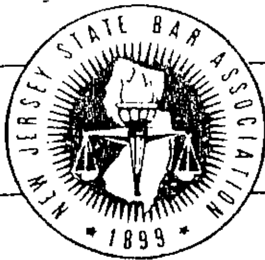

New Jersey Family Lawyer

VOLUME VIII, Number 8 APRIL 1989

Chair's Column

An Attorney's Responsibilities

by Myra T. Peterson

We are attorneys. As attorneys, *we* are required to be candid and forthright to the court. We are not permitted to knowingly allow our clients to lie to the court. We are charged with obtaining a just result for our clients. A just result presumes that the basis upon which the result is reached is the truth.

Why then are certifications submitted to our courts with blatantly untrue allegations? A response "Because that's what my client told me" isn't sufficient. One usually does not need the deductive powers of an Einstein to realize that what a client is saying about his or her finances is untrue, or half true, or highly unlikely. One usually knows that a husband has not had to repay 25-year-old debts to his friends, depleting all bank accounts, upon inception of litigation. One usually knows that the woman who has come to the office dressed in polyester does not have $500 monthly dry cleaning bills. One usually knows that a bonus which has been paid every year for the last 15 years will again be paid. The responsible attorney weeds through the factual morass and does not permit his or her client to present untrue "facts" to the court, even at the risk of losing the client. The attorney who considers himself or herself only as a mouthpiece for his or her client ignores that responsibility and says, "That's what my client told me, judge."

Unfortunately, since so few of our cases are ultimately tried where the truth can be weeded out by cross-examination and so many of our cases obtain their direction as a result to a *pendente lite* motion (decided often only upon certifications), we have cases which begin on the wrong foot. They begin with untruthful premises which lead to an unfair *pendente lite* result, which in turn may lead to (a usually denied) motion for leave to appeal, further trial court activity which should be unnecessary, or to added months of litigation since the litigant who "wins" a *pendente lite* motion is

(Continued on page 154)

Consideration of Theoretical Tax Consequences in Equitable Distribution

*by Frank A. Louis**

As early as 1974, the Supreme Court in *Painter v. Painter*, 65 N.J. 196, 212 (1974) observed that it would not be "improper for a judge to give appropriate heed to legitimate tax considerations" in making an equitable distribution of property. Almost 10 years later, in *Dugan v. Dugan*, 92 N.J. 423, 441 (1983), the Court observed simply that "potential federal tax consequences should be considered in determining equitable distribution." Those two observations, while logically appropriate, have created serious disagreements among lawyers and judges as to what, in each instance, the Supreme Court meant. No clear consensus exists as to how consideration of "potential federal tax consequences" should be addressed by our courts. It is surprising that no New Jersey decision has dealt specifically with this important issue since the issue is present in virtually every case where an equitable distribution of property is made. Certainly, tax consequences must be considered but no New Jersey case has provided any guidance as to *how* and the resultant uncertainty creates inconsistent results, confusion and ultimately a sense of frustration on behalf of lawyers and litigants. It is the object of this presentation to advance one point of view with the hope that discussion might be prompted resulting ultimately in a determination giving the Bench and Bar guidance on this crucial issue.

Considering Tax Consequences

There is no question that the *Dugan* decision mandates that tax consequences be considered. It does not require that theoretical tax consequences be deducted dollar-for-dollar, nor does it say they should not. In analyzing the issue of theoretical tax consequences, it is essential to appreciate that assets having equal values, after deducting liens or encumbrances, are not necessarily equal and it is important to carefully review the tax consequences of any distribution of property. While under DTRA it is now clear that a taxable event does not occur when property is equitably distributed, there are legitimate tax consequences that must be considered in any distribution. A brief illustration highlights the point. Commercial real estate that has been depreciated for

(Continued on page 155)

© 1988 by the Family Law Section of the New Jersey State Bar Association

Consideration of Theoretical Tax Consequences

(Continued from page 153)

a number of years, having a fair market value of $600,000 with a $200,000 mortgage, is not equal in economic value to $400,000 in treasury bills. The difference is that the spouse receiving the commercial real estate (aside from the fact it may be income generating) has a future tax liability that will have to be dealt with at some point in time. If it was the intent of the Court to make an equal distribution of assets, the commercial real estate, which might have a tax liability of $75,000, is not equal to $400,000 in treasury bills.

Yet, is it fair to deduct, at the time of distribution, $75,000.00 in theoretical tax consequences when: a) they may not be incurred; b) if they are incurred, they may not be incurred for years; and c) the tax rates at the time of the sale may differ substantially from the current rates. Is this what the Supreme Court meant to say, but didn't, in *Dugan*? Yet, it is equally unfair to ignore the future tax liability. Thus, the spouse (retaining the asset) advances the following arguments:

1. If what we are attempting to do in valuing assets is to assume a hypothetical sale, it is entirely appropriate, in this hypothetical valuation, to deduct theoretical tax consequences even if not actually incurred.

2. The American Institute of Certified Public Accountants (AICPA) specifically requires that personal financial statements reflect theoretical tax consequences and, therefore, under generally accepted accounting practice, tax consequences should be deducted from the value. (See AICPA Statement of Position 82-1.)

3. To ignore the theoretical tax consequences would inherently be unfair since awarding one spouse the low basis assets is, in effect, exacerbating a disproportionate distribution or, alternatively, making a distribution which appears to be equal, on the surface, but is actually unequal.

4. In *Kruger v Kruger*, 139 N.J. Super. 413, 422 (App. Div. 1976), mod. 73 N.J. 464 (1977), the Appellate Division specifically directed trial courts to deduct theoretical tax consequences from pensions. But why make a distinction between a pension and a business? If taxes are to be deducted for one asset, shouldn't they be deducted for all assets?

The Response

In contrast to these seemingly persuasive arguments, the other spouse contends that:

1. Deduction of theoretical tax consequences is entirely speculative, either as to the *amount* or the *timing* of payment and, therefore, is nothing more than a guess and equitable distribution of property should be based on facts—not mere surmise.

2. An individual with a portfolio of various assets can structure the sale of an asset when other tax losses are available—thus the theoretical tax consequences may, in whole or in part, be offset. To ignore the realities of effective tax planning inevitably results in one party receiving a windfall to the detriment of the other.

3. Sophisticated property owners can negotiate an exchange of like property thereby, if not eliminating the potential liability, then significantly delaying payment affecting the economic value of the payment. This delay would require an adjustment in the tax consequences to reduce the amount to present value (See IRC § 1031.)

4. A property owner has the option of using an asset's equity without having a sale, and avoiding hypothetical taxes, by refinancing the property. The proceeds from a refinancing are not taxed.

5. Notwithstanding the sharp circumscription of the rules governing charitable deductions, it still remains possible for a sophisticated investor to donate appreciated property and avoid the payment of taxes on the property's appreciation. (See IRC § 170.)

6. The sophisticated investor has the option of further deferring tax consequences by entering into an installment sales contract which might not only affect the timing of the tax payment, but the amount as well. (See IRC § 453A.)

7. A property owner always has the option of maintaining property until death. Thus, the property passes under a will receiving a "stepped-up basis" eliminating the necessity for anyone to pay theoretical tax consequences (See § 1014.)

8. It is a basic principle of economics that money has a current value, and $100,000 paid today is worth more than $100,000 paid ten years from now. If a court cannot determine when theoretical tax consequences are to actually be paid, how can it calculate, with specificity, the actual value in present day dollars of the theoretical tax consequences? Certainly, the true value of those tax consequences is different if the property is sold in five or 10 years.

9. The Appellate Division, in *Wadlow v. Wadlow*, 200 N.J. Super. 372 (App. Div. 1985), determined that a theoretical real estate commission is not to be deducted from the fair market value of a marital home. If that represents the policy of this state, particularly in light of the other arguments, why should money be deducted for taxes if not for commissions?

Clearly, each side advances persuasive arguments and it might be expected that a review of the out-of-state cases that have, unlike New Jersey, specifically dealt with the issue might reveal a divergence of views. Surprisingly, quite the opposite is true since there has been virtual unanimity on the issue across the country. Each court that has reviewed the question has made the distinction between a situation

where: a) by virtue of the distribution (property is ordered or must be sold), or the unique facts of the case (the parties' intend to immediately sell the property), taxes will be incurred; and, b) a tax-free exchange, or trade-off, of property without consequence at the time of distribution. Thus, it appears that based on the out-of-state decisions, taxes should only be deducted when the sale has occurred or will be required shortly after distribution of the assets.

Looking at Leading Cases

If there is a leading case across the country, it would be the California Supreme Court decision of *In re Fonstein*, 552 P.2d 1169, 1176 (Cal. 1969). If not the leading case, it is certainly one of the earliest and many other states have referred to it in their decisions. Interestingly, the California court specifically recognized what it characterized as a "risk" that the future tax liabilities might not necessarily be distributed evenly, but in accepting that risk, on policy grounds, concluded that any "hypothetical inequity . . . . is inadequate justification for introducing an *unnecessary, complicated and speculative factor* into the process of dividing the community property" (emphasis added). In clear and concise terms the Court, in a footnote, summarized what has become the law across the country:

> **"Regardless of the certainty that tax liability will be incurred if in the future an asset is sold, liquidated or otherwise reduced to cash, the trial court is *not required to speculate* on or *consider* such tax consequences in the absence of proof that a taxable event has occurred during the marriage or will occur in connection with the division of the community property." (emphasis added)**

The *Fonstein* decision was relied upon by the Supreme Court in Arizona in its decision *In re the Marriage of Goldstein*, 583 P.2d 1343, 1345 (Ariz. 1978). Interestingly, the *Goldstein* court, while relying on other out-of-state cases, specifically relied on *Stern v. Stern*, 66 N.J. 340 (1975), which held that accounts receivable should not be reduced by future income taxes. The Arizona court relied on the same distinction made by the California Supreme Court.

Continuing the virtual unanimity of the various Appellate Courts in the country, the Supreme Court of Minnesota, in *Aaron v. Aaron*, 281 N.W.2d 150, 153 (Minn. 1979) adopted the *Goldstein/Fonstein* rationale observing that:

> **"Generally, *courts* based the distribution of property on the value of the property at the time of distribution and, therefore, *are willing to consider only those tax consequences that arise from the distribution itself.* Because they are hesitant to *speculate* about the future value of the property, they are also hesitant to consider the possible tax consequences of either party's future dealings with the property." (emphasis added)**

Since the husband had not demonstrated that he "must sell his interest" to satisfy the equitable distribution award, or that he had any intention to do so, the Court declined to consider future or theoretical tax consequences. The *Aaron* court observed that where the sale of real estate is required, or is likely to occur within a short time after the dissolution, then the court should consider tax consequences. Similarly, the Supreme Court of Montana in *Beck v. Beck*, 631 P.2d 282, 285 (Mont. 1981), relying on *In re Marriage of Gilbert*, 628 P2d 1088 (Mont. 1981) held that a trial court had not abused its discretion by refusing to consider theoretical tax consequences when the property distribution did not contemplate any taxable event triggering a present tax liability. Yet, as did *Aaron*, the Court noted that if a tax liability will be triggered by the court ordered distribution, then there must be an allowance for the tax impact.

In *Clapperton v. Clapperton*, 649 P.2d 620 (Or. Ct. App.), the Oregon Court of Appeals held that the trial court, in dividing property in a dissolution decree, did not err in failing to consider tax consequences which it considered to be speculative. There was no sale compelled by the decree and therefore the court considered the theoretical tax consequences as entirely too speculative to deduct. In the same vein, the South Carolina Court of Appeals in *Josey v. Josey*, 351 S.E.2d 891 (S.C. Ct. App. 1986) concluded that a deduction of $171,000 in theoretical taxes was improper even where a decree required a sale of some assets. The Court believed it would still be required to speculate as to what, if any, taxes would have to be paid by the husband.

Consistent with the prevailing view across the country was the decision by the Oklahoma Supreme Court in *Carpenter v. Carpenter*, 657 P.2d 646, 652 (Okla. 1983) where the calculations as to tax liabilities were uncertain both in *quantum* and as to the *time*. Thus, the Court noted that:

> **"*We cannot speculate as to the tax bracket* the plaintiff will be in when the distributions to him are made, or as to *which future tax years they will be applied.*" (emphasis added)**

The Indiana Supreme Court, in *Berkhart v. Berkhart*, 349 N.E.2d 707, 711 (Ind. 1976), held that since there was no requirement under the Judgment of Divorce that certain shares of stock be transferred, and where it found factually that the obligations under the decree could be satisfied without such a mandatory transfer, there was no assurance that capital gains taxes would ever have to be paid.

Other Cases

In *Lien v. Lien*, 278 S.D. N.W.2d 436 (1979), the Supreme Court of South Dakota rejected the husband's argument that the trial court failed to fully consider the federal income tax consequences by refusing to deduct the full amount as if the husband liquidated his assets. That court, continuing the virtual unanimity of the courts across the country, concluded that there should be a deduction only if: a) the property division compelled a total liquidation of the assets; and, b) if it were probable that the most disadvantageous method of sale from a tax point would be used.

In *Biddulph v. Biddulph*, 711 P.2d 1244 (Ariz. Ct. App. 1985), the Arizona Court of Appeals, agreed with the wife's position, and the other courts across the country, that only immediate tax consequences resulting from the degree should be considered while tax consequences arising from future disposition of an asset should not. The court characterized the future reduction as "speculative" since the husband "might never sell the stock, he may donate it to charity, or may place it in trust for another."

A recent decision by the Pennsylvania Supreme Court is consistent with the nation-wide trend. (See *Hovis v. Hovis*, 14 FLR 1358 (Penn. 1988).) In reversing the lower court, the highest court in Pennsylvania held the trial court abused its discretion by deducting 10 percent of the value of the assets for potential federal income tax liabilities. The court observed that potential federal tax liabilities may be considered in valuing assets "only where a taxable event has occurred as a result of the divorce or equitable distribution or is certain to occur within a time frame that such tax liability can be reasonably predicted."[1]

The obvious question is if there is such virtual unanimity across the country on the question of deducting future or theoretical tax consequences how does one reconcile that with the clear admonition in New Jersey that such tax consequences must be *considered*.

In a related context, our Supreme Court provided a clue as to what they meant by the concept that tax consequences be "considered". In *Stern, supra*, the Supreme Court, after rejecting the view that the value of a law firm's accounts receivables should be reduced for tax liabilities, noted that "the fact that he will pay a tax on these receipts may be a *relevant* consideration when considering whether a distribution is equitable" (emphasis added). By observing that tax liabilities were a factor impacting upon the *fairness* of the distribution, the Court established the most appropriate conceptual approach as to future tax liabilities that are either uncertain as to amount or timing. Thus, the *Dugan* "consideration" of future taxes is best resolved by a trial court considering such liabilities as simply another equitable distribution factor. The Supreme Court, in *Painter*, noted that the tax consequences of a distribution should be considered in making an "equitable" distribution of property and, therefore, such an approach is both practical, fair and consistent with the limited precedent.

Justice, and the statutory policy implicit in equitable distribution, will best be served by requiring counsel to present to the court, as counsel has the obligation with valuations, specific information concerning the future tax consequences of the property. Only when the Court has that information, along with the other factors listed in *Painter*, such as the earning capability of the parties, their respective health, education, contributions to the marriage, etc., can a distribution of property with appropriate factual findings be made. The impact of theoretical taxes should be left, along with the other *Painter* factors, to the trial court to weigh in the proper exercise of its discretion.

Conclusion

In summary, the following procedures should be utilized:

1. Counsel should have the responsibility to present proof as to the tax consequences of any proposed distribution both at the time the distribution is being made and in the future. Compare *Rothman v. Rothman*, 65 N.J. 219, 233 (1974).
2. Court appointed experts should, as a matter of course, calculate theoretical tax consequences without expressing an opinion as to whether they should be deducted. The question of how theoretical consequences are to be handled is, in the first instance, a legal judgment. The *amount* of the consequences must be calculated by the expert yet how they are treated is the responsibility of the court.
3. Future tax consequences should be deducted dollar for dollar if: a) the taxable event occurred during the marriage; b) the property is to be sold pursuant to the terms of the Final Judgment; (c) to meet the equitable distribution, or support, provisions of the judgment, the property will have to be liquidated;
4. A trial court should have the obligation to make specific findings of fact both as to the amount of the theoretical tax consequences and why they were treated in the manner they were.[2] □

Footnotes

[1] It is not without some irony that the unanimity concerning professional practices and businesses seemingly disappears when we consider retirement plans. See e.g. *Sheskey v. Sheskey*, 415 N.E.2d (1987) (Mass. Ct. App. 1983); *In re the Marriage of Faulkner*, 582 S.W.2d 292 (Mo. Ct. App. 1979); *Selechert v. Selechert*, 280 N.W.2d 293 (Wis. Ct. App. 1979). *Accord: Kruger, supra.*

[2] The author thanks Barry Croland, whose prior article on the subject provided both knowledge and inspiration. Croland, 1981 N.J. Family Lawyer, 38.

* ***Frank A. Louis*** *is a contributing editor to* New Jersey Family Lawyer *and is former chair of the NJSBA's Family Law Section.*