date of marriage. This IRA is referred to as the "401(k) IRA." The husband made these rollovers because he was leaving the job he had held while the pension and the 401(k) fund had been accumulating value. The trial court used a source-of-funds analysis to trace out

71. Seifert v. Seifert, 82 N.C. App. 329, 332, 346 S.E.2d 504, 506 (1987).

72. *See* IRS, Tax Topics, Topic 424—401(k)Plans, www.irs.gov/taxtopics/tc424.html (last reviewed or updated Dec. 12, 2013).

73. 167 N.C. App. 567, 605 S.E.2d 667 (2004).

74. *See also* Curtis v. Curtis (unpublished opinion), 725 S.E.2d 472 (N.C. Ct. App., filed May 1, 2012) (specific holding in *Curtis* disapproved by *Watkins*).

the value in both IRAs attributable to the funds accumulated by the husband before the date of marriage and classified that portion of both accounts as the husband's separate property. On appeal, the husband argued that the trial court was required to use the coverture fraction to classify both IRAs, but the court of appeals disagreed. According to that court, only the 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.[75]

Based on this analysis, the court of appeals held that the trial court appropriately used the source-of-funds approach to classify the 401(k) IRA but erred in using that approach to classify the pension IRA. Because the husband's pension clearly was a retirement account within the meaning of G.S. 50-20.1, the trial court was required to classify the defendant's contribution to the initial funding of the pension 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

75. *Watkins*, 746 S.E.2d at 398.

> 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.[76]

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 G.S. 50-20.1 only when the benefits are "deferred," that is, not immediately "accessible to the employee." The *Watkins* opinion does not indicate what type of evidence was in the record to support the finding that the husband had immediate access to the funds in the 401(k) account used to fund the 401(k) IRA but not to the funds in the pension account used to fund the pension IRA. 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."[77]

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 "Investment Retirement Account," referred to by the court as an "IRA," is not deferred compensation except to the extent that it receives funds from a pension, retirement, or other form of deferred compensation account. The actual property owned on the date of separation and subject to equitable distribution in *Watkins* consisted of two IRAs, and the court of appeals stated that funds in all IRAs are immediately accessible to owners and therefore cannot be considered deferred compensation.[78]

Second, the fact that an employee will incur significant tax penalties for the withdrawal of funds before retirement will not affect the determination of whether an account is deferred compensation for the purpose of equitable distribution. Funds in both the 401(k) IRA and the pension IRA in *Watkins* clearly would be subject to tax penalties if withdrawn by the husband before retirement, but the court held nevertheless that, without evidence indicating otherwise, the employee spouse had immediate access to the funds.[79]

Third, the fact that funds can be removed from an account and rolled over into another account upon termination of employment does not mean that the funds are accessible to an employee. Both the 401(k) funds and the pension funds at issue in *Watkins* were withdrawn by the husband during the marriage when his employment ended even though he had not retired. Despite the husband's ability to withdraw the funds, the court nevertheless held that the pension funds were a form of deferred compensation. This seems to indicate that such pension

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76. *Id.* at 398–99.

77. *Id*. at 399.

78. *Id.* at 398.

79. *But cf. Robertson*, 167 N.C. App. 567, 605 S.E.2d 667 (trial court found that defined contribution profit sharing pension plan "would be difficult to liquidate and would cause unfavorable tax consequences"; court of appeals held that trial court was required to use coverture fraction to classify this plan).

funds 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 *Watkins* court acknowledged that defined contribution plans may contain both funds that an employee can access and funds that an employee cannot access, indicating that 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.