Forensic Forum

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Calendar

Recent and Upcoming Speeches Include:

February 2004

21 ICLE - Cutting Edge Financial Issues in Divorce (Fairfield)

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4 ICLE – Divorce Taxation (Fairfield)

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Ongoing

The BARSON GROUP CLE Series

- February 4, 2004
- April 12, 2004
- April 13, 2004
- April 21, 2004

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*Marshall is chair of the Matrimonial Services Committee of the NJ Society of CPA's and co-chair of the Standard of Value Sub-committee (of the Matrimonial Accounting Committee of the NJ Society of CPA's). This sub-committee has been charged with developing a white paper on the standard of value appropriate for divorce cases and coordinating that effort with the judicial and legal communities.

Divorce is the Name, Allocation is the Game.

As I am sure all of our readers readily recognize, when it comes to dividing up the marital pot, the allocation percentage between the parties can be just as important as the value numbers being used. In many cases, we have a value figure (whether it be for a business, investments, retirement account or whatever), we know it will be allocated between the parties, we just don't know yet what the allocation percentage will be. To put some complicating wrinkles into the equation, we also know that some assets carry tax liabilities and some don't. Further, those tax liabilities are not imminent, but rather some time down the road, even possibly hypothetically, and perhaps ultimately never to be paid, depending on a myriad of tax issues.

Probably as a truism, a business run and owned by one spouse is rarely divided equally, even in a long marriage. Reasons for unequal allocation, other than something to the effect "That's just the way it is" include the tax burden, if any, that goes along with the one that keeps the property; maybe an implicit pseudo belief in the double dip; a built in bias/prejudice in favor of the business owner (who we all know tends to be male), …?

Probably the clearest reason (other than the gender bias - which we can not quantify in dollars) for this unequal allocation is the tax burden that remains with the one who keeps the property. There are at least a few issues in the application of a tax burden:

- How much will the tax be – do you use today's tax rates (which is probably the most likely), do you try to speculate as to what rates might be in the future (and, if so, when in the future), do you do some historical tax rate blend.

- How much will the tax be – it's not only a matter of tax rates but, depending on the asset, a calculation needs to be done as to the basis (which in a sense means the first dollars coming out are a return of your money and are not taxable); is the remainder to be taxed at capital gain rates, ordinary income rates, some kind of blend; is there depreciation recapture. What about not only the federal tax rate but a state tax rate - and if so, which state (it is not always so obvious).

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• Will there be a tax - It is not clear on certain assets whether or not there will be a tax. To that extent, we are dealing with what is perhaps only a hypothetical tax.

• When will the tax be incurred – is it imminent (in which case it is fairly well accepted that you apply the tax burden before allocating the net proceeds - but in that case you are probably looking at a 50/50 allocation). In most cases there is no idea when the asset in play will be sold. The relevance here, in one sense, is that until the asset is sold, the one who retains the asset continues to have the benefit of the full value of the asset working for him/her and does not suffer the tax burden (if any), until the asset is sold some years (unknown) down the road. It doesn't seem quite fair to apply a tax burden (certainly not the "full" tax burden) against the portion of the person being bought out, which in that sense provides the person retaining the business with that part of the value to continue working for him/her for any number of years. In a sense, it is a present value of the tax burden issue.

With the preceding as a backdrop, let us consider a few possible scenarios. Assume we have an asset (a business) valued at one million dollars. The question at hand is "What kind of tax burden might be attached to that value?" We will present four different profit situations – involving a zero basis (meaning that the entire one million dollars is taxable gain), and a basis of $300,000, $600,000 and $800,000 (the last meaning that only $200,000 of the one million dollars is a taxable gain). We will also provide two tax alternatives – one at 20% (representing the combination of federal and New Jersey capital gains tax rates), and the other at 30% (representing a potential likely blend of partly capital gains and partly ordinary income). Of course, there can be a myriad of possibilities – depending how a deal is structured, there can be many components, each with a differing tax treatment. However, these two scenarios will cover a reasonable amount of the possible grounds, and provide an understanding of the issue at hand.

30% Blended tax rate

Tax Basis	Gain	Tax	Net after tax	50% share of net value	% of total value represented by 50% of net value
$ 0	$ 1,000,000	$ 300,000	$ 700,000	$ 350,000	35%
300,000	700,000	210,000	790,000	395,000	40%
600,000	400,000	120,000	880,000	440,000	44%
800,000	200,000	60,000	940,000	470,000	47%

The above illustrates that, depending on the basis in the property, which is another way of saying depending on the amount of the value that is subject to tax, a "fair" allocation might mean anywhere from 47% of the total value down to 35%.

20% Blended tax rate

Tax Basis	Gain	Tax	Net after tax	50% share of net value	% of total value represented by 50% of net value
$ 0	$ 1,000,000	$ 200,000	$ 800,000	$ 400,000	40%
300,000	700,000	140,000	860,000	430,000	43%
600,000	400,000	80,000	920,000	460,000	46%
800,000	200,000	40,000	960,000	480,000	48%

The above illustrates, under the optimum use of today's tax rates, that in order to provide one spouse with 50% of the net after tax value, the percentage allocation of the total value might range anywhere from 48% down to 40%. Keep in mind that these are merely hypothetical illustrations, and each and every case requires its own set of calculations.
We have heard sometimes that one of the reasons justifying less than a 50% share is that the one who retains the property continues with the burden of the risk of that property. That is, the one being bought out is now safe and secure, and can do whatever he/she wants with the money – while the one retaining the property (assume a business) has all the headaches, aggravations and risks associated with that business. Arguably, that's not a valid explanation. After all, those factors, including the risks, were considered in the valuation process when that business was valued. Therefore, whatever risks go along with that business, in theory, have been adequately accounted for in the valuation process. To argue that less than 50% is valid because of the risks of staying with that business is perhaps to allow for risk twice – unless the issue is not really the same type of financial risk that we're talking about, rather more the emotional/personal issue.

Despite the numerical illustrations above, if indeed the concept is to divide up the assets in some fair or equitable way, then doing an arithmetic calculation in line with the above illustrations, so as to determine the actual net after tax value, doesn't quite do it. We are still left with the issue that - even if a tax is believed to be in the offing (and not merely hypothetical), and even if we were to assume that within a narrow range, today's tax rates are reasonably representative of what the rates will be when the business/asset eventually sells - why should the spouse being bought out today, suffer his/her full share of a tax burden which is years away? Why should the spouse who is retaining the asset be allowed to keep not only his/her "half", but also keep an additional amount representing a tax which is years away and thus not a present financial hit or burden? Wouldn't it be more equitable to in some way attempt to present value what the tax will be – which is probably impossible unless you know when the tax will be incurred? Thus, most likely we are looking at some imperfect compromise between allowing the tax burden in full, and not allowing it at all.

Living La Vida Loca

In the divorce arena, much has been made lately of the standard of living enjoyed by the (once blissfully enraptured) couple. In most situations, the standard of living experienced by the couple is probably fairly well determined within a reasonable margin of error. Further, other than the typical middle-class concerns as to the near impossibility of maintaining two households as cheaply as one, we have a sense of what the parties should expect going forward.

The purpose of this article is to address two areas where the standard of living is greatly complicated by financial factors that distort how the couple has been living. We are not dealing with unreported income – but rather the perhaps more benign issues of debt and gifts.

Let us first address the matter of debt. What with credit cards, home equity lines, and other all too readily accessible sources of funds, there are too many examples of families living beyond their means, the living fueled by ever increasing levels of debt. There are probably two ways we can look at the matter of debt – that which tends to be paid off at various times, and that which tends to build up and doesn't get paid off.

As to the former, it is fairly common to see families stretching their resources, going into debt (credit cards are pretty common), but then reaching a point where they start paying down, or at the very least, the debt levels off and they manage to keep the debt approximately constant. At that point they are living, give or take, within their means. If debt is either paid off, or at least reaches a level where it doesn't increase, in all likelihood we have established a "real" or "normal" standard of living, though perhaps one needing to be averaged over a few year period.

However, what about the more dangerous situation – a regular, constant build-up of debt, ongoing and continuing, that is not paid down, that continues to increase – perhaps to the point where the family might even be on the edge of bankruptcy? Where clearly the standard of living has been, and continues to be, artificially inflated by relying on constant infusions of freshly borrowed funds, what need we do, if anything, to adjust those figures to a standard of living that is consistent with the family's actual resources? Do we simply go forward with the standard of living that has been established based on a foundation of ever increasing debt, or need we step that back so that it be within the parameters of what they can actually afford. Is it appropriate to take a position that the standard of living will need to be maintained at the same level as in the past – even though it is obvious that there is not the financial wherewithal to maintain it?

So much for living beyond one's income based on debt – let us now deal with living beyond one's income based on family largesse - where the parties going through the divorce were able to maintain a standard of living in excess of their income, because one or more family members (often parents) provided an ongoing source of revenue. Will they continue – and how can you be sure? Can the parents' long history of being a significant source of funding for the marital standard of living be imputed to this now shattered marital estate going forward? Does it matter if the source of funds was from the chief wage earner's side – in which case someone might make the argument that he/she will continue to be able to provide support for the family as in the past because of the likelihood that past generosity will continue? Is that even remotely allowed, or reasonable? If so, does it then require some form of investigation of the parents' financial resources to determine if they will be able to continue to afford to make these gifts. Can they possibly be held responsible to continue to make payments? If there are grandchildren involved, do we simply assume something to the effect that "everyone knows the grandparents will continue to be deep pockets?" Would it perhaps be fair to push the envelope, and assume that family will continue to help? Therefore, the support obligation is put at a level in excess of what would be appropriate based on income. This would seem to be a dangerous game, especially if the family source of revenues truly dries up.

What if the family gifts were from the non-wage earner (or the lower source of income) spouse? Is it appropriate to argue that he/she needs less support from the main wage earner because his/her family will cover the difference? Again, is that in any way a legitimate approach to future support needs? If there are grandchildren involved, does that make a difference in terms of expectations? Do we require only support payments in line with the level of income, and assume that the party being supported will continue to receive gifts? This one at least seems to be a little more reasonable and legitimate - if his/her family stops making the gifts, then indeed the support obligation is appropriate for that level of income through no manipulation of the party with the support obligation.

Let us carry this one step further. What if the lifestyle was funded by the parents and we are now coming to a point where they are old enough, frail enough, ill enough or whatever, that it is reasonable to assume a near term demise. Is it now appropriate to assume an inheritance – which in turn would continue to support the lifestyle? Does it matter if you have a copy of the will and the inheritance seems nearly certain; does it matter if you know that the parents are well off? What gives either party the right to insist or expect that this inheritance is a given? What if the parents change their mind, and leave their money to someone else? What if the parents really don't have that much money? What if

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the parents suffer a financial reversal? What if the parents don't follow the script – and instead live?

Would it be possible in some way to get the parents, or other source of family gifting, to become part of the divorce litigation – voluntarily or involuntarily? Can the parents be obligated to continue a stream of cash flow to the now broken-up marital unit because of a long past history? Is it possible to make an argument that the poorer of the two spouses somehow entered into, or continued in, this marriage/relationship based on expectations (can we possibly reach as far as representations) of a better lifestyle based on family deep pockets?

Or, was this all a waste, and all that counts is the actual income. Forget debt, forget gifts. Take the income and whack it up – or get those wild and crazy youngsters (?) to reconcile..

Calendar ....*continued from page 1*

- May 3, 2004
- June 1, 2004
- June 3, 2004
- June 8, 2004
- June 21,2004

Recent and Upcoming Media Situations:

BOOK: ***Second edition of Investigative Accounting in Divorce*** by Kal Barson, published by John Wiley and Sons

CHAPTER: ***Divorce Taxation - NJ Family Law*** by Lexislaw (March 2004)

ARTICLE: ***Cursed Infirmities Impact on Valuation*** **–** New Jersey Family Lawyer (October 2003)

ARTICLE: ***Detecting & Preventing Workplace Fraud*** **–** by Marshall A. Morris – Middlesex County Bar Advocate (January 2004)

ARTICLE: ***Value to the Holder – Valuation's Nadir? –*** to be in the American Journal of Family Law (Summer 2004)

ARTICLE: ***Forensic Accounting – A Force for Good*** **–** to be in New Jersey Family Lawyer (late 2004)

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