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Tracing Original Property to Replacement Property: What Evidence is Required?

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Cases Considered:

Scheffelmeier v. Krassman, 2011 ABCA 64

In *Scheffelmeier v. Krassman* the Alberta Court of Appeal once again dealt with tracing exempt property under the *Matrimonial Property Act,* R.S.A. 2000, c. M-8 (*MPA*). Tracing is one of the more contentious matters in matrimonial property litigation, as is the matter of non-disclosure of financial information, also a factor in this case. *Scheffelmeier* is of interest because it includes a dissenting opinion on the application of the long-standing principle that "[t]racing can be inferred, implied, or presumed" (*Harrower v. Harrower* (1989), 97 A.R. 141; 21 R.F.L. (3d) 369 at 376 (C.A.)). The point of contention between the majority opinion of Mr. Justice Ronald L. Berger and Madam Justice Patricia Rowbotham and the dissenting opinion of Mr. Justice J.D. Bruce McDonald also illustrates the problem caused by the lack of enforcement mechanisms for the disclosure requirements in the *MPA*.

Wayne Scheffelmeier (the Plaintiff/Respondent) and Penny Lee Krassman (the Defendant/Appellant) were married in 1997. They separated 10 years later in 2007. Krassman did not work outside the home during the marriage or after. She received Assured Income for the Severely Handicapped (AISH) up until the date she received an inheritance from her brother's estate. She suffered a stroke in 2007.

Scheffelmeier owned a share of a taxicab before the marriage, which was valued at $20,000. Both Scheffelmeier and Krassman owned their own homes before they began cohabiting in a house (the Taylor home) which they built in 1996. Krassman contributed $120,000 and Scheffelmeier contributed $60,000. The trial judge, Mr. Justice D.K. Miller, traced all of these exemptions, and a further gift of $52,000 from Krassman's brother, into the matrimonial home (the 13th Avenue home) registered in the name of Krassman alone. Each spouse received their exemptions from the proceeds of the sale of the 13th Avenue home and then the balance was divided equally between them. The Court of Appeal did not review this distribution.

The contentious tracing issue involved an inheritance Krassman received from her brother. Her brother died in 1998 and she inherited his entire estate which, at the time, was composed of the following assets:

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Condominium:	$ 88,000
Bank account:	$159,000
RSP:	$102,000
Proceeds of a life insurance policy:	$ 91,000
Pension payout:	$ 57,000
TOTAL:	$487,000

After the couple's separation in 2007, Krassman built a home located in the Hamptons. At the date of valuation, she owned the following assets:

Hampton home:	$318,000
TD investment account:	$137,500
TD account:	$ 33,700
Canada Trust account:	$ 5,600
Dodge handicapped equipped van:	$ 50,000
Household contents:	$ 25,000
TOTAL:	$569,800

The main issue on the appeal concerned how to distribute Krassman's $569,800 in assets. How much was exempt from distribution? Could the inheritance from her brother be traced to Krassman's current assets?

Section 7(2) of the *MPA* provides that, if property is acquired by a spouse by gift, inheritance, or before the marriage ("original property"), its market value on the date of marriage or the date when the property was acquired, whichever is later, is exempt from distribution to the other spouse. Section 7(3) requires that increases in value be shared. The difference between the exempted value of the original property and the market value as of the date of trial of the original property, or of the property acquired from an exchange or disposition of the original property ("replacement property"), is to be distributed by the court in a manner it considers just and equitable taking into account the factors set out in section 8. There is no presumption of an equal division for section 7(3) property.

The leading case on section 7(2) and tracing original property to replacement property is *Harrower v. Harrower* (1989), 97 A.R. 141; 21 R.F.L. (3d) 369 (C.A.). Prior to *Harrower*, section 7(2) had been interpreted in three different ways. At one extreme, the value of the exempt property had been treated as exempt from distribution for all purposes and all time. At the other extreme, only the value of original property still owned by a spouse at the date of trial was treated as exempt. In between, exemptions were allowed if the original property could be traced into replacement property. *Harrower* put an end to the confusion by reading section 7(2) together with section 7(3) and choosing the latter approach:

> [T]he two subsections must be read together and an exemption allowed for the market value defined by subs. (2) of exempt property which can be traced to the extent envisaged by subs. (3)(a). On the other hand, if the property cannot be traced, there is nothing to exempt from distribution. I cannot see how dissipated property could possibly fit within s. 7(3), which is by its terms restricted to original or traceable property. (R.F.L. at 376)

The original property must be retained or expended on the acquisition of capital assets; it cannot be used to pay living or other expenses (*Harrower*, R.F.L. at 379).

The court in *Harrower* was quick to point out that "tracing" was not being used as a special term of art, as it is in equity. It was merely a word used by the courts in matrimonial property cases to describe the effect of identifying property by a source. So what did a party attempting to trace assets have to prove? According to *Harrower*:

> When significant capital injections from exempt sources are shown, they are often presumed to be traceable. . . . Tracing can be inferred, implied, or presumed. The continued exemption is, after all, for property acquired directly or indirectly. (R.F.L. at 376)

The idea that tracing can be "inferred, implied, or presumed" might be taken to mean that the burden of proving the connection between the original property and its replacement is not a particularly onerous one. However, the Court of Appeal considered *Harrower* and tracing two years later in *Roenish v. Roenish* (1991), 32 R.F.L. (3d) 233 at 236, and cautioned that, while tracing might not be necessary because it could be inferred from the evidence, tracing would be necessary where, on the facts, an issue was raised as to the source of the replacement assets. In addition to confirming this cautionary note, in *Hughes v. Hughes*, 1998 ABCA 409, the Court of Appeal also warned (at para. 32) that, while some flexibility was possible, nevertheless "there must be some evidence linking the original exempt assets to replacement assets, or a good factual base for inferring that the exempt assets or the proceeds of the sale of original exempt assets resulted directly or indirectly in the acquisition of substituted matrimonial property."

In calculating the division of Krassman's $569,800 in assets, Justice Miller found that the sale proceeds from Krassman's brother's condominium and the retirement investment funds from her brother's estate — amounts totalling $350,000 — were exempt from distribution under section 7(2). Scheffelmeier had argued that the exemptions claimed by Krassman for the life insurance proceeds and the pension payout from her brother's estate could not be traced. Justice Miller did not specifically address this argument but he did not include the $91,000 value of her brother's life insurance proceeds or the $57,000 value of his pension payout in Krassman's exemptions.

The trial judge had also found Krassman to be an unreliable witness. He indicated that wherever her evidence conflicted with that of Scheffelmeier, he preferred the evidence of Scheffelmeier. Krassman had failed to disclose all of her assets in a timely fashion as required by section 31(1) of the *MPA*. She had failed to produce bank statements for her TD chequing account which showed the 1998 deposits of the life insurance proceeds and the pension payout until the beginning of the trial.

Krassman appealed the trial judge's property distribution on several grounds. The only argument dealt with by the Court of Appeal in any detail was her argument that the trial judge erred when he failed to grant her an exemption for the proceeds of the life insurance policy and the pension payout that she received as part of her inheritance from her brother's estate. Because the division of matrimonial property is an exercise of judicial discretion, courts of appeal do not intervene unless the trial judge misdirected himself on the facts, or unless the trial judge's decision is so clearly wrong as to amount to an injustice (*Panara v Di Ascenzo*, 2005 ABCA 47 at para 19).

Had Krassman proved that the proceeds of her brother's life insurance and pension payout could be traced to existing assets? What were the consequences of her failure to meet the disclosure requirements of the *MPA*? These were the two points of disagreement in the Court of Appeal.

On the substantive point, Krassman's argument was a simple one: given that she did not work and the other homes had been accounted for in the sale proceeds of the 13th Avenue home, how could she have acquired $569,800 in assets without using the entire inheritance, including the life insurance proceeds and the pension payout? Scheffelmeier argued the life insurance proceeds and the pension payout were used by Krassman to fund her living expenses and they were therefore dissipated. Krassman countered that the interest earned on her inheritance — an amount that was agreed to by Scheffelmeier — was enough to fund her moderate living expenses of $1,500 to $2,000 a month. The majority accepted that the amount of interest earned on all of the inherited assets would have covered all but $19,000 of Krassman's living expenses between 1999 and 2006. As a result, the majority concluded (at para. 22) that Krassman had not dissipated her inheritance. She had met her burden of proof:

> She has demonstrated that without the use of the full amount of the inheritance, $487,029.87, she could not have acquired assets in the amount of $569,000. In particular, we are satisfied that she could not have acquired the Hampton home valued at $318,000 without the use of the exempt assets, especially when one considers that she did not have available to her the proceeds of the sale of the 13th Avenue home. (at para. 23)

In other words, there was no other source for the replacement assets; they had to have been acquired by the use of the entire inheritance. Krassman had no income except the interest from the inheritance; the proceeds of the sale of the matrimonial home were not available to her. The Court of Appeal had cautioned in its earlier decision in *Roenish* that, while tracing might not be necessary because it could be inferred from the evidence, tracing would be necessary where, on the facts, an issue was raised as to the source of the replacement assets. Here, there was no issue as to the source of the replacement property. Tracing could be inferred from the evidence.

On the question of the impact of Krassman's lack of timely disclosure, the majority noted that Scheffelmeier did not ask for an adjournment or, in the end, oppose the entry of the TD chequing account statements which showed the 1998 deposits of the life insurance proceeds and the pension payout as exhibits. The majority also took into account Krassman's stroke and its apparent effect on her lawyer's ability to obtain disclosure from her. As a result, the majority held (at para. 19) that Krassman's non-disclosure did not prevent her from meeting the burden of proof imposed on her.

The dissent focused on Krassman's lack of credibility and her failure to disclose. Justice McDonald specifically disagreed with the majority's holding (at para 19) that "we do not view this disclosure issue as preventing the appellant from meeting the burden required of her." He found that Krassman's deliberate refusal to disclose relevant documentation did indeed prevent her from meeting the burden of proof imposed upon her in this case.

Because an exemption does not exist at large, Krassman had to establish a connection between the cash from the life insurance policy and pension payout and an extant asset at trial. Justice McDonald concluded (at para. 45) that she had simply failed to do so. He objected (at para 46) that the form of her argument — her question asking how could she have acquired $569,800 in assets without using the entire inheritance, including the life insurance proceeds and the pension payout — reversed the onus and put Scheffelmeier in the position of having to prove that his wife's current assets were not acquired by the life insurance policy and pension payout. Justice McDonald's objection, however, appears to overlook the point in *Roenish* that tracing is only

necessary where, on the facts, an issue is raised about the source of the replacement property. Scheffelmeier did not raise that type of issue; he merely alleged dissipation.

The dissent in this case does not take issue with the idea that tracing can be achieved by pointing to the lack of any source of funds for the acquisition of replacement property except funds from the original property. Tracing, after all, can be inferred, implied or presumed according to *Harrower*. However, the dissent was unwilling to infer that the life insurance policy and pension payout had to have been used to acquire Krassman's current assets because Krassman failed to disclose her assets in a timely manner as required by the *MPA* and was not a credible witness.

The failure to disclose has been called "the cancer of matrimonial property litigation": *Cunha v. Cunha* (1994), 99 B.C.L.R. (2d) 93 (S.C.) at para. 9, quoted with approval in *Leskun v. Leskun*, 2006 SCC 25, [2006] 1 S.C.R. 920 at para. 34. In Alberta, disclosure is mandated by section 31(1) of the *MPA,* by the *Matrimonial Property Regulation*, Alta. Reg. 13/1999, section 1 and by the overall objectives of the *MPA*. However, there is no provision for enforcement of the disclosure requirements in the *MPA*. No consequences for non-disclosure are specified. If there were, the dissent might have been able to tackle the issue of the connection between the original property and the replacement property directly, and not by refusing to draw an inference in order to penalize non-disclosure.

There could be specified consequences for non-disclosure. The *MPA* could be amended to provide that if a spouse does not disclose assets as required, the court may draw inferences adverse to the interests of the non-disclosing party, or assess a monetary penalty against them, or make findings of contempt against them. Without specified consequences in the act or regulation, however, should a spouse be penalized, as Justice McDonald penalized Krassman, by refusing to make inferences in her favour?

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Professor Watson Hamilton's review of ten years of case law interpreting and applying the Matrimonial Property Act for the Alberta Law Reform Institute (ALRI) formed the basis for this post. ALRI provided funding for student research assistance for that project in the summer of 2010. See http://www.law.ucalgary.ca/faculty/fulltime/hamilton/mpa to obtain a copy of the research paper or the database on which the paper was based.

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