

# Alternative Methods for Dividing Hybrid Property

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The distribution of equity in a hybrid property—where hybrid denotes the use of both marital and separate funds to acquire the asset—is complex and often contentious. Two extant methods for dealing with hybrid property have serious conceptual and practical shortcomings. Since neither yields consistent results and both create incentives to manipulate the financing of hybrid property, we propose a new alternative that corrects these flaws.

## Description of the Methods

### *Brandenburg v. Brandenburg*<sup>1</sup>

Although it was never considered the only way to divide equity in a hybrid property, the *Brandenburg* formula has been the predominant choice. This approach calculates the sources of funds for the paid-in investments in the house. (Paid-in investments are the total of the investments—separate and marital—made by the parties in the house.) It uses the shares of these investments attributable to separate and

marital sources to divide the equity in the house at the valuation date.

*Brandenburg* has at least two related flaws. First, it focuses on paid-in investments. It therefore ignores the fact and the amount of the mortgage—a potentially substantial and onerous obligation undertaken by both spouses—as a critical source of funds for the purchase of the property. Second, the division of funds under *Brandenburg* is sensitive to whether the house undergoes a cash-out refinancing or separate funds are used to pay down the mortgage. If either of these occurs, the level of paid-in investments changes and the separate and marital shares of the equity must be adjusted. *Brandenburg* provides little guidance on how this should be done, despite the fact that the implications can be drastic.

### *Keeling v. Keeling*<sup>2</sup>

Instead of focusing only on paid-in investments, *Keeling* centers on the total sources

of funds used in purchasing the house—including the mortgage—in calculating the separate share. This share is calculated by multiplying the equity in the house at the valuation date by the ratio of the separate contribution to the original purchase price. In other words, if a person contributed 10 percent of the purchase price from separate funds, that person would be allocated 10 percent of the equity as separate property when the asset is divided, regardless of how the remaining 90 percent of the purchase was financed. *Keeling* is flawed because it uses the share of the purchase price to determine the share of equity. This method may yield a reasonable result under certain facts, but unreasonable results for others.

### A New Approach

A fix for *Keeling* allocates separate and marital shares of the total value of the house—rather than the equity in it—at the valuation dates and assigns liability for the mortgage independently. The mort-

gage would be treated as a marital source of funds for purchasing the house. The marital and separate sources of funds would add to the purchase price, and their shares would be used to distribute the value of the house at the valuation date between the parties.

Responsibility for the mortgage would be treated independently as a joint, marital liability. Payments to principal from marital funds or the proceeds from a cash-out refinancing invested in marital property would only affect the magnitude of this marital liability. On the other hand, separate shares in the responsibility for the mortgage would arise if either a pay down of the mortgage came from separate funds or the proceeds of a refinancing were used to augment separate property. However, these transactions would affect only the allocation of the mortgage liability between the parties, not the allocation of the value of the house.

This method is impervious to tactics that could shape the distribution of equity in the event of a divorce. Like *Keeling*, this approach recognizes that responsibility for a mortgage matters in assigning shares in the value of the house. The alternative presented here goes beyond *Keeling* by distributing the liability for the mortgage and the value of the house completely separately. A situation in which a house is financed with a mortgage or an alternative debt instrument will yield the same distribution of total net assets.

**Application**

The strengths and weaknesses of these three approaches are evident in four cases. The parameters for each of the examples are displayed in Table 1. To simplify exposition, the wife is assumed to be the sole source of separate funds in each of the examples—although the results carry over directly to a case where both spouses make separate contributions—and transaction costs are ignored. The implications for each of the methods under the four cases are summarized in Table 2.

The focus of Table 2 is on the distribution of the capital gain on the house—the

**Table 1. Alternative Hybrid Property Scenarios**

Item	Case 1: Separate down payment	Case 2: Interest only loan	Case 3: Cash-out refinance	Case 4: Post separation pay down
Purchase price	500,000	500,000	500,000	500,000
Down payment	100,000	100,000	100,000	100,000
Wife's separate funds	50,000	50,000	50,000	50,000
Marital funds	50,000	50,000	50,000	50,000
Mortgage loan (original)	400,000	400,000	400,000	400,000
Marital payments to equity	50,000	-	(50,000)	50,000
Post-separation pay down (wife)	-	-	-	50,000
Mortgage balance at valuation date	350,000	400,000	450,000	300,000
Paid-in investments	150,000	100,000	50,000	200,000
Wife	100,000	75,000	50,000	150,000
Husband	50,000	25,000	-	50,000
House price at valuation date	800,000	800,000	800,000	800,000
Equity at valuation date	450,000	400,000	350,000	500,000

**Table 2. Outcomes Under Alternative Hybrid Property Scenarios**

Item	Case 1: Separate down payment	Case 2: Interest only loan	Case 3: Cash-out refinance	Case 4: Post separation pay down
House price at valuation date	800,000	800,000	800,000	800,000
Mortgage balance at valuation date	350,000	400,000	450,000	300,000
Equity at valuation date	450,000	400,000	350,000	500,000
Wife's separate paid-in investments				
Pre-separation	50,000	50,000	50,000	50,000
Post-separation	-	-	-	50,000
Marital paid-in investments	100,000	50,000	-	100,000
Profit on house	300,000	300,000	300,000	300,000
<i>Brandenburg</i>				
Wife's separate share of equity	150,000	200,000	350,000	250,000
Marital share of equity	300,000	200,000	-	250,000
Wife's profit on house	200,000	225,000	300,000	225,000
Husband's profit on house	100,000	75,000	-	75,000
<i>Keeling</i>				
Wife's separate share of equity	45,000	40,000	35,000	100,000
Marital share of equity	405,000	360,000	315,000	400,000
Wife's profit on house	147,500	145,000	142,500	150,000
Husband's profit on house	152,500	155,000	157,500	150,000
<i>New approach</i>				
Wife's separate share of house value	80,000	80,000	80,000	80,000
Marital share of house value	720,000	720,000	720,000	720,000
Wife's separate share of mortgage	-	-	-	(50,000)
Marital share of mortgage	350,000	400,000	450,000	350,000
Wife's profit on house	165,000	165,000	165,000	165,000
Husband's profit on house	135,000	135,000	135,000	135,000

profit that accrues during the marriage. This is \$300,000 in all cases, because it is simply the 60 percent increase in price from \$500,000 at purchase to \$800,000 at the valuation date.

**Case 1: Separate Down Payment by Wife and Normal Amortization**

This case serves as the reference case, not only to compare the three methods, but also to gauge the effect of alternative sce-

narios on the distribution of equity. In this case, the couple purchases a \$500,000 house. The wife contributes \$50,000 from separate funds to the down payment to augment \$50,000 of marital funds. Finally, the couple uses \$50,000 of marital funds to amortize the mortgage during the marriage. In *Brandenburg*, the distribution is based solely on the shares of equity supplied. Consequently, the wife receives two-thirds of the equity in the house. *Keeling*, on the other hand, limits the wife's separate share to 10 percent (calculated as the ratio of her \$50,000 down payment to the purchase price of \$500,000) of the equity, thereby reducing her share of equity distribution to only 55 percent.

An alternative method distributes the sources of funds for the purchase of the house in the same manner as *Keeling*, but allows the value of the separate source of funds to grow with the value of the house. The 10 percent separate contribution to the purchase is allocated 10 percent of the value of the house (\$800,000), rather than 10 percent of the equity (\$450,000). At the same time, it assigns liability for the mortgage (\$350,000) independently. The mortgage is entirely a marital debt, and each spouse is assigned 50 percent of this debt. Finally, the mortgage liabilities are subtracted from the shares of the value of the house to determine the distribution of equity. Allowing the value of the separate contribution to grow with the value of the house increases the share allocated to the separate contribution relative to *Keeling*. Under this approach, the wife receives 58.9 percent of the equity, rather than 55 percent.

### Case 2: Interest-Only Loan

This case shows the effect on distribution when no marital funds are used to pay down the mortgage. With an interest-only loan, the marital contribution is only \$50,000 (the down payment) and each spouse saves \$25,000 in mortgage amortization relative to the previous example. Under *Brandenburg*, the wife's separate share would be increased—concentrated—relative to Case 1, since no marital funds were used to amortize the mortgage. She would receive three quar-

ters of the equity rather than two thirds, as in Case 1. Consequently, even though the equity is only \$400,000, rather than \$450,000, she would still receive the same \$300,000 as her share. Since her share of the marital contribution to equity would be reduced by \$25,000, her profit on the house would be increased relative to Case 1 by \$25,000. The husband would receive \$50,000 less in distribution from the house, but would also save \$25,000 in amortization costs, leaving him \$25,000 worse off.

On the other hand, the situation relative to Case 1 is reversed under *Keeling*. The wife's separate share of the equity is based on the ratio of her separate down payment to the purchase price of the house, which has not changed. Consequently, she receives \$27,500 less as her share of equity (55 percent of the \$50,000 reduction in equity due to no amortization) and the husband receives only \$22,500 less (45 percent of the \$50,000 reduction in equity). After allowing for the benefits of no amortization, the wife is \$2,500 worse off and the husband is \$2,500 better off.

Only under the alternative method is the distribution of total assets unaffected by the choice of an interest-only loan. The only thing that changes in this method is the amount of mortgage debt distributed between the husband and wife. The increase of \$25,000 in mortgage liability for each spouse exactly offsets the \$25,000 in reduced amortization that each enjoyed. Opting for the interest only loan has no effect on the spouses, as it arguably should not. The new method eliminates incentives for choosing an interest-only loan.

### Case 3: Cash-Out Refinance

The appropriate treatment of a cash-out refinancing is not obvious in either *Brandenburg* or *Keeling*. In *Keeling*, the husband argued that the cash obtained in the refinance should be deducted solely from the marital source of funds for the purchase of the house. Of course, the appropriate treatment would depend on how the cash obtained was used—for instance, whether it went into a joint savings account or was used to increase the separate holdings of one of the spouses. Moreover, the treatment of a cash-out refi-

ancing under either *Brandenburg* or *Keeling* becomes especially problematic if the amount of cash obtained results in a negative marital share.

In the hypothetical case considered here, the mortgage is increased from \$400,000 at the time of purchase to \$450,000 at the time of the distribution of assets. Subtracting the increase in the mortgage from the original marital contribution to the down payment reduces the marital contribution to equity to zero. Under *Brandenburg*, the wife's separate contribution now represents 100 percent of the equity investment, so the wife receives 100 percent of the equity in the house in the division of assets. Her profit on the house increases by \$100,000 relative to Case 1. The husband, on the other hand, is \$100,000 worse off.

As with the interest-only loan, the cash-out refinancing has the opposite effect on the distribution under *Keeling*. Relative to Case 1, the wife's equity share is \$55,000 less (55 percent of the \$100,000 reduction in equity). She does save \$50,000 on her share of the marital contribution to equity, but her profit on the house is reduced by \$5,000 and the husband's profit is increased by \$5,000. Again, only with the alternative distribution method is the distribution of total assets unaffected by the choice of a cash-out refinancing. The increase in each spouse's mortgage debt is exactly offset by the reduction in the marital contribution to equity—that is, both spouses obtain \$50,000 less in equity from the house than they do in Case 1, but both also pay in \$50,000 in equity.

### Case 4: Post-Separation Paydown of the Mortgage

If separate funds are used, postseparation pay down of the mortgage can be a tactic for increasing the shares of the distribution for the spouse paying down the mortgage. Case 4 differs from Case 1 by adding a postseparation pay down of \$50,000 from the wife's separate assets. This has a slightly different effect on the total distribution, in that the wife gains under both *Brandenburg* and *Keeling*. Under *Brandenburg*, the pay down increases the wife's separate contribution

to equity from \$50,000 to \$100,000, and her share of the distribution of equity from \$300,000 (two thirds of \$450,000) to \$375,000 (75 percent of \$500,000). This increase in her equity share is more than enough to offset the cost of paying down the mortgage, increasing her profit on the house by \$25,000.

The wife's position is also improved under *Keeling* because, unlike in Cases 2 and 3, her separate contribution to the purchase of the house is increased (the \$50,000 pay down of the mortgage is added to her \$50,000 separate down payment). Consequently, she would now receive 20 percent of the equity as her separate share. Once more, the new approach eliminates the incentives to manipulate the financing of the house in anticipation of a property settlement. In this approach, the postseparation pay down reduces the wife's share of the mortgage liability, but does not increase her separate share of the equity. Relative to Case 1, her share of the mortgage liability would be reduced from \$175,000 to \$125,000, and this reduction is exactly offset by the cost of the pay down.

#### Additional Complications

At least three issues further complicate the distribution of equity from a hybrid property.

- **Negative marital contribution.** Under *Brandenburg*, the possibility exists for a negative marital contribution. This results from a cash-out refinancing that increases the mortgage to a level higher than the original purchase price. Only the new approach deals with this possibility without ad hoc adjustment.
- **Transactions costs.** The appropriate treatment of transactions costs is not clear. The judge in *Keeling* gave the husband credit for transactions costs in calculating the share of the purchase price financed with separate funds. A simpler approach would be to treat transactions costs as current outlays, rather than equity transactions, and ignore them in the division of the property.
- **One spouse on title or mortgage.** If only one of the spouses is listed on the

title or mortgage, it would be necessary to examine the degree to which the other spouse still contributed to the purchase and was responsible for the mortgage. The same tracing of funds can establish who provided the equity financing for the house. To allocate the house value and the mortgage however, it would be necessary to assign responsibility for the mortgage. If only spouse is listed on the mortgage, but marital funds are used for the amortization and default on the mortgage would have significant implications for the finances of the unlisted spouse, an argument could be made that the mortgage is a marital liability. On the other hand, if only one spouse is on the mortgage and all payments to equity are made from that spouse's separate funds, an argument could be made that the house is separate property, even if both names are on the title.

#### Summary

The three approaches to dividing the equity of a house in the event of a divorce follow a logical progression, from the seriously flawed *Brandenburg* to a much-improved—at least conceptually—*Keeling* to a new approach that adopts the basic concept in *Keeling* but avoids its anomaly:

- *Brandenburg* focuses on two measures of equity. The sources of paid-in equity are used to allocate the shares of equity at the valuation date. The value of the house and mortgage financing or refinancing are all ignored as irrelevant, except as they affect the two measures of equity, but decisions on how to finance and refinance will have impor-

tant and arbitrary effects on the *Brandenburg* shares.

- *Keeling* identifies the fatal flaw in this approach by drawing out the implications of ignoring the role of the mortgage as a source of financing and a marital debt. Although it uses the full purchase price of the house to identify separate and marital shares, avoiding the critical flaw in *Brandenburg*, it applies these shares to the equity at the valuation date in an arbitrary and unfair manner. The problem stems from the fact that—like *Brandenburg*—it operates directly on the equity at the valuation date in dividing the property.
- The new approach solves this problem by focusing entirely on the price of the house at the time of purchase and the price of the house at the valuation date to allocate separate and marital shares in the asset. The focus on the purchase price of the house recognizes the fact that the mortgage is a key source of financing for which the married couple accepts joint responsibility and for which they should receive credit in calculating separate and marital shares of the asset. The application of these shares to the price of the house at the valuation date recognizes that the mortgage at the time of valuation is best treated independently as a marital or hybrid debt. The equity at time of valuation is thus addressed implicitly, as a byproduct of separately allocating the asset—the value of the house—and debt—the mortgage. In so doing, it abstracts from any unintended consequences of the decision on how to finance the house or whether to refi-

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nance it. These decisions affect only the allocation of the debt, not the allocation of the marital asset.

- The new approach distributes the capital gain on the house in the hybrid property in a manner that exactly offsets the effect of alternative financing choices, including an interest-only loan, a cash-out refinancing or a postseparation pay down of the mortgage from separate funds. The approach is incentive-compatible, since it eliminates any gain that one spouse can obtain at the cost of the

other. The two parties receive the same profit under the new approach regardless of the financing arrangement. Because she invests \$50,000 more at the time of purchase, in each case she receives \$30,000 more in profit, the same 60 percent return that the house itself earns. It is interesting that the distribution the profits that have accrued in the house yielded by the new approach is bracketed by those under *Brandenburg* and *Keeling*, indicating that these two alternatives tilt too much toward one spouse or the other.<sup>3</sup> ❧

Endnotes:

- 1 617 S.W.2d 871 (Ky. Ct. App. 1981).
- 2 47 Va. App. 484; 624 S.E.2d 687 (January 24, 2006).
- 3 The cases considered in this note are all examples of the commingling of marital and separate assets. The approach will also appropriately treat cases in which a separate interest is created when one spouse independently augments the value of the house (for instance, by using an inheritance to finance an addition to the house), in all cases properly adjusting the value of separate and marital interests for the time at which they were made. These issues, as well as suggestions for how *Brandenburg* might be modified to address them, are discussed in a longer version of this paper available on request from the authors.