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## **Characterizing Separate or Community Expenditures on Community or Separate Assets**

*ROGER BERNHARDT*

With the decision in *Marriage of Allen* (2002) \_\_\_ CA4th \_\_\_, 116 CR2d 887, reported in this issue at p. 1, the Second District Court of Appeal has come to the same conclusion as did the Third District Court of Appeal six months earlier in *Marriage of Wolfe* (2001) 91 CA4th 962, 110 CR2d 921, reported in 25 CEB RPLR 45 (Jan. 2002): that an expenditure of community funds on one spouse's separate property is not to be treated as a gift of that money to the recipient. Thus, some clarity has been afforded to a surprisingly complex situation. I am now emboldened to lay out in some sort of coherent order the various outcomes that spouses may expect regarding the treatment of their expenditures when their marriages dissolve.

The key to analyzing any fact situation is to keep in mind that several variables are usually operating at the same time, so that a rule that fits one set of circumstances may not apply to another, even if there is only a slight variation in the facts. The interplay of these variables—at least three as I see it—produces a lot of categories—"pigeonholes"—that can be easily confused.

### **Three Variables**

#### *Whose Asset?*

The first variable is the character of the asset that money is being spent on: community property ("theirs") or separate property ("his" or "hers"). The rules governing the use of separate funds to acquire community assets are set forth in the Family Code; the rules governing community expenditures on separate assets come from judicial decisions. (This is a two-factor variable, but it was once a lot more complicated. Before 1973, it was a three-factor variable, because community expenditures on the husband's separate property were treated differently than expenditures on the wife's separate property. A gift was presumed when the community money was spent on the wife's assets, but not when it was spent on the husband's assets, based on the principle that the husband had management and control of the community and had a fiduciary duty not to make gifts to himself from funds he shared with his wife. Incidentally, even though this rule change was part of the economic fallout from the feminist revolution, ironically it probably benefited men far more than women in eliminating the former one-sided fiduciary assumption.)

#### *Whose Money?*

The second variable makes the same distinction as the first, but with regard to the character of the money being spent: community money ("theirs") versus separate money ("hers" or "his"). The pre-1973 "husband versus wife" distinction is gone, the identity cases (*i.e.*, when they spend their money on their property, when she spends her money on her property, and when he spends his money on his property) can be ignored as unproblematic, and the separate property crossover cases (when he spends his separate money on her separate property or she spends her separate money on his separate property) are outside the scope of this discussion. The focus here concerns situations where spouses spend community money on her or his separate property, and where he (or she) spends his (her) separate money on their community property. I have not covered here those situations in which the asset is held in "true" (*i.e.*, nonmarital) joint tenancy or tenancy in common.

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### ***What Purpose?***

The final variable concerns the purpose of the expenditure, which has three possibilities, *i.e.*, whether the money was used to (1) purchase the asset; (2) improve the asset; or (3) maintain the asset.

While these categories may seem too complicated, it could be much worse. Downpayments could be treated differently from loan payments, and loan payments could be further treated differently according to whose signature is on the mortgage. Improvements could be separated into those that increase the value of the property and those that don't, or those that both spouses wanted and those that only one wanted. Maintenance expenditures could be divided into those that are necessary (*e.g.*, taxes) and those that are merely elective (*e.g.*, painting). Perhaps, given enough time, all these finer distinctions will come to matter as attorneys try to get around the established rules.

### **Analyzing Expenditures for Reimbursement Purposes**

#### ***Gift, Loan, or Investment?***

Depending on the interplay of the three variables discussed above, any given expenditure can be treated as a gift, loan, or investment. If the expenditure receives gift treatment, the spender is a loser: There will be no recognition of it in the dissolution action; a gift may get you credit in heaven, but not in divorce court. Alternatively, if the expenditure is treated as a loan, there will be recognition of it and the spender will get reimbursed; the question of the amount expended and interest earned will then become relevant. Lastly, if the expenditure is characterized as an investment, it will be recognized and the spender will share in the subsequent appreciation (or depreciation) of the asset; that can make a significant difference when the family home was purchased years ago for a small fraction of its current value.

For purposes of finding the right "pigeonhole" for a particular fact situation, I think it is easiest to organize the analysis according to the direction of the flow of funds: Is separate money being spent on a community asset, or is community money being spent on a separate asset?

#### ***Separate Funds Spent on Community Assets***

##### **Acquisition and Improvement Payments: Loans**

The easier row of pigeonholes is the one where his (or her) separate money is spent on their community asset, and in particular where it is spent on the purchase of the asset. For example, when she furnishes the downpayment for their house, Fam C §2640(b) says that she is to be reimbursed on dissolution "without interest or adjustment for change in monetary values." This makes the expenditure an interest-free loan from her to the community. Because the section also says that reimbursement cannot exceed the value of the property, the loan is nonrecourse; if there is no equity in the house, she does not get repaid. The same principle applies to payments he makes on the mortgage; they are also acquisition expenditures. The statute further limits his reimbursement on mortgage payments solely to reductions of principal; interest payments are not reimbursable.

The same rules apply to payments for improvements; she is reimbursed for what she paid to buy a hot tub (except, I suspect, for interest on that debt), regardless of whether the hot tub increased or decreased the value of the house (unless it reduced the value below the existing mortgages). In this context, there is no distinction between acquisition and improvement expenditures.

## **Maintenance, Insurance, and Tax Payments: Gifts**

Finally, by declaring that reimbursable contributions do not include payments for “maintenance, insurance, or taxation,” §2640(a) confers gift treatment on contributions for those purposes, *i.e.*, they are nonreimbursable. Thus, an arrangement in which spouses split the bills so that one pays the mortgage and the other pays the taxes and insurance can lead to surprisingly different reimbursement results.

Overall, expenditures of separate funds on a community asset will either be ignored or receive limited recognition—at most, as an interest-free nonrecourse loan—but will never be treated as giving the spending spouse an interest in the property itself.

### ***Community Money Spent on Separate Assets***

## **Downpayments and Mortgage Payments: Investments or Loans**

The rules governing the next row of pigeonholes—categorizing community money spent on his or her separate asset—cannot be stated as dogmatically because there is no code provision comparable to Fam C §2640. In 1980, the supreme court held that mortgage payments advanced by the community on a wife’s separate asset give the community a corresponding interest in the asset. See *Marriage of Moore* (1980) 28 C3d 366, 168 CR 662. The payments are recognized, but are given different treatment than the code gives to comparable payments of separate funds on a community asset. Payments of community funds are treated as an investment rather than a loan, and the amount recovered will depend on the appreciated value of the asset. (Conversely, in stating that the amount recovered was not to include interest or taxes, *Moore* gave those kinds of expenditures the same treatment as the Family Code does for expenditures made from separate funds.) While *Moore* did not expressly say so, the opinion certainly reads as if a downpayment out of community funds would be treated the same as a mortgage payment made from community funds; and, since there is no interest component to a downpayment to exclude, the downpayment would be entirely reimbursable.

## **Improvement Expenditures: Loan or Investment?**

Until this past year, *Moore* was not applied to improvements and, under a pre-1973 rule, such expenditures were treated as gifts. The *Wolfe* and *Allen* decisions have now eliminated gift characterization, but they have not really told us whether to treat improvement payments as loans or as investments. Both opinions recognized that *Moore*’s investment treatment could be confined to original acquisition costs; thus, improvement expenditures would be presumably characterized as loans. Both opinions, however, avoided deciding that question (in *Wolfe*, because no one raised it; in *Allen*, because there was no evidence on it). I find the outcome hard to predict, because there are now attractive analogies both ways, with *Moore* on one side and §2640 on the other. We will just have to wait for the legislature or the judiciary to tell us.

## **Maintenance Expenses: Gifts**

It is, however, safe to say that community payments of maintenance expenses on separate assets will receive gift treatment, in light of both *Moore*’s and the statute’s refusal to allow any reimbursement for such expenditures. If you want to get some recognition for those kinds of expenditures, get a note from your spouse.

## **Summary**

Overall, expenditures of community funds on a separate asset may be ignored, when they are similar to the nonrecognized ordinary maintenance payments similarly ignored in the code section. Alternatively, they may get recognized, now, by giving the community an interest in the asset rather than just a right to recover what was lent.

## **Love Is Not Enough**

Getting married is supposed to save two people in love from engaging in what is perceived as ugly economic negotiations over their property rights; each simply says “I do” instead of signing a 50-page document. But, somehow, our rules haven’t really worked out. As a result, our system has created a battalion of “Certified Family Law Specialists,” and this little survey shows why that has become necessary. Too bad that love isn’t enough.

### **Postscript**

Many if not most of the decisions I read cite Miller and Starr’s California Real Estate as authority, and rightfully so. Starting from an inconspicuous beginning some 40 years, that treatise has grown to impressive and authoritative stature; it is certainly where I look first to get on top of an issue. Sadly, Harry Miller, its main author, died recently. Harry was a giant of California real estate law. We all suffer from his passing.