VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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PROPERTY DIVISION – AT A LATER DATE WHO IS RESPONSIBLE FOR THE TAXES?

Sometimes we find that marital property is not so easily valued, or not so easily divided. Sometimes, the exiting spouse is willing to take the potential downside risk of devaluation over time in exchange for the potential upside of post-divorce appreciation. Although our Family Courts make every attempt to separate the divorcing parties on a financial level as quickly as possible, sometimes the parties do agree to remain financially connected for specific reasons. When this happens, the question becomes: Who is responsible for the tax that is associated with the income from this asset that is not "divided" at the time of divorce?

In a Colorado divorce, *Kenfield, Allen F. v. U.S. (February 10, 1986) 783 F.2d 966 86-1 USTC*, Allen Kenfield held a 50% interest in a land sales partnership. Colorado is an equitable division state. The court held that the value of Kenfield's partnership interest was too indeterminate to calculate fairly and divide. Therefore, the court adopted the apparent alternative -- to divide the asset itself. It therefore awarded the wife 50% of all future "net proceeds received" by Kenfield from the partnership. The Court gave Kenfield "full control, with the wife's only participation being the right to receive half of his net after stated deductions." The partnership made substantial profits, but Kenfield did not withdraw any and therefore distributed nothing to his ex-wife. The partnership tax return listed Kenfield as a 50% partner, but he asserted that he should pay tax on only half of these profits, and the rest should be taxed to his ex-wife. The IRS did not agree and issued a deficiency notice.

The IRS argued that federal statutes command that partnership income be taxed directly to "partners." Perhaps under Colorado partnership law, Kenfield was a partner and his ex-wife was not. But it is federal tax law, not state partnership law, that determines who is a "partner" for federal taxation purposes. The Tax Court ruled in favor of Kenfield. His ex-wife was responsible for her portion of the taxes on the income, whether or not distributed.

Analogous to Kenfield's situation is that of a partner/spouse in a community property state, who invests the community property of a nonpartner/spouse into a partnership. In such a case, if the two spouses file separate returns, each spouse will individually report an appropriate portion of the partner/spouse's share of partnership profits and losses. This will occur despite the one spouse's lack of "partner" status. A husband contributing to partnership land owned partly by wife under community property laws is properly taxed only on income that his portion of land earned. In Kenfield's case, the state law property

rights of the ex-wife, which "vested" at her filing for divorce, are similar to those of the nonpartner community property spouse.

It is possible to be taxed on money to which one has no legal access. The federal partnership tax law does not insist that only a person having a right to participation in management or control of the assets or enterprise can be taxed. Limited partners, for example, have no such rights but receive partnership tax treatment.

In a New Jersey case (also an equitable division state) *Yonadi v. Commissioner, 21 F.3rd 1292*, the wife, Mollie, received a one-third interest in Yonadi's business that owned a golf course and restaurant, and a one-third interest in a management company, held solely for the purpose of receiving Mollie's one-third interest at the time the property may be sold. The Court denied Mollie's motion to have the stock transferred to her name.

The business entities were ultimately sold for $6.2 million. Basis in the property was $300,000 and therefore subject to substantial capital gains tax. None of the court orders specified whose responsibility it was to pay the capital gains tax on the appreciation of Mollie's one-third interest upon liquidation. Neither party reported the capital gains, as each had the view that it was the responsibility of the other.

The Tax Court held that Mollie did not receive an ownership interest in the business assets and therefore was not liable for the capital gains, characterizing Mollie's interest as an "award of payment of money contingent as to time and amount." It treated the property as collateral to secure payment. The Appellate Court did not agree.

The Appellate Court, holding that Mollie received an ownership interest in appreciated assets upon her divorce, wrote that a "common sense reading" of the language of the judgment of divorce leads to the conclusion that the judgment "contemplated an actual division of marital property upon the divorce." The term "interest" in the judgment means ownership interest, and the receipt of a "one-third interest" generally means ownership interest. To create a security interest instead would have required more explicit language.

Treating Mollie's interest as a nonownership interest and thereby excusing her from capital gains tax liability would defeat New Jersey's scheme of equitable distribution and conflict with the purpose of the divorce judgment. If it were determined that Mollie received no ownership interest, she would have received approximately 42 percent of the after-tax proceeds, while Yonadi would receive only 58 percent, which would conflict with the judgment of the divorce court that Yonadi should receive a two-thirds' interest to reflect his larger contribution to the acquisition and improvement of the assets. The Court also pointed out that New Jersey case law indicates that such a substantial tax liability, if placed solely on one party, would have been considered when the court exercised its equitable distribution powers.

Mollie bore the burden of ownership in that she was granted simply a one-third interest, the value of which could fluctuate up or down with the business assets. The court also wrote that the state court's denial of Mollie's motion for transfer of shares of the stock did not defeat her ownership interest in the business assets.

The basis of Mollie's interest for federal income tax purposes depends on whether the transfer from Yonadi was taxable or not. Mollie's interest in the business assets resulted from a division of property that was already co-owned by her and Yonadi prior to the divorce, so her basis in her interest is the adjusted basis in her interest before the divorce (carry-over basis), and not its fair market value at the time of the division of marital property.

To protect clients from run-ins with the IRS and potentially Tax Court, it is important to include specific instructions in the settlement agreement regarding tax consequences. This is especially important when the parties remain co-owners of an asset that was once marital property.

If you would like additional information, or have a question, please do not hesitate to call.

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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.