

C. ISSUES IN BUSINESS VALUATIONS

There are two basic forms of value and four major premises of valuation. The basic value forms are whether the business is an ongoing concern value or whether it is a liquidation value. A business is either a workable business entity or it is not and should be liquidated. The four premises of value are Fair Market Value, Fair Value or Intrinsic Value, Investment Value and Book Value. Finally, there are three basic valuation approaches. They include the Asset approach, the Income approach and the Market approach.

1. CONSIDERATIONS IN CLOSELY HELD BUSINESS:

The most widely used and accepted standard of value in Wisconsin is the Fair Market Value Approach. ¹This approach is the value of the business between a willing buyer and a willing seller who is not obligated to sell and both have full knowledge of all the relevant facts. Fair market value is based upon the cash or cash equivalent price of the business that would be expected considering the economic conditions as of the date of valuation.

The Fair Value or Intrinsic Value Approach is based on the value of the business to the owner. A good example would be a one-person law firm where the value to a prospective buyer is low because the current owner has developed relationships with his client base. The new owner would need to establish that same client base. The premise of fair value is rarely used and if so, careful research on applicable legal precedents should be considered.

¹ See Corliss v. Corliss, 107 Wis.2d 236 (Ct. App. 1982)
Arneson v. Arneson, 120 Wis. 2d 236 (Ct. App. 1984)
Liddle v. Liddle, 140 Wis. 2d 132 (Ct. App. 1987)
Sommerfield v. Sommerfield, 154 Wis. 2d 840 (Ct. App. 1990)
Shorer v. Shorer, 177 Wis. 2d 481 (Ct. App. 1993)
Sharon v. Sharon, 178 Wis. 2d 481 (Ct. App. 1993)

Investment Value takes into consideration a particular investor. It assumes that a business is not sold and will remain an ongoing entity. The value is derived through a myriad of calculations based on cash flow and rates of return premised to a specific buyer.

Book Value is an accounting term and refers to a dollar value of stockholder equity based upon specific point in time. For example, you may find Book Value in a quarterly financial statement. The problem with Book Value is that the longer an asset or liability remains on the books, the less likely it reflects its true fair market value. Use the value of real estate as an example, a \$500,000 value of a land and a building 10 years ago may reflect a book value of \$300,000 today due to depreciation, while the fair market value is \$1,000,000. In addition, some assets may have been completely depreciated but retain a substantial fair market value and thus are not reflected in the book value. Therefore, Book Value is not an accurate reflection of an ongoing concern.

There are a variety of approaches used in the valuation process but most can be classified as an Asset Based Approach, an Income Based Approach and a ²Market Based Approach. You will note in *Shorer v. Shorer* 177 Wis. 2d 387, 501 N.W. 2d 916 (Ct. App. 1993) the Court of Appeals stated that “fair market value” is not a method of valuation but a

² The amount of available data on market transactions of closely held businesses has increased. Here’s three:

Pratt’s Stats: Business Valuation Resources
4475 S.W. Scholls Ferry Road, Suite 101
Portland, OR 97225 e-mail: shannon@transport.com

Jack Sanders Bizcomps Asset Business Appraisal
P.O. Box 711777
San Diego, CA 92171

Institute of Business Appraisers
P.O. Box 1447
Boynton Beach, FL 33425
e-mail: IBAHq@aol.com

definition assuming a sale by one who desires, but is not obligated, to sell, and a purchase by one willing, but not obligated to buy. Thus, determining the fair market value of a closely held corporation turns on the credibility of the expert as well as the methods and analyses employed by the witness to arrive at his or her conclusion.” (177 Wis. 2d at 399)

The Asset Based Approach is used more for holding companies or investment companies where the assets generate the substantial portion of the business income. The net asset value is derived through adjustments from Book Value to fair Market Value and then adds in goodwill and other factors based on earnings.

The Income Approach is driven by earnings or cash flow rather than the value of underlying assets. The Income Approach is commonly referred to as the Discounted Future Benefits Approach and is the present value of the expected future benefits stream. The key variables are the benefits stream (earnings, income), the growth rate, and the required rate of return.

The Market Approach is widely used for comparable value. It considers the P/E ratio, Price/book ratio and Price/Sales ratio. The Market Approach will adjust the ratios for size of the company, diversity of customers, business and geographical factors. Thus, privately held companies are compared to publicly held companies that are similar to determine what the value would be if they were publicly held.

Possibly a ³minority discount should be considered. If others control the Corporation, the value of the shares to the minority shareholder may be worth significantly less than the liquidation value of the shares. An interest in a corporation is composed of three elements of value: the right to a share of the net wealth or asset value; the right to a share of distributions from the corporation or income value; and a proportionate participation in

the management of the enterprise or control value. The minority shareholder may enjoy the asset value and income value but if he/she is outsider, they may not enjoy the control value. In the Arnison case, the Court of Appeals stated: "The application of the 25% discount factor for minority status and non-marketability is supported by certain of the expert testimony in this case." Just as the determination of the true market value of the stock of a closely held corporation may lie somewhere between the extremes of two experts....so also may the selection of a discount factor lie somewhat between the extremes suggested.

2. PARTNERSHIP INTERESTS

The Uniform Partnership Act defines a partnership as an association of two or more persons to carry on a business as co-owners for profit. The dual nature of a partnership business entity causes confusion in tax matters. This duality often results in partners treating items of income, deduction and credit differently on their personal returns than the partnership return or the other partners.

Sole Proprietor and Partnership interests frequently present problems for valuation and the issues, the same as closely held corporations, remain largely unresolved. The trend of course is to recognize a business interest, including goodwill, as a marital asset and assign it a value, regardless of how difficult the task may be. Partnership interests both General and Limited requires the same valuation as any other marital asset. Unlike a corporation for example, when you analyze the financial statements, you won't find a line for partner compensation. Partner compensation is simply a part of the bottom line net income. From an economic point of view there is no difference, you must not overlook that the partner is entitled to fair compensation even though none is stated.

Furthermore, most Partnerships are operated less formally than corporations (in most cases), however the informality should not be a factor with the valuation process, other

³ See Arnison v. Arnison 355 N.W. 2d 16 (Wis. Ct. App. 1984)

than you may have issues with the quality and depth of the financial records. Many Partnerships involve real estate and for practical purposes the fair market value of the real estate can be obtained. Tax consequences for ⁴capital gains and recapture need to be considered for example.

3. PROFESSIONAL PRACTICES

Professional practices are largely service and people oriented businesses. Their primary assets are the people that own and operate their practice and may include a professional license and are thus intangible. The value of their business is in their reputation, skills, specialization and most likely their personality. A professional license is not transferable unless the buyer already holds the license. This will tend to substantially limit the number of prospective buyers and may limit the value of the business.

The myriad of valuation methods should be considered. Such factors, as buy-sell agreements and marketability discounts should not be overlooked. The Income Approach is usually used because the service generates the income in most cases, not the assets. In divorce however, a valuation must be able to recognize the impact of the owner-operator services, client loyalty and the owner's personality on the income of the business. The same may also apply to a professional staff whose professional good will leaves with them.

D. VALUATION OF INTANGIBLE ASSETS

The valuation of such intangibles as goodwill, degrees, licenses and career enhancements, like a business valuation present frequent problems and are largely unresolved.

⁴ See Liddle v. Liddle, 140 Wis. 2d 132 (Ct. App. 1987)
See Ondrasek v. Ondrasek 126 Wis. 2d 469 (Ct. App. 1985)

There are two types of goodwill, which are referred to as Professional Goodwill and Practice Goodwill. The classification of professional goodwill as a divisible marital asset first received significant attention in 1956, in *Mueller v. Mueller* decided by the California Court of Appeal. Professional Goodwill is based on the professional's personality, skill, knowledge, reputation, character and chemistry to name a few. An assumption is made that the client would follow the professional wherever the professional goes. ⁵A "Covenant not to Compete" is evidence of Professional Goodwill. Williams also stated that for goodwill to be marital it must exist separate and apart from the reputation or continued presence of the marital litigant. Some courts have felt that goodwill is not a marital asset but rather is a part of the person but many courts are mixed. In Texas for example, professional goodwill is not marital but practice goodwill is. In the Wisconsin ⁶Holbrook case the court relied on ⁷*DeWitt v. DeWitt* to state that "in which this court determined that a professional education or the increased earning capacity that it confers upon the spouse who holds it is not a divisible marital asset, even though the acquisition of the degree is partly attributable to the earnings and efforts of the other spouse." (See 103 Wis. 2d at 345-352) Practice Goodwill is solely attributed to the success of the business that is not based on the intangibles of the owner or staff. Sometimes it's hard to distinguish between the two and the family law attorney must be able to convey the distinction to the court. One way to do this is to compare the actual earnings of the business to another typical business. For example, if a business earns \$100,000 per year but the typical business earns only \$50,000 per year, then the excess is \$50,000, assuming that the excess is not attributable to goodwill. An example would be the only veterinarian clinic in a town where every citizen has two dogs and a cat. The earnings test must include a reasonable compensation to the owner.

⁵ See *Williams v. Williams* 95-00577 (Fla. App. 2 Dist. 1996)

⁶ See *Hollbrook v. Hollbrook* 103 Wis. 2d 327, 309 N.W. 2d 343 (Ct. App. 1981)

⁷ See *Dewitt v. Dewitt*, 98 Wis. 2d 44, 296 N.W. 2d 761 (Ct. App. 1980)

On the other hand, The Wisconsin Supreme Court stated “In many marriages, while one spouse pursues an undergraduate or professional degree or license, the other spouse works to support the couple and forgoes his or her own education or career and the immediate benefits of a second income which the student spouse might have provided. The couple typically expects that the degree will afford them a higher shared standard of living in the future. That standard is never realized by the ⁸supporting spouse when the marriage breaks up just as the newly educated spouse is beginning the long awaited career.” (117 Wis. 2d at 206-207)

Clearly, even though our courts have not defined a “valuation method” to determine the value of intangible assets, it’s up to the family law attorney to provide the factors necessary to be included for property division. Wisconsin Statute 767.255(3)(f)(2001) requires the court to consider “The contribution by one party to the education, training or increased earning power of the other.”

E. ISSUES IN PENSION/RETIREMENT PLAN VALUATIONS

WHAT TYPE OF PLAN IS IT? Most private sector retirement vehicles are either Individual Retirement Arrangements (IRAs), defined contribution (DC) plans, or defined benefit (DB) plans. The Employee Retirement Income Security Act (ERISA) of 1974 governs DC and DB Plans. The Retirement Equity Act (REA) of 1984 was enacted to resolve the growing conflict between ERISA and state law allowing for distribution of retirement rights in DC and DB plans upon dissolution of marriage. REA added I.R.C. § 414(p) which permits the creation, assignment and recognition of any right within DC and DB plans of a participant only through a Qualified Domestic Relations Order (QDRO). IRA’s are not qualified plans as defined by ERISA. Instead, IRA’s come

⁸ See Lundberg V. Lundberg, 107 Wis. 2d 1, 318 N.W. 2d 918 (1982)
See Roberto v. Brown, 107 Wis. 2d 17, 318 N.W. 2d 358 (1982)

under the provisions of I.R.C. § 408. Thus to transfer funds tax free⁹ from an IRA to a spouse or former spouse, a QDRO is not required nor are the QDRO rules applicable.

INDIVIDUAL RETIREMENT ARRANGEMENTS: An IRA is the most basic sort of retirement arrangement. Most people tend to think of an IRA as something that individuals establish on their own. However, there are three plans that businesses can sponsor and help their employees to fund their IRA's. With an IRA the amount that individual receives at retirement depends on the funding of the IRA and the earnings or losses on those funds. I.R.C. § 1041 is not applicable to transfers of funds from IRA's as it was never intended that I.R.C. § 1041 would override the provisions of I.R.C. § 408(d) applicable to IRA's which provision predated the adoption of the provisions of I.R.C. § 1041. Company sponsored IRA's are typically referred to as SAR-SEP, SIMPLE IRA and SEP-IRA Plans.

DEFINED BENEFIT PLAN: A plan that is expected to pay a monthly benefit at a certain retirement age, in most cases, based on a formula using the participant's length of service and/or salary is a defined benefit plan. While a participant is employed, sufficient actuarial calculated contributions are made by the employer to generate the defined monthly retirement benefit payable to the participant in the future. In essence, the retirees "benefit" in a defined benefit plan is "defined" or known in advance, and the contributions needed to provide the benefit are not defined. Usually there are no individual account balances within a defined benefit plan. Defined benefit plans are typically referred to as pension plans, retirement plans or benefit plans.

DEFINED CONTRIBUTION PLAN: A plan that defines the contributions while a participant is employed, with the future value of the benefits left uncertain, is a defined contribution plan. In essence, the "contribution" in a defined contribution plan is "defined" or known and the final benefits payable are not defined. The defined

⁹ I.R.C. § 408(d)(6)

contribution plan may contain individual account balances for each participant, which are valued at least once each year. Defined contribution plans are typically referred to as 401(k) plans, profit sharing plans, employee stock ownership plans (ESOP), money purchase, Keogh plans and savings plans. Many defined contribution plans may contain sub-accounts such as employer contributions, employee contributions, employer matching contributions, and pre-tax/after-tax contributions.

PRACTICE TIP: Many defined contribution plans provide for a single lump sum distribution to alternate payees¹⁰ while most defined benefit plans do not.

VALUATION ISSUES: Defined contribution plans have the least amount of valuation issues while defined benefit plans have the greatest number of issues.

On occasion a participant wishes to keep his entire interest in his retirement plan, and in exchange the non-participant former spouse will retain the equivalent value other marital property, such as investment accounts, equity in the home, vehicles, etc. Often this can be an efficient and cost effective means of assigning half of the value of the plan to the non-participant former spouse, especially if the value is not very large.

There are different accepted methods of determining the present value of a defined benefit retirement plan. Different methods of determining the present value of a retirement plan will yield surprisingly different results. An “economic” present value calculation uses different assumptions than an “actuarial” present value calculation.

The interest or discount rate is one assumption that differs between the two methods. Typically an actuary will rely on a tiered interest rate structure using rates published by the Pension Benefit Guarantee Corporation (PBGC). The rate structure the PBGC produces has, in effect, an insurance premium or guarantee built into these rates, which

are paid by the employer in calculating the employer's pension liability. An insurance premium is not necessary in the case of determining the value of a monthly benefit to an individual. The "cost of the plan to the employer, is not the same as the fair value to the employee".

An economic present value calculation will usually use an interest rate that is based on the U.S. Treasury Bond Yield for example. U.S. Treasuries are the most creditworthy of all debt instruments since they are backed by the "full faith and credit" of the U.S. Government. Using Treasuries as a barometer is considered the risk-free rate, meaning the minimum rate of return an individual can expect when considering all other types of investments.

Life expectancy of a participant based on gender and race is another important element to consider. The United States life tables and national vital statistics reports described above are excellent sources for estimating the reasonable life expectancy of an individual. Be aware of actuarial present value calculations that may consider life expectancies well over 100 years of age, as their assumptions tend to mimic those of an employer seeking to conservatively calculate its liability to fund a pension plan.

In determining the present value of a retirement benefit for purposes of a property offset or buy-out against other post-tax marital property, it is important to use assumptions that are suitable and logical in regard to the divorcing party. The assumptions used in an economic present value calculation are more appropriately geared towards a real life situation rather than a book of numbers.

DEFINED BENEFIT VALUATION STRATEGIES: A present value of a pension calculation has 5 basic factors, 2 of which are assumed, which directly affect the final present value. These are (1) duration of the payout period based on life expectancy, (2)

¹⁰ I.R.C. § 414(p)(8) Alternate Payee defined

mortality, (3) dollar amount of benefit, (4) the participant's tax bracket, and (5) the assumed interest rate. These factors become a chain of assumptions upon which the calculation of the present value is supported by the weakest link.

A key relationship for the attorney to understand is that the longer the payout period, the higher the present value. The duration or payout period is based on 3 factors: The participant's age, the normal retirement age and the life expectancy.

Another approach is to look for the "control point" in a pension. It is pure speculation as to when the participant will actually retire. However, the age at which the participant has the absolute and non-forfeitable right to retire is certain. Therefore, have the pension valued at the earliest possible retirement age.

A mortality discount is used to take into account the probability that the participant will decrease prior to commencing his or her pension. Pensions are promises of future benefits, unlike a defined contribution plan. Under a pension you are promised a benefit at a future date but one of the requirements is that you live until that date. Under many plans a single participant will forfeit his or her promised retirement benefit if they die prematurely.

The Plan Administrator usually provides the monthly benefit that is used to calculate a pension valuation. It would be wise to ascertain the last valuation of the accrued benefit. Many plans can be as long as 18 months in arrears with updating their actuarial calculations. You may consider doing your own calculations by seeking a copy of the Plan Document.

The tax discount may possibly be the most debatable assumption in the valuation process next to the assumed interest rate. The common question is what tax bracket is the participant in now, or likely to be in during retirement? Here is where the question of

certainty comes up again. If one thing is for certain, we know that tax rates and tax laws will continue to change in future years. A rule of thumb being employed is simply to discount the present value by 20%, the same discount rate used to withhold on distributions from qualified plans¹¹ unless a more suitable tax discount rate can be ascertained.

The interest rate assumption used to value a pension is without question the most critical of all the previous mentioned assumptions. The single most important mathematical relationship to know and understand is the lower the assumed interest rate used in the calculation the higher the present value. Conversely, the higher the rate used the lower the present value. For example, if a pension promises to pay \$1000 per month for 10 years the present value is \$98,770 using a 4% discount rate, whereas the present value is \$78,942 using a 9% rate. These are the lump sums needed based on the discount rate used to provide \$1000 per month for 10 years. The inverse relationship between interest rates and present value results from the fact that at a lower interest rate assumption, a larger lump sum of money would be required to provide the same monthly income over the specified period of time.

Other valuation issues may include vesting, cost of living adjustments (COLA), coverture fraction formulas, shortened life expectancy, and larger tax discounts.

PRACTICE TIP: Many clients are adamant about retaining their pension that they worked so hard to accrue over many years of service. Having a pension valuation completed is necessary to understand the value or worth of a plan, but with the above thoughts in mind, why would anyone want to offset their pension with other marital property? In reality, the participant may very well be paying a former spouse for something they may never realize. Great care and thought need to go into a property offset against a pension.

¹¹ I.R.C. § 3405©(1)(B) and (e)(1)(A)(I)

DEFINED CONTRIBUTION VALUATION STRATEGIES: As previously discussed there are not many issues when valuing a DC plan. However, you need to be aware of the valuation date to make certain that you get up to date information. The same tax discounts should apply to defined contribution plans as defined benefit plans. You need to consider the date upon which company contributions and forfeitures are added to the plan. Some companies will wait until they file their corporate income taxes to make their respective employer contributions to a plan. That means that company contributions could be over 18 months in arrears. Forfeitures are contributions made to a participant plan from the non-vested portion of a terminated employee's plan. If a distribution is being planned to a participant or alternate payee that was 50 years old before January 1, 1986, you have additional considerations. The possibility of 10-year forward averaging and capital gains tax treatment still applies. Lastly, the limits on contributions to plans have increased dramatically over the past several years. A participant could receive as much as \$42,000 into a defined contribution plan and as much as \$160,000 into a defined benefit plan. Don't disregard the contribution dates, it could cost your client over \$200,000!

PRACTICE TIP: If you're looking to free up some cash in a dissolution case and the parties have substantial "rollover" IRA accounts from a previous employer plan consider transferring the rollover IRA to a company sponsored retirement plan that allows such contributions and then divide the plan with a QDRO that requires an immediate distribution.

2. DEALING WITH QUALIFIED DOMESTIC RELATIONS ORDERS (QDRO):

Growing in importance is the division of retirement benefits by way of a qualified domestic relation's order (QDRO). A QDRO¹² is a court order that typically directs a

¹² See IRS Notice 97-11. Assistance for attorneys, judges, plan participants, spouses, former spouses in reviewing and drafting QDRO's

retirement plan to divide the income payments or account balances accrued to a participant between the parties in a divorce or legal separation. Alternatively retirement plans can be valued as to their present day value after tax consequences and offset against other marital property. However, quite often the appearance of an equitable division using present value is misleading and can result in inequities. More often, division by a QDRO is considered to be the most equitable way to divide retirement assets.

The first step may seem obvious; however, it worth repeating that it is imperative to determine what type of plan you are attempting to divide. Defined contribution plans are typically much easier to divide in terms of percentage splits than defined benefit plans. Once you have determined the type of plan it is equally important to thoroughly understand the benefit payment options available to the participant. An alternate payee generally may elect any option that is available to the participant in the plan other than a joint and survivor annuity with a subsequent spouse. Therefore, benefits payable to an alternate payee are derived “through the eligibility” of the participant. Benefits are payable to an alternate payee based upon the terms and conditions of the plan. You cannot require¹³ the plan to provide any type or form of benefit, or any option, otherwise provided under the plan. Benefits then are paid in accordance with the plan’s options.

DEFINED CONTRIBUTION PLAN: DC plans usually have an individual account balance which is valued at least once each year on the “valuation date”. Be prepared to ascertain the valuation date. The value of the plan illustrated on a participant statement reflects the last valuation date that could potentially be over 18 months old. Because of technology advances, many plans can value their individual accounts on a daily basis. These plans are relatively easy to divide whether using a dollar amount or based upon a percentage of the total plan assets.

¹³ I.R.C. § 414(p)(3)(A)

Assigning an alternate payee an exact dollar amount from a defined contribution plan will produce that stated dollar amount. Often a plan will require an effective date of the award, and additional verbiage assigning the applicable market value fluctuation to that awarded share. If you use a stated dollar amount some plans may forbid the assignment of market value gains and/or losses on an alternate payee's award. They may require that an exact dollar amount or percentage be awarded as of the date the plan accepts the QDRO or the date that the alternate payee applies for a distribution. Calculating a percentage award of the plan may ease the burden of trying to anticipate market gains and losses.

PRACTICE TIP: Determine the factual rights of the participant under the plan as it relates to the sub-accounts. For example, many plans allow in-service distributions from one sub-account and not the other. It might be appropriate to single out a certain sub-account to assign to an alternate payee. An example might be to require a 100% award of the "after tax" portion of the plan and require an immediate distribution. The proceeds of which could be used to pay attorneys fees and reduce consumer debt for example.

DEFINED BENEFIT PLAN: Defined benefit plans have a myriad of issues and obstacles when considering bifurcation. A few of them are:

SHARED INTEREST vs. INDEPENDENT INTEREST: Every divorce is different, and every plan is different. In determining which format is most beneficial to the parties, consider the age difference between the parties and how close they are to retirement age. Independent interest QDRO's usually provide the most equitable means of division when the parties are relatively close in age and in good health. Also consider the health of the parties. Shared interest QDRO's are usually beneficial when terminal illness afflicts one of the parties. Shared interest QDRO's are usually the only form of QDRO permissible once the participant has already retired.

DOLLAR AMOUNT DIVISION: Assigning an alternate payee an exact dollar amount per month from a defined benefit¹⁴ plan will produce that stated dollar amount, which the plan pays at a certain date, such as the date the participant attains age 65. However, the actual date of the alternate payee's application for benefits may provide for a different dollar amount. For example, if the alternate payee is awarded \$500 based upon the participant's age 65 benefit, the alternate payee would receive \$500 per month at the participant's age 65 and the benefit would stop at the participant's death if the alternate payee were not deemed the "surviving spouse"¹⁵. If the alternate payee were to commence her benefit at any other time, the benefit would be adjusted actuarially. Awarding an exact dollar amount may restrict the alternate payee from participating in future service credits, subsidies, and cost of living or benefit enhancements, unless specifically awarded.

PERCENTAGE DIVISION: Often the marital settlement agreement will assign an alternate payee a certain percentage of the participant's retirement benefits, without any specification as to the effective date of the award. A percentage award is acceptable, however specification of the effective date of the award is recommended. Such date may be expressed as of the date of divorce, as of the valuation date closest to the date of divorce or it could also be determined as of the date of commencement as an example.

MARRIAGE COVERTURE FORMULA: This is one of the most misunderstood methods of dividing a pension. In the Journal of Forensic Economics, Volume IV, Winter, 1990, pp. 47-54, the author Ralph A. Frasca points out four coverture methods of dividing pensions. Using a fraction formula to divide retirement plan benefits is popular in many states. A fraction formula can be designed to exclude from division any benefits attributable to a participant's service prior to the marriage. Alternatively, it can be designed to include a proportionate share of increases due to higher salaries earned by the

¹⁴ I.R.C. § 414(p)(2)(A)(B)(C)(D)

¹⁵ I.R.C. § 414(p)(5)(A)(B)

participant, and benefit improvements made by the plan, after the date of divorce. A fraction formula is commonly referred to as a marriage coverture adjustment, or a time formula. An example to assign one half of the “marital portion” of a participant’s retirement benefits may look like this:

$$\frac{1}{2} \times \frac{\text{Number of months of Participant's creditable service accrued as of the date of divorce (or during marriage)}}{\text{Total number of months of Participant's creditable service at the earlier of Participant's retirement or Alternate Payee's application for benefit commencement}} \times 100 = \text{Alternate Payee's percent of total retirement benefit earned as of the earlier of Participant's retirement or Alternate Payee's application for benefit commencement}$$

A marriage coverture formula is often advantageous to the alternate payee because it will allow her to participate in future service credits, enhancements and entitlements under the plan. The largest increase in benefit accrual will normally occur in the final five or ten years of service. When used for this purpose, the benefit paid to the alternate payee is determined at the time of application for benefits rather than the date of divorce. Most plans pay a benefit based on the number of years of service multiplied by a formula using the “final average earnings” method. As a result, this will dramatically increase the final benefit. When the QDRO requires the plan to provide a benefit payable to an alternate payee based upon the final benefit payable to the participant, it will generally be a division of the greatest benefit payable. This is an excellent negotiating tool for the alternate payee to provide the maximum benefit determined on the number of years of marriage. It is recommended that this be negotiated in advance and specified in the Marital Settlement Agreement to avoid problems during the drafting stage.

PLAN LOANS: It should be determined whether a qualified plan loan is a marital debt. Any amount borrowed from a plan by the participant is taxed as a distribution unless the

loan is not more than the lesser of (1) \$50,000 or (2) greater of \$10,000 or one half on the non-forfeitable accrued benefit to the participant. The loan must be repaid within 5 years and must be amortized in level installments over its term with payments not less frequently than quarterly. The 5-year amortization requirement does apply to any loan used to acquire a principal residence. Loans will generally only be an issue with defined contribution plans. Defined contribution plans have a definite account balance for each participant as well as an alternate payee if the alternate payee has retained her share with the plan. If loans are allowed within the terms and conditions of a plan, a QDRO may provide the right to borrow from the plan to the alternate payee. More often than not, plan documents require that the “participant” is an active employee, therefore loans would not be available to an alternate payee because they would not be an active employee. If all or a portion of the loan becomes taxable, it is subject to premature distribution rules and ordinary income taxes to the participant and/or alternate payee. Loans and the tax consequences should be considered in the equitable division of the marital property.

PROBLEM AREAS of QDRO

DEATH OF PARTICIPANT: Pension benefits in pay status may cease being paid or they could be forfeited to the plan upon the death of a single plan participant¹⁶ prior to or after the commencement of the benefits. If a plan will recognize an independent interest QDRO, the alternate payee’s awarded share of the participant’s benefits will not be affected by the participant’s death. If the alternate payee is deemed the “surviving spouse” for pre-retirement survivor annuity (QPSA) benefits, said QPSA benefits may commence immediately after the death of the participant, or they might be delayed until the date the participant would otherwise have been eligible to receive retirement benefits. The terms and conditions of the plan apply.

¹⁶ See 29 U.S.C. § 1055(a)(2) Provides joint and survivor annuity to spouse regardless if death occurs before or after retirement

PRACTICE TIP: Attempt to determine whether or not pre-retirement survivor benefits are necessary to secure the alternate payee's awarded share for the remainder of the alternate payee's life. If they are not necessary, excessive verbiage may be confusing. If they are necessary, be certain to specify to what extent the alternate payee is covered. Many plans allow only one "survivor". Otherwise the alternate payee may experience a windfall upon the death of the participant at the expense of the widow. For example, a participant is divorcing and has 20 years of service and accrued a benefit of \$1000 per month. A QDRO awarded the former spouse a 50% interest in the participant's monthly-accrued benefit as of the date of divorce. Assume over the next 10 years the participant's benefit increases to \$2000 per month and the QDRO provided for a 50% joint and survivor annuity to his "former spouse". Subsequently, the participant dies prematurely and now his former spouse now receives \$1000 per month (50% survivor) and his current widow receives nothing.

DISABILITY OF PARTICIPANT: In some plans the disability of a participant can trigger commencement of retirement benefits, regardless of age. If a participant becomes disabled and pension eligible, then the alternate payee becomes eligible to receive pension benefits, even if the disability is prior to the earliest retirement age. Conversely, the disability of a participant could also prohibit an alternate payee from commencing receipt of her benefit until the date on which the participant would have attained the normal retirement age under the plan. For example, if disability triggers a benefit unrelated to the pension, such as an insurance benefit, the terms of the plan may read that the participant will not become eligible to commence until his age 65. If these are the terms and conditions of the plan, then the alternate payee will not be eligible to commence receipt of her benefit until the participant reaches age 65.

PRACTICE TIP: A general clause that requires the alternate payee's benefit be payable at the time and in the manner described, regardless of a participant's disability should be

sufficient for the Plan to notify you if the terms of the Plan are contradictory to the intent of the parties.

TERMINATION OF EMPLOYMENT OF PARTICIPANT: Termination of employment prior to retirement eligibility will generally not cause benefits to become payable under a defined benefit plan. However, the terms and conditions of the plan will apply. Normally the participant and alternate payee must wait until the participant attains the earliest retirement age under the plan before either of them can begin receiving benefits. Some plans require a terminated employee to wait until the normal retirement age before they become pension eligible. Language to the effect that the alternate payee is allowed to select the earliest retirement age of the participant under the plan is sufficient to facilitate a distribution at the participant's termination, provided the plan will recognize the participant as retirement eligible upon termination.

DEATH OF ALTERNATE PAYEE: In a defined benefit plan, if the alternate payee dies prior to the commencement of benefits, said benefits will usually revert to the participant or be forfeited to the plan. If the alternate payee dies after commencement of benefits, the form of benefit elected at retirement will determine whether any amounts are payable following death. Often an alternate payee is limited to selecting a single life only option, which means that nothing further will be payable after death. In the event the Plan allows for payment under a period certain option, such as one that provides guaranteed payments for a specified period of months regardless of the survival of the payee, then an alternate payee may elect such option and designate a beneficiary, including a subsequent spouse.

Generally beneficiary designations are not allowed by an alternate payee in a defined benefit plan unless a specific death benefit is payable. Several plans pay lump sum death benefits, a proportionate amount of which can be awarded to an alternate payee in a QDRO. The terms and conditions of the Plan will apply.

Although a plan administrator is not required to accept a QDRO that names the children of the marriage as “contingent alternate payees”, some will. I.R.C. § 414(p)(8) states that the order must name each alternate payee. It does not limit a QDRO to name a single alternate payee. The same Code also states that an alternate payee may be a spouse, former spouse, child or other dependent of the participant. If a plan accepts a QDRO with contingent alternate payees, usually it is only for the pre-retirement period that such contingent alternate payees will be recognized. In other words, the children of the marriage may receive the alternate payee’s benefits if the alternate payee dies prior to alternate payee commencement of benefits. However, once the primary alternate payee begins to receive benefits, the form of benefit elected will determine whether or not amounts will be payable after death.

If an alternate payee is awarded a portion of a defined contribution plan, often the award is distributable immediately, and there is no concern over how the alternate payee’s share will be paid in the event of death. However, some defined contributions require that a separate account be maintained for the alternate payee’s award, and alternate payee is restricted from taking a distribution until the participant terminates employment, dies, becomes disabled or is eligible to retire. In such circumstance, the alternate payee should be allowed to name a beneficiary to the proceeds of alternate payee account. The beneficiary may be any person that the alternate payee may choose, including a subsequent spouse. It is also possible to require the alternate payee to maintain the former spouse as the beneficiary, which could be used to secure or guarantee support payments in the event of a premature death for example. Nonetheless, it is often an overlooked bargaining tool.

PRACTICE TIP: In a defined benefit plan, don’t risk complete forfeiture of the alternate payee’s benefits if alternate payee dies prior to commencement of benefits. A QDRO can specify that the alternate payee’s benefits shall revert to the participant in the

event of alternate payee pre-retirement death. While not all plans will approve this provision, in most cases it is worth an attempt. The alternate payee gains nothing from this reversion clause except that additional concessions could be secured for the alternate payee in exchange for including it.

If a plan will recognize the children of the marriage as contingent alternate payees, the drafter of the QDRO may wish to confirm how the plan interprets “child of the participant”. Some plans will recognize a child of the participant regardless of their age. Other plans will define such term as a minor child, and once that child reaches the age of majority they are no longer eligible to be considered a contingent alternate payee, regardless of the fact that he or she is still the child of the participant. If allowed, you could effectively get an alternate payee awarded share to the alternate payee’s children in the event of premature death before benefits commence.

PAYABLE OVER LIFE OF ALTERNATE PAYEE OR PARTICIPANT:

The most typical type of QDRO, an independent interest QDRO, assigns benefits to the alternate payee over the alternate payee’s lifetime, regardless of survival of the participant. In securing an independent interest QDRO it is essential to clearly define the intent. Phrases such as “actuarial equivalent”, “payable over the alternate payee’s lifetime” will reduce the likelihood of misinterpretation by the plan administrator. There have been numerous malpractice cases where the alternate payee’s benefit has either been forfeited or has ceased at the death of the participant because the QDRO preparer mistakenly assumed that benefits would be payable to the alternate payee for her lifetime.

A shared interest QDRO will pay benefits to the alternate payee over the lifetime of the participant. This means that retirement benefits will cease to be paid to the alternate payee upon the death of the participant. A shared interest may also provide for pre-retirement and post-retirement survivor benefits to be paid to the alternate payee upon the death of the participant, however they do not come without a cost.

SUBSIDIZED BENEFITS: Subsidized early retirement benefits are often offered by employers as enticements to retire early. In other words, if an employer wants to reduce the work force, it may offer an increase in retirement benefits to induce more employees to retire early. Sometimes these types of benefits are referred to as supplemental benefits or temporary benefits. Typically an employer will offer the same benefit payment otherwise payable at age 65 to an employee that is only age 60, without any reduction for early retirement. The difference between the total benefit payable at age 65 and the reduced benefit that would otherwise be payable at age 60 is the subsidized portion of the benefit.

A subsidized benefit is often offered as a result of the number of years of service performed by a participant. It can be argued that the alternate payee is entitled to receive a proportionate amount of any early retirement subsidy paid to the participant. However, an alternate payee generally cannot receive any portion of a subsidized early retirement benefit until the participant is actually receiving subsidized retirement benefits and a QDRO assigns her a proportionate share of the same. If an alternate payee begins to receive benefits prior to the retirement of the participant, and the participant subsequently retires with subsidized early retirement benefits, many plan administrators will recalculate the alternate payee's benefit upon the participant's retirement so that the alternate payee also receives a share of the subsidy that the participant has started to receive, if the QDRO so directs.

Subsidized benefits may not be freely disclosed by the plan, and as such can be difficult to identify. Even if a plan denies payment of subsidized early retirement benefits in the past, it is very possible that it could happen in the future. QDRO's can provide for the division of subsidy, even if it is not payable at the time.

PRACTICE TIP: To avoid possible disagreements, negotiations with the parties prior to QDRO preparation should include whether and how to divide potential subsidized early retirement benefits. Subsidized early retirement benefits are often a function of all of the years of service a participant completes. The most equitable means of dividing a subsidy may be to limit the alternate payee's entitlement to an amount that is proportionate to her awarded share of the participant's benefit, as compared to the total unsubsidized retirement benefit.

SEGREGATED BENEFITS: A QDRO that assigns a benefit to an alternate payee that is independent of the participant's employment status and survival is considered a separate interest QDRO, or an independent interest QDRO. An independent interest will allow the alternate payee to collect benefits at the participant's earliest retirement age (or the age the participant would have attained the earliest retirement age¹⁷ under the terms of the plan) or later, regardless of the survival of the participant. The plan administrator is directed to provide the alternate payee with benefits payable over her lifetime. Essentially the benefits awarded to the alternate payee are segregated from the benefits of the participant. In doing so, the alternate payee should not need to be deemed the "surviving spouse" of the participant to collect benefits for her lifetime. This is usually the most equitable and efficient manner in dividing defined benefit retirement plans. Also, it will provide the least cost to the participant. That is, the participant's benefit will be reduced only by the amount awarded to the alternate payee, without further reduction for the costs associated with survivor benefits. On occasion this approach will prohibit other options such as cost of living adjustments, subsidies, or a reversion to the participant upon the premature death of the alternate payee.

The opposite approach to an independent interest QDRO is a shared interest QDRO. A shared interest QDRO essentially treats the parties as a married couple, instead of single individuals. In certain circumstances this may be appropriate. The alternate payee

receives a portion of the participant's benefit during retirement and survivor benefits can be secured in the same fashion as if the parties were married. Rather than segregating the benefits and having the alternate payee receive benefits based on her own lifetime, the benefits are paid based on the joint lives of the parties.

RETIREMENT AGE: It is important for the attorney to ascertain the earliest retirement age under the plan that is being divided via QDRO. Most defined benefit plans provide early retirement at the participant's attainment of age 55. However some plans define the earliest retirement age as a function of the number of years of service or age plus years of service. Benefits paid sooner than the normal retirement age are subject to reduction for early commencement. For example, if a participant has earned a benefit equal to \$1,000 per month payable at age 65, he may be allowed to receive it early, at age 55, in reduced form, such as \$500 per month. The accrued benefit is reduced to compensate for the extended payout period.

In a standard defined benefit plan, benefits are not payable to an alternate payee until the participant attains the earliest retirement age under the plan. While the age of the alternate payee may impact the amount of benefit she receives under an independent interest QDRO, it has no impact on her ability to commence receipt of benefits.

Compare the age of the participant to the age of the alternate payee. Determine the earliest retirement age of the participant, which is the point at which benefits are payable to the alternate payee. If there is a large discrepancy in age between the alternate payee and the participant, it is possible that the awarded benefit will never become payable to an alternate payee. In some instances it is worthwhile to explore creative and cost effective solutions to the variety of problems that may be encountered.

¹⁷ I.R.C. § 414(p)(4)(B)(i)(I)(II)

For example, assume that you have a 60-year-old male participant that has accrued a vested lifetime benefit equal to \$2,000 per month. Assume the alternate payee is age 50, and she is awarded 50% of his benefit, or \$1,000 per month. If the alternate payee is to receive benefits in the amount of \$1,000 per month, they will be based on the participant's lifetime and will cease upon his death, often referred to as "if, as and when" type QDRO's. If benefits are to be paid to the alternate payee over her lifetime, which is most often the intent, then the amount she receives must be actuarially converted to accommodate her age and life expectancy under the terms of the plan. Given the age difference between the parties in this example, a benefit of \$1,000 payable for the lifetime of the participant may only yield \$350 per month for the lifetime of the alternate payee. This is because the alternate payee is younger, expected to live longer, and thus receive payments over a longer period of time.

PRACTICE TIP: Further assume that the plan allows for a 100% joint and survivor annuity equal to \$1,600 per month payable over the lifetimes of both the participant and his former spouse. The 100% joint and survivor annuity is less than the option that would provide the participant with a monthly benefit for his lifetime alone because it is reduced by the costs associated with paying the benefit out over the lifetimes of two individuals. A shared interest QDRO could require benefits to be paid in the form of a 100% joint annuity, with the alternate payee deemed the "surviving spouse". The QDRO could for example, award the participant \$1,200 per month (which is more than 50% of the accrued \$2,000 he would have received with a straight 50/50 division) and the former spouse \$400 per month (which is more than the actuarial equivalent she would have received under an independent interest QDRO). At the participant's death, which is likely to be substantially earlier than the alternate payee's in this example, the alternate payee would receive \$1,600 per month until her death (which is substantially greater than what would otherwise be payable to her under an independent interest QDRO). This example demonstrates how analyzing the spousal benefits in each particular marital

situation could provide increased value to each party and potentially solve a myriad of financial issues.

TAX RAMIFICATIONS OF QDRO: A plan may allow an alternate payee to elect a distribution immediately after the plan receives the order and deems the order “qualified”. A plan may not require an alternate payee to receive their distribution immediately unless the alternate payee’s account value is less than \$5000¹⁸. Payments to an alternate payee under a QDRO are not taxed to the participant; they would not be subject to the premature distribution penalties and would not interfere with the participant receiving a lump sum distribution in the future. Furthermore, the distribution to the alternate payee could be rolled over into an IRA. All distributions from qualified retirement plans (with the exception of distributions to children via QDRO for child support purposes) are considered ordinary income to the recipients, and taxed as such. A direct distribution from a defined contribution plan to an alternate payee is pursuant to a QDRO is exempt from the 10% federal and 3.3% Wisconsin state premature distribution penalties that would otherwise apply to distributions prior to age 59½. Please note that once the distribution is rolled over or transferred to an IRA, the exemption from the premature distribution penalties no longer apply.

Distributions from defined contribution plans that are not directly rolled over into an IRA or other qualified retirement plan are subject to an automatic 20% federal tax withholding. The rollover of assets from one qualified plan to another qualified plan is permissible, provided that the receiving plan will accept rollovers from other plans. Most often, however, alternate payees will opt to transfer their awards into an IRA.

Any payments made to an alternate payee that is not the spouse or former spouse (i.e. child of the participant) via QDRO will be considered taxable income to the participant. Usually this type of award is made for purposes of collecting child support.

Clearly an attorney should not simply fill in the blanks of “model documents”, but rather gain a thorough understanding of the retirement plan and its benefits, leading to his/her own draft to submit to the plan administrators. Discovery, analysis and a pension valuation should be completed before the negotiation and drafting of a QDRO begins.

F. ROLE OF THE EXPERT

The effect of equitable distribution upon divorce has created a new emphasis toward the economic aspects of marriage. These include valuation, division and tax considerations of marital property. The concept of equitable distribution of property also brought the need for attorneys to find and use experts to establish many of the values. Just about every divorce case involves tax issues and retirement pan issues, some simple, some complex. The attorney and client need the help of the expert in these matters.

The financial expert in particular can provide a myriad of services to the client and attorney. These include developing a theory of the case, valuation of a business, marshaling the assets, providing tax advice, preparing an expert report, testifying at trial, assisting the attorney in cross-examination of the opposing expert as well as helping to negotiate a settlement. No case should be settled without consideration of the tax aspects of the entire settlement. Finally, the expert may also help the attorney in following-up after the divorce is final to facilitate an equitable and orderly bifurcation of the marital assets. These include the transfer of assets from one spousal account to another, draft of the QDRO, follow-through with the change of beneficiary designations, re-title of assets etc.

IV. TAX ISSUES IN DIVORCE SETTLEMENTS

¹⁸ I.R.C. § 411(a)(11)

A. MAINTENANCE: Just calling a payment “maintenance” doesn’t make it tax deductible. The controlling statute for deductibility of support payments is I.R.C. Section 71. The section applies to any spousal payments intended to be deductible whether they are labeled “spousal support,” “Section 71 cash periodic payments in lieu of maintenance,” or “family support.” In order for support payments to be deductible all of the following must be true:

1. Payments must be made in cash or the equivalent. Payments cannot be made via an interest in other assets or by the provision of service.
2. Payments must be made to and on behalf of the payor’s spouse or former spouse. Payments for health insurance and life insurance could be deductible under Section 71.
3. Payments must be made pursuant to a formal divorce decree or separation decree/agreement.
4. Payments must cease upon death of the payee. This language must be explicit in the agreement even with respect to lump sum payments. Even if the payments include some amount (not fixed) for support of minor children, the payments must be terminated upon the death of the payee spouse.

PRACTICE TIP: If you have any reservations and/or concerns regarding the premature death of the payor spouse look to the life insurance policies owned by the parties. It is possible that both spouses may carry group term life through their respective employers. If not, consider the negotiation of buying term life to cover the period of payments.

5. A portion of the payments must not be fixed as child support within the decree/agreement.

PRACTICE TIP: Inclusion of child support as family support does not disqualify the payments from deductibility as long as the amount of child support

is not fixed and set forth. The payments must be “unallocated family support.”
See *Miller v. Commissioner*, T.C. Memo 1999-273

Courts will consider any reduction in family support conditioned upon the happening of a child related contingency specified in the decree/agreement relating to a child as child support and render that portion as payable for support of minor children. Therefore, this amount would not be taxable/deductible under Section 71. Note that a child related contingency payment might be treated as fixed and payable for the support of a child of the payor even if other separate payments are detailed in the decree/agreement for the support of the child. There are two situations in which the reduction of payments will be presumed to be clearly associated with events relating to a child:

- a. The payments are reduced not more than six months before or after a child is to attain age 18, 21, or the local age of majority
- b. The payments are reduced on two or more occasions that occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive. (Treas. Reg. 1.71-1T Q/A-18)

In Wisconsin, with the passage of child support percentage standards, the IRS has made noise over the years about whether the percentages would be imputed in the family support payments, making such portion of the payment nondeductible, as that portion is for child support. Currently, if the agreement does not specifically provide a mechanism for determining what portion of each payment is actually for child support, the entire payment will be treated as deductible upon satisfaction of all other requirements.

Most circuit courts presumptively apply the child support standards. The parties must agree that no allocation of child support is necessary to convince the court that the support guideline is satisfied within the agreement.

6. Within the decree/agreement the payments must not be designated as nontaxable/nondeductible.
7. The former spouses must live in different households. The sharing of the same address, even if it's in different units, disqualifies the payments. This requirement does not apply to payments made under a temporary order.
8. Payments must not decrease from year to year during the first 3 years beyond certain guidelines set forth in the statute. If the decrease in payments exceeds the maximum guidelines, the overage is subject to recapture and is not taxable/deductible under Section 71. This limitation is included to prevent front-loading of income from payor to payee.

EXCESSIVE FRONT – LOADING OF MAINTENANCE

Under IRC Section 71, excessive front-loading of maintenance, and the a recapture problem occurs when:

1. The total amount of Section 71 payments made in the first year of payment less the average of the total amount of payments made in years 2 and 3 exceeds \$15,000
2. Or, the total amount of Section 71 payments made in year 2 exceeds the total amount of payments made in year 3 by \$15,000

Parties may be able to avoid recapture by setting Section 71 payments as a percentage of the payor's income. Such fluctuating payments are specifically excluded from recapture under Section 71(f) though it remains unclear whether courts will abide by the exclusion. A fluctuation as a result of modification by the Court does not qualify.

WHY SECTION 71 PAYMENTS?

Benefits for the payor:

1. Payments are deductible to payor and includable to payee “above the line.” The effect is reflected in computing each party’s adjusted gross income.
2. Except as otherwise provided in the settlement agreement, the payments are for a fixed period regardless of marital status and changes in circumstances.
3. Except as otherwise provided in the settlement agreement the payments are not variable. Both parties have comfort in that the payment obligation will not be modified with an increase or decrease in income which leaves both better able to budget for their futures
4. Satisfaction of the statutory requirements within a divorce agreement can convert property settlement payments to deductible payments.
5. Satisfaction of the statutory requirements can also convert the following to tax deductible amounts: Attorneys’ fees paid on behalf of the spouse or former spouse, spouse or former spouses interest in a closely held business, college expenses, child support and debt retirement
6. There will be no further court proceedings relative to support as long as the payor fulfils all obligations.

Benefits for the payee:

1. Payments are for fixed amount and for a fixed period regardless of the payee’s remarriage unless otherwise provided in the marital settlement agreement. Payments will not decrease with the payor’s income or any other foreseeable or unforeseeable event.

2. The parties may agree to a higher payment based on the mutual tax implications. Thus the payee spouse, presumably in a lower tax bracket, can achieve a higher net income than if the payments were not deductible by the payor spouse.
3. There will be no further court proceedings relative to support as long as the payor fulfills all obligations.

Benefits for the children:

1. If unallocated support payments will be higher when they are designated to qualify under Section 71, children will be better supported by the payor spouse

Benefits according to the Court:

1. “Unallocated family support encourages sensible cash-flow planning between separated spouses. If used correctly the technique enables the parties to achieve a higher net transfer of funds to the payee spouse because the payor spouse, whom is generally in a higher tax bracket, reaps an economic benefit from the larger tax deduction obtained when allocated family support payments are structured to be deductible as alimony.” See *Miller v. Commissioner*, T.C. memo 1999-273 (1999)
2. Courts cannot order Section 71 payments at trial but rather can approve marital settlements with Section 71 provisions and will enforce them as well. If parties desire support in the form of Section

71 payments, they must stipulate to said payments and ask the Court to accept their stipulation.

SECURITY DEVICES WITHIN MARITAL SETTLEMENT AGREEMENTS

Often attorneys opt to include certain security devices in marital settlement agreements that are designed to better insure compliance with the other agreements contained in the agreement. Unfortunately, the practical application of such security devices often has less than the intended effect. For example, acceleration clauses with respect to support are often included and triggered by non-compliance. Such clauses can bring with them problems with front-loading and recapture as described above.

Life insurance and trusts are also considered security devices. Problems emerge when the intended insured fails to qualify for the level of coverage needed. Further attorneys must be diligent about tracking any beneficiary changes that could trigger major probate problems.

Phantom stock interest in a company owned by the payor spouse is sometimes used to “secure” payment of ordered support or other obligations. Binding agreements are difficult to draft and enforce. Beyond the difficulty in drafting, there are effects on other stockholders, which negate or weaken the payee’s spouse’s interest. Attorneys must be diligent about detecting buy-out provisions in corporate agreements and determining if

such provisions can be overwritten. Otherwise, stockholders could buy the payee spouse's "security interest" from him or her at a much-reduced price.

B. THE MARITAL RESIDENCE

The 1997 Tax Payer Relief Act increased the threshold for capital gains taxes to \$250,000 for a single taxpayer and \$500,000 for a married taxpayer. Couples who plan or realize the need to sell their marital home as a result of divorce should time their sale accordingly and based upon the gain they can reasonably anticipate from the sale of the home. The capital gains taxes are calculated pre-divorce as in following example:

Illustrative Example:

Selling Price of Home	\$900,000
Mortgage(s)	200,000
Basis	150,000
Depreciation/Bus. Use	none

Sale when property is owned by both parties-tax and cash flow are calculated as follows:

One Spouse's "share" of selling price	450,000
<u>Less \$250,000 exclusion</u>	<u>-250,000</u>
Revised "selling price"	200,000
<u>Less: Basis (adj. for depreciation, if any)</u>	<u>-150,000</u>
Capital Gain	50,000
Capital Gain Tax (fed 20%)	10,000
Tax on depreciation (if any-non in example)	0
Plus State Tax	?

Post-tax cash flow calculation:

	Total	Husband	Wife
Selling price of home	\$900,000	\$450,000	\$450,000
<u>Less: mortgages</u>	<u>-200,000</u>	<u>-100,000</u>	<u>-100,000</u>
Pre-tax cash flow	700,000	350,000	350,000

<u>Less: C/G Tax*</u>	<u>20,000</u>	<u>10,000</u>	<u>10,000</u>
<i>Post-tax cash flow</i>	\$500,000	\$250,000	\$250,000

However, if, as a result of the divorce, one spouse has “bought” the other out of his or her share of the marital home by trading other marital property for his/her interest only to find that, thereafter, the home must be sold, the tax question would be quite different:

Sale by one spouse post-divorce – tax and cash flow are calculated as follows:

Spouse’s “share” of selling price	900,000
<u>Less \$250,000 exclusion</u>	<u>(250,000)</u>
Revised “selling price”	650,000
<u>Less: Basis (adj. for depreciation, if any)</u>	<u>(150,000)</u>
Capital Gain	500,000
Capital Gain Tax (fed 20%)	900,000
Tax on depreciation (if any-none in example)	0
Plus State Tax	?

Post tax cash flow calculation:

Selling price	900,000
<u>Less: mortgages</u>	<u>(200,000)</u>
Pre-tax cash flow	700,000
<u>Less: C/G Tax</u>	<u>(100,000)</u>
<i>Post-tax cash flow</i>	<i>\$600,000</i>

The net effect of the latter example is that the home-owner spouse “traded” away \$450,000 worth of property (nontaxable) to realize a net of \$600,000 on the sale of the home which resulted in a net gain to his or her estate of \$150,000 after the payment of taxes. Had the sale of the home been better planned, he or she could have realized an individual net gain of \$250,000.

Case Note: Profits realized on the sale of the property transferred, as part of a divorce agreement could not be characterized as alimony. The taxpayer transferred a house to his former wife when they were divorced in 1995. At the time, there was little equity in the house due to a mortgage and other encumbrances. Two years later, values having increased considerably, the taxpayer's former wife sold the house for an amount substantially in excess of its value at the time of the divorce. The taxpayer sought to deduct as alimony one-half the profit, which his former wife had realized.

In rejecting the taxpayer's deduction claim, the Tax Appeals Commission held that nothing in Wisconsin law, or in Internal Revenue Code Sec. 71, would characterize the sales gains as alimony. The taxpayer made no payment to his former wife, and it is the making of payments that is the basis of alimony. If the taxpayer had been dissatisfied with the divorce court's division of the property, he should have appealed that action at the time rather than now trying to get an alimony deduction. The Wisconsin Tax Appeals Commission rightfully commented that the tax code simply does not provide a remedy for people aggrieved by the actions of the courts in divorce actions. *See Bronson v. Wisconsin Department of Revenue*, WTAC Dkt. Nos. 01-I-119 and 01-I-128, 6/7/2002

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C. TRANSFERS OF PROPERTY BETWEEN SPOUSES

Overview of Internal Revenue Code Section 1041

- i. Generally, a divorce involves some type of property division or property settlement in which one or both parties will transfer cash or other property to the other.
- ii. A payment that does not meet the requirements of maintenance and which is not fixed as child support, will constitute a property settlement.
- iii. If property is transferred between spouses incident to a divorce, the tax treatment of the transferred is governed by Section 1041

Scope of Section 1041

- i. The general rule of Section 1041 is that no gain or loss shall be recognized on a transfer of property from an individual to a spouse or to a former spouse, but in the case of a former spouse, only if the transfer is incident to a divorce. This non-recognition treatment is MANDATORY.
- ii. “Divorce” as used in Section 1041 includes any cessation of marriage – e.g., annulment, legal separation
- iii. “Incident to a divorce”
 - 1. Occurs within one year after the date on which the marriage ceases (whether or not the transfer is actually related to cessation of the marriage) or
 - 2. Is related to the cessation of the marriage. There is a presumption that a transfer is related to the cessation or the marriage if the transfer is pursuant to a divorce or separation

instrument and the transfer occurs within six years after the date on which the marriage ceases. Treas. Reg. Section 1041-1T

- iv. A property transfer is related to the ending of a marriage if:
 - 1. The transfer is made under the original or modified divorce decree or separation agreement and
 - 2. The transfer occurs within six years after the date the marriage ends.
 - 3. This test is presumptive and can be overcome if it can be shown that the transfer did not occur due to business or legal factors that prevented an earlier transfer.
- v. Prior federal law was set forth in United States v. Davis, 370 U.S. 65 and included in Rev. Rul. 74-347 and 81-292. Codification of Section 1041 repealed these provisions (July 18, 1984).

B. Tax Treatment of Qualifying Transfers

- i. If one spouse transfers property to a third party on behalf of the other spouse, the property is treated as two separate transfers. The transferee spouse may have to recognize gain on the second transfer. To avoid tax on the first transfer however, the transfer must be required by the decree or separation agreement or requested in writing by the transferee spouse.

1. Detailed consideration should be given to corporate stock redemptions and a line of cases beginning with Joann Arnes vs. United States. Careful planning is required to achieve the appropriate results.

ii. The general rule of no gain or loss shall not apply to a transfer of property in trust to the extent that:

1. An installment obligation is transferred for the benefit of a spouse or former spouse.
2. The amount of liabilities assumed plus the amount of liabilities to which the property is subject exceeds the adjusted basis of the property transferred.
3. If gain is recognized on the transfer by the transferee in the property is increased to take the recognized gain into account.

iii. Transferring an interest in a passive activity with unused passive losses does not result in freeing up the losses to be used by the transferor. The transferee spouse takes the property with an increased basis to the extent of the unused passive losses.

iv. Transferring nonstatutory stock options or deferred compensation does not result in income to the transferor at the time of the transfer. The transferee spouse will recognize ordinary income when the options are exercised or the deferred compensation is paid.

1. Consider the marital property tax aspects of this deferred income. It may be advisable to state with some certainty in the

divorce decree that the spouse receiving the interest in the options or deferred compensation is ultimately responsible for the income taxes on it.

- v. Qualified retirement plans fall outside the scope of Section 1041 and are treated as ordinary income when receive. Although they are treated as property for purposes of the property settlement, they are treated as income when receive. (See Section V of this presentation for issues regarding valuing and dividing of retirement plans.)
- vi. E-bonds transferred at the time of the divorce results in interest income to the transferor (See Rev. Rul. 87-112).
- vii. Section 104-1 non-recognition treatment applies to losses as well as gains. A loss will not be recognized on the transfer and the basis in the property will carryover to the transferee.
- viii. The holding period of the transferor will carry over and “tack” and become the holding period of the transferee.
- ix. There is no depreciation recapture upon a Section 1041 transfer because the Section 1041 transfer is essentially treated as a gift for income tax purposes. However, the transferee assumes the transferor’s depreciation recapture at the time of the transfer.

C. Sale of Principal Residence

- i. Section 1034 regarding rollover of gains on sale of a principal residence and old Section 121 regarding the once in a lifetime exclusion for taxpayers over age 55 was repealed for sales after May 6, 1997.
- ii. New Section 121 provides that each taxpayer may exclude up to \$250,000 of gain on the sale of a principal residence if:
 1. The home is used as the principal residence of two years of the five years immediately preceding the date of sale and
 2. The taxpayer must have owned the home for periods aggregating two years out of five years immediately preceding the sale.
- iii. On a joint return, a husband and a wife may claim a \$500,000 exclusion of capital gain if:
 1. Either spouse meets ownership requirements, and
 2. Both spouses meet the occupancy requirements.
- iv. This capital gain exclusion on the sale may not be claimed more than once every two years.
- v. Divorced taxpayers are allowed to preserve the capital gain exclusion under certain provisions of Section 121
 1. If ownership interest is transferred from one spouse to the other spouse, the ownership period of the spouse receiving interest in the home includes the other spouse's ownership

2. One spouse is treated as using the home as his or her principal residence for any time during which the spouse is granted the use of occupancy of the home under a divorce or separation instrument.
- vi. There is a proration of gain exclusion for the sales of home held less than two out of five years.
 - vii. Care needs to be taken in planning for use, occupancy and ownership of the principal residence during the pendency of a divorce action to ensure that the \$250,000 gain exclusion is preserved.

E. Transfers Not Covered by Section 1041

- i. Section 1041 does not protect the transferor spouse from liabilities in excess of basis in trust for the benefit of the ex-spouse. The transferor spouse must recognize gain in the amount of liabilities in excess of basis.
- ii. Section 1041 excludes the transfers of property to a non-resident alien spouse or former spouse.
- iii. Transfers of property prior to marriage are not covered by Section 1041; transfers pursuant to prenuptial agreement will result in gain or loss on the transfer.
- iv. The transfer of an installment obligation into a trust will result in the deferred gain being accelerated on the transfer.

- v. Section 1041 does not address the tax treatment of an assignment of income; however, the IRS takes the position that it is taxable to the transferor.

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Appendix QDRO

QUALIFICATION REQUIREMENTS: (I.R.C. and ERISA)

The Order must designate each alternate payee. An alternate payee is any spouse, former spouse, child or other dependent of the participant who is recognized by a domestic relations order as having a right to receive all or a portion of the benefits payable under the plan with respect to the participant. (I.R.C. §414(p)(8) and ERISA §206(d)(3)(K))

The Order must clearly specify the amount or percentage of the participant's benefits to be paid to alternate payee, or the manner in which the amount is to be determined. (I.R.C. §414(p)(2)(B) and ERISA §206(d)(3)(C)(ii))

The Order must specify the number of payments or the period to which the order applies. (I.R.C. §414(p)(2)(C) and ERISA §206(d)(3)(C)(iii))

The Order must specify each plan to which the order applies. (I.R.C. §414(p)(2)(D) and ERISA §206(d)(3)(C)(iv))

The Order must specify the name and last known mailing address of the participant and alternate payee. Social security numbers, dates of birth and the date of divorce are not required under the Code, but most plan administrators require this information to process and calculate benefits payable to the alternate payee, especially if the awarded benefits are to be based upon the lifetime of the alternate payee. (I.R.C. §414(p)(2)(A) and ERISA §206(d)(3)(C)(i))

A domestic relation's order is any judgment, decree, or orders including a property settlement agreement which:

- a. relates to the provision of child support, alimony or marital property rights to a spouse, former spouse, child or other dependent of a participant.
- b. is made pursuant to a state domestic relations law, including a community property law. (I.R.C. §414(p)(B)(i)(ii) and ERISA §206(d)(B)(ii)(I)(II))

The qualified status of the domestic relation's order is determined only by the plan administrator in accordance with I.R.C. §414(p) and ERISA §206(d).

The order must create or recognize the existence of an alternate payee's right to, or assigns to, the right to receive all or a portion of the benefits. (I.R.C. §414(p)(1)(A)(i) and ERISA §206(d)(3)(B)(i)(I))

The order cannot require the plan to provide any type or form of benefits, or any option, not otherwise provided under the plan. (I.R.C. §414(p)(3)(A) and ERISA §206(d)(3)(D)(i))

The order cannot require the plan to provide increased benefits determined on an actuarial value. (I.R.C. §414(p)(3)(B) and ERISA §206(d)(3)(D)(ii))

The order cannot require the payment of benefits to an alternate payee that are already required to be paid to another alternate payee under a previous order. (I.R.C. §414(p)(3)(C) and ERISA §206(d)(3)(D)(iii))

In the case of any payment before a participant has separated from service, an order *may* provide that payments to the alternate payee can begin on or after the date on which the participant attains the earliest retirement age under the plan whether or not the participant has actually retired. The earliest retirement age means the earlier of:

- a. the date the participant is entitled to a distribution under the Plan, or
- b. the date the participant reaches age 50, or, if later, the earliest date on which the participant could receive benefits if the participant separated from service. (I.R.C. §414(p)(4)(B)(i)(ii) and ERISA §206(d)(3)(E)(ii)(I)(II))

An Order that is determined to be qualified will remain qualified with respect to a successor plan of the same employer or a plan of a successor employer (§ 414(a) of the I.R.C.).

Information in regard to a Qualified Domestic Relations Order can be obtained from the I.R.C. §414(p), Employee Retirement Income Security Act (ERISA) of 1974 §206(d) and the Retirement Equity Act of 1984 (REA-84), Public Law 98-397 §104, which amended certain sections of ERISA to improve the delivery of benefits to an alternate payee.

I.R.C. §401(a)(13) creates an exception to the anti-alienation requirements of Code §401(a)(13)(A). ERISA qualified plans are subject to the anti-alienation rules unless they are divided by means of a domestic relations order that is determined to be qualified by the plan administrator.