Alert
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COZEN O'CONNOR

BC Court of Appeal Clarifies the Appropriate Approach to Tracing Co-Mingled Property

In the recent case of *Mills v. O'Connor,* 2025 BCCA 34, the BC Court of Appeal offered some fresh insight on the relatively new and unsettled area of tracing property under the Family Law Act (the FLA). Under the FLA, the tracing provisions are those found in s.84 and s.85 of the Act.

The Concept of Tracing Under the FLA

When does property need to be "traced" in the context of family law?

The principle of tracing is used in family law when property once considered to be "excluded property" for the purposes of the FLA changes nature during the course of the relationship and becomes "family property," which is typically subject to 50/50 division. This change in how property goes from being characterized as excluded property to family property, can happen because of various reasons, both advertent and inadvertent.

Under the FLA, property characterized as excluded property is not subject to 50/50 division upon separation. Excluded property may include any property acquired by a spouse before the relationship, as well as any property acquired by a spouse by way of an inheritance or a gift.[1]

Excluded property owned by a spouse may become family property if it is co-mingled with other assets or converted to purchase other assets. For example, where a spouse inherits $300,000 and then uses the inherited funds to purchase a family asset, the inherited funds may lose their status as excluded property and instead become family property.

When such conversions occur during a spouse's relationship, the spouse seeking to maintain their exclusion must "trace" the property value back to its excluded origin.

Methods of Tracing

Up until the recent *Mills v. O'Connor* case, uncertainty remained with respect to the correct tracing methodology to be applied when excluded property had been co-mingled with other excluded property and other family property.

Courts had applied different tracing methodologies to interpret the tracing provisions in the FLA, including:

- **The pro rata approach**: the ratio of excluded funds to non-excluded funds that had been deposited into an account is applied to the amount remaining in the account at the date of separation.
- **Lowest intermediate balance rule**: the spouse seeking to separate an excluded contribution is limited to a claim at or lesser than the smallest balance in the fund during the interval between the contribution and the date of division (typically, at settlement or at trial).
- **First in, first out approach**: a tracing principle that presumes that funds in an account exit the account in the order in which they were deposited. If the excluded funds were first in an account, the first funds paid out of the account would be the excluded funds, with the sole determining factor is the timing of the deposits.

Due to the various approaches used, and the lack of predictability, the already difficult exercise of tracing was made even more challenging in British Columbia.

Case Background

The center of the dispute between Mr. Mills and Ms. O'Connor was with respect to the division of

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property of insurance funds that had been obtained from an insurance payout received after a property developed using Mr. Mills inheritance had been destroyed by a fire.

Over the years, Mr. Mills had received cash, securities, and the first property where the couple cohabited by way of his parents' inheritance. Shortly after receiving the inheritance, Mr. Mills would obtain $1,000,000 from a secured line of credit, which he would use to renovate and sell the property. In 2006, the property sold for $3,650,000. Of this amount, the net proceeds from the sale after the payment of legal fees, commissions, and debts was $2,596,500.

In 2005, just before the sale of the property, Mr. Mills purchased a bare lot in his name, for the purposes of building a family summer home. While the bare lot was purchased using the $1,000,000 secured line of credit Mr. Mills had obtained, the construction of the summer home was funded using the proceeds obtained from the sale of the excluded property.

Following the parties separation in 2015, a fire took place and the summer home was destroyed. The loss of the summer home resulted in an insurance claim that would lead to a net insurance payout of approximately of $2.6 million dollars.

The Trial Decision

The trial judge engaged in a tracing analysis to determine the value of Mr. Mills' excluded property that should be removed from the total value of the summer home.

Applying the "first in, first out" tracing method, the trial judge found that, as $1,850,000 of Mr. Mills' inheritance had been used to fund the construction of the summer home, from which the insurance proceeds flowed, the entire amount of $1,850,000 was to be "excluded property" of Mr. Mills.

The *pro rata ex post facto* tracing methodology is the methodology to be applied when tracing Excluded Property

The BC Court of Appeal reviewed the trial judge's analysis and determined that the trial judge's approach to tracing was an error of law. In speaking to the trial judge's approach, the Court of Appeal found that the trial judge had incorrectly applied the "first in, first out" tracing principle, which treats excluded property more favorably than family property.

On appeal, Mr. Mills argued that the entire amount of the insurance proceeds obtained from the summer home were excluded property. In contrast, Ms. O'Connor contended that the increase in value of the funds represented "family property" that should be subject to equal division under the FLA.

In overturning the trial judge's decision, the Court of Appeal found that the tracing exercise to be applied when there had been a co-mingling of excluded property and family property is the *pro rata* approach to tracing, which treats excluded property and family property equally.

The court further explained that the *pro rata* approach to tracing can be further distinguished between two different methodologies, one being the *pro rata ex post facto* approach and the other being the *pro rata* approach using the lowest intermediate balance approach. Although the court noted that the *pro rata* lowest intermediate balance approach may sometimes be the most accurate tracing methodology, this benefit of accuracy, is often overshadowed from the costs it imposes on family litigants.

After applying the *pro rata* tracing methodology, the Court of Appeal concluded that the trial judge was correct in characterizing the initial property purchased by Mr. Mills as excluded property. However the Court of Appeal found that the increase in value of the excluded property, from the time it was first inherited by Mr. Mills to the time it was sold, amounted to family property subject to 50/50 division for the purposes of the FLA.