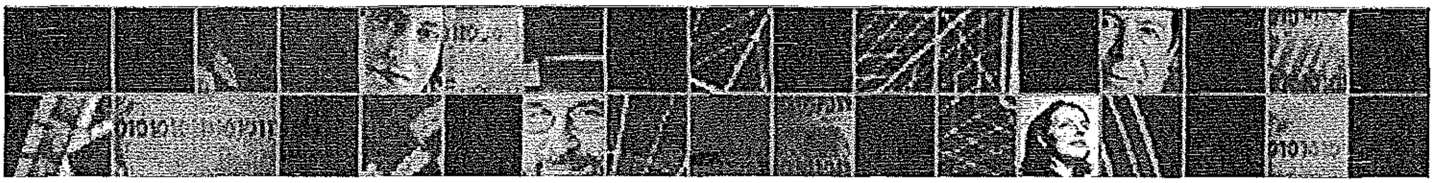

STATE BAR OF ARIZONA

TAX-EFFECTING THE DIVISION OF ASSETS IN DIVORCE CASES
ARS 25.31(B)

THURSDAY, DECEMBER 18, 2008

NEW DIVORCE DISPOSITION OF PROPERTY – TAX-EFFECTING THE DIVISION OF ASSETS IN DIVORCE CASES – ARS 25-318(B)

By Melvin Sternberg
Sternberg & Singer, Ltd.

NEW DIVORCE DISPOSITION OF PROPERTY – TAX-EFFECTING THE DIVISION OF ASSETS IN DIVORCE CASES – ARS 25-318(B)

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A. ARS 25-318 Disposition of property; retroactivity; notice to creditors; assignment of debts; contempt of court

(B) In dividing property, **the court may consider all debts** and obligations that are **related to the property, including accrued or accruing taxes** that would become due on the receipt, sale or other disposition of the property. The court may also consider the exempt status of particular property pursuant title 33, chapter 8.

B. Legislative Notes and Arizona Bill Summary, Senate Bill 1112
May 5, 2008
Effective September 26, 2008

New legislation: SB 1112, ARS 25-318(B) divorce, disposition of property
Sponsor: Senator L. Gray

Purpose
SB 1112 allows the court to consider all debt related to the property when dividing community property and requires the court to make specific findings of fact if any part of the division is in the nature of support.

C. Definition from Webster's Dictionary

Accrue: to grow, to increase, 1: to come into existence as a legally enforceable claim 2: to come by way of increase or addition 3: to be periodically accumulated whether as an increase or a decrease

D. Tax Consequences of Following Property Being Divided the Court May Consider

1. Community residence
2. Other real property
3. Bank accounts, certificates of deposit (non-business, non-retirement)
4. Stocks, bonds, mutual funds (non-business, non-retirement)
5. Businesses (corp., LLC, proprietorships)
6. Retirement accounts (IRAs, 401(k)), defined benefit plans, profit sharing plan, etc.
7. Stock options
8. Investments in not trading corps, LLCs, R.E.I.T.s, mortgage loans
9. Automobiles, boats, trailers, etc.
10. Furniture, furnishings, household items, art and antiques
11. Jewelry

E. ARS 320.02, Self-employed Parent; tax Practitioner; Definition

A. On request of either parent or on the court's own motion, before the court enters an order for child support pursuant to section 25-320, the court may order both parents to meet with a federally authorized tax practitioner if at least one of the parents is self-employed. The federally authorized tax practitioner shall review the accuracy of the self-employed parent's records and submit a written report to the court to help it determine the child support obligation.

B. Each parent may submit to the court the names of not more than two federally authorized tax practitioners. If the parents cannot agree on a federally authorized tax practitioner to conduct the review, the court shall make this choice from a list of names submitted by the parents.

C. The court shall determine which parent shall pay for the cost of the federally authorized tax practitioner or determine each parent's share of this cost.

D. For the purposes of this section, "federally authorized tax practitioner" has the same meaning prescribed in section 42-2069.

F. <u>Consideration of tax Consequences by Trial Courts</u>
In re the Marriage of Goldstein
583 P.2d 1343, Supreme Court of Arizona, September 11, 1978

The Supreme Court held (1) trial court did not err in including accounts receivable in its equitable division of property; (2) when evaluating worth of corporation, trial court did not err by not reducing accounts receivable and corporation's checking account by overhead figure for corporation; and (3) trial court properly declined to value corporation's checking account, accounts receivable, and pension and profit-sharing plans in light of husband's tax bracket.

Appellant does not dispute the fact that the accounts receivable represents a valuable asset which arose from his efforts during the marriage. As such, the trial court properly included the accounts receivable as an asset on appellant's side of the ledger in apportioning the property.

Appellant contends that the trial court erred by not reducing the accounts receivable and the corporation's checking account by 36.9 percent, the overhead figure for the corporation. Although appellant may choose to utilize the cash in the checking account and the income from the accounts receivable to pay future overhead expenses in order to generate new accounts, for dissolution purposes future overhead bears no relationship to the cash and accounts already in existence. The overhead incurred in generating the balance currently in the checking account and accounts receivable has either been paid, or is preset in the form of an incurred debt. In either case, the past overhead which generated these assets would be reflected in the present value of the corporation. To then subtract future overhead expenses would amount, in essence, to a double deduction from the same assets.

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December 2, 2008

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Melvin Sternberg
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Re: Crystal Ball Gazing

Dear Annette and Mel:

Thank you for the invitation to send you a letter expressing the opinions that I have been circulating by e-mail. The added language of A.R.S. §25-318 reads as follows:

> "... in dividing property, the court may consider all debts and obligations that are related to the property, including accrued or accruing taxes that would become due on the receipt, sale or other disposition of the property. The court may also consider the exempt status of particular property pursuant to title 33, chapter 8."

I have not researched in preparing this letter, although I will be referring to some research that has been done by a colleague. My comments are primarily common sense and are informed, of course, by my familiarity with Arizona family law generally. Also, the revised statute is so poorly worded that it is necessary for me to speculate about what the Legislature intended. Based on my conversations with Mel, who disagrees with my opinions, it appears we are both making the same guesses about legislative intent. It would be preferable to be able to apply a

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statute according to the expressed intention of the drafters, rather than according to what we suspect they had in mind.

The revised statute apparently treats "taxes that would become due on the receipt[???], sale or other disposition of property" as already "accrued and accruing". But the Arizona Supreme Court in Johnson made a ruling in regard to the value of contributory retirement plans that is being applied in valuing other types of property, whereby we cannot take future taxes into account, because there is no way to know what those future taxes would be. It turned out the Johnson Court was prescient. Shortly after the case was decided, there were massive changes in the Internal Revenue Code, which would have invalidated valuations based on projecting the previous tax laws into the future.

Taxes that will only become payable if property is sold or disposed of are not presently "accrued or accruing", and even if they were, there would be no way to know how the Internal Revenue Code might be amended before the sale or disposition of the property. The fact the Legislature says we "may" take such taxes into account simply gives us permission to attempt doing what the Johnson court has already ruled to be impossible. Being given permission to attempt the impossible does not make it possible.

Mel pointed out that accepted accounting principles allow adjusting value to reflect future taxes. We all know that is correct. We all also know this is an example of the reasons that in court cases we need to work with accountants who are familiar with the law, not just with accepted accounting principles. Accountants generally do not much like the Johnson case. However, an accepted accounting principle cannot prevail over an opinion of the Supreme Court.

Incidently, I am chairing the January 9, 2009, For Better or For Worse advanced CLE program, which is co-sponsored each year by the State Bar of Arizona and the American Academy of Matrimonial Lawyers. The faculty member who is going to be covering this statute on that program tells me that in his research, he has found that a majority of courts who have considered this issue have ruled that it is impossible to adjust value to reflect taxes that would not be payable unless or until property were sold or disposed of in the future. They make this finding even in states where considering such taxes is permitted or even mandated by statute.

In regard to real estate, we all know Waldren ruled that hypothetical commissions and costs of a future sale on an unknown date cannot be taken into account in determining value. If circumventing that holding was intended, then on this topic the revised statute is even more defective than it is in regard to taxes. The phrase "that would become due on the receipt [???], sale or other disposition" applies only to taxes. Hypothetical sales commissions and costs of sale would have to be considered under the rubric "debts and obligations that are related to the property". I am aware of no authority that would allow the court to infer the words "possible future" and make an adjustment for debts and obligations that do not presently exist but might or might not come into existence later. For some years, the court has been empowered to take into account present debts and obligations related to the property, and because this phrase in the revised statute does not grant license to speculate about future debts and obligations that might come into existence, it adds nothing to the court's authority.

It is important to keep in mind that we cannot know whether any of the subject debts and obligations or taxes will ever become due. That is partly because of the possibility of revisions in the tax law. It is also because assets can be sold or otherwise disposed of in ways that do not incur tax liability. For example, if the party awarded the family residence sold it and realized less than $250,000 gain on the sale, that party would not have to pay any capital gains tax. If the party remarried before selling the residence and filed a joint return with the new spouse, that party could avoid recognizing up to $500,000 in gain on the sale. So whether capital gains ever became due might depend on whether the party remarried.

Here is another example: The Code allows unlimited transfer at death between spouses, so if after dissolution the party (A) who is awarded an item of property marries B and predeceases B, then A will never have to pay any sales commissions or capital gains taxes on the property. If B then marries C and predeceases C, B also will never have to pay any sales commissions or capital gains taxes on the property that A received in the dissolution. You can assume C marries D and predeceases D and extend this example out until you run out of letters of the alphabet.

One more example: If the party awarded property dies without having sold it, there is a good chance he or she (like about 98% of decedents in America) will have an estate with a low enough value to be exempt from estate taxes, which means there would be no taxes due on such "disposition" of the property.

If a trial court were absolutely determined to try to devise some way to project taxes or other sums that would become due on "receipt [???], sale or other disposition of the property", that would raise even more questions not answered by the statute. In addition to guessing about a party's future marital status, should the court assume there will be no changes in the tax law and the $250,000 and $500,000 capital gain figures will still apply? Should the court assume the attempts to abolish capital gains taxes will fail? Should the court assume capital gains taxes will go back to their pre-Bush levels? Should the court assume the efforts to abolish what Karl Rove calls "death taxes" will fail? Should the court assume the value up to which estates are exempt from taxes will continue to be raised? Should the court predict a future increase in basis or a future increase in fair market value of an asset? If this statute had been in force a couple of years ago, should the court have assumed the decreases in the stock market and real estate market that have in fact occurred? If so, how should the court have predicted those decreases?

The foregoing are not spurious questions. They exemplify the reasoning of the appellate decisions that ruled it is impossible to do what the added language of A.R.S. §25-318 seems to envision doing.

It is vital to realize that under Johnson and Waldren, if a withdrawal from a retirement account or the sale of a property is already imminent, the deferred taxes on the retirement account or commissions and costs of sale of the property can be determined with reasonable certainty and, therefore, could be taken into account in determining values without the revision of A.R.S. §25-318. So the revised statute comes into play only in instances in which it would be necessary for the court to engage in speculation.

My prediction, and hope, is that most trial judges know they are not omniscient, and because the statue says "may" rather than "shall", they will not engage in crystal ball gazing.

Very truly yours,

STOMPOLY & STROUD, P.C.

Jim

James L. Stroud

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