VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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APPRECIATION ALLOCATION

MARITAL VERSUS SEPARATE

Times are changing, and with time comes changes in the law. We have seen considerable change in how to allocate the appreciation in a marital residence in the past few years. Let's take a look at some of the nuances that accompany allocation of the appreciation of the home that accrues during the course of a marriage.

In order to determine the amount of appreciation due to each party, the Court formerly allocated the entire amount of appreciation with a logical mathematical equation which gave each spouse a percentage of the total amount according to their overall contributions. *Nine v. Nine* (Mar. 1, 1995), 9th Dist. No. 16625. Four factors were considered:

1. Equity at the time of the marriage
2. Amount of mortgage paydown during the marriage
3. Cost of improvements to the home during the marriage
4. Appreciation of the home during the marriage

Items 1, 2, and 3 were added together to determine the percentage of each to be allocated to the amount of appreciation (item 4). Take, for example, Bob and Lucy who married in 1990. They purchased a home a month after the wedding using the sale proceeds of Bob's former home as a down payment ($100,000). Over the course of the next 10 years, they pay down the mortgage by $50,000 and add a sizeable 4-season room off the back of the house that cost $50,000. Bob's down payment is separate property. Assuming joint funds were used, the mortgage paydown and the cost of the addition are both marital property. Under the *Nine* calculation, the appreciation would be allocated as 50% separate and 50% marital.

Furthermore, pursuant to *Nine*, Bob's separate property investment would essentially be refunded at the time of divorce. Following the refund, proportional shares of appreciation would be distributed to each spouse. By refunding the separate property to Bob, he was essentially insulated from potential loss in the net equity in the marital residence, resulting in an inequitable distribution to Lucy.

Bob and Lucy attempt reconciliation for a couple of years. But alas, in 2003 they determine that their differences are irreconcilable. The allocation of appreciation of their home looks very different now. The *Nine* calculation was overruled by *Ray v. Ray*, 9th Dist. No. 03CA0026-M, 2003-Ohio-6323. The new analysis under *Ray* requires a classification of the source of the appreciation. Appreciation that occurs due to market forces alone is passive and that which occurs due to improvements, labor, or the efforts of the parties during marriage is active. First, the active appreciation is applied to the marital property. Then, the passive appreciation is allocated marital versus separate based on relative contribution.

In the above example, the appreciation during the marriage is $100,000. Testimony by the real estate appraiser indicates that of this total appreciation, the incremental value of the 4-season room addition is $40,000. As such, the addition to the home provided additional value of $40,000 which is 40% of the total appreciation. This is active appreciation, and therefore marital property. The remaining appreciation of $60,000 is then allocated as separate or marital based on the down payment of $100,000 (2/3 = $40,000) and mortgage paydown of $50,000 (1/3 = $20,000). Under this analysis, the appreciation is allocated 40% as separate property to Bob for his down payment, 40% as marital property for the room addition, and 20% as marital property for the mortgage paydown.

Value at Time of Divorce
Less: Value at Time of Marriage
Appreciation during Marriage

Passive (Separate) | Active (Marital)

Separate | Marital | Marital

It is important to keep in mind that although the contributing spouse is entitled to a pro rata share of the passive appreciation of the marital residence, neither spouse is insulated from a loss in the net equity either. As a result, both spouses realize their fair share of either a gain or loss of net equity in the marital residence. If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

Terri

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.