Arizona Chapter Of American Academy AAML of Matrimonial Lawyers Presents

Arizona Divorce Conference

Advanced Financial Topics

JW Marriott Desert Ridge Resort & Spa

Grand Sonoran Ballroom

Thursday, October 22, 2015
9:00 a.m. - 5:30 p.m.
Reception & Lunch Included

Friday, October 23, 2015
9:00 a.m. - 12:30 p.m.

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The State Bar of Arizona does not approve or accredit CLE activities for the Mandatory Continuing Legal Education requirement. This activity may qualify for up to 10.75 hours toward your annual CLE requirement for the State Bar of Arizona, of which 2.0 hours are professional responsibility.

ARIZONA DIVORCE CONFERENCE 2015

Phoenix, Arizona
October 22-23, 2015

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THURSDAY, OCTOBER 22, 2015

9:00–10:00 **Joint Representation Issues in Estate Planning and Gift Taxes**

Robert L. Schwartz, Esq., Dickinson Wright, PLLC
Victoria Harris, CPA, Hunter Hagan & Company, Ltd.
Les Raatz, Esq., Dickinson Wright, PLLC
John Vryhof, Esq., Snell & Wilmer, LLP
Steven H. Everts, Esq., Udall Shumway, PLC

10:00–10:30 **Non-Qualified Stock, Retirement and Disability Plans: The Bottom Line on Top-Hat Deferred Compensation**

Stephen R. Smith, Esq., Fromm, Smith & Gadow, PC

10:30–10:45 **Break**

10:45–11:30 **Avoiding QDRO Malpractice Plus the Power of the Time Rule**

Raymond Scott Dietrich, Esq., Raymond S. Dietrich, PLC

11:30-Noon **Creative Ways to Analyze and Structure Settlements**

Helen R. Davis, Esq., The Cavanagh Law Firm, PA
Annalisa Moore Masunas, Esq., Moore, Masunas & Moore, PLLC

Noon–1:30 **Lunch** **Speaker:** **The Honorable Suzanne Cohen,**
Maricopa County Superior Court

1:30–3:30 **Sure-Fire Techniques in Cross-Examining the Financial Expert**

Leonard Karp, Esq., Karp & Weiss, PC
The Honorable Maurice Portley, Arizona Court of Appeals-Division One
The Honorable Jay M. Polk, Maricopa County Superior Court
Mario R. Ventrelli, Esq., Ventrelli Simon, LLC
Anita M. Ventrelli, Esq., Schiller, DuCanto & Fleck, LLP
Robert A. Jensen, Esq., Jensen and Gordon, PLLC
Peter Economidis, Esq., Waterfall Economidis Caldwell
Marc D. Fleischman, CPA, Beach Fleischman PC

3:30–3:45 **Break**

3:45–4:15 **Divorce and Income Taxes: Using Tax Returns as Discovery Tools**

Sheri Trinchero, CPA, Beach Fleischman PC
Julia Miessner, CPA, Beach Fleischman PC

4:15–5:00 **Forensic Evidence: What's Possible and What's Not**

John E. Herrick, Esq., Law Office of John E. Herrick
Scott Greene, Evidence Solutions, Inc.

5:00–5:30 **Spousal Rights and Benefits Relating to Social Security**

James F. Dew, MBA, Dew Wealth Management

5:30–7:00 **Networking Session/Happy Hour**

FRIDAY, OCTOBER 23, 2015

9:00–9:45 **Divorce and Income Taxes: Relevant Matters to Consider**

Marc D. Fleischman, CPA, Beach Fleischman PC
Sheri Trinchero, CPA, Beach Fleischman PC

9:45-12:30 **A Detailed Look at Valuation Concepts**

Barry L. Brody, Esq., Barry L. Brody, PC
Lynton Kotzin, CPA, Kotzin Valuation Partners
Mark R. Hughes, CPA, Gorman Consulting Group, LLC
Kathleen A. McCarthy, Esq., The McCarthy Law Firm
Jeffrey G. Pollitt, Esq., Jeffrey G. Pollitt, PC

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Negotiation/Mediation/Litigation

- Imputing Income to Assets
- Lifestyle Analysis
- Presenting Settlement Offers
- Separate Property Analysis Tracing

Consultation

- Financial Modeling for Post-Divorce Lifestyle both as an Advocate or Neutral.
- Assist in Developing Divorce, Strategy Based on Financial Needs of Client.
- Decree Implementation

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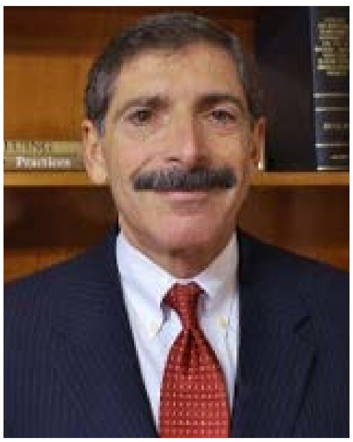
Faculty

▶ Raymond S. Dietrich

Raymond S. Dietrich manages a multi-jurisdictional law practice specializing in the drafting and litigation of Qualified Domestic Relations Orders ("QDROs") and related issues. Mr. Dietrich has created a unique niche law practice that specializes in an area of law that is notoriously mishandled. Mr. Dietrich is licensed and actively practices law in Arizona, Nevada, Virginia, District of Columbia, Florida, and New York. Mr. Dietrich is the author of *Qualified Domestic Relations Orders: Strategy and Liability for the Family Law Attorney* (Copyright © 2015 Matthew Bender). The firm's website is located at www.galleongroup.net. 602.252.7227.



▶ Barry L. Brody

Barry L. Brody is a sole practitioner in Phoenix. Mr. Brody is a Certified Family Law Specialist, and a Fellow of the American Academy of Matrimonial Lawyers, including current President of the Arizona Chapter. His practice is limited to the areas of complex family law litigation, and alternative dispute resolution. Mr. Brody received his Bachelor of Science Degree in Accounting, with high distinction, from Arizona State University in 1975, his Juris Doctor Degree from Pepperdine University-School of Law in 1977, and was admitted to the Arizona State Bar in 1978. Mr. Brody is a Judge *Pro Tempore* in the Maricopa County Superior Court Family Court Division, and is a Member of the Judges and Commissioners Family Law Study Committee. He is a Past-Chair of the Executive Council of the Family Law Section of the State Bar of Arizona, is a Past President of the Maricopa County Bar Association Family Law Section, and is a Member of the Family Law Certification Advisory Commission. Mr. Brody is also a contributing author to Arizona Guide for Family Practice and Editor of The Divorce and Children Handbook. Mr. Brody is listed in The Best Lawyers in America in the practice areas of Family Law, including Lawyer of the Year for 2011 and 2015, and Family Law Mediation, Martindale-Hubbell's Bar Register of Preeminent Lawyers, Super Lawyers of the Southwest in both Family Law and Alternative Dispute Resolution, AVVO as a "Superb" member, Ten Leaders, Marquis Who's Who in American Law, and he has spoken at numerous seminars. Mr. Brody's website is located at www.divorceaz.com.

Faculty

▶ Marc Fleischman, CPA/ABV/CFF, CGMA

Marc Fleischman is a founding shareholder of BeachFleischman, PC, one of Ari-zona's largest locally owned certified public accounting firms. Working in public practice since 1976, he has extensive experience working with small- to medium-sized businesses throughout various stages of their development. Mr. Fleisch-man has participated in hundreds of engagements involving litigation and has offered testimony numerous times in the Superior Courts throughout Arizona. He has managed engagements concerning business valuation, litigation support services and damage calculation, and taxation issues in domestic relations mat-ters, as well as general business and financial consulting for businesses and their owners. He is regularly involved in marital dissolution matters involving busi-ness valuation, property identification, and taxation issues and has successfully mediated property settlements.

▶ Mark Hughes

Mark Hughes is an Arizona Certified Public Accountant who has performed over 500 business valuation and litigation support engagements over the past ten years. Mark has assisted counsel in areas of financial dispute ranging from valuing professional practices for marital dissolution purposes to the restructuring of large corporations in bankruptcy proceedings. His expertise includes preparation of valuations of small to medium-sized businesses for a variety of purposes including marital dissolutions, business acquisition or sales and dispute resolution. Mr. Hughes is Accredited in Business Valuation (ABV) and Certified in Financial Forensics (CFF) by the American Institute of Certified Public Accountants.

Mark has studied the Rueschenberg and Walsh appellate decisions carefully and has written articles and moderated panels on the financial implications of these rulings. A published expert on personal goodwill, Mr. Hughes regularly consults with attorneys and provides expert testimony with respect to the value of professional practices for marital dissolution purposes. Mark has also conducted community lien analyses and performed asset tracing in some of the largest marital dissolution cases in Arizona history.

Faculty

▶ Leonard Karp

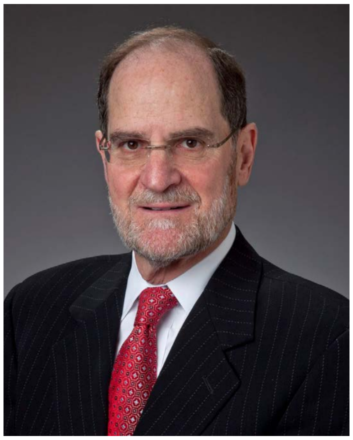
Leonard Karp, ESQ., Karp & Weiss, P.C.; graduated from Law School at the University of Arizona in 1965; is a senior partner in the law firm of Karp & Weiss, P.C., in Tucson, Arizona; is a Fellow of the American Academy of Matrimonial Lawyers (Board of Governors, 1999-2008; Chapter President, 2013-2014); a Diplomate of the American College of Family Trial Lawyers (1994-present); member of International Academy of Matrimonial Lawyers (2007-present); member of the American Bar Association - Family Law & Litigation Sections - Co-Chair of the Marital Torts & Domestic Violence Committee; Pima County Domestic Relations Bar/Bench Committee; Consultant to the Family Law Reporter; member of the Editorial Board of Divorce Litigation (1989-2005); on the faculty of the People's Law School at the University of Arizona (1989-1993); frequent national speaker and panelist at domestic relations and family law seminars; authored "Sexual Domestic Torts, Transmission of Contagious Diseases" for the 1987 winter edition of American Law Journal; Spousal Tort Litigation for Divorce Litigation, March 1990 issue; Domestic Torts for Fairshare, April, 1990 issue; has coauthored an award winning book entitled Domestic Torts: Family Violence, Conflict, and Sexual Abuse with his wife, Cheryl Karp, Ph.D., published by Shepard's McGraw-Hill in June, 1989 as part of their Family Law Series (Supp. 2000); is listed as one of the top 1% of family law practitioners in America in Best Lawyers in America (1987-present); was named as Tucson's Best Family Law Lawyer of the year in 2012 by Best Lawyers in America; is selected as one of the top lawyers in the Southwest by superlawyers.com; and has been rated AV by Martindale-Hubbell for 26 years (1987-present). Mr. Karp is considered one of the foremost legal authorities concerning civil litigation regarding domestic violence, spousal abuse and child molestation.

Faculty

▶ Lynton Kotzin

Lynton Kotzin is the Managing Partner of Kotzin Valuation Partners, LLC. He specializes in the valuation of privately held businesses and intangible assets for purposes of litigation support (marital dissolution, dissenting and oppressed shareholder disputes, bankruptcy matters and quantification of economic damages), mergers and acquisitions, financial reporting, ESOPs, incentive stock option and estate and gift tax planning and reporting. Mr. Kotzin also performs forensic accounting analysis for marital dissolution, economic damage matters and bankruptcy litigation. Mr. Kotzin has 25 years of experience analyzing closely held companies and has valued companies across most major industry groups including manufacturing, wholesale, retail, healthcare, oil and gas, professional practices and service industries. Mr. Kotzin, he has also been designated an expert in businesses valuation and forensic accounting and has testified on valuation, forensic accounting and economic damage issues in federal and state court. Prior to forming Kotzin Valuation Partners Mr. Kotzin was a Director with PricewaterhouseCoopers LLP. Mr. Kotzin is a Certified Public Accountant (CPA), Chartered Financial Analyst (CFA), Certified Insolvency and Restructuring Advisor (CIRA), and Accredited Senior Appraiser (ASA). Additionally, he is accredited in Business Valuation (ABV) and Certified in Financial Forensics (CFF), and is a member of the American Institute of Certified Public Accountants (AICPA), the CFA Institute and the American Society of Appraisers. Mr. Kotzin is an instructor for the ASA business valuation courses and a frequent speaker on business valuation issues.

Faculty



▶ Robert L. Schwartz

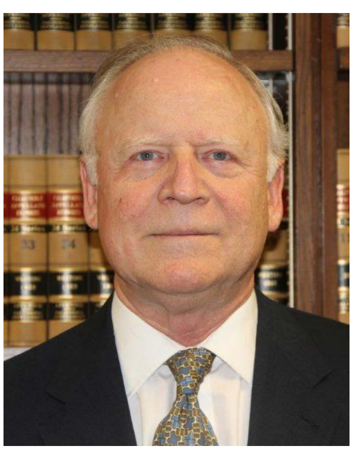
Robert L. Schwartz has been practicing law for over 35 years, specializing in domestic relations. He is a member of the American, Arizona and Maricopa County Bar Associations. He is admitted to practice in the federal courts of New York, Arizona, Ninth Circuit Court of Appeals, and the U.S. Supreme Court. Mr. Schwartz is a fellow of the American Academy of Matrimonial Lawyers and former president of the Arizona chapter. He serves as a judge pro tem for the Superior Court of Maricopa County in domestic relations and criminal matters. He is a certified family law specialist by the State Bar of Arizona; is a frequent lecturer on family law and related matters; and was the co-chairman of the State Bar Family Law Advisory Commission. Mr. Schwartz was a member of the Arizona Supreme Court Committee on Rules of Procedure for Family Law. Mr. Schwartz has been previously listed and is currently listed in the publication "Best Lawyers in America" in the areas of family practice and mediation. Mr. Schwartz is a shareholder in the law firm of Dickinson Wright Mariscal Weeks and is the head of the Family Law Practice Group. He received his B.A. from the University of Miami, Coral Gables, Florida and J.D. from Brooklyn Law School.

Robert L. Schwartz has been named as one of the Best Lawyers in America for each year consecutively since 1999. In addition to being named as Lawyer of the Year in Family Law for 2010 by Best Lawyers in America, Mr. Schwartz has also been selected as one of the top 50 Lawyers in Arizona by Super Lawyers.

Faculty

▶ Peter Economidis

Peter Economidis is a founding shareholder of the Tucson law firm of Waterfall, Economidis, Caldwell, Hanshaw & Villamana, P.C.. He received a B.S. degree from the University of Rochester, an M.S. degree from the University of Arizona and his J.D. degree from the University of Arizona in 1965. Mr. Economidis was admitted to the Arizona Bar in 1966; the U.S. District Court of Arizona in 1966; the U.S. Supreme Court in 1970; and the United States District Court for the Eastern District of Wisconsin in 1982. He is a past member of the Board of Directors of the Family Law Sections of the State Bar of Arizona and Pima County Bar Association, he has served on several committees of both bar associations and was appointed to the Governor's Task Force on Marriage and Family in 1976-1978, to study the causes of divorce. He was admitted to Fellowship in the American Academy of Matrimonial Lawyers in 1974 and continues such Fellowship to the present serving as President of the Local Chapter in 1987-1988, and again in 2000-2001. He was certificated as a Mediator by the Academy in 1999. He has been rated an AV Preeminent Lawyer by Martindale-Hubbell, for more than 30 years and has been named in all editions of Naifeh and Smith's Best Lawyers in America, in the category of Family Law since its inception. He is currently listed in the 2015 edition of Best Lawyers in the categories of Mediation, Arbitration, Family Law, Family Law Mediation and Mediation. He was named Best Lawyers, 2009 Tucson Family Law Lawyer of the Year and has again been honored by being named Best Lawyers, 2015 Tucson Mediation Lawyer of the Year.



▶ John E. Herrick

John E. Herrick has been practicing law for over 40 years, most of which has been in Family Law (www.HerrickLaw.com). He is a Fellow in the American Academy of Matrimonial Lawyers and is a Certified Specialist in Family Law (certified by the Board of Legal Specialization of the State Bar of Arizona). He is a member of the American, Arizona and Maricopa County Bar Associations. He is listed in The Best Lawyers in America in family law. He previously served 4 years as Chair of the Arizona State Bar Board of Legal Specialization. He is a frequent lecturer on family law. He has served in many cases as a court appointed special master on discovery disputes in complex family law cases.

Faculty

▶ Helen R. Davis

Helen R. Davis is a Senior Member of The Cavanagh Law Firm in Phoenix, Arizona, where she practices exclusively in the area of family law. Helen received her Bachelor of Arts degree summa cum laude, and juris doctorate degree, cum laude, Order of the Coif, from Arizona State University. Helen is a Fellow of the American Academy of Matrimonial Lawyers, is certified as a Family Law Specialist by the State Bar of Arizona, has been AV rated by Martindale-Hubbell since 2007 and is listed in Best Lawyers in America and Best Lawyers in Arizona (2013). Helen is also a volunteer Best Interests Attorney/Court Advisor. Helen is a member of the American, Arizona, and Maricopa County Bar Associations (and the Family Law Sections of each); is the past-Chair (twice) of the Executive Council of the Family Law Section of the Arizona State Bar; is a past-President of the Arizona Women Lawyer's Association (2005); is a Fellow of the American Bar Foundation; was a member of the Marriage and Family Communications Committee of the Arizona legislature; is a former member of the CLE Committee of the Arizona State Bar; was a member of the Economic Workgroup subcommittee of the Arizona Child Support Guidelines Committee and was a member of the Quadrennial Child Support Guidelines Review Committee (2008-2010); is a member of the East Valley Community Board of Directors of Chandler Regional Medical Center and Mercy Gilbert Medical Center (October 2012 to present); is the board liaison to the St. Joseph's Hospital Community Board on behalf of the East Valley Community Board, is a former board member and past-President (2012) of the Desert Cancer Foundation of Arizona; and is a past board member of the Arizona Family and Conciliation Courts Association (AFCC) (2008 to 2012). Helen is also a member of Order of the Barristers and the Daughters of Penelope. Helen has presented topics and chaired programs at multiple seminars to judges, lawyers and accountants, including at Arizona State Bar Conventions, on a variety of family law topics over the years, including without limit, ethics, spousal maintenance, settlement documents, uniform acts, custody, sexual abuse allegations in the custody context, jurisdiction, business valuation, depositions, evolving family configurations, children in the courtroom, bankruptcy and taxes in divorce. Ms. Davis authored *"Offers of Judgment: Should Rule 68 Apply to Family Law Cases?,"* January, 2002 (also reprinted in 2009), The Family Law News; "I'm Not Tolerant," January 2006, The Family Law News; *"Judicial Interviews of Children: A.R.S. § 25-405 May Be Unconstitutional as Applied,"* 2012, The Family Law News; and Helen writes a regularly appearing column for The Family Law News devoted to balancing leisure and business obligations and commitments. Ms. Davis also co-authored the *Note: "Recent Legislation on Genetics and Insurance"*, Jurimetrics Journal of Law Science and Technology, Vol. 37, No. 1, Fall 1996 (republished in Family Futures).

Faculty

▶ Robert A. Jensen

Robert A. Jensen is the senior partner of Jensen and Gordon, PLLC, a Phoenix law firm concentrating on family law practice. He is certified as a Family Law Specialist by the State Bar of Arizona. Mr. Jensen chaired the committee that drafted Arizona's current no-fault divorce law. He tried several landmark cases that helped shape Arizona family law. Mr. Jensen has been designated among the Best Lawyers in America every year since the inception of this listing in 1980 and was named as the "Phoenix Best Lawyers, Family Law Lawyer of the Year" for 2009. He is AV rated by Martindale Hubbell and is one of only two Arizona family lawyers currently admitted to the American College of Trial Lawyers. He is a former president and current member of the Arizona Chapter of American Academy of Matrimonial Lawyers. In 2012 he received a lifetime achievement award from the Family Law Section of the State Bar of Arizona. He has lectured over seventy times to professional groups on family law topics.

▶ Stephen R. Smith

Stephen R. Smith is a partner in the Phoenix law firm of Fromm Smith & Gadow, P.C. where his practice is limited to complex family law litigation, mediation, and appellate matters. He has been a Certified Specialist in Family Law since 2000 and a fellow of the American Academy of Matrimonial Lawyers since 2011. Admitted to the State Bar of Arizona in 1994, Mr. Smith received his Bachelor of Science degree in Finance from Arizona State University in 1991 and his law degree from Whittier College in 1994 where he was a member of the Whittier Law Review. He has been a member of the Family Law Advisory Commission to the Arizona State Bar Board of Legal Specialization since 2008 and currently chairs the Commission. He has been a Judge Pro Tem of the Maricopa County Superior Court since 2003. Mr. Smith has presented at numerous seminars on all aspects of family law and has served as an adjunct professor for Arizona Summit Law School.

Faculty

▶ Jim Dew

Jim Dew's affinity for investing and financial matters began in college when he majored in mathematics. Jim brought his love of finances to his career as a Certified Financial Planner® (www.dewwealth.com). In the past, he has been a compliance officer and regional manager for a national financial services company. His experience supervising financial planners motivated him to start his own independent firm in order to provide unbiased, objective advice.

Jim has been quoted in several national and local publications including: The Wall Street Journal, Kiplinger's Personal Finance Magazine, Consumer Reports Money Adviser, The Arizona Republic, The Scottsdale Tribune, The Business Journal, Financial Advisor, Investment Advisor, Arizona Business, Mutual Funds Magazine, Consumer Reports and Chartered Financial Analyst (CFA) Magazine. Jim has been interviewed on KFNN radio and has appeared as a guest on TV's Channel 3 Good Day Arizona Show.

Jim's Credits include:
BS, University of Arizona
MBA, Arizona State University
Certified Financial Planner (CFP®)
Chartered Financial Consultant (ChFC®)
Certified Divorce Financial Analyst (CDFA™)
Financial Planning Association (FPA)
Past President, FPA of Greater Phoenix
Executive Council Charities, Life Member
New Pathways for Youth, Board of Directors

Jim has taught Continuing Education classes to many CPAs and attorneys in the Phoenix area. He has instructed at the Maricopa Bar Association, Arizona Society of Certified Public Accountants (ASCPA) and the Arizona Forum for Improvement of Taxation Jim is an Independent Registered Investment Advisor approved by the National Ethics Bureau™.

Jim is also active in the community raising over $800,000 for children's charities in the last twentyyears. He continues to work with other organizations in the area as well.

Jim is a native Arizonan and a resident of Scottsdale. Jim likes working out and eating healthy. He enjoys reading, hiking, and socializing. He is extremely happily married for more than 20 years to his beautiful wife, Mimi. They enjoy time together and time with their rescued dog, Jackson, the cutest dog in the world (according to them).

Faculty

▶ Les Raatz

Les Raatz is a member of the law firm of Dickinson Wright PLLC, in Phoenix, Arizona. He practices primarily in the areas of estate planning, probate and trust administration, entity structuring, and taxation. Mr. Raatz has significant experience representing many hundreds of business clients and their families in connection with estate and tax planning. He has been an author and speaker at numerous seminars on areas of income and estate and gift taxation, probate and trust issues, and selection of business entities. After graduation from law school, he practiced as a Certified Public Accountant with KPMG Peat Marwick, CPAs. Since that time, he has practiced law in Texas before practicing in Arizona. Mr. Raatz is a Fellow of the American College of Trust and Estate Counsel (ACTEC). He is listed in Best Lawyers in America in fields of Tax Law and Trusts and Estates and in Southwest Superlawyers in the fields of Tax, Estate Planning & Probate, Estate & Trust Litigation. He is certified as a Tax Specialist by the Board of Legal Specialization of the State Bar of Arizona. He was President of the Central Arizona Estate Planning Council, Chair of the Probate and Trust Law Section of the State Bar of Arizona, Chair of its Arizona Trust Code Comment Committee, and Chair of the Tax Advisory Commission for the Board of Legal Specialization, and a member of the Probate Rules Committee of the Arizona Supreme Court. His recent articles are DIVORCE, SLATS AND THE GRANTOR TRUST SECTION 677 GHOST," appearing in Trust & Estates Magazine, August 2015; "DELAWARE TAX TRAP' OPENS DOOR TO HIGHER BASIS FOR TRUST ASSETS," appearing in Estate Planning, Feb. 2014 (41 ETPL 3), and "STRUCTURING BUSINESS OWNERSHIP, OPERATION AND SALE TO MITIGATE THE 3.8% OBAMACARE TAX, SECA TAX AND FICA TAX," appearing in Practical Tax Strategies (June 2014), Tax & Accounting business of Thomson Reuters as Publisher. He also authored "The Arizona Trust Code," Arizona Attorney Magazine, Jan. 2009 (45–Jan Ariz.Att'y 20), cited favorably in In re the Estate of King, 228 Ariz. 565; 269 P.3d 1189; 627 Ariz. Adv. Rep. 6 (Ariz. App., 2012).

Faculty

▶ Annalisa Moore Masunas

Annalisa Moore Masunas is a partner in the Tucson firm of Moore, Masunas & Moore, P.L.L.C., and she practices with her sister, Angela C. Moore. Annalisa is a fellow of the American Academy of Matrimonial Lawyers, and is a certified specialist in family law. She handles divorce, parenting time and legal decision making issues, complex property and debt division, paternity, spousal maintenance, child support, post decree matters, and premarital agreements. The firm also handles estate-planning matters.

Annalisa is president of the Arizona Chapter of the American Academy of Matrimonial Lawyers for 2015-2016. Annalisa is a member and past Chair of the Executive Council of the Family Law Section of the State Bar of Arizona (she has been on the Council since 2002, and has served as a member and in every officer position). She is a member of Arizona Women Lawyers Association and the Family Law Section of the State Bar of Arizona. She serves as a Judge Pro Tem of the Pima County Superior Court, and as an attorney for minor children in various capacities. Annalisa co-chairs an annual attorney CLE program in Tucson each November (since 2006), and is a regular speaker on family law topics.

Annalisa is married to Mike, and they have three children, Alanna, who is 10, Michael who is 11, and Tyler, who is 18. She is a native of Tucson, and graduated from Rincon High School. Annalisa attended the University of Arizona for her undergrad, and then for law school as well. Annalisa is active with activities for Alanna and Michael, and you will always see her taking pictures of their sports. She has been a photographer since high school. Annalisa enjoys many sports, spending time with her family and friends, and traveling.

Faculty

▶ Max Taylor

Max Taylor is a Supervisor for BeachFleischman PC's Tax Department. He has provided accounting, tax, and consulting services for a variety of privately held companies in his four years of public accounting. He is a member of the Real Estate, Healthcare and Trust taxation service groups at BeachFleischman. He is a licensed CPA in Arizona and has developed an expertise in partnership taxation.

Areas of Specialty
Partnership Taxation
Estate and Trust Taxation

Industry Experience
- Healthcare
- Real estate
- Hospitality

Education
New Mexico State University, Master of Accounting
New Mexico State University, Bachelor of Accountancy

Professional Associations
Member of Arizona State Society of Certified Public Accounting
Member of Urban Land Institute

Community Involvement
Tucson Little League

▶ Anita M. Ventrelli

Anita Ventrelli is senior partner of Schiller DuCanto & Fleck LLP in Chicago. A partner since 1997, Anita simplifies the legal process for clients and develops proactive strategy tailored to each client's needs while using analytical skills to master financial matters for an optimum position in trial or settlement of complex matters for high profile clients. She is included in Best Lawyers in America, was peer recommended to the Leading Lawyer's Network and Illinois Super Lawyers, named one of the Chicago Daily Law Bulletin's 2003 "40 Under 40 Illinois Attorneys To Watch," served as chair of the American Bar Association's Family Law Section, sits in the American Bar Association House of Delegates and on the Board and Faculty of the ABA/NITA Family Law Trial Advocacy Institute. Ms. Ventrelli is a fellow of the American Academy of Matrimonial Lawyers.

Faculty

▶ Victoria C. Harris, CPA

Since joining Hunter Hagan in 1989, Vicki has developed specializations in the Trust, Estate and Gift tax area in both planning and compliance. Her experience includes charitable planning, family limited partnerships, and planning for business succession. She has a strong background in the professional services industries as well as experience with high net worth individuals and divorce consulting. Vicki has the ability to make complex concepts and requirements more understandable to clients, who may often be dealing with a loss of some type.

As managing shareholder, Vicki is particularly focused on the firm's strategic planning, marketing implementation, branding, public relations and client satisfaction initiatives.

An (almost) native of Phoenix, Vicki has been involved with various charitable organizations serving the Phoenix area allowing her to carry on her family commitment to the community. Through her work with non-profit organizations, Vicki understands the critical role they play in our community and realizes the significance of being involved. In 2010 she was appointed to the Board of Directors for the Jewish Community Foundation. In addition, she serves on the Professional Advisory Boards for the Jewish Community Foundation and the Arizona Community Foundation.

Vicki is also a member of the Arizona Society of Certified Public Accountants, the American Institute of Certified Public Accountants, Past President and Board Member of Valley Estate Planners and past Chairperson for the Tax & Legal Seminar jointly sponsored by the Jewish Community Foundation and the Arizona Community Foundation.

Vicki graduated from Wellesley College with a Bachelor of Arts in Economics, pursued her accounting education at Arizona State University and is licensed to practice as a CPA in Arizona.

Faculty

▶ Steven H. Everts

Steven H. Everts is a certified family law specialist (1998) and Fellow of the American Academy of Matrimonial Lawyers (2005). He has been a presenter the last eight years at the Arizona Family Law Institute and other organizations and is scheduled to present again in 2016. He has an AVVO rating of 10.0. He has been selected for inclusion in Southwest Super Lawyers the last six years, by the American Registry to the list of Top Attorneys in Arizona, and as one of Arizona's Finest Lawyers in Phoenix Magazine. He has served as Judge Pro Tern of the Maricopa County Superior Court for 14 years. He has been AV rated (Pre-eminent 5.0 out of 5) by Martindale-Hubbell Law Directory for many years and included for selection in Arizona's Top Rated Lawyers. He has been lead counsel and/or written briefs for at least 50 appeals. He recently re-published on his website (www.udallshumway.com) a Powerpoint presentation on the "15 Symptoms of an Unhealthy Marriage" in an effort to strengthen marriage relationships. He graduated from the University of Utah College of Law in 1976 and has been in private practice with the East Valley law firm of Udall Shumway his entire 39-year career. He served on the Management Committee of the firm for 16 years, including 7 years as Chairman and Managing Shareholder, and has served as Trustee of the firm's Pension and Profit Sharing Plan for approximately 31 years. For the first 12-15 years of his career he practiced complex tort litigation, including products liability and medical malpractice cases, and was lead counsel in approximately 12 jury trials. He authored, "Strict Liability: Recovery for Damage to the Defective Product Itself," 18 Arizona Bar Journal 18 (1982). He assisted the Supreme Court Committee on Examinations as writer and grader of bar examination questions for 7 years. He is also an active member of the Utal1 Bar Association and practices there as well as in Arizona.

Faculty

▶ Scott Greene

Scott is the CEO of Evidence Solutions, Inc. Scott Greene has been doing Data Recovery, Computer, Technology and Digital Forensics, and EDiscovery work for over 30 years.

Directly out of high school, Scott went to work for IBM as a programmer.

In 2008 he created Evidence Solutions, Inc., a full service Computer, Technology & Digital Forensics firm, from the Technology Forensics department of Great Scott Enterprises.

Scott has developed and presented strategic planning seminars, taught numerous classes in database design & optimization, cyber security and technology forensics. Scott's extensive knowledge draws clients to him from all over the United States as well as Internationally for consulting and expert witness services in the field of Technology, Computer & Digital Forensics. His extensive and diverse experience allows him to be an expert in many facets of computer & digital technology.

Scott and Evidence Solutions have been involved in Civil & Criminal Cases, for Plaintiff, Defense and Special Master in Justice, Superior & District Courts as well as Internationally.

He is a sought after speaker and educator and travels throughout the country presenting to local, regional, national and International organizations.

Faculty

▶ Mario Ventrelli

Since 1995, **Mario Ventrelli** has practiced solely in the area of matrimonial law. Over nearly 20 years, Mr. Ventrelli has represented leaders in the business world and professions, influential civic and political personalities, celebrities, and professional athletes. He is skilled in complex litigation including: financial discovery, analysis and planning; valuation of closely-held corporations; drafting premarital, marital and separation agreements; allocation of retirement plans and benefits; analysis of executive compensation; personal and corporate taxation issues; property division; maintenance/alimony and child support; custody, visitation and removal of children; parentage; domestic violence and orders of protection. Mr. Ventrelli practices in virtually every county in the Chicago Metropolitan Area including Cook, Lake, Du Page, Kane, Kendall, Winnebago, McHenry and Will. On both the state and national level, he is a sought-after lecturer on a wide variety of family law topics. He is a faculty member of the DePaul University College of Law and of the prestigious American Bar Association Family Law Trial Advocacy Institute. Since 2006, Mr. Ventrelli has been a member of the Illinois Leading Lawyers Network and was named a Super Lawyer "Rising Star" in 2008. He has been named one of the Top 100 Trial Lawyers by the National Trial Lawyers since 2011 and, in each year since 2010, Mr. Ventrelli has been named one of the "Best Lawyers In America" by the Naifeh & Smith publication.

▶ Sheri L. Trinchero, CPA

Sheri Trinchero is a manager of the litigation support department at Beach-Fleischman PC. She specializes in business valuation, income tax matters, and marital dissolution consulting services. Ms. Trinchero has participated in and successfully managed numerous engagements involving business valuation, damage calculations, and litigation support throughout Arizona. Her work in marital dissolution matters includes business valuation, property identification, forensic accounting, and taxation issues and she assists with property settlements.

Faculty

▶ Jeffrey Pollitt

"The practice of law is for ladies and gentlemen." This is a central tenet to **Jeff Pollitt's** law practice, and Jeff and his colleagues and staff strive to conduct themselves accordingly.

Jeff's practice includes all aspects of divorce litigation, with special emphasis on:

- complex financial issues,
- high-income spousal maintenance and child support matters,
- professional practice and business valuations,
- high-asset tracing and commingling issues,
- family law appellate cases,
- drafting and litigating prenuptial agreements, and
- mediation of complex family law cases.

He also has extensive experience as a court-appointed family law special master.

Jeff is a Fellow of the American Academy of Matrimonial Lawyers™, is certified as a Family Law Specialist by the State Bar of Arizona and enjoys the AV Preeminent® Highest Rating in Legal Ability and Ethics by Martindale-Hubbell®.

In 2010, the Chief Justice of the Arizona Supreme Court appointed Jeff to serve on the Attorney Discipline Probable Cause Committee, which he considers the most consequential committee on which he has ever had the privilege to serve. He was reappointed to serve another term through 2017. The Probable Cause Committee consists of three members of the public and six lawyers who are tasked with scrutinizing State Bar charges of unethical or unprofessional conduct against lawyers. The Committee protects the public interest and ensures consistent treatment of lawyers through this intensive oversight system.

Jeff frequently presents legal seminars for basic through advanced course work for lawyers, and he has authored numerous articles and mathematical formulas that assist attorneys with complex financial issues related to divorce litigation. Jeff also enjoys teaching, including Ethics and Professional Responsibility as an Adjunct Professor of Law and family law courses at local colleges.

Faculty

▶ Kathleen A. McCarthy

Kathleen A. McCarthy is the owner of The McCarthy Law Firm, a law firm that is devoted solely to the practice of family law. Ms. McCarthy has been a lawyer for 38 years, is a Fellow of the American Academy of Matrimonial Lawyers (AAML), is certified as a domestic relations specialist by the State Bar of Arizona, is listed in *Best Lawyers in America,* 1999-present (and earned the recognition as being named as the Best Lawyers' *2010 Tucson Family Lawyer of the Year), Super Lawyers of the Southwest*, 2007-pres., and in Martindale-Hubbell's *Bar Register of Preeminent Lawyers.* She is the recipient of the *2012 State Bar of Arizona Continuing Education Award* for outstanding contributions to the State Bar's Continuing Legal Education (CLE) Program. She is currently a member of the State Bar of Arizona Family Law Advisory Commission, which certifies family law specialists in Arizona. She served on the St. Bar CLE Committee (2009-2011). Ms. McCarthy is the former Co-Chair of the Family Law Section of the Pima County Bar Association and former President of the American Academy of Matrimonial Lawyers, Arizona Chapter. She is a past Chair of the Family Law Council of the State Bar of Arizona and a past President of the Association of Family and Conciliation Courts (AFCC). She has been a guest lecturer at the Judicial College for family law judges, has written a handbook on spousal maintenance for judges and she frequently lectures and writes on family law related issues.

TAB 1

Joint Representation Issues in Estate Planning

HUNTER HAGAN
& COMPANY, LTD.

Victoria C. Harris, CPA

Managing Shareholder

Since joining Hunter Hagan in 1989, Vicki has developed specializations in the Trust, Estate and Gift tax area in both planning and compliance. Her experience includes charitable planning, family limited partnerships, and planning for business succession. She has a strong background in the professional services industries as well as experience with high net worth individuals and divorce consulting. Vicki has the ability to make complex concepts and requirements more understandable to clients, who may often be dealing with a loss of some type.

As managing shareholder, Vicki is particularly focused on the firm's strategic planning, marketing implementation, branding, public relations and client satisfaction initiatives.

An (almost) native of Phoenix, Vicki has been involved with various charitable organizations serving the Phoenix area allowing her to carry on her family commitment to the community. Through her work with non-profit organizations, Vicki understands the critical role they play in our community and realizes the significance of being involved. In 2010 she was appointed to the Board of Directors for the Jewish Community Foundation. In addition, she serves on the Professional Advisory Boards for the Jewish Community Foundation and the Arizona Community Foundation.

Vicki is also a member of the Arizona Society of Certified Public Accountants, the American Institute of Certified Public Accountants, Past President and Board Member of Valley Estate Planners and past Chairperson for the Tax & Legal Seminar jointly sponsored by the Jewish Community Foundation and the Arizona Community Foundation.

Vicki graduated from Wellesley College with a Bachelor of Arts in Economics, pursued her accounting education at Arizona State University and is licensed to practice as a CPA in Arizona.

Gift & Estate Taxes

WHAT IS FEDERAL GIFT TAX?

A tax imposed upon irrevocable transfers from a living person to other person(s), or Trust(s) of assets exceeding $14,000 (2015 amount - indexed for inflation) per year per person (The Annual Exclusion) without any consideration being given to the transferor.

NOTE: Gifts ***received*** are considered sole and separate assets and only will be considered community if co-mingled – Even between spouses – except that gifts between spouses can be unlimited and not subject to any gift tax.

WHAT IS THE ANNUAL EXCLUSION?

The amount of ***present interest*** gifts which can be given gift and estate tax free each year to any individual(s) No gift tax return is required for gifts which do not exceed this threshold.

> EXAMPLE: You AND your spouse give $10,000 cash each to your 2 children and their spouses and six grandchildren. Between you, you disperse $200,000, however there is no gift tax to be paid and no gift tax return required to be filed by you NOR are your children/grandchildren subject to any tax on the transfer. Your estate is reduced by $200,000.
>
> EXCEPTIONS:
> Payments for medical, dental or tuition expenses on behalf of anyone (relatives, friends, etc) are not included in amounts transferred for gift tax purposes as long as the payments are made directly to the provider of the services. Transfers to political organizations are also exempt from the gifting provisions.

HOW MUCH IS GIFT TAX?

The Gift Tax rates are the same as the Estate Tax rates. No payment of gift tax is required unless and until you exceed your cumulative LIFETIME EXCLUSION AMOUNTS. (See Chart below)

RECENT GIFT & ESTATE TAX RATES

YEAR	LIFETIME EXCLUSION		RATE %
2011	$	5,000,000	35
2012	$	5,120,000	35
2013	$	5,250,000	40
2014	$	5,340,000	40
2015	$	5,430,000	40
2016**	**$**	**5,450,000**	**40**

**projected

529 PLANS

Commonly known as 529 plans, Qualified Tuition Programs are specially designated accounts which can hold substantial assets. The assets used to fund these accounts become the "property" of the beneficiary and are intended to be used for qualified educational expenses. The assets are no longer considered owned by the donor, even though the donor may be the Trustee and have the ability to disperse, transfer or withdraw the funds at any time. Assuming one or the other parent funded the plan, **in the event of a divorce, the assets don't belong to either party in an asset allocation, but the spouse/ Trustee would ultimately have access and control over those assets.**

Contributors to a 529 plan may fund up to 5 years worth of "Annual exclusions" at one time and file gift tax returns spreading out the annual amount for each of 5 years. (For 2015 that would be $70,000)

Use of Gifting Techniques to make Irrevocable transfers.

We can transfer assets to reduce our estate tax liabilities – just give it away. This would accomplish one of the main goals of estate planning by **SAVING ESTATE TAXES.** Given the current high lifetime exclusion amounts, saving taxes may no longer be the primary reason to affect these transfers.

More typically, various legal entities are created; partnerships, trusts of varying shapes and sizes which when utilized correctly achieves a second primary goal of **CONTROL** over the assets, and at the same time saves taxes if that is needed.

EXAMPLE: Assume you have a variety of assets (land, real estate, securities, and business interests) and they are of high value, or could be of high value in the future. You can leverage various gift planning techniques to reduce the value of the asset(s) you are gifting, and in the process, you reduce your future estate tax liability as well as controlling the use and disposition of the assets.

CO-ORDINATION OF GIFT & ESTATE TAXES
Without Partnership
Structure

YEAR	TRANSFER		TYPE	CUMULATIVE AMOUNTS		
2008	$	1,000,000	LAND	$	1,000,000	no gift tax paid
2009	$	500,000	SECURITIES	$	1,500,000	no gift tax paid
2011	$	2,500,000	BUSINESS INT	$	4,000,000	no gift tax paid
2015	DEATH OCCURS - FMV OF ASSETS:			$	4,000,000	
	VALUE OF ESTATE UPON DEATH			$	8,000,000	
	Less: Lifetime Exemption			$	(5,430,000)	
	TAXABLE ASSETS UPON DEATH			$	2,570,000	
			TAX:	**$**	**1,028,000.0**	

CO-ORDINATION OF GIFT & ESTATE TAXES
Partnership formed and
Discounts obtained

YEAR	TRANSFER		TYPE	CUMULATIVE AMOUNTS	
2011	$	4,000,000	P/S INT	$ 4,000,000	no gift tax paid
VALUATION OCCURS AND DISCOUNT OF 35% TAKEN				***$ (1,400,000)***	
				$ 2,600,000	
2015	DEATH OCCURS - FMV OF ASSETS:			$ 4,000,000	
	VALUE OF ESTATE UPON DEATH			$ 6,600,000	
	Less: Lifetime Exemption			$ (5,430,000)	
	TAXABLE ASSETS UPON DEATH			$ 1,170,000	
			TAX:	**$ 468,000.0**	
	TAX SAVINGS UPON DEATH			***$ 560,000.0***	

It makes very good financial sense go to the trouble and expense of getting a valid, defensible valuation in order to save over $500,000.

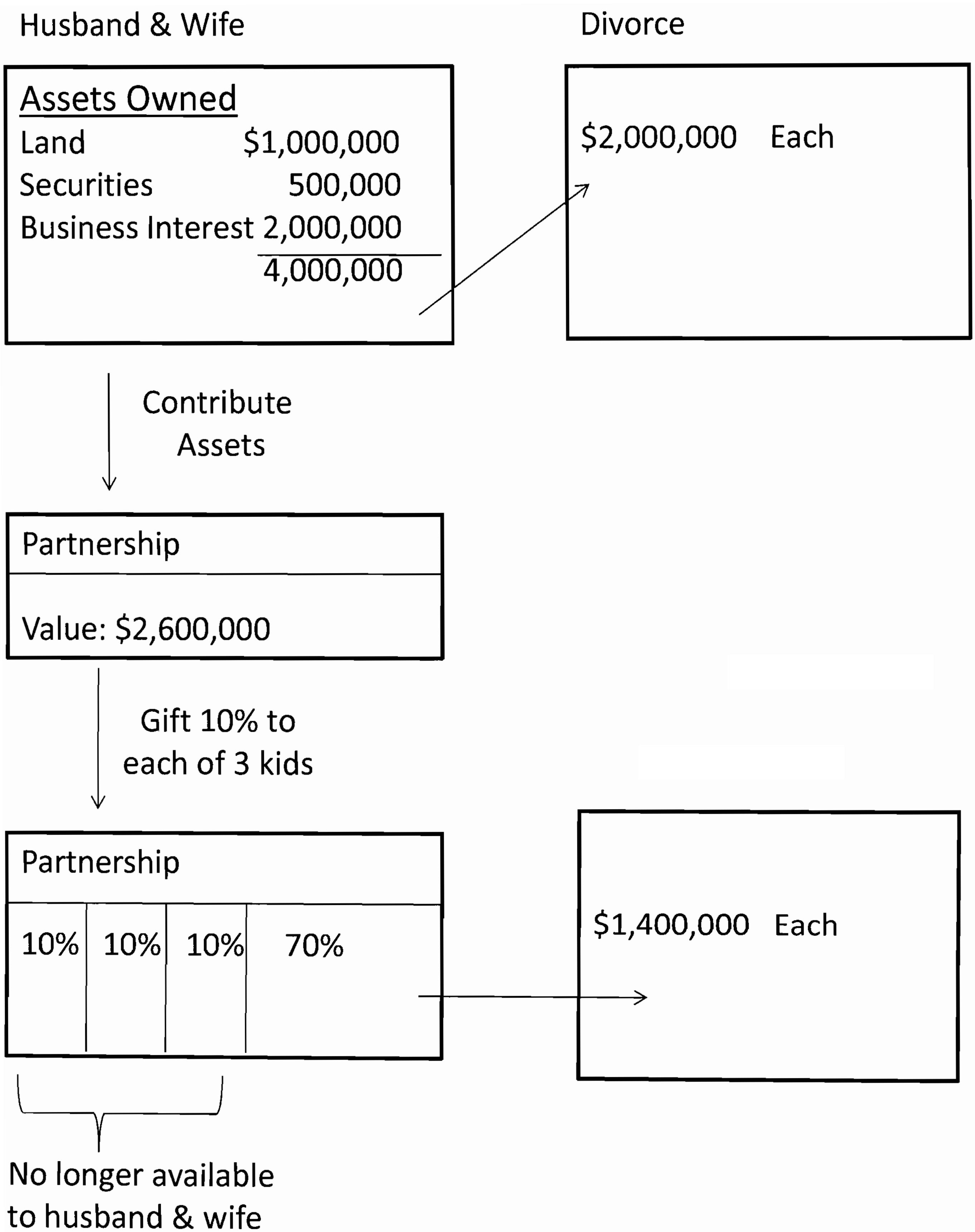
More importantly, it isn't necessary to wait until someone dies to take advantage of the valuation discounts. The valuation, which must be performed by a qualified professional, provides substantiation to **gift partial interests** in the partnership. If done correctly, future appreciation is transferred out of the estate at lower values than would be available in the future. The gift tax return is filed to memorialize the transaction and establish the value of the transfer.

In the context of divorce however, these transfers can cause major disruption. Once the assets have been transferred to an IRREVOCABLE Trust or into a partnership (with other assets co-mingled), it become extremely difficult, if not impossible to get them back out.

The transfer of assets via gifting techniques can have a significant impact on divorcing spouses. Techniques designed to transfer assets at lower costs could end up being detrimental to one spouse or the other in the event of divorce.

A perfect example of this is the Austin case, (Austin vs. Austin, Appeal from the Superior Court in Pima County No. 2 CA-CV 2014-0134) where the wife had significant sole and separate assets and through the creation of a series of partnerships and their related operating agreements, assets which were intended by the wife to benefit her children from a previous marriage were effectively controlled by the husband. Significant assets were also transmuted from sole and separate to community assets without her understanding the agreements used or the potential impact on her financial situation.

Illustration - Transfers incident to Divorce AFTER Gifting



Form **709**

Department of the Treasury
Internal Revenue Service

United States Gift (and Generation-Skipping Transfer) Tax Return

► Information about Form 709 and its separate instructions is at *www.irs.gov/form709.*
(For gifts made during calendar year 2014)
► See instructions.

OMB No. 1545-0020

2014

PART 1 GENERAL INFORMATION

1 Donor's first name and middle initial: JIM	2 Donor's last name: SMITH	3 Donor's social security number: 123-45-6789
4 Address (number, street, and apartment number): 12345 N WATER ST.		5 Legal residence (domicile): MARICOPA
6 City or town, state or province, county, and ZIP or foreign postal code: ANYTOWN, AZ 85555		7 Citizenship (see instructions): USA

		Yes	No
8	If the donor died during the year, check here ► ☐ and enter date of death		
9	If you extended the time to file this Form 709, check here ► ☐		
10	Enter the total number of donees listed on Schedule A. Count each person only once ► 3		
11 a	Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If 'No,' skip line 11b		X
b	Has your address changed since you last filed Form 709 (or 709-A)?		
12	**Gifts by husband or wife to third parties.** Do you consent to have the gifts (includ made by you and by your spouse to third parties during the calendar year considered as you? (see instructions.) (If the answer is 'Yes,' the following information must be sign the consent shown below. **If the answer is 'No,' skip lines 13-18.)**	N/A	
13	Name of consenting spouse — 14 SSN		
15	Were you married to one another during the entire calendar year? (see instructions)		
16	If 15 is 'No,' check whether ☐ married ☐ divorced or ☐ widowed/deceased, and give date (see instructions) ►		
17	Will a gift tax return for this year be filed by your spouse? (If 'Yes,' mail both returns in the same envelope.)	X	

Unless Gift Splitting, Gift tax returns are always filed for an individual - so we would file two returns, one for each spouse.

18 **Consent of Spouse.** I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.

Consenting spouse's signature ► **Date ►**

		Yes	No
19	Have you applied a DSUE amount received from a predeceased spouse to a gift or gifts reported on this or a previous Form 709? If 'Yes,' complete Schedule C		X

PART 2 TAX COMPUTATION

1	Enter the amount from Schedule A, Part 4, line 11	1	348,000.
2	Enter the amount from Schedule B, line 3	2	
3	Total taxable gifts. Add lines 1 and 2	3	348,000.
4	Tax computed on amount on line 3 (see *Table for Computing Gift Tax* in instructions)	4	104,120.
5	Tax computed on amount on line 2 (see *Table for Computing Gift Tax* in instructions)	5	
6	Balance. Subtract line 5 from line 4	6	104,120.
7	Applicable credit amount. If donor has DSUE amount from predeceased spouse(s), enter amount from Schedule C, line 4; otherwise, see instructions	7	2,081,800.
8	Enter the applicable credit against tax allowable for all prior periods (from Schedule B, line 1, column C)	8	
9	Balance. Subtract line 8 from line 7. Do not enter less than zero	9	2,081,800.
10	Enter 20% (.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (see instructions)	10	
11	Balance. Subtract line 10 from line 9. Do not enter less than zero	11	2,081,800.
12	Applicable credit. Enter the smaller of line 6 or line 11	12	104,120.
13	Credit for foreign gift taxes (see instructions)	13	
14	Total credits. Add lines 12 and 13	14	104,120.
15	Balance. Subtract line 14 from line 6. Do not enter less than zero	15	0.
16	Generation-skipping transfer taxes (from Schedule D, Part 3, column H, Total)	16	
17	Total tax. Add lines 15 and 16	17	0.
18	Gift and generation-skipping transfer taxes prepaid with extension of time to file	18	
19	If line 18 is less than line 17, enter **balance due** (see instructions)	19	
20	If line 18 is greater than line 17, enter **amount to be refunded**	20	

ATTACH CHECK OR MONEY ORDER HERE

Sign Here

Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☒ No

► Signature of donor — Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
SELF PREPARED				

Firm's name ►

Firm's address ► — Firm's EIN ► — Phone no.

Form **709** (2014) JIM SMITH 123-45-6789 Page **2**

SCHEDULE A Computation of Taxable Gifts (Including transfers in trust) (see instrs)

A Does the value of any item listed on Schedule A reflect any valuation discount? If 'Yes,' attach explanation .... Yes [X] No [ ]

B [ ] ◄ Check here if you elect under section 529(c)(2)(B) to treat any transfers made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

Part 1 — Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions. (see instructions)

A Item no.	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP number • If closely held entity, give EIN	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract column G from column F)
	SEE ATTACHMENT		112,500.		390,000.	0.	390,000.
Gifts made by spouse — *complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 1. Add amounts from Part 1, column H ►							390,000.

This represents only 5% of the total 10% gifts, since the other 5% is being reported on the spouses gift tax return.

Part 2 — Direct Skips. Gifts that are direct skips and are subject to both gift tax and generation-skipping transfer tax. You must list the gifts in chronological order.

A Item no.	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP number • If closely held entity, give EIN	C 2632(b) election out	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract column G from column F)
Gifts made by spouse — *complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 2. Add amounts from Part 2, column H ►							

Part 3 — Indirect Skips. Gifts to trusts that are currently subject to gift tax and may later be subject to generation-skipping transfer tax. You must list these gifts in chronological order.

A Item no.	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP number • If closely held entity, give EIN	C 2632(c) election	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract column G from column F)
Gifts made by spouse — *complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 3. Add amounts from Part 3, column H ►							

EXAMPLE

Part 4 — Taxable Gift Reconciliation

1	Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3	1	390,000.
2	Total annual exclusions for gifts listed on line 1 (see instructions) (3 x $14,000)	2	42,000.
3	Total included amount of gifts. Subtract line 2 from line 1	3	348,000.
	Deductions (see instructions)		
4	Gifts of interests to spouse for which a marital deduction will be claimed, based on item numbers ______ of Schedule A 4		
5	Exclusions attributable to gifts on line 4 5		
6	Marital deduction. Subtract line 5 from line 4 6		
7	Charitable deduction, based on item nos. ______ less exclusions 7		
8	Total deductions. Add lines 6 and 7	8	
9	Subtract line 8 from line 3	9	348,000.
10	Generation-skipping transfer taxes payable with this Form 709 (from Schedule D, Part 3, column H, Total)	10	0.
11	**Taxable gifts.** Add lines 9 and 10. Enter here and on page 1, Part 2 — Tax Computation, line 1	11	348,000.

Terminable Interest (QTIP) Marital Deduction. (see instructions for Schedule A, Part 4, line 4)

If a trust (or other property) meets the requirements of qualified terminable interest property under section 2523(f), and:

a The trust (or other property) is listed on Schedule A, and

b The value of the trust (or other property) is entered in whole or in part as a deduction on Schedule A, Part 4, line 4, then the donor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2523(f).

If less than the entire value of the trust (or other property) that the donor has included in Parts 1 and 3 of Schedule A is entered as a deduction on line 4, the donor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on Schedule A, Part 4, line 6. The denominator is equal to the total value of the trust (or other property) listed in Parts 1 and 3 of Schedule A.

If you make the QTIP election, the terminable interest property involved will be included in your spouse's gross estate upon his or her death (section 2044). See instructions for line 4 of Schedule A. If your spouse disposes (by gift or otherwise) of all or part of the qualifying life income interest, he or she will be considered to have made a transfer of the entire property that is subject to the gift tax. See *Transfer of Certain Life Estates Received From Spouse* in the instructions.

12 Election Out of QTIP Treatment of Annuities

☐ ◄ Check here if you elect under section 2523(f)(6) **not** to treat as qualified terminable interest property any joint and survivor annuities that are reported on Schedule A and would otherwise be treated as qualified terminable interest property under section 2523(f). See instructions. Enter the item numbers from Schedule A for the annuities for which you are making this election ► ______________

SCHEDULE B Gifts From Prior Periods

If you answered 'Yes' on line 11a of page 1, Part 1, see the instructions for completing Schedule B. If you answered 'No,' skip to the Tax Computation on page 1 (or Schedule C or D, if applicable). Complete Schedule A before beginning Schedule B. See instructions for recalculation of the column C amounts. Attach calculations.

A Calendar year or calendar quarter (see instructions)	B Internal Revenue office where prior return was filed	C Amount of applicable credit (unified credit) against gift tax for periods after December 31, 1976	D Amount of specific exemption for prior periods ending before January 1, 1977	E Amount of taxable gifts

Presented by: Victoria C. Harris, CPA

1	Totals for prior periods	1	0.	0.	0.
2	Amount, if any, by which total specific exemption, line 1, column D, is more than $30,000			2	
3	Total amount of taxable gifts for prior periods. Add amount on line 1, column E and amount, if any, on line 2. Enter here and on page 1, Part 2 — Tax Computation, line 2			3	0.

JIM SMITH 123-45-6789

Form **709** (2014) Page **4**

SCHEDULE C Deceased Spousal Unused Exclusion (DSUE) Amount

Provide the following information to determine the DSUE amount and applicable credit received from prior spouses. Complete Schedule A before beginning Schedule C

A Name of Deceased Spouse (dates of death after December 31, 2010 only)	B Date of Death	C Portability Election Made? Yes	 No	D If 'Yes,' DSUE Amount Received from Spouse	E DSUE Amount Applied by Donor to Lifetime Gifts (list current and prior gifts)	F Date of Gift(s) (enter as mm/dd/yy for Pt 1 and as yyyy for Pt 2
Part 1 – DSUE RECEIVED FROM LAST DECEASED SPOUSE						
Part 2 – DSUE RECEIVED FROM PREDECEASED SPOUSE(S)						
TOTAL (for all DSUE amounts applied from column E for Part 1 and Part 2)						

1	Donor's basic exclusion amount (see instructions)	1	
2	Total from column E, Parts 1 and 2	2	
3	Add lines 1 and 2	3	
4	Applicable credit on amount in line 3 (See *Table for Computing Gift Tax* in the instructions). Enter here and on line 7, Part 2 – Tax Computation	4	

SCHEDULE D Computation of Generation-Skipping Transfer Tax

Note: Inter vivos direct skips that are completely excluded by the GST exemption must still be fully reported (including value and exemptions claimed) on Schedule D.

Part 1 – Generation-Skipping Transfers

A Item Number (from Schedule A, Part 2, column A)	B Value (from Schedule A, Part 2, column H)	C Nontaxable Portion of Transfer	D Net Transfer (subtract column C from column B)
Gifts made by spouse (for gift splitting only)			

BAA *(If more space is needed, attach additional statements.)* FDGA0104L 11/12/14 Form **709** (2014)

JIM SMITH 123-45-6789

Part 2 – GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) Election

Check here ► ☐ if you are making a section 2652(a)(3) (special QTIP) election (see instructions)

Enter the item numbers from Schedule A of the gifts for which you are making this election ►

1	Maximum allowable exemption (see instructions)	1	1,000,000.
2	Total exemption used for periods before filing this return	2	
3	Exemption available for this return. Subtract line 2 from line 1	3	1,000,000.
4	Exemption claimed on this return from Part 3, column C total, below	4	
5	Automatic allocation of exemption to transfers reported on Schedule A, Part 3. To opt out of the automatic allocation rules, you must attach an **'Election Out'** statement. (see instructions)	5	
6	Exemption allocated to transfers not shown on line 4 or 5, above. **You must attach a 'Notice of Allocation.'** (see instructions)	6	
7	Add lines 4, 5, and 6	7	
8	Exemption available for future transfers. Subtract line 7 from line 3	8	1,000,000.

Part 3 – Tax Computation

A Item No. (from Schedule D, Part 1)	**B** Net transfer (from Schedule D, Part 1, column D)	**C** GST Exemption Allocated	**D** Divide column C by column B	**E** Inclusion Ratio (Subtract column D from 1.000)	**F** Maximum Estate Tax Rate	**G** Applicable Rate (multiply column E by column F)	**H** Generation-Skipping Transfer Tax (multiply column B by column G)
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
Gifts made by spouse (for gift splitting only)							
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
					40% (.40)		
Total exemption claimed. Enter here and on Part 2, line 4, above. May not exceed Part 2, line 3, above			**Total generation-skipping transfer tax.** Enter here; on page 3, Schedule A, Part 4, line 10; and on page 1, Part 2 – Tax Computation, line 16				

BAA *(If more space is needed, attach additional statements.)* FDGA0105L 11/12/14 Form **709** (2014)

EXAMPLE

Form 709

Donor's name: JIM SMITH

Social security number: 123-45-6789

SCHEDULE A Computation of Taxable Gifts

FDGL0112L 05/12/14

Part 1 - Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions - see instructions

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP number	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract column G from column F)
1	DAUGHTER #1 12345 N WATER ST. ANYTOWN, AZ 85555 DAUGHTER 5% LIMITED PARTNER INTEREST IN XYZ PARTNERSHIP, EIN: 99-888888 (VALUATION ATTACHED)		37,500.	1/15/14	130,000.	0.	130,000.
2	DAUGHTER #2 12345 N WATER ST. ANYTOWN, AZ 85555 5% LIMITED PARTNER INTEREST IN XYZ PARTNERSHIP, EIN: 99-888888 (VALUATION ATTACHED)		37,500.	1/15/14	130,000.	0.	130,000.
3	SON 12345 N WATER ST. ANYTOWN, AZ 85555 5% LIMITED PARTNER INTEREST IN XYZ PARTNERSHIP, EIN: 99-888888 (VALUATION ATTACHED)		37,500.	1/15/14	130,000.	0.	130,000.
	TOTAL SCHEDULE A, PART 1		$ 112,500.		$ 390,000.	$ 0.	$ 390,000.

Presented by: Victoria C. Harris, CPA

2014

Instructions for Form 709

Department of the Treasury
Internal Revenue Service

United States Gift (and Generation-Skipping Transfer) Tax Return

For gifts made during calendar year 2014.

Section references are to the Internal Revenue Code unless otherwise noted.

Future Developments

For the latest information about developments related to Form 709 and its instructions, such as legislation enacted after they were published, go to *www.irs.gov/form709*.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see later.

For Gifts Made		Use Revision of Form 709 Dated
After	**and Before**	
-----	January 1, 1982	November 1981
December 31, 1981	January 1, 1987	January 1987
December 31, 1986	January 1, 1989	December 1988
December 31, 1988	January 1, 1990	December 1989
December 31, 1989	October 9, 1990	October 1990
October 8, 1990	January 1, 1992	November 1991
December 31, 1992	January 1, 1998	December 1996
December 31, 1997	-----	*

* Use the corresponding annual form.

What's New

- The annual gift exclusion for 2014 remains $14,000. See *Annual Exclusion*, later.
- For gifts made to spouses who are not U.S. citizens, the annual exclusion has increased to $145,000. See *Nonresidents not Citizens of the United States*, later.
- The top rate for gifts and generation-skipping transfers remains at 40%. See *Table for Computing Gift Tax*, later.
- The basic credit amount for 2014 is $2,081,800. See *Table of Basic Exclusion and Credit Amounts*, later.
- The applicable exclusion amount consists of the basic exclusion amount ($5,340,000 in 2014) and, in the case of a surviving spouse, any unused exclusion amount of the last deceased spouse (who died after December 31, 2010). The executor of the predeceased spouse's estate must have elected on a timely and complete Form 706 to allow the donor to use the predeceased spouse's unused exclusion amount.

On June 26, 2013, the United States Supreme Court held that Section 3 of the Defense of Marriage Act, which said that the terms "marriage" and "spouse" only apply to heterosexual couples, was unconstitutional. (United States v. Windsor, 570 U.S. 12 (2013)). The ruling impacts a number of federal laws, including those governing the reporting and collection of federal taxes. For federal tax purposes, the IRS recognizes same-sex marriages that are valid in the state where they were entered into, regardless of the married couple's residence. See Rev. Rul. 2013-17, 2013-38 I.R.B. 201, available at *www.irs.gov/pub/irs-irbs/irb13-38.pdf*. If you believe the new law may affect your estate or gift tax liability or filing requirement, please continue to monitor IRS.gov for additional guidance on the application of Windsor.

Photographs of Missing Children

The IRS is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in instructions on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

General Instructions

Purpose of Form

Use Form 709 to report the following:

- Transfers subject to the federal gift and certain generation-skipping transfer (GST) taxes and to figure the tax due, if any, on those transfers, and
- Allocation of the lifetime GST exemption to property transferred during the transferor's lifetime. (For more details, see *Schedule D, Part 2—GST Exemption Reconciliation*, later, and Regulations section 26.2632-1.)

CAUTION *All gift and GST taxes must be computed and filed on a calendar year basis. List all reportable gifts made during the calendar year on one Form 709. This means you must file a separate return for each calendar year a reportable gift is given (for example, a gift given in 2014 must be reported on a 2014 Form 709). Do not file more than one Form 709 for any one calendar year.*

How To Complete Form 709

1. Determine whether you are required to file Form 709.
2. Determine what gifts you must report.
3. Decide whether you and your spouse, if any, will elect to split gifts for the year.
4. Complete lines 1 through 19 of Part 1—General Information.
5. List each gift on Part 1, 2, or 3 of Schedule A, as appropriate.
6. Complete Schedules B, C, and D, as applicable.
7. If the gift was listed on Part 2 or 3 of Schedule A, complete the necessary portions of Schedule D.
8. Complete Schedule A, Part 4.
9. Complete Part 2—Tax Computation.
10. Sign and date the return.

CAUTION *Make sure to complete page 1 and the applicable schedules in their entirety. Returns filed without entries in each field will not be processed.*

TIP *Remember, if you are splitting gifts, your spouse must sign line 18, in Part 1—General Information.*

Who Must File

In general. If you are a citizen or resident of the United States, you must file a gift tax return (whether or not any tax is ultimately due) in the following situations.

- If you gave gifts to someone in 2014 totalling more than $14,000 (other than to your spouse), you probably must file Form 709. But see *Transfers Not Subject to Gift Tax* and *Gifts to Spouse*, later, for more information on specific gifts that are not taxable.

• Certain gifts, called future interests, are not subject to the $14,000 annual exclusion and you must file Form 709 even if the gift was under $14,000. See *Annual Exclusion*, later.
• Spouses may not file a joint gift tax return. Each individual is responsible for his or her own Form 709.
• You must file a gift tax return to split gifts with your spouse (regardless of their amount) as described in *Part 1—General Information*.
• If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of $100,000 of community property is considered a gift of $50,000 made by each spouse, and each spouse must file a gift tax return.
• Likewise, each spouse must file a gift tax return if they have made a gift of property held by them as joint tenants or tenants by the entirety.
• Only individuals are required to file gift tax returns. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries, partners, or stockholders are considered donors and may be liable for the gift and GST taxes.
• The donor is responsible for paying the gift tax. However, if the donor does not pay the tax, the person receiving the gift may have to pay the tax.
• If a donor dies before filing a return, the donor's executor must file the return.

Who does not need to file. If you meet all of the following requirements, you are not required to file Form 709:
• You made no gifts during the year to your spouse,
• You did not give more than $14,000 to any one donee, and
• All the gifts you made were of present interests.

Gifts to charities. If the only gifts you made during the year are deductible as gifts to charities, you do not need to file a return as long as you transferred your entire interest in the property to qualifying charities. If you transferred only a partial interest, or transferred part of your interest to someone other than a charity, you must still file a return and report all of your gifts to charities.

If you are required to file a return to report noncharitable gifts and you made gifts to charities, you must include all of your gifts to charities on the return.

Transfers Subject to the Gift Tax

Generally, the federal gift tax applies to any transfer by gift of real or personal property, whether tangible or intangible, that you made directly or indirectly, in trust, or by any other means.

The gift tax applies not only to the free transfer of any kind of property, but also to sales or exchanges, not made in the ordinary course of business, where value of the money (or property) received is less than the value of what is sold or exchanged. The gift tax is in addition to any other tax, such as federal income tax, paid or due on the transfer.

The exercise or release of a general power of appointment may be a gift by the individual possessing the power. General powers of appointment are those in which the holders of the power can appoint the property under the power to themselves, their creditors, their estates, or the creditors of their estates. To qualify as a power of appointment, it must be created by someone other than the holder of the power.

The gift tax may also apply to forgiving a debt, to making an interest-free or below market interest rate loan, to transferring the benefits of an insurance policy, to certain property settlements in divorce cases, and to giving up of some amount of annuity in exchange for the creation of a survivor annuity.

Bonds that are exempt from federal income taxes are not exempt from federal gift taxes.

Sections 2701 and 2702 provide rules for determining whether certain transfers to a family member of interests in corporations, partnerships, and trusts are gifts. The rules of section 2704 determine whether the lapse of any voting or liquidation right is a gift.

Gifts to your spouse. You must file a gift tax return if you made any gift to your spouse of a terminable interest that does not meet the exception described in *Life estate with power of appointment*, or if your spouse is not a U.S. citizen and the total gifts you made to your spouse during the year exceed $145,000.

You must also file a gift tax return to make the Qualified Terminable Interest Property (QTIP) election described under *Line 12. Election Out of QTIP Treatment of Annuities*.

Except as described earlier, you do not have to file a gift tax return to report gifts to your spouse regardless of the amount of these gifts and regardless of whether the gifts are present or future interests.

Transfers Not Subject to the Gift Tax

Three types of transfers are not subject to the gift tax. These are:
• Transfers to political organizations,
• Payments that qualify for the educational exclusion, and
• Payments that qualify for the medical exclusion.

These transfers are not "gifts" as that term is used on Form 709 and its instructions. You need not file a Form 709 to report these transfers and should not list them on Schedule A of Form 709 if you do file Form 709.

Political organizations. The gift tax does not apply to a transfer to a political organization (defined in section 527(e)(1)) for the use of the organization.

Educational exclusion. The gift tax does not apply to an amount you paid on behalf of an individual to a qualifying domestic or foreign educational organization as tuition for the education or training of the individual. A qualifying educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and its regulations.

The payment must be made directly to the qualifying educational organization and it must be for tuition. No educational exclusion is allowed for amounts paid for books, supplies, room and board, or other similar expenses that are not direct tuition costs. To the extent that the payment to the educational organization was for something other than tuition, it is a gift to the individual for whose benefit it was made, and may be offset by the annual exclusion if it is otherwise available.

Contributions to a qualified tuition program (QTP) on behalf of a designated beneficiary do not qualify for the educational exclusion. See *Line B—Qualified Tuition Programs (529 Plans or Programs)* in the instructions for Schedule A, later.

Medical exclusion. The gift tax does not apply to an amount you paid on behalf of an individual to a person or institution that provided medical care for the individual. The payment must be to the care provider. The medical care must meet the requirements of section 213(d) (definition of medical care for income tax deduction purposes). Medical care includes expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, or for transportation primarily for and essential to medical care. Medical care also includes amounts paid for medical insurance on behalf of any individual.

The medical exclusion does not apply to amounts paid for medical care that are reimbursed by the donee's insurance. If payment for a medical expense is reimbursed by the donee's insurance company, your payment for that expense, to the extent of the reimbursed amount, is not eligible for the medical exclusion and you are considered to have made a gift to the donee of the reimbursed amount.

To the extent that the payment was for something other than medical care, it is a gift to the individual on whose behalf the payment was made and may be offset by the annual exclusion if it is otherwise available.

The medical and educational exclusions are allowed without regard to the relationship between you and the donee. For examples illustrating these exclusions, see Regulations section 25.2503-6(c).

Qualified disclaimers. A donee's refusal to accept a gift is called a *disclaimer*. If a person makes a qualified disclaimer of any interest in property, the property will be treated as if it had never been transferred to that person. Accordingly, the disclaimant is not regarded as making a gift to the person who receives the property because of the qualified disclaimer.

Requirements. To be a qualified disclaimer, a refusal to accept an interest in property must meet the following conditions:

1. The refusal must be in writing.
2. The refusal must be received by the donor, the legal representative of the donor, the holder of the legal title to the property disclaimed, or the person in possession of the property within 9 months after the later of:

   a. the day the transfer creating the interest is made or

   b. the day the disclaimant reaches age 21.
3. The disclaimant must not have accepted the interest or any of its benefits.
4. As a result of the refusal, the interest must pass without any direction from the disclaimant to either:

   a. the spouse of the decedent or

   b. a person other than the disclaimant, and
5. The refusal must be irrevocable and unqualified.

The 9-month period for making the disclaimer generally is determined separately for each taxable transfer. For gifts, the period begins on the date the transfer is a completed transfer for gift tax purposes.

Annual Exclusion

The first $14,000 of gifts of present interest to each donee during the calendar year is subtracted from total gifts in figuring the amount of taxable gifts. For a gift in trust, each beneficiary of the trust is treated as a separate donee for purposes of the annual exclusion.

All of the gifts made during the calendar year to a donee are fully excluded under the annual exclusion if they are all gifts of present interest and they total $14,000 or less.

Note. For gifts made to spouses who are not U.S. citizens, the annual exclusion has been increased to $145,000, provided the additional (above the $14,000 annual exclusion) $131,000 gift would otherwise qualify for the gift tax marital deduction (as described in the *Schedule A, Part 4, line 4* instructions, later).

A gift of a future interest cannot be excluded under the annual exclusion.

A gift is considered a present interest if the donee has all immediate rights to the use, possession, and enjoyment of the property or income from the property.

A gift is considered a future interest if the donee's rights to the use, possession, and enjoyment of the property or income from the property will not begin until some future date. Future interests include reversions, remainders, and other similar interests or estates.

A contribution to a QTP on behalf of a designated beneficiary is considered a gift of a present interest.

A gift to a minor is considered a present interest if all of the following conditions are met:

1. Both the property and its income may be expended by, or for the benefit of, the minor before the minor reaches age 21;
2. All remaining property and its income must pass to the minor on the minor's 21st birthday; and
3. If the minor dies before the age of 21, the property and its income will be payable either to the minor's estate or to whomever the minor may appoint under a general power of appointment.

The gift of a present interest to more than one donee as joint tenants qualifies for the annual exclusion for each donee.

Nonresidents not Citizens of the United States

Nonresidents not citizens of the United States are subject to gift and GST taxes for gifts of tangible property situated in the United States. A person is considered a *nonresident not a citizen of the United States* if he or she, at the time the gift is made, (1) was not a citizen of the United States and did not reside there or (2) was domiciled in a United States possession and acquired citizenship solely by reason of birth or residence in the possession. Under certain circumstances, they are also subject to gift and GST taxes for gifts of intangible property. See section 2501(a).

If you are a nonresident not a citizen of the United States who made a gift subject to gift tax, you must file a gift tax return where:

- You gave any gifts of future interests,
- Your gifts of present interests to any donee other than your spouse total more than $14,000, or
- Your outright gifts to your spouse who is not a U.S. citizen total more than $145,000.

Transfers Subject to the GST Tax

You must report on Form 709 the GST tax imposed on inter vivos direct skips. An *inter vivos direct skip* is a transfer made during the donor's lifetime that is:

- Subject to the gift tax,
- Of an interest in property, and
- Made to a skip person. (See *Gifts Subject to Both Gift and GST Taxes*, later.)

A transfer is subject to the gift tax if it is required to be reported on Schedule A of Form 709 under the rules contained in the gift tax portions of these instructions, including the split gift rules. Therefore, transfers made to political organizations, transfers that qualify for the medical or educational exclusions, transfers that are fully excluded under the annual exclusion, and most transfers made to your spouse are not subject to the GST tax.

Transfers subject to the GST tax are described in further detail in the instructions.

CAUTION *Certain transfers, particularly transfers to a trust, that are not subject to gift tax and are therefore not subject to the GST tax on Form 709 may be subject to the GST tax at a later date. This is true even if the transfer is less than the $14,000 annual exclusion. In this instance, you may want to apply a GST exemption amount to the transfer on this return or on a Notice of Allocation. For more information, see* Schedule D, Part 2—GST Exemption Reconciliation *and* Schedule A, Part 3—Indirect Skips.

Transfers Subject to an Estate Tax Inclusion Period (ETIP)

Certain transfers that are direct skips receive special treatment. If the transferred property would have been includible in the donor's estate if the donor had died immediately after the transfer (for a reason other than the donor having died within 3 years of making the gift), the direct skip will be treated as having been made at the end of the ETIP rather than at the time of the actual transfer.

For example, if A transferred her house to her granddaughter, B, but retained the right to live in the house until her death (a retained life estate), the value of the house would be includible in A's estate if she died while still holding the life estate. In this case, the transfer to B is a completed gift (it is a transfer of a future interest) and must be reported on Part 1 of Schedule A. The GST portion of the transfer would not be reported until A died or otherwise gave up her life estate in the house.

Report the gift portion of such a transfer on Schedule A, Part 1, at the time of the actual transfer. Report the GST portion on Schedule A, Part 2, but only at the close of the ETIP. Use Form 709 only to report those transfers where the ETIP closed due to something other than the donor's death. (If the ETIP closed as the result of the donor's death, report the transfer on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.)

If you are filing this Form 709 solely to report the GST portion of transfers subject to an ETIP, complete the form as you normally would with the following exceptions:

1. Write "ETIP" at the top of page 1;
2. Complete only lines 1 through 6, 8, and 9 of Part 1—General Information;
3. Complete Schedule A, Part 2, as explained in the instructions for that schedule;
4. Complete Schedule D. Complete Column B of Schedule D, Part 1, as explained in the instructions for that schedule;
5. Complete only lines 10 and 11 of Schedule A, Part 4; and
6. Complete Part 2—Tax Computation.

Section 2701 Elections

The special valuation rules of section 2701 contain three elections that you must make with Form 709:

1. A transferor may elect to treat a qualified payment right he or she holds (and all other rights of the same class) as other than a qualified payment right;
2. A person may elect to treat a distribution right held by that person in a controlled entity as a qualified payment right; and,
3. An interest holder may elect to treat as a taxable event the payment of a qualified payment that occurs more than 4 years after its due date.

The elections described in (1) and (2) must be made on the Form 709 that is filed by the transferor to report the transfer that is being valued under section 2701. The elections are m
statement to Form 709. For information on what must be in the statement and for definitions and other details on the elections, see section 2701 and Regulations section 25.2701-2(c).

The election described in (3) may be made by attaching a statement to the Form 709 filed by the recipient of the qualified payment for the year the payment is received. If the election is made on a timely filed return, the taxable event is deemed to occur on the date the qualified payment is received. If it is made on a late filed return, the taxable event is deemed to occur on the first day of the month immediately preceding the month in which the return is filed. For information on what must be in the statement and for definitions and other details on this election, see section 2701 and Regulations section 25.2701-4(d).

All of the elections may be revoked only with the consent of the IRS.

When To File

Form 709 is an annual return.

Generally, you must file the Form 709 no earlier than January 1, but not later than April 15, of the year after the gift was made. However, in instances when April 15 falls on a Saturday, Sunday, or legal holiday, Form 709 will be due on the next business day. See section 7503.

If the donor died during 2014, the executor must file the donor's 2014 Form 709 not later than the earlier of:

- The due date (with extensions) for filing the donor's estate tax return, or
- April 15, 2015, or the extended due date granted for filing the donor's gift tax return.

Extension of Time To File

There are two methods of extending the time to file the gift tax return. Neither method extends the time to pay the gift or GST taxes. If you want an extension of time to pay the gift or GST taxes, you must request that separately. See Regulations section 25.6161-1.

By extending the time to file your income tax return. Any extension of time granted for filing your calendar year 2014 federal income tax return will also automatically extend the time to file your 2014 federal gift tax return. Income tax extensions are made by using Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, or Form 2350, Application for Extension of Time To File U.S. Income Tax Return. You may only use these forms to extend the time for filing your gift tax return if you are also requesting an extension of time to file your income tax return.

By filing Form 8892. If you do not request an extension for your income tax return, use Form 8892, Application for Automatic Extension of Time To File Form 709 and/or Payment of Gift/ Generation-Skipping Transfer Tax, to request an automatic 6-month extension of time to file your federal gift tax return. In addition to containing an extension request, Form 8892 also serves as a payment voucher (Form 8892-V) for a balance due on federal gift taxes for which you are extending the time to file. For more information, see Form 8892.

Private delivery services

You can use certain private delivery services designated by the IRS to meet the "timely mailing as timely filing/paying" rule for tax returns and payments. These private delivery services include only the following:

- DHL Express (DHL): DHL Same Day Service.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, FedEx International First.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

The private delivery service can tell you how to get written proof of the mailing date.

Where To File

File Form 709 at the following address:

Department of the Treasury
Internal Revenue Service Center
Cincinnati, OH 45999

If submitting Form 709 by private delivery service (discussed earlier), mail to:

Internal Revenue Service
201 West Rivercenter Boulevard
Covington, KY 41011

TIP *See the Caution under* Lines 12 – 18. Split Gifts, *later, before you mail the return.*

Adequate Disclosure

CAUTION *To begin the running of the statute of limitations for a gift, the gift must be adequately disclosed on Form 709 (or an attached statement) filed for the year of the gift.*

In general, a gift will be considered adequately disclosed if the return or statement includes the following:

- A full and complete Form 709.
- A description of the transferred property and any consideration received by the donor;

- The identity of, and relationship between, the donor and each donee;
- If the property is transferred in trust, the trust's employer identification number (EIN) and a brief description of the terms of the trust (or a copy of the trust instrument in lieu of the description); and
- Either a qualified appraisal or a detailed description of the method used to determine the fair market value of the gift.

See Regulations section 301.6501(c)-1(e) and (f) for details, including what constitutes a qualified appraisal, the information required if no appraisal is provided, and the information required for transfers under sections 2701 and 2702.

Penalties

Late filing and late payment. Section 6651 imposes penalties for both late filing and late payment, unless there is reasonable cause for the delay.

Reasonable cause determinations. If you receive a notice about penalties after you file Form 709, send an explanation and we will determine if you meet reasonable cause criteria. Do **not** attach an explanation when you file Form 709.

There are also penalties for willful failure to file a return on time, willful attempt to evade or defeat payment of tax, and valuation understatements that cause an underpayment of the tax. A substantial valuation understatement occurs when the reported value of property entered on Form 709 is 65% or less of the actual value of the property. A gross valuation understatement occurs when the reported value listed on the Form 709 is 40% or less of the actual value of the property.

Return preparer. Penalties may also be applied to tax return preparers, including gift tax return preparers.

The Small Business and Work Opportunity Tax Act of 2007 extended section 6694 income tax return preparer penalties to all tax return preparers, including gift tax return preparers. Now, gift tax return preparers who prepare any return or claim for refund with an understatement of tax liability due to willful or reckless conduct can be penalized $5,000 or 50% of the income received (or income to be received), whichever is greater, for each return. See section 6694, its regulations, and Ann. 2009-15, 2009-11 I.R.B. 687, (available at *www.irs.gov/pub/irs-irbs/irb09-11.pdf*) for more information.

Joint Tenancy

If you buy property with your own funds and the title to the property is held by you and a donee as joint tenants with right of survivorship and if either you or the donee may give up those rights by severing your interest, you have made a gift to the donee in the amount of half the value of the property.

If you create a joint bank account for yourself and a donee (or a similar kind of ownership by which you can get back the entire fund without the donee's consent), you have made a gift to the donee when the donee draws on the account for his or her own benefit. The amount of the gift is the amount that the donee took out without any obligation to repay you.

If you buy a U.S. savings bond registered as payable to yourself or a donee, there is a gift to the donee when he or she cashes the bond without any obligation to account to you.

Transfer of Certain Life Estates Received From Spouse

If you received a qualified terminable interest (see *Line 12. Election Out of QTIP Treatment of Annuities* in the instructions for Schedule A, later) from your spouse for which a marital deduction was elected on your spouse's estate or gift tax return, you will be subject to the gift tax (and GST tax, if applicable) if you dispose of all or part of your life income interest (by gift, sale, or otherwise).

Generally, the entire value of the property transferred less:

1. The amount you received (if any) for the life income interest, and

2. The amount (if any) determined after the application of section 2702, valuing certain retained interests at zero, for the life income interest you retained after the transfer,

will be treated as a taxable gift.

That portion of the property's value that is attributable to the remainder interest is a gift of a future interest for which no annual exclusion is allowed. To the extent you made a gift of the life income interest, you may claim an annual exclusion, treating the person to whom you transferred the interest as the donee for purposes of figuring the annual exclusion.

Specific Instructions

Part 1—General Information

Lines 4 and 6. Address. Enter your current mailing address.

Foreign address. If your address is outside of the United States or its possessions or territories, enter the information as follows: city, province or state, and name of country. Follow the country's practice for entering the postal code. Do not abbreviate the country name.

Line 5. Legal residence (domicile). In general, your legal residence (also known as your domicile) is acquired by living in a place, for even a brief period of time, with no definite present intention of moving from that place.

Enter the state of the United States (including the District of Columbia) or a foreign country in which you legally reside or are domiciled at the time of the gift.

Line 7. Citizenship. Enter your citizenship.

The term *citizen of the United States* includes a person who, at the time of making the gift:
- Was domiciled in a possession of the United States,
- Was a U.S. citizen, and
- Became a U.S. citizen for a reason other than being a citizen of a U.S. possession or being born or residing in a possession.

A *nonresident not a citizen of the United States* includes a person who, at the time of making the gift:
- Was domiciled in a possession of the United States,
- Was a U.S. citizen, and
- Became a U.S. citizen only because he or she was a citizen of a possession or was born or resided in a possession.

Lines 12–18. Split Gifts

CAUTION *A married couple may not file a joint gift tax return. However, if after reading the instructions below, you and your spouse agree to split your gifts, you should file both of your individual gift tax returns together (that is, in the same envelope) to help the IRS process the returns and to avoid correspondence from the IRS.*

If you and your spouse agree, all gifts (including gifts of property held with your spouse as joint tenants or tenants by the entirety) either of you make to third parties during the calendar year will be considered as made one-half by each of you if:
- You and your spouse were married to one another at the time of the gift;
- If divorced or widowed after the gift, you did not remarry during the rest of the calendar year;
- Neither of you was a nonresident not a citizen of the United States at the time of the gift; and
- You did not give your spouse a general power of appointment over the property interest transferred.

If you transferred property partly to your spouse and partly to third parties, you can only split the gifts if the interest transferred to the third parties is ascertainable at the time of the gift.

The consent is effective for the entire calendar year; therefore, all gifts made by both you and your spouse to third parties during the calendar year (while you were married) must be split.

If the consent is effective, the liability for the entire gift tax of each spouse is joint and several.

If you meet these requirements and want your gifts to be considered made one-half by you and one-half by your spouse, check the "Yes" box on line 12; complete lines 13 through 17; and have your spouse sign the consent on line 18.

If you are not married or do not wish to split gifts, skip to line 19.

Line 15. If you were married to one another for all of 2014, check the "Yes" box and skip to line 17. If you were married for only part of the year, check the "No" box and go to line 16. If you were divorced or widowed after you made the gift, you cannot elect to split gifts if you remarried before the end of 2014.

Line 16. Check the box that explains the change in your marital status during the year and give the date you were married, divorced, or widowed.

Consent of Spouse

Your spouse must sign the consent for your gift-splitting election to be valid. The consent may generally be signed at any time after the end of the calendar year. However, there are two exceptions.

1. The consent may not be signed after April 15 following the end of the year in which the gift was made. But, if neither you nor your spouse has filed a gift tax return for the year on or before that date, the consent must be made on the first gift tax return for the year filed by either of you.
2. The consent may not be signed after a notice of deficiency for the gift tax for the year has been sent to either you or your spouse.

The executor for a deceased spouse or the guardian for a legally incompetent spouse may sign the consent.

When the Consenting Spouse Must Also File a Gift Tax Return

In general, if you and your spouse elect gift splitting, then both spouses must file his or her own, individual, gift tax return.

However, only one spouse must file a return if the requirements of either of the exceptions below are met. In these exceptions, *gifts* means transfers (or parts of transfers) that do not qualify for the political organization, educational, or medical exclusions.

Exception 1. During the calendar year:

- Only one spouse made any gifts,
- The total value of these gifts to each third-party donee does not exceed $28,000, and
- All of the gifts were of present interests.

Exception 2. During the calendar year:

- Only one spouse (the donor spouse) made gifts of more than $14,000 but not more than $28,000 to any third-party donee,
- The only gifts made by the other spouse (the consenting spouse) were gifts of not more than $14,000 to third-party donees other than those to whom the donor spouse made gifts, and
- All of the gifts by both spouses were of present interests.

If either of the above exceptions is met, only the donor spouse must file a return and the consenting spouse signifies consent on that return.

Specific instructions for *Part 2—Tax Computation* are discussed later. Because you must complete Schedules A, B, C, and D to fill out *Part 2*, you will find instructions for these schedules later.

Line 19. Application of DSUE Amount

If the donor is a citizen or resident of the United States and his or her spouse died after December 31, 2010, the donor may be eligible to use the deceased spouse's unused exclusion (DSUE) amount. The executor of his or her spouse's estate must have elected on Form 706 to allow use of the unused exclusion amount. See instructions for Form 706, Part 6—Portability of the Deceased Spousal Unused Exclusion. If the executor of the estate made this election, attach Form 706 filed by the estate and include a calculation of the DSUE amount (either as an attachment or on Part 6—Portability of the Deceased Spousal Unused Exclusion). See also section 2010(c)(4) and related regulations.

Using the checkboxes provided, indicate whether the donor is applying or has applied a DSUE amount from a predeceased spouse to gifts reported on this or a previous Form 709. If so, complete Schedule C before going to Part 2—Tax Computation.

Schedule A. Computation of Taxable Gifts

Do not enter on Schedule A any gift or part of a gift that qualifies for the political organization, educational, or medical exclusions. In the instructions below, *gifts* means transfers (or parts of transfers) that do not qualify for the political organization, educational, or medical exclusions.

Line A. Valuation Discounts

If the value of any gift you report in either Part 1, Part 2, or Part 3 of Schedule A includes a discount for lack of marketability, a minority interest, a fractional interest in real estate, blockage, market absorption, or for any other reason, answer "Yes" to the question at the top of Schedule A. Also, attach an explanation giving the basis for the claimed discounts and showing the amount of the discounts taken.

Line B. Qualified Tuition Programs (529 Plans or Programs)

If in 2014, you contributed more than $14,000 to a Qualified Tuition Plan (QTP) on behalf of any one person, you may elect to treat up to $70,000 of the contribution for that person as if you had made it ratably over a 5-year period. The election allows you to apply the annual exclusion to a portion of the contribution in each of the 5 years, beginning in 2014. You can make this election for as many separate people as you made QTP contributions.

You can only apply the election to a maximum of $70,000. You must report all of your 2014 QTP contributions for any single person that exceed $70,000 (in addition to any other gifts you made to that person).

For each of the 5 years, you report in Part 1 of Schedule A one-fifth (20%) of the amount for which you made the election. In column E of Part 1 (Schedule A) list the date of the gift as the calendar year for which you are deemed to have made the gift (that is, the year of the current Form 709 you are filing). Do not list the actual year of contribution for subsequent years.

However, if in any of the last 4 years of the election, you did not make any other gifts that would require you to file a Form 709, you do not need to file Form 709 to report that year's portion of the election amount.

Example. In 2014, D contributed $100,000 to a QTP for the benefit of her son. D elects to treat $70,000 of this contribution as having been made ratably over a 5-year period. Accordingly, for 2014, D reports the following:

$30,000	(the amount of the contribution that exceeded $70,000)
+ $14,000	(the 1/5 portion from the election)
$44,000	the total gift to her son listed in Part 1 of Schedule A for 2014

In 2015, D gives a gift of $20,000 cash to her niece and no other gifts. On her 2015 Form 709, D reports in Part 1 of Schedule A the $20,000 gift to her niece and a $14,000 gift to her son (the one-fifth portion of the 2014 gift that is treated as made in 2015). In column E of Part 1 (Schedule A), D lists "2015" as the date of the gift.

D makes no gifts in 2016, 2017, or 2018. She is not required to file Form 709 in any of those years to report the one-fifth portion of the QTP gift, because she is not otherwise required to file Form 709.

You make the election by checking the box on line B at the top of Schedule A. The election must be made for the calendar year in which the contribution is made. Also attach an explanation that includes the following:

- The total amount contributed per individual beneficiary,
- The amount for which the election is being made, and
- The name of the individual for whom the contribution was made.

If you are electing gift splitting, apply the gift-splitting rules before applying the QTP rules. Each spouse would then decide individually whether to make this QTP election.

Contributions to QTPs do not qualify for the education exclusion.

How To Complete Parts 1, 2, and 3

After you determine which gifts you made in 2014 that are subject to the gift tax, list them on Schedule A. You must divide these gifts between:

1. Part 1—those subject only to the gift tax (gifts made to nonskip persons—see *Part 1—Gifts Subject Only to Gift Tax*),
2. Part 2—those subject to both the gift and GST taxes (gifts made to skip persons—see *Gifts Subject to Both Gift and GST Taxes* and *Part 2—Direct Skips*), and
3. Part 3—those subject only to the gift tax at this time but which could later be subject to GST tax (gifts that are indirect skips, see *Part 3—Indirect Skips*).

If you need more space, attach a separate sheet using the same format as Schedule A.

Use the following guidelines when entering gifts on Schedule A:

- *Enter a gift only once—in Part 1, Part 2, or Part 3;*
- *Do not enter any gift or part of a gift that qualified for the political organization, educational, or medical exclusion;*
- *Enter gifts under "Gifts made by spouse" only if you have chosen to split gifts with your spouse and your spouse is required to file a Form 709 (see* Part 1—General Information, Lines 12–18. Split Gifts*); and*
- *In column F, enter the full value of the gift (including those made by your spouse, if applicable). If you have chosen to split gifts, that one-half portion of the gift is entered in column G.*

Gifts to Donees Other Than Your Spouse

You must always enter all gifts of future interests that you made during the calendar year regardless of their value.

Gift splitting not elected. If the total gifts of present interests to any donee are more than $14,000 in the calendar year, then you must enter all such gifts that you made during the year to or on behalf of that donee, including those gifts that will be excluded under the annual exclusion. If the total is $14,000 or less, you need not enter on Schedule A any gifts (except gifts of future interests) that you made to that donee. Enter these gifts in the top half of Part 1, 2, or 3, as applicable.

Gift splitting elected. Enter on Schedule A the entire value of every gift you made during the calendar year while you were married, even if the gift's value will be less than $14,000 after it is split in Column G of Part 1, 2, or 3 of Schedule A.

Gifts made by spouse. If you elected gift splitting and your spouse made gifts, list those gifts in the space below "Gifts made by spouse" in Part 1, 2, or 3. Report these gifts in the same way you report gifts you made.

Gifts to Your Spouse

Except for the gifts described below, you do not need to enter any of your gifts to your spouse on Schedule A.

Terminable interests. Terminable interests are defined in the instructions to *Part 4, line 4.* If all the terminable interests you gave to your spouse qualify as life estates with power of appointment (defined under *Life estate with power of appointment*), you do not need to enter any of them on Schedule A.

However, if you gave your spouse any terminable interest that does not qualify as a life estate with power of appointment, you must report on Schedule A all gifts of terminable interests you made to your spouse during the year.

Charitable remainder trusts. If you make a gift to a charitable remainder trust and your spouse is the only noncharitable beneficiary (other than yourself), the interest you gave to your spouse is not considered a terminable interest and, therefore, should not be shown on Schedule A. See section 2523(g)(1). For definitions and rules concerning these trusts, see section 2056(b)(8)(B).

Future interest. Generally, you should not report a gift of a future interest to your spouse unless the future interest is also a terminable interest that is required to be reported as described earlier. However, if you gave a gift of a future interest to your spouse and you are required to report the gift on Form 709 because you gave the present interest to a donee other than your spouse, then you should enter the entire gift, including the future interest given to your spouse, on Schedule A. You should use the rules under *Gifts Subject to Both Gift and GST Taxes*, later, to determine whether to enter the gift on Schedule A, Part 1, Part 2, or Part 3.

Spouses who are not U.S. citizens. If your spouse is not a U.S. citizen and you gave him or her a gift of a future interest, you must report on Schedule A all gifts to your spouse for the year. If all gifts to your spouse were present interests, do not report on Schedule A any gifts to your spouse if the total of such gifts for the year does not exceed $145,000 and all gifts in excess of $14,000 would qualify for a marital deduction if your spouse were a U.S. citizen (see the instructions for Schedule A, Part 4, line 4). If the gifts exceed $145,000, you must report all of the gifts even though some may be excluded.

Gifts Subject to Both Gift and GST Taxes

Definitions

Direct skip. The GST tax you must report on Form 709 is that imposed only on inter vivos direct skips. An *inter vivos direct skip* is a transfer that is:

- Subject to the gift tax,
- Of an interest in property, and
- Made to a skip person.

All three requirements must be met before the gift is subject to the GST tax.

A gift is "subject to the gift tax" if you are required to list it on Schedule A of Form 709. However, if you make a nontaxable gift (which is a direct skip) to a trust for the benefit of an individual, this transfer is subject to the GST tax unless:

1. During the lifetime of the beneficiary, no corpus or income may be distributed to anyone other than the beneficiary, and
2. If the beneficiary dies before the termination of the trust, the assets of the trust will be included in the gross estate of the beneficiary.

Note. If the property transferred in the direct skip would have been includible in the donor's estate if the donor died immediately after the transfer, see *Transfers Subject to an Estate Tax Inclusion Period (ETIP)*.

To determine if a gift "is of an interest in property" and "is made to a skip person," you must first determine if the donee is a "natural person" or a "trust," as defined below.

Trust. For purposes of the GST tax, a *trust* includes not only an ordinary trust, but also any other arrangement (other than an estate) that although not explicitly a trust, has substantially the same effect as a trust. For example, a *trust* includes life estates with remainders, terms for years, and insurance and annuity contracts. A transfer of property that is conditional on the occurrence of an event is a transfer in trust.

Interest in property. If a gift is made to a *natural person,* it is always considered a gift of an interest in property for purposes of the GST tax.

If a gift is made to a trust, a natural person will have an *interest in the property* transferred to the trust if that person either has a present right to receive income or corpus from the trust (such as an income interest for life) or is a permissible current recipient of income or corpus from the trust (for example, possesses a general power of appointment).

Skip person. A donee, who is a natural person, is a *skip person* if that donee is assigned to a generation that is two or more generations below the generation assignment of the donor. See *Determining the Generation of a Donee*.

A donee that is a trust is a skip person if all the interests in the property transferred to the trust (as defined above) are held by skip persons.

A trust will also be a skip person if there are no interests in the property transferred to the trust held by any person, and future distributions or terminations from the trust can be made only to skip persons.

Nonskip person. A *nonskip person* is any donee who is not a skip person.

Determining the Generation of a Donee

Generally, a generation is determined along family lines as follows:

1. If the donee is a lineal descendant of a grandparent of the donor (for example, the donor's cousin, niece, nephew, etc.), the number of generations between the donor and the descendant (donee) is determined by subtracting the number of generations between the grandparent and the donor from the number of generations between the grandparent and the descendant (donee).
2. If the donee is a lineal descendant of a grandparent of a spouse (or former spouse) of the donor, the number of generations between the donor and the descendant (donee) is determined by subtracting the number of generations between the grandparent and the spouse (or former spouse) from the number of generations between the grandparent and the descendant (donee).
3. A person who at any time was married to a person described in (1) or (2) above is assigned to the generation of that person. A person who at any time was married to the donor is assigned to the donor's generation.
4. A relationship by adoption or half-blood is treated as a relationship by whole-blood.

A person who is not assigned to a generation according to (1), (2), (3), or (4) above is assigned to a generation based on his or her birth date as follows:

1. A person who was born not more than 12½ years after the donor is in the donor's generation.
2. A person born more than 12½ years, but not more than 37½ years, after the donor is in the first generation younger than the donor.
3. Similar rules apply for a new generation every 25 years.

If more than one of the rules for assigning generations applies to a donee, that donee is generally assigned to the youngest of the generations that would apply.

If an estate, trust, partnership, corporation, or other entity (other than governmental entities and certain charitable organizations and trusts, described in sections 511(a)(2) and 511(b)(2), as discussed later) is a donee, then each person who indirectly receives the gift through the entity is treated as a donee and is assigned to a generation as explained in the above rules.

Charitable organizations and trusts, described in sections 511(a)(2) and 511(b)(2), and governmental entities are assigned to the donor's generation. Transfers to such organizations are therefore not subject to the GST tax. These gifts should always be listed in Part 1 of Schedule A.

Charitable Remainder Trusts

Gifts in the form of charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds are not transfers to skip persons and therefore are not direct skips. You should always list these gifts in Part 1 of Schedule A even if all of the life beneficiaries are skip persons.

Generation Assignment Where Intervening Parent Is Deceased

If you made a gift to your grandchild and at the time you made the gift, the grandchild's parent (who is your or your spouse's or your former spouse's child) is deceased, then for purposes of generation assignment, your grandchild is considered to be your child rather than your grandchild. Your grandchild's children will be treated as your grandchildren rather than your great-grandchildren.

This rule is also applied to your lineal descendants below the level of grandchild. For example, if your grandchild is deceased, your great-grandchildren who are lineal descendants of the deceased grandchild are considered your grandchildren for purposes of the GST tax.

This special rule may also apply in other cases of the death of a parent of the transferee. If property is transferred to a descendant of a parent of the transferor and that person's parent (who is a lineal descendant of the parent of the transferor) is deceased at the time the transfer is subject to gift or estate tax, then for purposes of generation assignment, the individual is treated as if he or she is a member of the generation that is one generation below the lower of:

- The transferor's generation, or
- The generation assignment of the youngest living ancestor of the individual who is also a descendant of the parent of the transferor.

The same rules apply to the generation assignment of any descendant of the individual.

This rule does not apply to a transfer to an individual who is not a lineal descendant of the transferor if the transferor at the time of the transfer has any living lineal descendants.

If any transfer of property to a trust would have been a direct skip except for this generation assignment rule, then the rule also applies to transfers from the trust attributable to such property.

Ninety-day rule. For assigning individuals to generations for purposes of the GST tax, any individual who dies no later than 90 days after a transfer occurring by reason of the death of the transferor is treated as having predeceased the transferor. The 90-day rule applies to transfers occurring on or after July 18, 2005. See Regulations section 26.2651-1(a)(2)(iii) for more information.

Examples

The GST rules can be illustrated by the following examples.

Example 1. You give your house to your daughter for her life with the remainder then passing to her children. This gift is made to a "trust" even though there is no explicit trust instrument. The interest in the property transferred (the present right to use the house) is transferred to a nonskip person (your daughter). Therefore, the trust is not a skip person because there is an interest in the transferred property that is held by a nonskip person, and the gift is not a direct skip. The transfer is an indirect skip, however, because on the death of the daughter, a termination of her interest in the trust will occur that may be subject to the GST tax. See the instructions for *Part 3—Indirect Skips* for a discussion of how to allocate GST exemption to such a trust.

Example 2. You give $100,000 to your grandchild. This gift is a direct skip that is not made in trust. You should list it in Part 2 of Schedule A.

Example 3. You establish a trust that is required to accumulate income for 10 years and then pay its income to your grandchildren for their lives and upon their deaths distribute the corpus to their children. Because the trust has no current beneficiaries, there are no present interests in the property transferred to the trust. All of the persons to whom the trust can make future distributions (including distributions upon the termination of interests in property held in trust) are skip persons (that is, your grandchildren and great-grandchildren). Therefore, the trust itself is a skip person and you should list the gift in Part 2 of Schedule A.

Example 4. You establish a trust that pays all of its income to your grandchildren for 10 years. At the end of 10 years, the corpus is to be distributed to your children. Since for this purpose interests in trusts are defined only as present interests, all of the interests in this trust are held by skip persons (the children's interests are future interests). Therefore, the trust is a skip person and you should list the entire amount you transferred to the trust in Part 2 of Schedule A even though some of the trust's ultimate beneficiaries are nonskip persons.

Part 1—Gifts Subject Only to Gift Tax

List in Part 1 gifts subject only to the gift tax. Generally, all of the gifts you made to your spouse (that are required to be listed, as described earlier), to your children, and to charitable organizations are not subject to the GST tax and should, therefore, be listed only in Part 1.

Group the gifts in four categories:
- Gifts made to your spouse,
- Gifts made to third parties that are to be split with your spouse,
- Charitable gifts (if you are not splitting gifts with your spouse), and
- Other gifts.

If a transfer results in gifts to two or more individuals (such as a life estate to one with remainder to the other), list the gift to each separately.

Number and describe all gifts (including charitable, public, and similar gifts) in the columns provided in Schedule A.

Column B

Describe each gift in enough detail so that the property can be easily identified, as explained below.

For real estate, give:
- A legal description of each parcel;
- The street number, name, and area if the property is located in a city; and
- A short statement of any improvements made to the property.

For bonds, give:
- The number of bonds transferred;
- The principal amount of each bond;
- Name of obligor;
- Date of maturity;
- Rate of interest;
- Date or dates when interest is payable;
- Series number, if there is more than one issue;
- Exchanges where listed or, if unlisted, give the location of the principal business office of the corporation; and
- CUSIP number. The CUSIP number is a nine-digit number assigned by the American Banking Association to traded securities.

For stocks:
- Give number of shares;
- State whether common or preferred;
- If preferred, give the issue, par value, quotation at which returned, and exact name of corporation;
- If unlisted on a principal exchange, give the location of the principal business office of the corporation, the state in which incorporated, and the date of incorporation;
- If listed, give principal exchange; and
- CUSIP number.

For interests in property based on the length of a person's life, give the date of birth of the person. If you transfer any interest in a closely held entity, provide the EIN of the entity.

For life insurance policies, give the name of the insurer and the policy number.

Clearly identify in the description column which gifts create the opening of an ETIP as described under *Transfers Subject to an Estate Tax Inclusion Period (ETIP)*. Describe the interest that is creating the ETIP. An allocation of GST exemption to property subject to an ETIP that is made prior to the close of the ETIP becomes effective no earlier than the date of the close of the ETIP. See *Schedule D. Computation of GST Tax*.

Column D. Donor's Adjusted Basis of Gifts

Show the basis you would use for income tax purposes if the gift were sold or exchanged. Generally, this means cost plus improvements, less applicable depreciation, amortization, and depletion.

For more information on adjusted basis, see Pub. 551, Basis of Assets.

Columns E and F. Date and Value of Gift

The value of a gift is the fair market value (FMV) of the property on the date the gift is made (valuation date). The FMV is the price at which the property would change hands between a willing buyer and a willing seller, when neither is forced to buy or to sell, and when both have reasonable knowledge of all relevant facts. FMV may not be determined by a forced sale price, nor by the sale price of the item in a market other than that in which the item is most commonly sold to the public. The location of the item must be taken into account whenever appropriate.

The FMV of a stock or bond (whether listed or unlisted) is the mean between the highest and lowest selling prices quoted on the valuation date. If only the closing selling prices are available, then the FMV is the mean between the quoted closing selling price on the valuation date and on the trading day before the valuation date. If there were no sales on the valuation date, figure the FMV as follows:

1. Find the mean between the highest and lowest selling prices on the nearest trading date before and the nearest trading date after the valuation date. Both trading dates must be reasonably close to the valuation date.

2. Prorate the difference between mean prices to the valuation date.

3. Add or subtract (whichever applies) the prorated part of the difference to or from the mean price figured for the nearest trading date before the actual valuation date.

If no actual sales were made reasonably close to the valuation date, make the same computation using the mean between the bona fide bid and the asked prices instead of sales prices. If actual sales prices or bona fide bid and asked prices are available within a reasonable period of time before the valuation date but not after the valuation date, or vice versa, use the mean between the highest and lowest sales prices or bid and asked prices as the FMV.

Stock of close corporations or inactive stock must be valued on the basis of net worth, earnings, earning and dividend capacity, and other relevant factors.

Generally, the best indication of the value of real property is the price paid for the property in an arm's-length transaction on or before the valuation date. If there has been no such transaction, use the comparable sales method. In comparing similar properties, consider differences in the date of the sale, and the size, condition, and location of the properties, and make all appropriate adjustments.

The value of all annuities, life estates, terms for years, remainders, or reversions is generally the present value on the date of the gift.

Sections 2701 and 2702 provide special valuation rules to determine the amount of the gift when a donor transfers an equity interest in a corporation or partnership (section 2701) or makes a gift in trust (section 2702). The rules only apply if, immediately after the transfer, the donor (or an applicable family member) holds an applicable retained interest in the corporation or partnership, or retains an interest in the trust. For details, see sections 2701 and 2702, and their regulations.

Column G. Split Gifts

Enter an amount in this column only if you have chosen to split gifts with your spouse.

Split Gifts—Gifts Made by Spouses

If you elected to split gifts with your spouse and your spouse has given a gift(s) that is being split with you, enter in this area of Part 1 information on the gift(s) made by your spouse. If only you made gifts and you are splitting them with your spouse, do not make an entry in this area.

Generally, if you elect to split your gifts, you must split all gifts made by you and your spouse to third-party donees. The only exception is if you gave your spouse a general power of appointment over a gift you made.

Supplemental Documents

To support the value of your gifts, you must provide information showing how it was determined.

For stock of close corporations or inactive stock, attach balance sheets, particularly the one nearest the date of the gift, and statements of net earnings or operating results and dividends paid for each of the 5 preceding years.

For each life insurance policy, attach Form 712, Life Insurance Statement.

Note for single premium or paid-up policies. In certain situations, for example, where the surrender value of the policy exceeds its replacement cost, the true economic value of the policy will be greater than the amount shown on line 59 of Form 712. In these situations, report the full economic value of the policy on Schedule A. See Rev. Rul. 78-137, 1978-1 C.B. 280, for details.

If the gift was made by means of a trust, attach a certified or verified copy of the trust instrument to the return on which you report your first transfer to the trust. However, to report subsequent transfers to the trust, you may attach a brief description of the terms of the trust or a copy of the trust instrument.

Also attach any appraisal used to determine the value of real estate or other property.

If you do not attach this information, Schedule A must include a full explanation of how value was determined.

Part 2—Direct Skips

List in Part 2 only those gifts that are currently subject to both the gift and GST taxes. You must list the gifts in Part 2 in the chronological order that you made them. Number, describe, and value the gifts as described in the instructions for Part 1.

If you made a transfer to a trust that was a direct skip, list the entire gift as one line entry in Part 2.

Column C. 2632(b) Election

If you elect under section 2632(b)(3) to not have the automatic allocation rules of section 2632(b) apply to a transfer, enter a check in column C next to the transfer. You must also attach a statement to Form 709 clearly describing the transaction and the extent to which the automatic allocation is not to apply. Reporting a direct skip on a timely filed Form 709 and paying the GST tax on the transfer will qualify as such a statement.

How to report generation-skipping transfers after the close of an ETIP. If you are reporting a generation-skipping transfer that was subject to an ETIP (provided the ETIP closed as a result of something other than the death of the transferor; see Form 706), and you are also reporting gifts made during the year, complete Schedule A as you normally would with the transfer subject to an ETIP listed on Schedule A, Part 2.

Column B. In addition to the information already requested, describe the interest that is closing the ETIP; explain what caused the interest to terminate; and list the year the gift portion of the transfer was reported and its item number on Schedule A that was originally filed to report the gift portion of the ETIP transfer.

Column E. Give the date the ETIP closed rather than the date of the initial gift.

Columns F, G, and H. Enter "N/A" in these columns.

The value is entered only in Column B of Part 1, Schedule D. See *Column B*, earlier.

Split Gifts—Gifts Made by Spouse

See this heading under Part 1.

Part 3—Indirect Skips

Some gifts made to trusts are subject only to gift tax at the time of the transfer but later may be subject to GST tax. The GST tax could apply either at the time of a distribution from the trust, at the termination of the trust, or both.

Section 2632(c) defines indirect skips and applies special rules to the allocation of GST exemption to such transfers. In general, an indirect skip is a transfer of property that is subject to gift tax (other than a direct skip) and is made to a GST trust. A GST trust is a trust that could have a generation-skipping transfer with respect to the transferor, unless the trust provides for certain distributions of trust corpus to nonskip persons. See section 2632(c)(3)(B) for details.

List in Part 3 those gifts that are indirect skips as defined in section 2632(c) or may later be subject to GST tax. This includes indirect skips for which election (2), described below, will be made in the current year or has been made in a previous year. You must list the gifts in Part 3 in the chronological order that you made them.

Column C. 2632(c) Election

Section 2632(c) provides for the automatic allocation of the donor's unused GST exemption to indirect skips. This section also sets forth three different elections you may make regarding the allocation of exemption.

Election 1. You may elect not to have the automatic allocation rules apply to the current transfer made to a particular trust.
Election 2. You may elect not to have the automatic rules apply to both the current transfer and any and all future transfers made to a particular trust.
Election 3. You may elect to treat any trust as a GST trust for purposes of the automatic allocation rules.

See section 2632(c)(5) for details.

When to make an election. Election 1 is timely made if it is made on a timely filed gift tax return for the year the transfer was made or was deemed to have been made.

Elections 2 and 3 may be made on a timely filed gift tax return for the year for which the election is to become effective.

To make one of these elections, check column C next to the transfer to which the election applies. You must also attach an explanation as described below. If you are making election 2 or 3 on a return on which the transfer is not reported, simply attach the statement described below.

If you are reporting a transfer to a trust for which election 2 or 3 was made on a previously filed return, do not make an entry in column C for that transfer and do not attach a statement.

Attachment. Attach a statement to Form 709 that describes the election you are making and clearly identifies the trusts and/or transfers to which the election applies.

Split Gifts—Gifts Made by Spouse

See this heading under Part 1.

Part 4—Taxable Gift Reconciliation

Line 1

Enter only gifts of the donor. If gift-splitting has been elected, enter only the value of the gift that is attributable to the spouse that is filing the return.

Line 2

Enter the total annual exclusions you are claiming for the gifts listed on Schedule A. See *Annual Exclusion*, earlier. If you split a gift with your spouse, the annual exclusion you claim against that gift may not be more than the smaller of your half of the gift or $14,000.

Deductions

Line 4. Marital deduction

Enter all of the gifts to your spouse that you listed on Schedule A and for which you are claiming a marital deduction. Do not enter any gift that you did not include on Schedule A. On the dotted line on line 4, indicate which numbered items from Schedule A are gifts to your spouse for which you are claiming the marital deduction.

TIP *Do not enter on line 4 any gifts to your spouse who was not a U.S. citizen at the time of the gift.*

You may deduct all gifts of nonterminable interests made during the year that you entered on Schedule A regardless of amount, and certain gifts of terminable interests as outlined below.

Terminable interests. Generally, you cannot take the marital deduction if the gift to your spouse is a terminable interest. In most instances, a terminable interest is nondeductible if someone other than the donee spouse will have an interest in the property following the termination of the donee spouse's interest. Some examples of terminable interests are:

- A life estate,
- An estate for a specified number of years, or
- Any other property interest that after a period of time will terminate or fail.

If you transfer an interest to your spouse as sole joint tenant with yourself or as a tenant by the entirety, the interest is not considered a terminable interest just because the tenancy may be severed.

Life estate with power of appointment. You may deduct, without an election, a gift of a terminable interest if all four requirements below are met:

1. Your spouse is entitled for life to all of the income from the entire interest;
2. The income is paid yearly or more often;
3. Your spouse has the unlimited power, while he or she is alive or by will, to appoint the entire interest in all circumstances; and,
4. No part of the entire interest is subject to another person's power of appointment (except to appoint it to your spouse).

If either the right to income or the power of appointment given to your spouse pertains only to a specific portion of a property interest, the marital deduction is allowed only to the extent that the rights of your spouse meet all four of the above conditions. For example, if your spouse is to receive all of the income from the entire interest, but only has a power to appoint one-half of the entire interest, then only one-half qualifies for the marital deduction.

A partial interest in property is treated as a specific portion of an entire interest only if the rights of your spouse to the income and to the power are a fractional or percentile share of the entire property interest. This means that the interest or share will reflect any increase or decrease in the value of the entire property interest. If the spouse is entitled to receive a specified sum of income annually, the capital amount that would produce such a sum will be considered the specific portion from which the spouse is entitled to receive the income.

Election to deduct qualified terminable interest property (QTIP). You may elect to deduct a gift of a terminable interest if it meets requirements (1), (2), and (4) earlier, even though it does not meet requirement (3).

You make this election simply by listing the qualified terminable interest property on Schedule A and deducting its value from Schedule A, Part 4, line 4. You are presumed to have made the election for all qualified property that you both list and deduct on Schedule A. You may not make the election on a late filed Form 709.

Line 5

Enter the amount of the annual exclusions that were claimed for the gifts listed on line 4.

Line 7. Charitable Deduction

You may deduct from the total gifts made during the calendar year all gifts you gave to or for the use of:

- The United States, a state or political subdivision of a state or the District of Columbia for exclusively public purposes;
- Any corporation, trust, community chest, fund, or foundation organized and operated only for religious, charitable, scientific, literary, or educational purposes, or to prevent cruelty to children or animals, or to foster national or international amateur sports competition (if none of its activities involve providing athletic equipment unless it is a qualified amateur sports organization), as long as no part of the earnings benefits any one person, no substantial propaganda is produced, and no lobbying or campaigning for any candidate for public office is done;
- A fraternal society, order, or association operating under a lodge system, if the transferred property is to be used only for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals; or
- Any war veterans' organization organized in the United States (or any of its possessions), or any of its auxiliary departments or local chapters or posts, as long as no part of any of the earnings benefits any one person.

On line 7, show your total charitable, public, or similar gifts (minus annual exclusions allowed). On the dotted line, indicate which numbered items from the top of Schedule A are charitable gifts.

Line 10. GST Tax

If GST tax is due on any direct skips reported on this return, the amount of that GST tax is also considered a gift and must be added to the value of the direct skip reported on this return.

If you entered gifts on Part 2, or if you and your spouse elected gift splitting and your spouse made gifts subject to the GST tax that you are required to show on your Form 709, complete Schedule D, and enter on line 10 the total from Schedule D, Part 3, column H. Otherwise, enter zero on line 10.

Line 12. Election Out of QTIP Treatment of Annuities

Section 2523(f)(6) creates an automatic QTIP election for gifts of joint and survivor annuities where the spouses are the only possible recipients of the annuity prior to the death of the last surviving spouse.

The donor spouse can elect out of QTIP treatment, however, by checking the box on line 12 and entering the item number from Schedule A for the annuities for which you are making the election. Any annuities entered on line 12 cannot also be entered on line 4 of Schedule A, Part 4. Any such annuities that are not listed on line 12 must be entered on line 4 of Part 4, Schedule A. If there is more than one such joint and survivor annuity, you are not required to make the election for all of them. Once made, the election is irrevocable.

Schedule B. Gifts From Prior Periods

If you did not file gift tax returns for previous periods, check the "No" box on page 1 of Form 709, line 11a of *Part 1—General Information*. If you filed gift tax returns for previous periods, check the "Yes" box on line 11a and complete Schedule B by listing the years or quarters in chronological order as described below. If you need more space, attach a separate sheet using the same format as Schedule B.

CAUTION *Complete Schedule A before beginning Schedule B.*

Column A. If you filed returns for gifts made before 1971 or after 1981, show the calendar years in column A. If you filed returns for gifts made after 1970 and before 1982, show the calendar quarters.

Column B. In column B, identify the IRS office where you filed the returns. If you have changed your name, be sure to list any other names under which the returns were filed. If there was any other variation in the names under which you filed, such as the use of full given names instead of initials, please explain.

Column C. To determine the amount of applicable credit (formerly unified credit) used for gifts made after 1976, use the *Worksheet for Schedule B, Column C (Credit Allowable for Prior Periods)*, later, unless your prior gifts total $500,000 or less.

Prior gifts totaling $500,000 or less. In column C, enter the amount of applicable credit actually applied in the prior period.

Prior gifts totaling over $500,000. See *Redetermining the Applicable Credit*, later.

Column D. In column D, enter the amount of specific exemption claimed for gifts made in periods ending before January 1, 1977.

Column E. In column E, show the correct amount (the amount finally determined) of the taxable gifts for each earlier period.

See Regulations section 25.2504-2 for rules regarding the final determination of the value of a gift.

Redetermining the Applicable Credit.

To redetermine the Applicable Credit for prior gifts in excess of $500,000, use the Worksheet for Schedule B, Column C (Credit Allowable for Prior Periods).

Instructions for Worksheet for Schedule B, Column C (Credit Allowable for Prior Periods)

Beginning with the earliest year after 1976 in which gifts using a credit amount were made, determine the credit amount (at current rates) for each quarter/year as follows:	
Column	
A **Period**	Enter the quarter/year of the prior gift(s). Pre-1977 gifts will be on the first row.
B **Taxable Gifts for Current Period**	Enter the amount of all taxable gifts for the year in Column A. The total of all pre-1977 gifts should be combined in the first row.
C **Taxable Gifts for Prior Periods**	Enter the amount from Column D of the ***previous*** row.
D **Cumulative Taxable Gifts Including Current Period**	Enter the sum of Columns B and C from the current row.
E **Tax on Gifts for Prior Periods**	Enter the amount from Column F of the ***previous*** row.
F **Tax on Cumulative Gifts Including Current Period**	Enter the tax based on the amount in Column D of the current row using the *Table for Computing Gift Tax.*
G **Tax on Gifts for Current Period**	Subtract the amount in Column E from the amount in Column F of the current row and enter here.
H **Used DSUE Amount from Predeceased Spouse(s)**	Enter the total Deceased Spousal Unused Exclusion amount (if any) received from the estate of the donor's last deceased spouse and used by the donor in prior periods and the current period. DSUE may not be applied to gifts made before the DSUE arose.
I **Basic Exclusion Amount for Year of Gift**	Enter the exclusion amount corresponding with the year listed in Column A of the current row. (See*Table of Exclusion and Credit Amounts*), later.
J **Applicable Exclusion Amount**	Add the amounts in Columns H and I of the current row and enter here.
K **Applicable Credit Amount (based on Amount in Column J)**	Using the *Table for Computing Gift Tax*, determine the credit corresponding to the amount in Column J of the current row and enter here. For each row in Column K, subtract 20 percent of any amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977.
L **Applicable Credit Amount Used in Prior Periods**	Enter the total of the amounts in Columns L and N of the ***previous*** row.
M **Available Credit in Current Period**	Subtract the amount in Column L from the amount in Column K of the current row and enter here.
N **Credit Allowable**	Enter the lesser of Column G or Column M of the current row.
Repeat this process for each prior year with taxable gifts. Do not enter less than zero.	

Worksheet for Schedule B, Column C (Credit Allowable for Prior Periods).

Prior Years Credit Recalculation (for Form 709 Schedule B, Column C)
(Keep for your records.)

A	B	C	D	E	F	G	H	I	J	K	L	M	N
Period	**Taxable Gifts for Current Period**	**Taxable Gifts for Prior Periods**[1]	**Cumulative Taxable Gifts Including Current Period** *(Col. B + Col. C)*	**Tax on Gifts for Prior Periods (Col. C)**[2, 3]	**Tax on Cumulative Gifts Including Current Period (Col. D)**[3]	**Tax on Gifts for Current Period** *(Col. F - Col. E)*	**DSUE from Pre-deceased Spouse(s)**	**Basic Exclusion for Year of Gift**[4]	**Applicable Exclusion Amount** *(Col. H + Col. I)*	**Applicable Credit Amount based on Column J**[3, 5]	**Applicable Credit Amount Used in Prior Periods**[3, 6]	**Available Credit in Current Period** *(Col. K - Col. L)*	**Credit Allowable** *(lesser of Col. G or Col. M)*
Pre-1977													
YYYY													
YYYY													
YYYY													
Total Applicable Credit Used in Prior Periods *(Enter the Total of Column N on Schedule B, Line 1, Column C)* :													

1. Column C: Enter amount from Column D of the ***previous*** row.
2. Column E: Compute the tax on the amount in Column C or enter amount from Column F of the ***previous*** row.
3. To compute tax or credit amount, see *Table for Computing Gift Tax*, later.
4. For years prior to 2010, the basic exclusion amount equals the applicable exclusion amount.
5. For each row in Column K, subtract 20 percent of any amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977.
6. Enter the total of Columns L and N of the ***previous*** row.

Example 1. Prior Years Credit Recalculation (for Form 709 Schedule B, Column C) (Three post-1976 years involved. All have the same maximum credit available. Tentative tax exceeds available credit.)													
A	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**I**	**J**	**K**	**L**	**M**	**N**
Period	**Taxable Gifts for Current Period**	**Taxable Gifts for Prior Periods**[1]	**Cumulative Taxable Gifts Including Current Period** *(Col. B + Col. C)*	**Tax on Gifts for Prior Periods (Col. C)**[2,3]	**Tax on Cumulative Gifts Including Current Period (Col. D)**[3]	**Tax on Gifts for Current Period** *(Col. F - Col. E)*	**DSUE from Pre-deceased Spouse(s)**	**Basic Exclusion for Year of the Gift**[4]	**Applicable Exclusion Amount** *(Col. H + Col. I)*	**Applicable Credit Amount based on Column J**[3,5]	**Applicable Credit Amount Used in Prior Periods**[3,6]	**Available Credit in Current Period** *(Col. K - Col. L)*	**Credit Allowable** *(lesser of Col. G or Col. M)*
Pre-1977													
2004	800,000	0	800,000	0	267,800	267,800	0	1,000,000	1,000,000	345,800	0	345,800	267,800
2007	300,000	800,000	1,100,000	267,800	385,800	118,000	0	1,000,000	1,000,000	345,800	267,800	78,000	78,000
2009	200,000	1,100,000	1,300,000	385,800	465,800	80,000	0	1,000,000	1,000,000	345,800	345,800	0	0
Total Applicable Credit Used in Prior Periods *(Enter the Total of Column N on Schedule B, Line 1, Column C)* :													345,800

1. Column C: Enter amount from Column D of the ***previous*** row.
2. Column E: Compute the tax on the amount in Column C or enter amount from Column F of the ***previous*** row.
3. To compute tax or credit amount, see *Table for Computing Gift Tax*, later.
4. For years prior to 2010, the basic exclusion amount equals the applicable exclusion amount.
5. For each row in Column K, subtract 20 percent of any amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977.
6. Enter the total of Columns L and N of the ***previous*** row.

Example 2. Prior Years Credit Recalculation (for Form 709 Schedule B, Column C) (Pre-1977 gifts plus 3 post-1976 years: Earlier years' gifts exceed credit then available. Last gift made after credit increased.)													
A	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**I**	**J**	**K**	**L**	**M**	**N**
Period	**Taxable Gifts for Current Period**	**Taxable Gifts for Prior Periods**[1]	**Cumulative Taxable Gifts Including Current Period** *(Col. B + Col. C)*	**Tax on Gifts for Prior Periods (Col. C)**[2,3]	**Tax on Cumulative Gifts Including Current Period (Col. D)**[3]	**Tax on Gifts for Current Period** *(Col. F - Col. E)*	**DSUE from Pre-deceased Spouse(s)**	**Basic Exclusion for Year of the Gift**[4]	**Applicable Exclusion Amount** *(Col. H + Col. I)*	**Applicable Credit Amount based on Column J**[3,5]	**Applicable Credit Amount Used in Prior Periods**[3,6]	**Available Credit in Current Period** *(Col. K - Col. L)*	**Credit Allowable** *(lesser of Col. G or Col. M)*
Pre-1977	200,000		200,000		54,800								
1987	600,000	200,000	800,000	54,800	267,800	213,000	0	600,000	600,000	192,800	0	192,800	192,800
1999	200,000	800,000	1,000,000	267,800	345,800	78,000	0	650,000	650,000	211,300	192,800	18,500	18,500
2002	100	1,000,000	1,000,100	345,800	345,840	40	0	1,000,000	1,000,000	345,800	211,300	134,500	40
Total Applicable Credit Used in Prior Periods *(Enter the Total of Column N on Schedule B, Line 1, Column C)* :													211,340

1. Column C: Enter amount from Column D of the ***previous*** row.
2. Column E: Compute the tax on the amount in Column C or enter amount from Column F of the ***previous*** row.
3. To compute tax or credit amount, see *Table for Computing Gift Tax*, later.
4. For years prior to 2010, the basic exclusion amount equals the applicable exclusion amount.
5. For each row in Column K, subtract 20 percent of any amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977.
6. Enter the total of Columns L and N of the ***previous*** row.

Example 3. Prior Years Credit Recalculation (for Form 709 Schedule B, Column C) ($6M gift exceeds the applicable credit, $5M DSUE received prior to subsequent $4M gift in the same year.)													
A	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**I**	**J**	**K**	**L**	**M**	**N**
Period	**Taxable Gifts for Current Period**	**Taxable Gifts for Prior Periods**[1]	**Cumulative Taxable Gifts Including Current Period** *(Col. B + Col. C)*	**Tax on Gifts for Prior Periods (Col. C)**[2, 3]	**Tax on Cumulative Gifts Including Current Period (Col. D)**[3]	**Tax on Gifts for Current Period** *(Col. F - Col. E)*	**DSUE from Pre-deceased Spouse(s)**[4]	**Basic Exclusion for Year of the Gift**[5]	**Applicable Exclusion Amount** *(Col. H + Col. I)*	**Applicable Credit Amount based on Column J**[3, 6]	**Applicable Credit Amount Used in Prior Periods**[3, 7]	**Available Credit in Current Period** *(Col. K - Col. L)*	**Credit Allowable** *(lesser of Col. G or Col. M)*
Pre-1977													
2011	10,000,000	0	10,000,000	0	3,945,800	3,945,800	4,000,000	5,000,000	9,000,000	3,545,800	0	3,545,800	3,545,800
YYYY													
YYYY													
Total Applicable Credit Used in Prior Periods *(Enter the Total of Column N on Schedule B, Line 1, Column C)* :													3,545,800

[1] Column C: Enter amount from Column D of the ***previous*** row.
[2] Column E: Compute the tax on the amount in Column C or enter amount from Column F of the ***previous*** row.
[3] To compute tax or credit amount, see *Table for Computing Gift Tax*, later.
[4] DSUE may not be applied to gifts made prior to when it arises. Consequently, the available DSUE for the current period is limited to $4,000,000, the value of gifts made after the DSUE arose.
[5] For years prior to 2010, the basic exclusion amount equals the applicable exclusion amount.
[6] For each row in Column K, subtract 20 percent of any amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977.
[7] Enter the total of Columns L and N of the ***previous*** row.

Example 4. Prior Years Credit Recalculation (for Form 709 Schedule B, Column C) (Prior gift exceeds applicable credit, $5M DSUE received prior to subsequent gift.)													
A	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**I**	**J**	**K**	**L**	**M**	**N**
Period	**Taxable Gifts for Current Period**	**Taxable Gifts for Prior Periods**[1]	**Cumulative Taxable Gifts Including Current Period** *(Col. B + Col. C)*	**Tax on Gifts for Prior Periods (Col. C)**[2, 3]	**Tax on Cumulative Gifts Including Current Period (Col. D)**[3]	**Tax on Gifts for Current Period** *(Col. F - Col. E)*	**DSUE from Pre-deceased Spouse(s)**	**Basic Exclusion for Year of the Gift**[4]	**Applicable Exclusion Amount** *(Col. H + Col. I)*	**Applicable Credit Amount based on Column J**[3, 5]	**Applicable Credit Amount Used in Prior Periods**[3, 6]	**Available Credit in Current Period** *(Col. K - Col. L)*	**Credit Allowable** *(lesser of Col. G or Col. M)*
Pre-1977													
2002	4,000,000	0	4,000,000	0	1,545,800	1,545,800	0	1,000,000	1,000,000	345,800	0	345,800	345,800
2011	4,000,000	4,000,000	8,000,000	1,545,800	3,145,800	1,600,000	4,000,000	5,000,000	9,000,000	3,545,800	345,800	3,200,000	1,600,000
YYYY													
Total Applicable Credit Used in Prior Periods *(Enter the Total of Column N on Schedule B, Line 1, Column C)* :													1,945,800

[1] Column C: Enter amount from Column D of the ***previous*** row.
[2] Column E: Compute the tax on the amount in Column C or enter amount from Column F of the ***previous*** row.
[3] To compute tax or credit amount, see *Table for Computing Gift Tax*, later.
[4] For years prior to 2010, the basic exclusion amount equals the applicable exclusion amount.
[5] For each row in Column K, subtract 20 percent of any amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977.
[6] Enter the total of Columns L and N of the ***previous*** row.

Table of Basic Exclusion and Credit Amounts (as Recalculated for 2014 Rates)

Period	Exclusion Amounts	Credit Amounts
1977 (Quarters 1 & 2)	$30,000	$6,000
1977 (Quarters 3 & 4)	$120,667	$30,000
1978	$134,000	$34,000
1979	$147,333	$38,000
1980	$161,563	$42,500
1981	$175,625	$47,000
1982	$225,000	$62,800
1983	$275,000	$79,300
1984	$325,000	$96,300
1985	$400,000	$121,800
1986	$500,000	$155,800
1987 through 1997	$600,000	$192,800
1998	$625,000	$202,050
1999	$650,000	$211,300
2000 and 2001	$675,000	$220,550
2002 through 2010	$1,000,000	$345,800
2011	$5,000,000	$1,945,800
2012	$5,120,000	$1,993,800
2013	$5,250,000	$2,045,800
2014	$5,340,000	$2,081,800

Schedule C. Portability of Deceased Spousal Unused Exclusion (DSUE) Amount

Section 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 authorized estates of decedents dying on or after January 1, 2011, to elect to transfer any unused exclusion to the surviving spouse. The amount received by the surviving spouse is called the *deceased spousal unused exclusion, or DSUE*, amount. If the executor of the decedent's estate elects transfer, or portability, of the DSUE amount, the surviving spouse can apply the DSUE amount received from the estate of his or her last deceased spouse (defined later) against any tax liability arising from subsequent lifetime gifts and transfers at death.

CAUTION *Complete Schedule A before beginning Schedule C.*

Note. A nonresident surviving spouse who is not a citizen of the United States may not take into account the DSUE amount of a deceased spouse, except to the extent allowed by treaty with his or her country of citizenship.

Last Deceased Spouse Limitation

The *last deceased spouse* is the most recently deceased person who was married to the surviving spouse at the time of that person's death. The identity of the last deceased spouse is determined as of the day a taxable gift is made and is not impacted by whether the decedent's estate elected portability or whether the last deceased spouse had any DSUE amount available. Remarriage also does not affect the designation of the last deceased spouse and does not prevent the surviving spouse from applying the DSUE amount to taxable transfers.

When a taxable gift is made, the DSUE amount received from the last deceased spouse is applied before the surviving spouse's basic exclusion amount. A surviving spouse who has more than one predeceased spouse is not precluded from using the DSUE amount of each spouse in succession. A surviving spouse may not use the sum of DSUE amounts from multiple predeceased spouses at one time nor may the DSUE amount of a predeceased spouse be applied after the death of a subsequent spouse.

When a surviving spouse applies the DSUE amount to a lifetime gift, the IRS may examine any return of a predeceased spouse whose executor elected portability to verify the allowable DSUE amount. The DSUE may be adjusted or eliminated as a result of the examination; however, the IRS may make an assessment of additional tax on the return of a predeceased spouse only within the applicable limitations period under section 6501.

Completing Schedule C

Complete Schedule C if the donor is a surviving spouse who received a DSUE amount from one or more predeceased spouses.

CAUTION *Entry spaces with gray shading and columns and lines marked "Reserved" are inactive. Do not enter any information in these areas.*

Schedule C requests information on all DSUE amounts received from the donor's last deceased spouse and any previously deceased spouses. Each line in the chart should reflect a different predeceased spouse.

Part 1. DSUE Received From the Last Deceased Spouse

In this Part, include information about the DSUE amount from the donor's most recently deceased spouse (whose date of death is after December 31, 2010). In column E, enter the total of the amount in column D that the donor has applied to gifts in previous years and is applying to gifts reported on this return. A donor may apply DSUE only to gifts made after the DSUE arose.

Part 2. DSUE Received From Other Predeceased Spouse(s)

Enter information about the DSUE amount from the spouse(s), if any, who died prior to the donor's most recently deceased spouse (but not before January 1, 2011) if the prior spouse's executor elected portability of the DSUE amount. In column D, indicate the amount of DSUE received from the estate of each predeceased spouse. In column E, enter the portion of the amount of DSUE shown in column D that was applied to prior lifetime gifts or transfers. A donor may apply DSUE only to gifts made after the DSUE arose.

CAUTION *Any remaining DSUE from a predeceased spouse cannot be applied against tax arising from lifetime gifts if that spouse is not the most recently deceased spouse on the date of the gift. This rule applies even if the last deceased spouse had no DSUE amount or made no valid portability election, or if the DSUE amount from the last deceased spouse has been fully applied to gifts in previous periods.*

Determining the Applicable Credit Amount including DSUE

On line 1, enter the donor's basic exclusion amount; for 2014, this amount is $5,340,000. Add the amounts listed in column E from Parts 1 and 2 and enter the total on line 2. On line 3, enter the total of lines 1 and 2. Using the Table for Computing Gift Tax, later, determine the donor's applicable credit by applying the appropriate tax rate to the amount on line 3. Enter this amount on line 4 and on line 7 of Part 2—Tax Computation.

Schedule D. Computation of GST Tax

Part 1—Generation-Skipping Transfers

Enter in Part 1 all of the gifts you listed in Part 2 of Schedule A, in the same order and showing the same values.

Column B

If you are reporting a generation-skipping transfer that occurred because of the close of an ETIP, complete column B for such transfer as follows:

1. If the GST exemption is being allocated on a timely filed (including extensions) gift tax return, enter the value as of the close of the ETIP.

2. If the GST exemption is being allocated on a late filed (past the due date including extensions) gift tax return, enter the value as of the date the gift tax return was filed.

Column C

You are allowed to claim the gift tax annual exclusion currently allowable for your reported direct skips (other than certain direct skips to trusts—see *Note*), using the rules and limits discussed earlier for the gift tax annual exclusion. However, you must allocate the exclusion on a gift-by-gift basis for GST computation purposes. You must allocate the exclusion to each gift to the maximum allowable amount and in chronological order, beginning with the earliest gift that qualifies for the exclusion. Be sure that you do not claim a total exclusion of more than $14,000 per donee.

Note. You may not claim any annual exclusion for a transfer made to a trust unless the trust meets the requirements discussed under *Part 2—Direct Skips*.

Part 2—GST Exemption Reconciliation

Line 1

Every donor is allowed a lifetime GST exemption. The amount of the exemption for 2014 is $5,340,000. For transfers made through 1998, the GST exemption was $1 million. The exemption amounts for 1999 through 2014 are as follows:

Year	Amount
1999	$1,010,000
2000	$1,030,000
2001	$1,060,000
2002	$1,100,000
2003	$1,120,000
2004 and 2005	$1,500,000
2006, 2007, and 2008	$2,000,000
2009	$3,500,000
2010 and 2011	$5,000,000
2012	$5,120,000
2013	$5,250,000
2014	$5,340,000

In general, each annual increase can only be allocated to transfers made (or appreciation occurring) during or after the year of the transfer.

Example. A donor made $1,750,000 in GSTs through 2005, and allocated all $1,500,000 of the exemption to those transfers. In 2014, the donor makes a $207,000 taxable generation-skipping transfer. The donor can allocate $207,000 of exemption to the 2014 transfer but cannot allocate the $3,633,000 of unused 2014 exemption to pre-2014 transfers.

However, if in 2005, the donor made a $1,750,000 transfer to a trust that was not a direct skip, but from which generation-skipping transfers could be made in the future, the donor could allocate the increased exemption to the trust, even though no additional transfers were made to the trust. See Regulations section 26.2642-4 for the redetermination of the applicable fraction when additional exemption is allocated to the trust.

Keep a record of your transfers and exemption allocations to make sure that any future increases are allocated correctly.

Enter on line 1 of Part 2 the maximum GST exemption you are allowed. This will not necessarily be the highest indexed amount if you made no generation-skipping transfers during the year of the increase.

The donor can apply this exemption to inter vivos transfers (that is, transfers made during the donor's life) on Form 709. The executor can apply the exemption on Form 706 to transfers taking effect at death. An allocation is irrevocable.

In the case of inter vivos direct skips, a portion of the donor's unused exemption is automatically allocated to the transferred property unless the donor elects otherwise. To elect out of the automatic allocation of exemption, you must file Form 709 and attach a statement to it clearly describing the transaction and the extent to which the automatic allocation is not to apply. Reporting a direct skip on a timely filed Form 709 and paying the GST tax on the transfer will prevent an automatic allocation.

Special QTIP election. If you elect QTIP treatment for any gifts in trust listed on Schedule A, then on Schedule D you may also elect to treat the entire trust as non-QTIP for purposes of the GST tax. The election must be made for the entire trust that contains the particular gift involved on this return. Be sure to identify the item number of the specific gift for which you are making this special QTIP election.

Line 5

Enter the amount of GST exemption you are applying to transfers reported in Part 3 of Schedule A.

Section 2632(c) provides an automatic allocation to indirect skips of any unused GST exemption. The unused exemption is allocated to indirect skips to the extent necessary to make the inclusion ratio zero for the property transferred. You may elect out of this automatic allocation as explained in the instructions for Part 3.

Line 6

Notice of allocation. You may wish to allocate GST exemption to transfers not reported on this return, such as a late allocation.

To allocate your exemption to such transfers, attach a statement to this Form 709 and entitle it "Notice of Allocation." The notice must contain the following for each trust (or other transfer):

- Clear identification of the trust, including the trust's EIN, if known;
- If this is a late allocation, the year the transfer was reported on Form 709;
- The value of the trust assets at the effective date of the allocation;
- The amount of your GST exemption allocated to each gift (or a statement that you are allocating exemption by means of a formula such as "an amount necessary to produce an inclusion ratio of zero"); and
- The inclusion ratio of the trust after the allocation.

Total the exemption allocations and enter this total on line 6.

Note. Where the property involved in such a transfer is subject to an ETIP because it would be includible in the donor's estate if the donor died immediately after the transfer (other than by reason of the donor having died within 3 years of making the gift), an allocation of the GST exemption at the time of the transfer will only become effective at the end of the ETIP. For details, see *Transfers Subject to an Estate Tax Inclusion Period (ETIP)*, earlier, and section 2642(f).

Part 3—Tax Computation

You must enter in Part 3 every gift you listed in Part 1 of Schedule D.

Column C

You are not required to allocate your available exemption. You may allocate some, all, or none of your available exemption, as you wish, among the gifts listed in Part 3 of Schedule D. However, the total exemption claimed in column C may not exceed the amount you entered on line 3 of Part 2 of Schedule D.

Column D

Carry your computation to three decimal places (for example, "1.000").

Part 2—Tax Computation (Page 1 of Form 709)

Lines 4 and 5

To compute the tax for the amount on line 3 (to be entered on line 4) and the tax for the amount on line 2 (to be entered on

Table for Computing Gift Tax

Column A	Column B	Column C	Column D
Taxable amount over	Taxable amount not over—	Tax on amount in Column A	Rate of tax on excess over amount in Column A
-----	$10,000	-----	18%
$10,000	20,000	$1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	----	345,800	40%

line 5), use the *Table for Computing Gift Tax*, earlier.

Line 7

The applicable credit (formerly unified credit) amount is the tentative tax on the applicable exclusion amount. For gifts made in 2014, the applicable exclusion amount equals:

- The basic exclusion amount of $5,340,000, PLUS
- Any deceased spousal unused exclusion (DSUE) amount.

If you are a citizen or resident of the United States, you must apply any available applicable credit against gift tax. If you are not eligible to use a DSUE amount from a predeceased spouse, enter $2,081,800 on Line 7. Nonresidents not citizens of the United States may not claim the applicable credit and should enter zero on line 7.

If you are eligible to use a DSUE amount from a predeceased spouse, complete Schedule C—Deceased Spousal Unused Exclusion (DSUE) Amount and enter the amount from line 4 of that schedule on line 7 of Part 2—Tax Computation.

Determine the tentative tax on the applicable exclusion amount using the rates in *Table for Computing Gift Tax*, earlier, and enter the result on Line 7.

Line 10

Enter 20% of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977. (These amounts will be among those listed in Schedule B, column D, for gifts made in the third and fourth quarters of 1976.)

Line 13

Gift tax conventions are in effect with Australia, Austria, Denmark, France, Germany, Japan, and the United Kingdom. If you are claiming a credit for payment of foreign gift tax, figure the credit and attach the calculation to Form 709, along with evidence that the foreign taxes were paid. See the applicable convention for details of computing the credit.

Line 19

Make your check or money order payable to "United States Treasury" and write the donor's social security number on it. You may not use an overpayment on Form 1040 to offset the gift and GST taxes owed on Form 709.

Signature

As a donor, you must sign the return. If you pay another person, firm, or corporation to prepare your return, that person must also sign the return as preparer unless he or she is your regular full-time employee.

Third-party designee. If you want to allow the return preparer (listed on the bottom of page 1 of Form 709) to discuss your 2014 Form 709 with the IRS, check the "Yes" box to the far right of your signature on page 1 of your return.

If you check the "Yes" box, you (and your spouse, if splitting gifts) are authorizing the IRS to call your return preparer to answer questions that may arise during the processing of your return. You are also authorizing the return preparer of your 2014 Form 709 to:

- Give the IRS any information that is missing from your return,
- Call the IRS for information about the processing of your return or the status of your payment(s),
- Receive copies of notices or transcripts related to your return, upon request, and
- Respond to certain IRS notices about math errors, offsets, and return preparation.

You are not authorizing your return preparer to receive any refund check, to bind you to anything (including any additional tax liability), or otherwise represent you before the IRS. If you want to expand the authorization of your return preparer, see Pub. 947, Practice Before the IRS and Power of Attorney.

The authorization will automatically end three years from the date of filing Form 709. If you wish to revoke the authorization before it ends, see Pub. 947.

Disclosure, Privacy Act, and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need the information to figure and collect the right amount of tax. Form 709 is used to report (1) transfers subject to the federal gift and certain GST taxes and to figure the tax, if any, due on those transfers, and (2) allocations of the lifetime GST exemption to property transferred during the transferor's lifetime.

Our legal right to ask for the information requested on this form is found in sections 6001, 6011, 6019, and 6061, and their regulations. You are required to provide the information requested on this form. Section 6109 requires that you provide your identifying number.

Generally, tax returns and return information are confidential, as stated in section 6103. However, section 6103 allows or requires the Internal Revenue Service to disclose or give such information shown on your Form 709 to the Department of Justice to enforce the tax laws, both civil and criminal, and to cities, states, the District of Columbia, and U.S. commonwealths or possessions for use in administering their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

We may disclose the information on your Form 709 to the Department of the Treasury and contractors for tax administration purposes; and to other persons as necessary to obtain information which we cannot get in any other way for purposes of determining the amount of or to collect the tax you owe. We may disclose the information on your Form 709 to the Comptroller General to review the Internal Revenue Service. We may also disclose the information on your Form 709 to Committees of Congress; federal, state, and local child support agencies; and to other federal agencies for the purpose of determining entitlement for benefits or the eligibility for, and the repayment of, loans.

If you are required to but do not file a Form 709, or do not provide the information requested on the form, or provide fraudulent information, you may be charged penalties and be subject to criminal prosecution.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	52 min.
Learning about the law or the form	1 hr., 53 min.
Preparing the form	2 hrs., 21min.
Copying, assembling, and sending the form to the IRS	1 hr., 3 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can send us comments from www.irs.gov/formspubs. Click on "More Information" and then on "Give us your feedback." Or you can also send your comments to the Internal Revenue Service, Tax Forms and Publications Division, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send the tax form to this office. Instead, see *Where To File*, earlier.

get a secondary opinion℠:

how life settlements & policy valuations impact estate & business planning

By **Jason T. Mendelsohn** | **Ashar Group**
Secondary Market & Valuation Specialists℠

The Secondary Market for Life Insurance

The Life Settlement market has delivered more than $5.6 billion over the cash surrender value to consumers.

Government Accountability Office Report -10-775

The Life Settlement market has delivered more than $5.6 billion over the cash surrender value to consumers.

Most complex decisions in life require getting a second opinion. Assessing the needs and recommendations regarding the suitability of a client's life insurance plan is no different. The Secondary Market for Life Insurance has generated many options for consumers that are seeking alternatives to the traditional exit-strategies: lapse, surrender, or completing a 1035 exchange. Life insurance is an asset that may have considerably more value in the Secondary Market that can provide financial security or a method to fund long term care needs.

Our experienced team has created a predictable and systematic approach to uncovering the Secondary Market Value of life insurance and annuity assets. By employing proprietary analytics, current market insight, institutional funding relationships, and professional industry relationships, a policy owner can have a clear understanding of the current market value of their life insurance policy.

Prior to the credit crisis in 2008, the Secondary Market was growing at such a rapid pace that regulation was developed and enacted in over 40 states affecting 90% of the US population. The senior population continues to grow at staggering rates. According to Pew Research, "increasing numbers of seniors are relying on advisors to be their trusted resources and fiduciaries that will provide them with guidance towards decisions that impact their quality of life."

Today's market is comprised of sophisticated institutional buyers, including pension funds, private equity, reinsurers, municipalities, financial institutions, and hedge funds purchasing policies on senior clients who most often have age-related impairments and health issues. Transactions are highly transparent, involve regulation and oversight during contracting, and include multiple phases of due diligence that protect consumers' interests throughout the process.

Secondary Market Valuation Strategies - Determine Fair Market Value for Transfer or Planning Purposes

With a Secondary Market Valuation℠, (SMV℠,) advisors can finally provide the clarity and concise policy analysis clients demand with the simplicity, accuracy and trustworthy judgment with which to stake their reputation. Many feel there are outdated rules for determining the fair market value of a policy. Ashar's unique blend of industry insight, carrier intelligence, proprietary underwriting formulas, integrates into the most valuable resource for valuing a policy.

The SMV℠ can be a prudent and valuable solution in the following situations:

- Determining the fair market value of a contract
- Completing a business valuation - including Term insurance and annuities
- Transferring a policy from one entity to another
- Exiting a Split Dollar contract
- M&A or bankruptcy transactions - business insurance could have value
- Partner disputes and Buy/Sell agreements
- Marital disputes or funding care for family members

When It Works It Works – Success Story For The Right-Fit Client

A life settlement is not always the best solution for a senior client, but when it is, there is no mistaking it. Please review the following:

Client	Cash Value	Secondary Market Value
Female 81	$48,000	$1,100,000
$3,000,000 Universal Life *No longer needed as much coverage for planning purposes due to changes in the estate tax exclusion amount.*		
Male 74	$0	$125,000
$750,000 Term policy *Retiring and no longer needed "key-man" policy*		

Want to see if your clients' policy qualifies?
Take our Policy Value Quiz at **www.ashargroup.com/quiz/**

What is the Ideal Policy For Most Buyers?

Over $4.5 Billion of policies lapse annually on insureds 70 and older.

Determining the transfer value provides attractive options for your clients:

1. All types of policies can be exchanged for a lump sum, including Term
2. Retain a portion of coverage and eliminate future premium payments
3. Convert a policy to fund Long-Term Care as a qualified Medicaid spend-down

continued >

continued

What is the Ideal Policy For Most Buyers?

Factors considered when calculating the value:

1 Premium costs and policy values
2 Insurance carrier rating and face amount
3 Health of the insured

The Life Settlement Option: A 100 Year Precedent

A life settlement is the sale or assignment of an existing life insurance policy to a third party institutional investor for an immediate cash payment in excess of the cash surrender value. The new policy owner pays all premiums and receives the future benefit. Some investors may offer an alternative to a cash settlement, in which the client retains a portion of the death benefit, without paying any future premiums.

The Government Accountability Office found insureds that completed a life settlement received on average 7 times more than the cash surrender value.

Government Accountability Office Report -10-775

The basis for today's life settlement transaction stems from the 1911 court case where the United States Supreme Court ruled in Grigsby v. Russell (222 U.S. 149) that a life insurance policy becomes the personal private property of the owner following its issuance and may be assigned to any person at the owner's discretion.

Who Represents Whom In A Life Settlement Transaction?

willing buyer | willing seller

In the Secondary Market, there are two sides to a life settlement transaction: the seller (policy owner) and the buyer. The seller is represented by his or her advisors, which include the life settlement brokerage firm. Their objective is to represent the seller, by producing the most competitive offers while relying on best execution principles. Providers represent the purchaser, whose primary concern is receiving the highest rate of return. In most states, licenses are required to represent the sellers and buyers of policies. Many states require a minimum of a life insurance license as well as a separate and specific life settlement license when representing a policy owner.

Why Are Institutional Investors Attracted to this Asset Class?

During the financial meltdown, insurance carriers performed better than banks from a credit-risk perspective.

As the senior population continues to grow there are more sophisticated investors entering the Secondary Market. This asset class is not directly correlated to the equity markets. Pension funds and municipalities view life settlements as a method by which they can receive competitive returns while overcoming pension shortfalls. One example of this occurred in 2010 when the Oregon Investment Council (OIC) approved a proposal to commit $100 million to Apollo Global Management to purchase a life settlement portfolio. OIC oversees investments for the Oregon state pension fund, and is just one of several public pension fund administrators pursuing investments in life settlements.

Summary and Next Steps

The decision to value a life insurance asset has become integral to the overall planning process. How can recommendations be made without exploring the unrealized asset that could be worth more to a client than their entire equity or real estate portfolio?

Integrating the Secondary Market ValuationSM (SMVSM) into mainstream planning can assist both advisors and their clients. The process is simple and efficient, with essentially no downside to the client besides taking the time to have their policy reviewed. In fact, many advisors feel that it's the prudent thing to do when protecting and growing the wealth of their clients.

A qualified Secondary Market partner can prescreen policies both medically and financially, saving advisors and clients' months of work. This is critical in setting the most accurate target offer that both the seller and buyers can agree upon. This approach strengthens advisor-client relationships and avoids entering a lengthy process that delivers unproductive results. In a market where many companies aren't able to provide the technical analytics that advisors and client require, and instead are essentially guessing at market values, our team provides a more sophisticated and reliable level of due diligence and accuracy.

To see if your client's policy qualifies, take our **Policy Value Quiz** at **www.ashargroup.com/quiz**

Contact Information

To learn more about the Secondary Market ValuationSM or to discuss a potential life settlement opportunity, please contact Ashar Group at **1-800-384-8080** and visit our website at **www.ashargroup.com**

ashar group SECONDARY MARKET & VALUATION SPECIALISTS

we help premier advisors appraise, negotiate & monetize their client's life insurance & annuity assets

JOINT REPRESENTATION OF SPOUSES IN ESTATE PLANNING

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602-285-5000
October 22, 2015

It is well established that, generally, a lawyer can represent spouses jointly with respect to their estate planning.

The Rules of Professional Conduct governing lawyers require satisfaction of specific conditions, especially compliance with Rule 1.7. Arizona follows the Model Rule 1.7 with a slight deviation (disclosed below). An important component to such a joint representation is to effectively address the material issues in the engagement letter with the spousal clients.

MODEL RULES OF PROFESSIONAL CONDUCT: 1.7: CONFLICT OF INTEREST: CURRENT CLIENTS

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing. **(NOT IN ARIZONA's RPC)"**

WHAT ARE THE IMPORTANT GROUND RULES?

- Does the lawyer represent the spouses jointly or separately? ACTEC commentary says either is possible. Typically the representation is joint.

> - SPECIAL SITUATION FOR SEPARATE REPRESENTATION AND SELECTED NONDISCLOSURE OF INFORMATION: **Spouses are divorcing, and there is an unraveling of the joint estate plan** and the need to create separate estate plans. Again the engagement letter should address the issues and knowing waivers should be obtained.

- Does the lawyer agree not to disclose information learned from one from the other? This may be a bad idea that can get a lawyer into an ethical nightmare. The better approach is that lawyer should state at the outset that material information learned from one may be disclosed to the other by the lawyer.

- Lawyer can withdraw if the spouses' interests further diverge.

- Separate property of a spouse. There is an inherent conflict of interest if separate property is transmuted to community property. Observe care with use of automatic conversion to community property clauses in a joint living trust. Consider the following language to negate such unexpected conversion:

> The transfer of property to the Trusts created hereunder shall not transmute any property or change the ownership of the property as separate or community unless otherwise provided by the transferor Settlor.

- The firm that represented a spouse in a prenuptial agreement should not thereafter represent the spouses jointly without carefully considering the consequences if there is a subsequent divorce or negotiation between the spouses. Perhaps as important, the lawyer should advise the client that he or she may lose the the right to confidentiality of discussions between the lawyer and the client about the agreement.

IN WHAT CAPACITY DOES THE LAWYER REPRESENT A SPOUSE?

- If there are trusts or entities involved, the lawyer should consider if representation of more than one person might create a conflict of duties of loyalty owed to a trustee and to a spouse of the trustee. *In the Matter of the Estate of Shano*,[1] an Arizona appellate court held that a lawyer who had represented a woman client in filing a holographic Will, and then represented another as special administrator in opposing distributions to and claims of the spouse of the decedent, was found to not exercise independent judgment to avoid a conflict of interest. The lawyer was found to have had a conflict of interest and was denied attorney's fees in the fiduciary representation. Part of the reasoning revolved around the fact that the property subject to the administration was in part the community interest of the spouse, which heightened the concern. The court did note:[2]

> Common representation of persons having similar interests is proper if the risk of adverse effect on those persons is minimal and the attorney complies with the provisions of ER 1.7(b). ER 1.7 comment (Conflicts in Litigation).

The take away from *Shano* is to consider potential conflicts if there are persons acting other than in their individual capacities. This is normally not an additional factor if the joint trust is revocable and the settlors are the trustees, because all duties of the trustees remaineowed solely to the spouses.[3]

CONFLICT SITUATIONS TO ANTICIPATE IN A JOINT REPRESENTATION:

The following describes a couple of potential conflict situations. Of course, other situations can arise that implicate conflicts of interests.

[1] 869 P.2d 1203 (1993).
[2] Id at 1210.
[3] A.R.S. Section 14-10603(A).

Rueschenberg v. Rueschenberg:[4] A spouse held a separate business interest at marriage. It appreciated substantially after marriage. Thereafter a marital dissolution proceeding ensued. The special master appointed by the trial court found that a substantial portion of the appreciation was due to post-marriage community effort. There was specific evidence that the non-owner spouse was the manager of the business until the spouses separated. The court held that two-thirds of the appreciation was community property, which was affirmed by the appellate court.

Does the result possibly depend upon whether the non-owner spouse provides the community effort? Would the result be different if only the owner spouse was involved in the business after marriage?

The interests of the business owner spouse and the other spouse are adverse with respect to the effect of community effort on separate business property. This does not preclude joint representation, but it is one more fact the estate planning lawyer may address.

Austin v. Austin:[5] The effectiveness of a partnership agreement entered into between spouses was held to a "clear and convincing evidence" standard that applied to post-nuptial agreement enforcement. The standard is set so as to insure that spouses who waive or release rights do so knowingly. The following is from the opinion:

> "Finally, Josiah contended at oral argument that application of *Harber's Estate* in this context would result in the need for separate counsel for both spouses before creating trusts or other complex estate documents, which would burden the delivery of legal services. **To the extent that separate property is transferred to the community estate, or even significant limitations are placed on separate property, lawyers have always had to consider whether joint representation is possible or nonconsentable.** *See, e.g.,* ER 1.7, Ariz. R. Prof'l Conduct, Ariz. R. Sup. Ct. 42. Even if separate counsel is deemed necessary to ensure the independence and loyalty of counsel's advice, it preserves "essential elements in the lawyer's relationship to a client." *Id.* at cmt. 1. Although we do not see our holding as an expansion of *Harber's Estate*, if there is an increase in independent legal advice, it will be for a permissible and laudable purpose.

[4] 196 P.3d 852 (Ariz. App. 2008).
[5] No. 2 CA-CV 2014-0134 (April 30, 2015).

> "In sum, the mere use of a limited liability company to effectuate changes to the property rights of spouses does not transmute such an agreement into an arm's-length business transaction as Josiah suggests. The trial court did not err in applying the requirements in *Harber's Estate* to the facts of the instant case. **Because the operating agreements were made during Valer and Josiah's marriage and altered each spouse's property rights in the event of death, the ECH operating agreements meet the definition of a postnuptial agreement**. Therefore, the requirements of *Harber's Estate* apply. *See* 104 Ariz. at 88, 449 P.2d at 16. The court did not err when it required Josiah **to demonstrate by clear and convincing evidence** that Valer was aware of the property subject to the arbitration provision or advised of the effect of the arbitration provision, or her rights therein."

Estate planners should consider this case when preparing an asymmetrical plan of spouses.

> For example, in year 1, husband contributes property into a trust for wife, and in year 2, wife contributes different property into another trust for husband, and a partition of community property preceded the activity. Does the partition, the trust creation, and the funding constitute a postnuptial agreement for purposes of determining enforceability?

SPOUSAL JOINT REPRESENTATION ENGAGEMENT LETTER: SAMPLE PROVISION -

> The Firm agrees, and you authorize the Firm, to represent you jointly as described above. Because our representation is joint, we owe each of you a duty to advise you with respect to material issues of fact relevant to the representation that come to our attention. **On the other hand, because we are representing you jointly, any information relevant to the representation obtained from one of you may not be kept confidential from the other.** If we come to believe that your interests are adverse or either of you believes your interests are adverse in any material way or manner, then we may determine that we can no longer represent either or both of you, and

we reserve the right to withdraw from such representation. It is understood that our Client for the purpose of this representation is you, and not any other entities or individuals.

CONCLUSION:

In most cases, estate planners can represent spouses jointly, enhancing efficiency and with effectiveness. However, specific situations may make such representation challenging or a basis to set aside certain planning.

Source material:

From AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL (ACTEC):

ACTEC COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT

MRPC 1.7: CONFLICT OF INTEREST: CURRENT CLIENTS

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

* * * * * * * * * * * * * * *

ACTEC COMMENTARY ON MRPC 1.7

General Nonadversary Character of Estates and Trusts Practice; Representation of Multiple Clients. It is often appropriate for a lawyer to represent more than one member of the same family in connection with their estate plans, more than one beneficiary with common interests in an estate or trust administration matter, co-fiduciaries of an estate or trust, or more than one of the investors in a closely held business. See ACTEC Commentary on MRPC 1.6 (Confidentiality of Information). In some instances the clients may actually be better served by such a representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations. The fact that the estate planning goals of the clients are not entirely consistent does not necessarily preclude the lawyer from representing them: Advising related clients who have somewhat differing goals may be consistent with their interests and the lawyer's traditional role as the lawyer for the "family". Multiple representation is also generally appropriate because the interests of the clients in cooperation, including obtaining cost effective representation and achieving common objectives, often clearly predominate over their limited inconsistent interests. Recognition should be given to the fact that estate planning is fundamentally nonadversarial in nature and estate administration is usually nonadversarial.

Disclosures to Multiple Clients. Before, or within a reasonable time after, commencing the representation, a lawyer who is consulted by multiple parties with related interests should discuss with them the implications of a joint representation (or a separate representation if the lawyer believes that mode of representation to be more appropriate and separate representation is permissible under the applicable local rules). See ACTEC Commentary on MRPC 1.6 (Confidentiality of Information). In particular, the prospective clients and the lawyer should discuss the extent to which material information imparted by either client would be shared with the other and the possibility that the lawyer would be required to withdraw if a conflict in their interests developed to the degree that the lawyer could not effectively represent each of them. The information may be best understood by the clients if it is discussed with them in person and also provided to them in written form, as in an engagement letter or brochure. As noted in the ACTEC Commentary on MRPC 1.2 (Scope of Representation and Allocation of Authority Between Client and Lawyer), a lawyer may represent co-fiduciaries whose interests do not conflict to an impermissible degree. A lawyer who represents co-fiduciaries may also represent one or both of them as beneficiaries so long as no disabling conflict arises.

Before accepting a representation involving multiple parties a lawyer may wish to consider meeting with the prospective clients separately, which may allow each of them to be more candid and, perhaps, reveal conflicts of interest.

Existing Client Asks Lawyer to Prepare Will or Trust for Another Person. A lawyer should exercise particular care if an existing client asks the lawyer to prepare for another person a will or trust that will benefit the existing client, particularly if the existing client will pay the cost of providing the estate planning services to the other person. If the representation of both the existing client and the new client would create a significant risk that the representation of one or both clients would be materially limited, the representation can only be undertaken as permitted by MRPC 1.7(b). In any case, the lawyer must comply with MRPC 1.8(f) and should consider cautioning both clients of the possibility that the existing client may be presumed to have exerted undue influence on the other client because the existing client was involved in the procurement of the document.

Joint or Separate Representation. **As indicated in the ACTEC Commentary on MRPC 1.6 (Confidentiality of Information), a lawyer usually represents multiple clients jointly.** However, some experienced estate planners regularly represent husbands and wives as separate clients. They also undertake to represent other related clients separately with respect to related matters. Such representations should only be undertaken with the informed consent of each client, confirmed in writing. See ACTEC Commentaries on MRPC 1.0 (e)) (defining "informed consent") and MRPC 1.0 (b) (defining "confirmed in writing"). The writing may be contained in an engagement letter that covers other subjects as well.

From ATTORNEY'S LIABILITY ASSURANCE SOCIETY (ALAS):

Section 2 Conflicts of Interest

2.1 Representation of Husband and Wife

Lawyers owe their clients a duty of undivided loyalty. That requires a lawyer representing multiple clients to exercise special care in recognizing and dealing with any incongruities between their interests. When a lawyer represents a husband and wife in preparing an estate plan, as lawyers frequently do, special attention is needed to identify any conflicts and to ensure that both clients receive the lawyer's best efforts. This representation may not ordinarily be "directly adverse" within the meaning of Model Rule 1.7(a)(1), but it could present a "significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client." Model Rule 1.7(a)(2).

The situation can be significantly complicated when one spouse provides information to the lawyer with a direction that it is not to be shared with the other spouse. The information can vary from a desire to benefit one child over others, to an undisclosed prior marriage or illegitimate child, to the existence of an extramarital relationship. Sections 3.1 and 3.2 below address confidentiality concerns in greater detail, but we are told by practitioners that this is one of their most frequent and vexing challenges.

Examples of the different interests that even happily married couples may have include how to treat children from prior marriages, whether to characterize particular property as separate or community, and whether gifts should be made outright or in trust. Often, couples will agree on all these things at the time the will is executed, but failure to document the agreement clearly can come back to haunt the lawyer. These differing interests often arise in second or third marriages.

Comment [27] to Model Rule 1.7 recognizes the possible conflicts but offers limited guidance:

> [C]onflict questions may arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may be present. … In order to comply with conflict of interest rules, the lawyer should make clear the lawyer's relationship to the parties involved.

Restatement Third, The Law Governing Lawyers § 130, Comment *c* (2000), provides a fuller discussion of how conflicts can arise in representing multiple parties, like husband and wife:

c. Assisting multiple clients with common objectives, but conflicting interests. When multiple clients have generally common interests, the role of the lawyer is to advise on relevant legal considerations, suggest alternative ways of meeting common objectives, and draft instruments necessary to accomplish the desired results. Multiple representations do not always present a conflict of interest requiring client consent (see § 121). For example, in representing spouses jointly in the purchase of property as co-owners, the lawyer would reasonably assume that such a representation does not involve a conflict of interest. A conflict could be involved, however, if the lawyer knew that one spouse's objectives in the acquisition were materially at variance with those of the other spouse.

...

Clients might not fully understand the potential for conflict in their interests as the result of ignorance about their legal rights, about possible alternatives to those that the clients have considered prior to retaining the lawyer, or about the uncommunicated plans or objectives of another client. In other situations, prospective clients might agree on objectives when they first approach the common lawyer, but it should be reasonably apparent that a conflict is likely to develop as the representation proceeds. A client's right to communicate in confidence with the attorney should not be constrained by concern that discord might result (cf. § 75). A lawyer is not required to suggest or assume discord where none exists, but when a conflict is reasonably apparent or foreseeable, the lawyer may proceed with multiple representation only after all affected clients have consented as provided in § 122.

We agree that a lawyer need not assume that every husband-wife representation involves a conflict. Still, based on years of claims experience, we have always advised beginning every joint representation, including one involving a husband and wife, with a discussion of the ground rules for the joint representation. This discussion should include a warning that confidences from either client and any other information relevant to the joint representation will be shared with both clients (*see* Section 3.1 below); discussion of the possibility that a conflict could develop during the course of the representation; and a plan for how the lawyer will proceed in the event a conflict does develop. The lawyer should send a letter to both clients confirming the discussion of these ground rules and the clients' agreement to them. Many lawyers who have encountered unexpected conflicts during husband-wife representations have learned the value of following this procedure at the outset of every joint representation, even where the likelihood of a conflict initially seems remote. *Smith v. Hastie*, 626 S.E.2d 13 (S.C. Ct. App. 2005), provides a cautionary illustration. A lawyer had jointly represented both spouses in estate planning. The wife sued the lawyer, alleging that the lawyer did not explain the ground rules of joint representation to the couple and did not probe into any existing conflicts between the couple, who had previously engaged in marital counseling. While the trial court had granted summary judgment for the lawyer on claims of negligence and breach of fiduciary duty, the appellate court reversed and remanded those claims for trial.

TAB 2

Non-Qualified Stock and More

The Bottom Line on Top-Hat Compensation

By
Stephen R. Smith

Allow me start with this piece with a fairly obvious, dare I say, entirely unassailable observation: Corporate executives make a lot of money. I know – ***Shocking!*** But what does "*a lot of money?*" According to an Equilar/Associated Press study, the median total direct compensation for Chief Executive Officers ("CEOs") at S&P 500 companies in 2013 was $10.5M. For a slightly broader view, consider direct compensation in 2013 for *Russell 3000* Chief Executive Officers which is reflected in the chart below.[1] *Total Direct Compensation* includes salary, other cash incentives, and grant-date value of stock and option awards in a fiscal year.

Market Cap Group	Total Direct Compensation ($)		
	25th Percentile	Median	75th Percentile
1	818,767	1,349,278	2,299,465
2	1,779,375	3,053,776	4,743,986
3	4,637,262	7,251,698	11,127,000

Needless to say, litigating a divorce between a corporate executive and his/her spouse will likely involve complicated issues of income and asset identification, valuation, and division. So the obvious question for the divorce practitioner representing a corporate executive or his spouse is "What should I be looking for?" This article will begin by identifying and defining several types of qualified and non-qualified components found in corporate executive compensation packages. The second section will discuss discovery procedures and tools to identify where to look to determine which of these elements are included in the compensation

[1] "*Executive Compensation Index,*" Economic Research Institute - March 2015. (Group 1 - Small Cap: less than $750 million (1,093 companies); Group 2 - Medium Cap: $750 million to $4 billion (1,086 companies); Group 3 - Large Cap: greater than $4 billion (820 companies).

package of the executive spouse. Then finally, we will address strategies for dividing the community portion of such assets and the potential tax implications related thereto.

I.
ELEMENTS OF CORPORATE COMPENSATION

Certain elements of the corporate executives' compensation are relatively easy to identify and value. Typically, high level executives will have an employment contract that defines the specifics of his/her current base salary, periodic bonuses (discretionary or nondiscretionary), and other benefits such as health insurance, life insurance, and qualified pension and profit-sharing plans. These elements of the executive's compensation are relatively straightforward, fairly easy to identify. They also usually constitute the smaller portion of highly compensated executives' pay packages. For many highly compensated executives, the lion's share of their compensation comes in the form of stock options and nonqualified deferred compensation (deferred stock, deferred investments, cash, or a combination thereof). These nonqualified plans are often referred to as "*Top-Hat plans.*"

Qualified v. Nonqualified

So when we're talking about "qualified" versus "nonqualified" deferred compensation, what exactly do we mean? *Nonqualified deferred compensation* means compensation that is paid through a plan or plans which do not meet the qualification requirements under Section 401(a) of the Internal Revenue Code (26 U.S. Code § 401) and which are free from the constraints of the Employee Retirement Income Security Act of 1974 ("ERISA") and other federal rules and regulations. Such nonqualified deferred compensation benefits do not afford the same tax advantages available to the corporate entity as qualified plans, such as a "401(k)." However, such nonqualified deferred compensation plans are not constrained by the contribution limits and testing required under the IRC and ERISA, meaning that corporations can provide much greater financial benefit to a limited number of key employees and executives.

Nonqualified deferred compensation plans are used by business entities for a variety of reasons including, but not necessarily limited to:

- Attracting and retaining senior management;
- As a supplement to pension benefits for highly compensated executives to bypass federal limits;

- As a pension supplement to attract key employees who will suffer a reduction in overall retirement plan benefits because of a midcareer or late-career employment change;
- To enhance early retirement programs or "golden parachute plans";
- As a substitute for equity incentive plans in closely held corporations;
- As a tool for attracting and compensating members of a corporation's board of directors;

Simply put, the biggest reason that companies will use nonqualified stock options and deferred compensation plans is so that they can provide substantial benefits to key personnel or highly compensated employees of the company without the limitations created by the Code. Qualified deferred compensation plans such as 401(k)s must comply with a number of IRC mandated qualifications, including that the "***contributions and benefits***" under such plan may not "***discriminate in favor of highly compensated employees***." So the reality is that companies will utilize nonqualified plans so that they *can discriminate* in favor of top level executives and key personnel.

Types of Nonqualified Benefits

A. Deferred Compensation

Simply put, a deferred compensation arrangement is, in essence, an agreement to delay payment of amounts otherwise owed to an employee until a later date. The employee's objective in such arrangements is to ensure that he/she will be taxed, generally at ordinary income rates, when and as such payments are received. With such a plan, employees may be able effectively to delay taxation and to reduce the rate of such taxation. The corporate objectives in adopting such plans are to offer an incentive to key employees and to ensure deductibility of the compensation payments when they are actually paid.

B. Stock Appreciation Rights (SARs)

A stock appreciation right ("SAR") is a contractual right granted by a corporate employer which entitles the employee to receive, either in cash or in stock of the employer, the appreciation in the value of the employer's stock over a certain period of time. For example, Corporation X issues to CEO 1,000 SARs. Each SAR entitles CEO to receive the appreciation in one share of the employer's stock between the issuance date and the exercise date. If the price of Corporation X's stock on the issuance date is $10.00 per share and the price per share increases to $20.00 per share on the exercise date, CEO would be entitled to receive $10,000 in cash or 500 shares of Corporation X stock. Typically, SARs provide that if not exercised by a specific date, they will expire.

C. Phantom Stock Plan

The term "phantom stock plan" generally refers to a long-term incentive program which grants employees "units" equivalent to the actual shares of a company's stock. These units are often referred to as "phantom stock." Phantom stock is a contractual agreement between a corporation and recipients of phantom shares that bestow upon the grantee the right *to a cash payment* at a designated time or in association with a designated event in the future, which payment is to be in an amount tied to the market value of an equivalent number of shares of the corporation's stock. As with any incentive based compensation, the amount of the payout will increase as the stock price rises, and decrease if the stock price falls, but without the grantee actually receiving any stock. Phantom stock plans are non-qualified compensation arrangements and do not involve the actual issuance of stock or securities by the company. These plans allow key executives, employees, or directors to participate in the growth of a company, without adding actual additional shareholders.

D. Restricted Stock Plans

Restricted stock means just that - stock which is awarded to an employee under various types of “vesting” restrictions and conditions. Under a restricted stock plan, a corporation (usually through its Board of Directors) determines to whom and at what price restricted stock is to be issued. The stock restrictions are conditioned on the employee's continued service to the company over a specific number of years (or other criteria, such as meeting performance objectives). At the completion of each year of service or at the end of the specified period, a portion or all of the employee's shares become unrestricted stock owned by the employee.

E. Incentive Stock Options

Boiled down to its bare essence, a stock option is simply the granting of the right to an employee to purchase a certain number of shares of the corporation’s stock at a pre-established price (the “*Strike Price*.”) *Incentive stock options* (ISOs) are stock options issued by a corporate employer which meet the requirements of §422 of the IRC. (A discussion of those requirements is beyond the scope of this article.) Generally, stock options are granted to employees at a price which is greater than the market price of the corporate stock on the date of the grant. Said option therefore creates the “incentive” for the employee to work hard and improve the market value of the company, thus raising the value of the stock option.

F. Non-Qualified Stock Options

Options that do not meet the requirements of an ISO under IRC § 422, are called nonqualified stock options (NQSO). Nonqualified stock options do not enjoy the same favorable tax treatment that incentive stock options do. NQSOs tax treatment is governed by IRC §83. Under the code, the tax consequences to the employee and the corporation depend on a determination of when the option has a “readily ascertainable” fair market value. Under the Regulations, the option has a readily ascertainable fair market value at the time it is granted only if traded on an exchange. In those rare cases where the option has a "readily ascertainable fair market value," the option holder realizes income either (1) when his right in the option becomes transferable or (2) when his right in the option is not subject to a substantial risk of forfeiture. In essence, the difference between and ISO and an NQSO is that an ISO only triggers a taxable event when it is exercised, whereas an unexercised NQSO could still create a taxable event if it is “transferable” (i.e., vested and/or unrestricted) and is not subject to forfeiture or loss.

II.

Identifying the Elements of a Corporate Executive’s Compensation: The Discovery Process

So where does a lawyer look to find out what a particular executive’s compensation package looks like? Federal securities laws require that publicly traded companies issue clear, concise and understandable disclosure about compensation paid to CEOs, CFOs and certain other high-ranking executive officers. Several types of documents that a company files with the SEC and are therefore public record contain information about the company's executive compensation policies and practices. For example, you can locate information about the very top level executives’ pay in:

(1) The company's annual proxy statement;

(2) The company's annual report on Form 10-K; and

(3) Registration statements filed by the company to register securities for sale to the public.

In the annual proxy statement, a company must disclose information concerning the amount and type of compensation paid to its chief executive officer, chief financial officer and no fewer than the three other most highly compensated executive officers. A company also must disclose the criteria used in reaching executive compensation decisions and the relationship between the company's executive compensation practices and corporate performance. [2]

Attached hereto as Appendix A are a couple of examples of *Executive Compensation Summary Tables* from corporate proxy statements for *Apple, Inc.* and *Ford Motor Company*. These summary tables, which are mandated to be included in the proxy statement, condense the entire compensation package for, at a minimum, the 5 most highly compensated executives (including the chief executive officer and chief financial officer) for every publicly traded corporation. These tables are intended to reflect every form of compensation paid to by the executives including cash salary and bonuses, stock or other equity awards, non-equity incentive compensation, and the value of any other form of compensatory benefit that the executive receives. Proxy statements are a great starting point for information regarding the executive divorce litigant.

But what if the executive doesn't work for a publicly traded company or is not one of the five highest paid executives? Just because a company isn't publicly held doesn't mean that it can't be very large. Each year, Forbes magazine publishes a list of the largest private companies in the world. The 2014 list includes companies like Mars ($33 Billion in revenue), Dell Computer ($52B), and Koch Industries ($115B). Privately held companies including C corporations, S corporations, and limited liability companies often utilize nonqualified deferred compensation tools to compensate their highly paid executives. Because these companies are privately held, they are not necessarily required to publish the same types of information that publicly traded companies must. When dealing with these types of companies, the best source of information is going to be the company itself.

[2] http://www.sec.gov/answers/execomp.htm

Whether the company is publicly traded or privately held, a well drafted subpoena to the corporate entity is likely to be the best method for obtaining detailed information regarding the compensation package of the spouse. Under the Arizona Rules of Family Law Procedure, the executive spouse is, of course, obligated to disclose any and all information and details regarding his employment compensation and benefits. But relying solely on the disclosure from an opposing party is a dangerous proposition. I routinely issue subpoenas to employers even when the opposing side has indicated they are willing to provide complete disclosure. The role of the divorce attorney should be to *trust but verify* the information provided by the opposing party. Issuing a well drafted subpoena to the spouse's employer is simply a step in the *trust-but-verify* process. (Attached as Appendix B is a copy of a standard form document request for an employment subpoena.)

III.

Division Strategies and Tax Traps

Once you have identified the scope of the executive spouse's compensation benefits, you must then address how to appropriately divide or allocate them in the context of the divorce. Often in the case of highly compensated individuals, the marital community has amassed a sizable estate consisting of readily liquid assets (cash, publicly traded securities, etc.) as well as not so liquid assets (real estate and other investments/holdings) which can be used to offset employment benefits held in the name of the employee spouse.

For example, assume that the executive spouse has a compensation package which includes $3M in restricted stock, options, and deferred compensation. Also assume that the parties personally hold $10M of other assets, which include a couple of homes, a stock portfolio, and interests in a few closely held LLC's. In such a situation, the employment assets can be assigned to the executive spouse with a like assignment of $3 million of comparable assets to the nonemployee spouse, with the remainder of the community estate divided between the parties. Of course, detailed analysis is required to ensure that you are trading apples for apples, but with publicly traded or long-established companies which are unlikely to have substantial short-term gains or losses in their stock value, such an arrangement is likely feasible and equitable.

But what if the executive spouse works for a startup company in which he has been awarded substantial stock, options, or other equity benefits that could potentially increase dramatically in value. In this situation, it may be more beneficial to the nonemployee spouse to receive her actual share in such equity assets rather than receive other offsetting assets. Equity positions in rapid growth or startup companies can often be like a lottery ticket - the shares could end up being worth a substantial sum, or they could end up being worth nothing. Awarding such equity assets to the employee spouse could therefore be remarkably unfair to him/her (if the company tanks) or remarkably unfair to the nonemployee spouse (if the company ends up being the next Facebook or Google.) In these situations, the best result for the nonemployee spouse is to actually receive a share of the options or stock, or at least receive the beneficial interest in the options or stock. Methods for such division are discussed below.

Tax Treatment of Incentive Compensation

Internal Revenue Code § 1041 generally provides that divorce-related transfers of property are tax-free and that the transferee spouse takes such property with a carryover basis from the transferor spouse. It applies to nearly all kinds of property commonly transferred in a divorce, such as houses, cars, investments, etc.

Revenue Ruling 2002-22 (See Appendix C) provides that, if *vested options* are transferred in connection with a divorce, the transfer constitutes a transfer of property under Section 1041. The transfer of vested stock or unrestricted stock also falls under the umbrella of section 1041. Thus, transferring vested options or stock is not a taxable event, so the transferee spouse receives the stock options at the same basis as the employee spouse held them (which in the event of an un-exercised incentive stock option is a zero basis). When the transferee spouse exercises the option, he/she realizes income equal to the spread between the option strike price and exercise price. In other words, from a tax perspective, the nonemployee spouse who receives a vested option or a share of unrestricted stock simply steps into the employee spouse's shoes. For reporting and withholding purposes, the employer reports the income upon exercise by the non-employee spouse on a 1099-MISC and makes supplemental withholding at the appropriate rate.

Often, employees will exercise options and then immediately sell the underlying stock. This is frequently a cash free transaction whereby the employee "borrows" the strike price from the employer and then repays the borrowed funds out of the sales proceeds from the sale of the underlying stock. If the corporate option agreement allows for transfers of options to a non-employee former spouse, said transferee spouse can likewise execute a cashless exercise of the options. The end result is that the transferee/nonemployee spouse receives a check equal to the spread between the value of the stock and strike price reduced by supplemental withholding (at the appropriate flat rate), as well as a reduction for employment tax withholding (which is generally calculated on the transferor/employee's wages).

For example, assume that employee X gets divorced and at the time, holds an option to buy 100 shares of Employer's stock for $50 a share. Assume also that the corporate stock plan allows the transfer of the options to a nonemployee spouse. Nonemployee spouse elects, one year later, to exercise her 50 shares at a sale price of $100. The cashless transaction results in a gross benefit to the nonemployee spouse of $2500. (50 shares X the $50 spread between the strike price of $50 and the sale price of $100.) The Corporation issues a check to the nonemployee spouse, after appropriate withholdings.

While the *income tax burden* should always be borne by the transferee/non-employee spouse on her exercise of options, potential complications arise from the *employment tax burden* for such options. Normally, that tax is calculated by reference to the *employee spouse's W-2 wages*. Well drafted marital settlement agreements should make clear that, despite this problem, the transferee/nonemployee spouse bears the burden *of all taxes* resulting from exercise of an option.

Unvested Benefits

While Revenue Ruling 2002-22 clarified the treatment of *vested* options, it explicitly exempted unvested rights. Therefore, it does not apply to transfers of nonstatutory stock options and other nonqualified compensation such as unfunded deferred comp rights or other future income rights (SARs, RSUs, Phantom Stock, etc.) Any employment benefits that are unvested at the time of transfer or to which the transferor's rights are subject to substantial contingencies at the time of the transfer do not necessarily get the benefit of section 1041 protection. *See, e.g., Kochansky v.Commissioner*, 92 F.3d 957 (9th Cir. 1996).

This carve-out applies to unvested stock options (which are specifically mentioned in RR2002-22), and also to restricted stock because these "future income rights" are unvested at the time of transfer. This suggests that if unvested rights or nonqualified benefits are transferred in connection with a divorce, the transferor/employee spouse could remain liable for the tax upon the subsequent taxable event. For example, in *Kochansky*, a personal injury lawyer transferred half of an unmatured contingent fee to his spouse who later collected half of the fee when the case was settled. An issue arose as to whether WIFE was responsible for the taxes on her gross portion of the fee that she received. The Ninth Circuit held that the lawyer, not his transferee spouse, was liable for the tax on the transferee spouse's share. Care must be taken in crafting settlement documents to make sure the parties are acknowledging the potential tax implications. Language should always be included that requires indemnification of the employee spouse by the non-employee spouse in the event the taxing authority disavows the spouses' agreed-upon tax arrangement.

Further confusing the "vested v. unvested issue), a 2010 IRS private letter ruling (2010-16-031), held that restricted stock transferred pursuant to a divorce was taxable to the transferee spouse "upon vesting." (See Appendix D[3].) This appears totally inconsistent with *Kochansky*. The private letter ruling addresses Revenue Ruling 2002-22 but does not mention the ruling's carve-out for unvested rights. The Private Letter Ruling's conclusion was the result desired by the parties, and the divorce decree explicitly provided that (i) the parties intended "a result consistent with RR2002-22" and (ii) the transferee spouse was "responsible for paying all costs attributable to [the transferee's] allocation of restricted stock, including taxes other than [employment] taxes." The Private Letter Ruling seems to imply the RR2002-22 approach will apply all equity compensation items transferred in connection with a divorce whether vested or not. However, private letter rulings ***do not constitute binding precedent on the IRS*** except with regard to the particular taxpayers to whom they are issued.

Division/Allocation

There exists a lack of clarity regarding how the IRS will treat allocation of vested equity benefits as opposed to nonqualified and unvested equity benefits. So how can the careful practitioner best handle this problem? The safest, most obvious approach would be to avoid transferring unvested and non-qualified assets altogether. If an equitable distribution can be accomplished by transferring only non-compensation items and vested assets, then the risk is avoided. Delaying the entry of the divorce settlement for a short period of time to allow pending benefits to vest could be beneficial in some cases.

[3] IRS Private Letter Rulings are available to the public at: http://apps.irs.gov/app/picklist/list/writtenDeterminations.html

You can also seek a private letter ruling from the IRS, such as the one addressed above. This will likely involve additional time and cost, but if the stakes are significant enough, it is likely well worth the trouble. If large amounts of unvested items need to be transferred and delay is not a significant concern, the private letter ruling should be considered.

If unvested and nonqualified compensation assets must be transferred and a private letter ruling request is not feasible, the most conservative approach would be for the parties to agree that the transferor spouse will report the income and employment tax resulting from the future taxable event, but that the transferee spouse will bear the economic burden of the tax. To implement this structure, the parties would use a constructive trust whereby the employee spouse retains legal title to the unvested items for the benefit of the nonemployee spouse. This option may be the only option available with certain companies that absolutely prohibit any transfer of unvested benefits to a former spouse. (See Appendix E for sample language regarding such a constructive trust.)

In the case of stock options, the employee spouse would agree to exercise the options and sell the underlying stock at the direction of the non-employee spouse and then pay the after-tax proceeds to him/her. This approach has a number of attractive features. First, the tax treatment is most consistent with Revenue Ruling 2002-22's explicit carve-out of unvested assets. Second, as mentioned above, some employers preclude or discourage employees from transferring unvested compensation items in divorce making a constructive trust a necessity. Finally, because legal title to the items remains in the hands of its employee and the eventual tax consequences are reported on the employee's W-2, the employer's procedures for tax reporting are unaffected.

Constructive trust arrangements should always include some technical provisions to ensure that the parties receive the results that they expect. As mentioned above, the spouses must agree to indemnify one another in the event the IRS disallows the planned tax treatment anticipated by the parties' settlement. This will ensure neither spouse is double taxed on the item and no one receives a windfall.

Second, to calculate the after-tax payments that go to the transferee spouse upon vesting or exercise, <u>*the transferor's effective marginal tax rate*</u> needs to be determined. Since the rate will be known with accuracy only after the end of a taxable year and because withholding rates may differ from a taxpayer's ultimate marginal tax rate, a stipulated or assumed rate can be used. For high-income earners, the highest effective marginal federal income and employment tax rate approaches 50% (39.5% Federal, plus 3% Obama Care/Medicare, and anywhere from 4% to 8% state tax). It must also be noted that future tax law changes could make an agreed rate obsolete in the future. There are two advantages to using a stipulated or assumed tax rate instead of determining the actual tax rate on an ex post basis. First, it gives both parties clarity as to the amount of taxes to be withheld upon each transfer of money from the transferor spouse to the transferee spouse. Second, using a stipulated rate avoids the need for the transferor spouse to periodically share his or her post-dissolution tax returns with the former spouse for the purpose of determining the actual effective marginal tax rate. In the event that a stipulated tax rate cannot be negotiated, then the parties can agree to exchange tax documents and to make true up payments after the end of the year once the actual marginal tax rate is calculated.

CONCLUSION

Great care must be taken when representing highly compensated corporate executives or their spouses in a marital dissolution matters. The complexities of equity and incentive compensation, as well various potential forms of non-qualified benefits and deferred compensation, create a vast minefield of potential tricks and traps that must be understood and avoided. Moreover, potential concerns regarding tax treatment of unvested or deferred benefits must be carefully analyzed and addressed.

APPENDIX A

Executive Compensation Tables

Summary Compensation Table—2014, 2013, and 2012

The following table shows information regarding compensation of each named executive officer for 2014, 2013 and 2012, except in the cases of Mr. Maestri and Ms. Ahrendts, who were not named executive officers in 2013 and 2012.

Name and Principal Position (a)	Year (b)	Salary ($)(c)	Bonus ($)(d)	Stock Awards (1) ($)(e)	Non-Equity Incentive Plan Compensation (2) ($)(f)	All Other Compen-sation ($)(g)	Total ($)(h)
Tim Cook	2014	1,748,462	—	—	6,700,000	774,176(3)	9,222,638
Chief Executive Officer	2013	1,400,006	—	—	2,800,000	52,721	4,252,727
	2012	1,357,718	—	—	2,800,000	17,274	4,174,992
Luca Maestri Senior Vice President, Chief Financial Officer	2014	717,211	—	11,335,043	1,608,255	342,292(4)	14,002,801
Peter Oppenheimer	2014	947,596	—	—	3,437,500	132,624(5)	4,517,720
Former Senior Vice President,	2013	866,061	—	—	1,750,000	16,791	2,632,852
Chief Financial Officer	2012	805,400	—	66,169,750	1,600,000	16,412	68,591,562
Angela Ahrendts Senior Vice President, Retail and Online Stores	2014	411,538	500,000	70,001,196	1,648,352	790,038(6)	73,351,124
Eddy Cue	2014	947,596	—	20,000,900	3,437,500	59,743(7)	24,445,739
Senior Vice President,	2013	866,061	—	—	1,750,000	31,044	2,647,105
Internet Software and Services	2012	805,400	—	47,975,262	1,600,000	39,753	50,420,415
Jeff Williams	2014	947,596	—	20,000,900	3,437,500	17,239(8)	24,403,235
Senior Vice President,	2013	866,061	—	—	1,750,000	16,791	2,632,852
Operations	2012	805,400	—	66,269,800	1,600,000	16,412	68,691,612

(1) The grant date fair value for time-based RSUs is measured based on the closing fair market value of the Company's common stock on the date of grant. The grant date fair value for performance-based RSUs is calculated based on a Monte-Carlo valuation of each award on the date of grant, determined under FASB Topic 718. Assuming the highest level of performance is achieved under the applicable performance conditions, the maximum possible value of the performance-based RSUs granted to the named executive officers in 2014, using the grant date fair value, is: (i) in the case of Mr. Maestri, $3,468,490; (ii) in the case of Ms. Ahrendts, $26,401,560; (iii) in the case of Mr. Cue, $16,001,386; (iv) and in the case of Mr. Williams, $16,001,386. For a description of the assumptions and

Executive Compensation

COMPENSATION OF EXECUTIVE OFFICERS

The table below shows the before-tax compensation for Mark Fields, who served as President and CEO from July 1, 2014, Robert L. Shanks, who served as Executive Vice President and Chief Financial Officer during 2014, and the three most highly compensated executive officers at the end of 2014 and Alan Mulally, our former President and CEO.

SUMMARY COMPENSATION TABLE

(a) Name and Principal Position	(b) Year	(c) Salary ($)	(d) Bonus [1] ($)	(e) Stock Awards [2] ($)	(f) Option Awards [2] ($)	(g) Non-Equity Incentive Plan Compensation [3] ($)	(h) Change in Pension Value and Nonqualified Deferred Compensation Earnings [4] ($)	(i) All Other Compensation [5] ($)	(j) Total ($)
Mark Fields	2014	1,662,500	0	3,412,489	6,249,994	3,185,000	3,647,336	439,178	18,596,497
President and Chief	2013	1,537,500	996,000	3,637,492	1,249,995	2,604,000	0	145,591	10,170,578
Executive Officer	2012	1,385,833	1,301,250	1,000,994	1,099,995	1,038,750	2,900,420	126,823	8,854,065
Robert L. Shanks	2014	798,750	267,450	2,183,995	799,995	732,550	1,454,163	83,743	6,320,646
Executive Vice President	2013	772,500	0	1,745,994	599,999	875,000	14,339	81,789	4,089,621
and Chief Financial Officer	2012	700,000	227,500	818,998	899,999	562,500	1,908,803	64,048	5,181,848
William Clay Ford, Jr.	2014	2,000,000	0	4,777,493	1,749,996	910,000	4,427,336	1,245,870	15,110,695
Executive Chairman	2013	2,000,000	560,000	5,092,491	1,749,997	1,120,000	0	1,433,341	11,955,829
	2012	2,000,000	375,000	3,184,990	3,499,999	750,000	3,257,519	1,768,505	14,836,013
Joseph R. Hinrichs	2014	936,250	135,000	2,183,995	799,995	910,000	1,048,145	79,245	6,092,630
Executive Vice President	2013	853,750	126,800	1,745,994	599,999	963,200	0	120,206	4,409,949
and President — The Americas	2012	782,917	0	682,493	750,000	660,000	840,218	381,527	4,097,155
James D. Farley, Jr.	2014	868,750	0	1,979,244	724,994	800,000	0	121,776	4,494,764
Executive Vice President	2013	843,750	0	1,745,994	599,999	955,000	0	116,482	4,261,225
and President — Europe, Middle East & Africa	2012	707,500	181,000	682,493	750,000	474,000	0	1,802,024	4,597,017
Alan Mulally	2014	1,000,000	0	10,237,495	3,749,994	3,185,000	0	3,869,639	22,042,128
Former President and	2013	2,000,000	1,960,000	10,912,488	3,749,996	3,920,000	0	662,050	23,204,534
Chief Executive Officer	2012	2,000,000	1,325,000	6,824,998	7,499,999	2,625,000	0	680,809	20,955,806

1 The amounts shown for 2012 reflect discretionary bonus awards paid in 2013 for 2012 performance; amounts shown for 2013 reflect discretionary bonus awards paid in 2014 for 2013 performance; and amounts shown for 2014 reflect discretionary bonus awards paid in 2015 for 2014 performance (see Compensation Discussion and Analysis — Incremental Bonuses on pp. 51-52).

2 The amounts shown in columns (e) and (f) reflect the aggregate grant date value computed in accordance with FASB ASC Topic 718 for stock-based and option awards for each of the Named Executives for the years ended December 31, 2014, 2013, and 2012. The assumptions used for the 2014, 2013, and 2012 calculations can be found at Note 19 to our audited financial statements in Ford's Annual Report on Form 10-K for the year ended December 31, 2014; Note 20 to our audited financial statements in Ford's Annual Report on Form 10-K for the year ended December 31, 2013; Note 22 to our audited financial statements in Ford's Annual Report on Form 10-K for the year ended December 31, 2012, respectively. Pursuant to SEC rules, we disregarded the estimate of forfeitures related to service-based vesting conditions.

APPENDIX B

You are commanded to produce at the above place and date true and exact copies of the following information pertaining to your employee JOHN SMITH, Social Security Number xxx-xx-_____, date of birth ________. Said information shall be for the time period from the date of hire through the date of your response to this Subpoena Duces Tecum.

1. All earning statements, including wage and tax statements, income statements, W-2 forms, W-4 forms, 1099 forms, periodic check stubs, payroll records, commission statements, bonus statements, overtime statements, and all other documentation relating to all income of any kind or nature earned by JOHN SMITH. This information must include documentation pertaining to deferral of all past, present or future income of any kind, whether such income has been paid or is being held for any reason.

2. All documents of the entire employee file for JOHN SMITH, accumulated from the date of hire through the date of your response to this Subpoena Duces Tecum, including, but not limited to: All information pertaining to evaluation reports, contracts, any type of agreement(s) to purchase business interest, resumes, letters, requests for job change, promotions, demotions, garnishment of wages actions, liens of any kind, memorandums or any other written document contained in said file.

3. All documentation outlining all requests or negotiations for any different position(s) within your organization as requested by JOHN SMITH or JOHN SMITH's superiors, together with information as to any schooling or other educational pursuits by JOHN SMITH.

4. All documents pertaining to office expenses, office supplies, services, cellular telephone, insurances, automobile or other such expenses of any kind billed to or on behalf of JOHN SMITH.

5. All available benefits and the costs therefore including, but not limited to:

a) medical benefits including the medical plan;

b) dental benefits including the dental plan;

c) stock options, warrants, restricted stock, restricted stock units, stock appreciation rights, and/or stock purchase plans of any nature. For such benefits, please provide detailed information including, but not limited to all written stock agreements, option agreements, or other written materials detailing the nature of any and all equity plans in which the employee participates;

d) life insurance benefits;

e) accumulated sick leave benefits, accumulated vacation benefits, accumulated compensatory time benefits, and the like; and

f) any and all other benefits associated with the employment of JOHN SMITH.

Said information shall be provided for any such benefits offered, whether or not accepted or exercised, and shall include any minimum or maximum commitment requirements (such as a one year minimum commitment to remain on health insurance benefits) related thereto. The explanation of charges for such benefits shall include benefits for the employee alone and for family benefits (such as insurance).

6. All information regarding COBRA health insurance conversion, including any application for COBRA benefits, premium information and the like.

7. The following information regarding participation by JOHN SMITH in any profit-sharing plan(s), pension plan(s), defined contribution plan(s) (including 401(k), 403(b), etc), employee savings plans, salaried employees thrift plan, defined benefit plans, deferred compensation plan, or any and all other type(s) of retirement benefits:

A. Copy of the plan documents(s) and summary plan description(s);

B. Copies of the three (3) most recent annual participant statements;

C. Date of hire and date of participation in plan(s);

D. Whether or not there are any breaks in service for JOHN SMITH under the plan(s); and

E. Copy of predecessor or prior plan(s), if any.

8. All statements, reports, or valuations prepared by any actuarial firm or pension administrator for any plan for all years in which JOHN SMITH has been a participant.

APPENDIX C

Rev. Rul. 2002-22 (IRS RRU), 2002-19 I.R.B. 849, 2002-1 C.B. 849, 2002 WL 881644

Internal Revenue Service (I.R.S.)

IRS RRU
Revenue Ruling

GROSS INCOME; TRANSFERS OF PROPERTY INCIDENT TO DIVORCE

Released: May 08, 2002
Published: May 13, 2002

Section 83.--Property Transferred in Connection With Performance of Services, *26 CFR 1.83-7: Taxation of nonqualified stock options.*
***1** A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

Section 1041.--Transfers of Property Between Spouses or Incident to Divorce, *26 CFR 1.1041-1T: Treatment of transfer of property between spouses or incident to divorce.*
A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

Section 61.--Gross Income Defined, *26 CFR 1.61-1: Gross income.*
Gross income; transfers of property incident to divorce. A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse. Rev. Rul. 87-112 clarified.

Gross income; transfers of property incident to divorce. A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

ISSUES

(1) Is a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce required to include an amount in gross income upon the transfer?

(2) Is the taxpayer or the former spouse required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse?

FACTS

Prior to their divorce in 2002, *A* and *B* were married individuals residing in State *X* who used the cash receipts and disbursements method of accounting.

A is employed by Corporation *Y.* Prior to the divorce, *Y* issued nonstatutory stock options to *A* as part of *A*'s compensation. The nonstatutory stock options did not have a readily ascertainable fair market value within the meaning of § 1.83-7(b) of the Income Tax Regulations at the time granted to *A*, and thus no amount was included in *A*'s gross income with respect to those options at the time of grant.

Y maintains two unfunded, nonqualified deferred compensation plans under which *A* earns the right to receive post-employment payments from *Y*. Under one of the deferred compensation plans, participants are entitled to payments based on the balance of individual accounts of the kind described in § 31.3121(v)(2)-1(c)(1)(ii) of the Employment Tax Regulations. By the time of *A*'s divorce from *B*, *A* had an account balance of $100x under that plan. Under the second deferred compensation plan maintained by *Y*, participants are entitled to receive single sum or periodic payments following separation from service based on a formula reflecting their years of service and compensation history with *Y*. By the time of *A*'s divorce from *B*, *A* had accrued the right to receive a single sum payment of $50x under that plan following *A*'s termination of employment with *Y*. *A*'s contractual rights to the deferred compensation benefits under these plans were not contingent on *A*'s performance of future services for *Y*.

Under the law of State *X*, stock options and unfunded deferred compensation rights earned by a spouse during the period of marriage are marital property subject to equitable division between the spouses in the event of divorce. Pursuant to the property settlement incorporated into their judgment of divorce, *A* transferred to *B* (1) one-third of the nonstatutory stock options issued to *A* by *Y*, (2) the right to receive deferred compensation payments from *Y* under the account balance plan based on $75x of *A*'s account balance under that plan at the time of the divorce, and (3) the right to receive a single sum payment of $25x from *Y* under the other deferred compensation plan upon *A*'s termination of employment with *Y*.

In 2006, *B* exercises all of the stock options and receives *Y* stock with a fair market value in excess of the exercise price of the options. In 2011, *A* terminates employment with *Y*, and *B* receives a single sum payment of $150x from the account balance plan and a single sum payment of $25x from the other deferred compensation plan.

LAW AND ANALYSIS

Section 1041 and the assignment of income doctrine

Section 1041(a) provides that no gain or loss is recognized on a transfer of property from an individual to or for the benefit of a spouse or, if the transfer is incident to divorce, a former spouse. Section 1041(b) provides that the property transferred is generally treated as acquired by the transferee by gift and that the transferee's basis in the property is the adjusted basis of the transferor.

Section 1041 was enacted in part to reverse the effect of the Supreme Court's decision in *United States v. Davis*, 370 U.S. 65 (1962), which held that the transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims was a taxable event resulting in the recognition of gain or loss to the transferor. *See* H.R. Rep. No. 432, 98 th Cong., 2d Sess. 1491 (1984). Section 1041 was intended to "make the tax laws as unintrusive as possible with respect to relations between spouses" and to provide "uniform Federal income tax consequences" for transfers of property between spouses incident to divorce, "notwithstanding that the property may be subject to differing state property laws." *Id.* at 1492. Congress thus intended that § 1041 would eliminate differing federal tax treatment of property transfers and divisions between divorcing taxpayers who reside in community property states and those who reside in non-community property states.

The term "property" is not defined in § 1041. However, there is no indication that Congress intended "property" to have a restricted meaning under § 1041. To the contrary, Congress indicated that § 1041 should apply broadly to transfers of many types of property, including those that involve a right to receive ordinary income that has accrued in an economic sense (such as interests in trusts and annuities). *Id.* at 1491. Accordingly, stock options and unfunded deferred compensation rights may constitute property within the meaning of § 1041. *See also* *Balding v. Commissioner*, 98 T.C. 368 (1992) (marital rights to military pension treated as property under § 1041).

Although § 1041 provides nonrecognition treatment to transfers between spouses and former spouses, whether income derived from the transferred property and paid to the transferee is taxed to the transferor or the transferee depends upon the applicability of the assignment of income doctrine. As first enunciated in *Lucas v. Earl*, 281 U.S. 111 (1930), the assignment of income doctrine provides that income is ordinarily taxed to the person who earns it, and that the incidence of income taxation may not be shifted by anticipatory assignments. However, the courts and the Service have long recognized that the assignment of income doctrine does not apply to every transfer of future income rights. *See, e.g.*, *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970); *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974), *cert. denied*, 419 U.S. 826 (1974); Rev. Rul. 80-198 (1980-2 C.B. 113). Moreover, in cases arising before the effective date of § 1041, a number of courts had concluded that transfers of income rights between divorcing spouses were not voluntary assignments within the scope of the assignment of income doctrine. *See Meisner v. United States*, 133 F.3d 654 (8th Cir. 1998); *Kenfield v. United States*, 783 F.2d 966 (10th Cir. 1986); *Schulze v. Commissioner*, T.C.M. 1983-263; *Cofield v. Koehler*, 207 F. Supp. 73 (D. Kan. 1962).

In *Hempt Bros., Inc. v. United States*, the court concluded that the assignment of income doctrine should not apply to the transfer of accounts receivable by a cash basis partnership to a controlled corporation in a transaction described in § 351(a), where there was a valid business purpose for the transfer of the accounts receivable together with the other assets and liabilities of the partnership to effect the incorporation of an ongoing business. The court reasoned that application of the assignment of income doctrine to tax the transferor in such circumstances would frustrate the Congressional intent reflected in the nonrecognition rule of § 351(a). Accordingly, the transferee, not the transferor, was taxed as it received payment of the receivables. In Rev. Rul. 80-198, the Service adopted the court's position in *Hempt Bros.*, but ruled that the assignment of income doctrine would nonetheless apply to transfers to controlled corporations where there was a tax avoidance purpose.

Similarly, applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as *Meisner* that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.

Specific provisions governing nonstatutory stock options

Section 83(a) provides, in general, that if property is transferred to any person in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property is included in the gross income of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. In the case of nonstatutory stock options that do not have a readily ascertainable fair market value at the date of grant, § 83 does not apply to the grant of the option, but applies to property received upon exercise of the option or to any money or other property received in an arm's length disposition of the option. *See* § 83(e) and § 1.83-7(a).

Although a transfer of nonstatutory stock options in connection with a marital property settlement may, as a factual matter, involve an arm's length exchange for money, property, or other valuable consideration, it would contravene the gift treatment prescribed by § 1041 to include the value of the consideration in the transferor's income under § 83. Accordingly, the transfer of nonstatutory stock options between divorcing spouses is entitled to nonrecognition treatment under § 1041.

When the transferee exercises the stock options, the transferee rather than the transferor realizes gross income to the extent determined by § 83(a). Since § 1041 was intended to eliminate differing federal tax treatment for property transferred or divided between spouses in connection with divorce in community property states and in non-community property states, § 83(a) is properly applied in the same manner in both contexts. Where compensation rights are earned through the performance of services by one spouse in a community property state, the portion of the compensation treated as owned by the non-earning spouse under state law is treated as the gross income of the non-earning spouse for federal income tax purposes. *Poe v. Seaborn*, 282 U.S. 101 (1930). Thus, even though the non-employee spouse in a non-community property state may not have state law ownership rights in nonstatutory stock options at the time of grant, § 1041 requires that the ownership rights acquired by such a spouse in a marital property settlement be given the same federal income tax effect as the ownership rights of a non-employee spouse in a community property state. Accordingly, upon the subsequent exercise of the nonstatutory stock options, the property transferred to the non-employee spouse has the same character and is includible in the gross income of the non-employee spouse under § 83(a) to the same extent as if the non-employee spouse were the person who actually performed the services.

The same conclusion would apply in a case in which an employee transfers a statutory stock option (such as those governed by § 422 or 423(b)) contrary to its terms to a spouse or former spouse in connection with divorce. The option would be disqualified as a statutory stock option, see §§ 422(b)(5) and 423(b)(9), and treated in the same manner as other nonstatutory stock options. Section 424(c)(4), which provides that a § 1041(a) transfer of stock acquired on the exercise of a statutory stock option is not a disqualifying disposition, does not apply to a transfer of the stock option. *See* H.R. Rep. No. 795, 100th Cong., 2d Sess. 378 (1988) (noting that the purpose of the amendment made to § 424(c) is to "clarif[y] that the transfer of stock acquired pursuant to the exercise of an incentive stock option between spouses or incident to divorce is tax free").

CONCLUSION

Under the present facts, the interests in nonstatutory stock options and nonqualified deferred compensation that *A* transfers to *B* are property within the meaning of §1041. Section 1041 confers nonrecognition treatment on any gain that *A* might otherwise realize when *A* transfers these interests to *B* in 2002. Further, the assignment of income doctrine does not apply to these transfers. Therefore, *A* is not required to include in gross income any income resulting from *B*'s exercise of the stock options in 2006 or the payment of deferred compensation to *B* in 2011. When *B* exercises the stock options in 2006, *B* must include in income an amount determined under § 83(a) as if *B* were the person who performed the services. In addition, *B* must include the amount realized from payments of deferred compensation in income in the year such payments are paid or made available to *B.* The same conclusions would apply if *A* and *B* resided in a community property state and all or some of these income rights constituted community property that was divided between *A* and *B* as part of their divorce.

This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer. *See Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996). Transfers of certain types of property incident to divorce, the tax consequences of which are governed by a specific provision of the Code or regulations (for example, § 402, 408, 414, 424, or 453B) are not affected by this ruling.

HOLDINGS

(1) A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer.

(2) The former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

PROSPECTIVE APPLICATION

The Service will apply § 7805(b) and assignment of income principles to treat income as gross income of the transferor and not of the transferee if--

(i) The income is attributable to an interest in nonstatutory stock options, unfunded deferred compensation rights, or other similar intangible property rights;

(ii) The options or rights were transferred from one party to a divorce to the other party to the divorce;

(iii) The transfer was required by a provision of an agreement or court order;

(iv) The provision was contained in the agreement or order before November 9, 2002; and

(v) (a) The agreement or court order specifically provides that the transferor must report gross income attributable to the transferred interest, or

(b) It can be established to the satisfaction of the Service that the transferor has reported the gross income for federal income tax purposes.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 87-112 (1987-2 C.B. 207) which deals with the treatment of transfers of United States savings bonds between spouses or former spouses, is clarified by eliminating references to assignment of income principles. As so clarified, the ruling is reaffirmed respecting the application of § 454 and the regulations thereunder to the transfer and the determination of the transferee's basis.

FURTHER INFORMATION

For further information or questions regarding § 61 or 1041, contact Edward Schwartz of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622-4960. For further information or questions regarding § 83, 402, 408, 414, 422, 423, 424, or 453B, contact Erinn Madden of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622-6030. These are not toll-free calls.

APPENDIX D

Internal Revenue Service Department of the Treasury
Washington, DC 20224
Number: **201016031**
Release Date: 4/23/2010
Index Number: 83.00-00

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

Telephone Number:

Refer Reply To:
CC:TEGE:EB:EC
PLR-133864-09
Date:
January 15, 2010
Legend
X = --------------------
Company = ---
State A = ----------------
Date 1 = -------------------
Date 2 = --------------------------
Date 3 = ----------------------
Date 4 = -----------------------
a = -----
b = -----
c = ----
Dear -----------------:

This letter responds to your request for a private letter ruling regarding the treatment of stock transferred to you pursuant to a divorce decree. The facts represented in your request follow.

You and your spouse, X, were married and resided in State A, a non-community property state. On Date 1, a shares of restricted stock were issued to X by Company, X's employer, as compensation for the performance of services. The restricted stock is held by X in X's name and is non-transferable in accordance with the terms of Company's Equity Compensation Plan. On Date 2, you and X were divorced by a decree ordered by the State A Superior Court.

The division of restricted stock occurred in the context of a judicial proceeding and was formalized in the divorce decree and associated Memorandum of Decision of the Superior Court (together referred to as the "divorce decree"). Pursuant to the divorce decree, you are entitled to receive an allocation of X's restricted stock awards as well as any dividends or dividend equivalents attributable to your allocation of X's PLR-133864-09 2 restricted stock awards. More specifically, you are entitled to c% of the shares of Company restricted stock issued to X on Date 1.

Pursuant to the terms of the divorce decree, you and X intend that the transfer of the restricted stock constitute a transfer incident to a divorce in accordance with Section 1041 of the Internal Revenue Code (Code) and not a taxable event for either you or X. The divorce decree further provides that you and X intend a result consistent with Revenue Ruling 2002-22, 2002-1 C.B. 849, and Revenue Ruling 2004-60, 2004-1 C.B. 1051. The divorce decree also provides that the restricted stock shall be divided as part of the property settlement and shall not be alimony or child support. In accordance with the terms of the divorce decree, you will be responsible for paying all costs attributable to your allocation of the restricted stock, including taxes other than Medicare and Social Security taxes.

After the divorce decree was issued and until the restricted stock vested, the restricted stock remained in the name of X. On Date 3, a shares of restricted stock vested and became transferable. On Date 4, the stock issued to X on Date 1 was divided, and b shares were allocated to you and placed in a brokerage account under your name.

Your request asks for rulings that: (1) the division of the restricted stock after vesting is not a taxable event and (2) the income attributable to the vesting of your allocation of the restricted stock on Date 3 is includible in your gross income, regardless of whether Company reports such income on a form 1099-MISC filed on your behalf, and all subsequent tax consequences with respect to the stock will be yours.

Section 83(a) of the Code provides, in general, that if property is transferred to any person in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property is included in the gross income of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Section 1041 of the Code provides, in part, that no gain or loss shall be recognized on a transfer of property from an individual to a former spouse, but only if the transfer is incident to the divorce. Incident to divorce is defined in section 1041(c) as a transfer of property within one year after the date on which the marriage ceases or a transfer of property that is related to the cessation of the marriage.

In Rev. Rul. 2002-22, individuals A and B were married and resided in a noncommunity property state. During the marriage, Corporation Y granted nonstatutory stock options to A. Pursuant to a property settlement incorporated into their divorce, A transferred one-third of the options to B. B exercised all of the options, and received Y stock with a fair market value in excess of the exercise price of the options. The ruling PLR-133864-093 concludes that the options are property within the meaning of section 1041, and it explains that section 1041 confers nonrecognition treatment on any gain that A may otherwise realize when A transfers the options to B. Under the ruling, A is not required to include in gross income any income resulting from B's exercise of the options. When B exercises the options, B must include in income an amount determined under section 83(a) as if B were the person who performed the services. The ruling further provides that the same conclusions would apply if A and B resided in a community property state and all or some of the options constituted community property that was divided between A and B as part of their divorce.

In light of the specific provisions of the divorce decree in this case, and the other relevant facts, we rule as follows:

1. The division of the restricted stock occurred in the context of a judicial proceeding that was formalized in a divorce decree and is therefore a nontaxable event under section 1041.
2. The income attributable to the vesting of the restricted stock is includible in your gross income for federal income tax consequences, and all subsequent tax consequences with respect to such stock will be yours.

A copy of this letter should be attached to any of your income tax returns to which it is relevant.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a properly executed penalty of perjury statement. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely yours,
THOMAS D. SCHOLZ
Assistant Branch Chief
Executive Compensation Branch
Office of Division Counsel/Associate
Chief Counsel (Tax Exempt and
Government Entities)

APPENDIX E

AGREEMENT RELATED TO STOCK OPTIONS

This Agreement shall implement those provisions of that certain Decree of Divorce entered by the Court in Case No. FC200X-XXXXXX on October XX, 200X, as it relates to American Express Stock Options and Restricted Stock Awards (hereinafter, cumulatively, the "Stock Options") and the taxation related thereto, and shall be binding upon the Parties as of the last date that either of the Parties executes this Agreement. While the Decree of Divorce calls for the division of those Options "in general," the specific and accurate division of those options is set forth in an Attachment to this Agreement, which shall be referred to herein as "the Attachment".

Wife is awarded 50% of the Stock Options reflected in column B, to the extent that such Stock Options are vested at this time or vest in the future under the terms of such Stock Options. If Husband shall cease employment and by doing so forfeit any of the Stock Options not yet vested at that time, each Party shall lose their unvested share of such Stock Options in equal shares.

As soon as practicable after Wife requests in writing that Husband exercise any of the Options (or provide her with her share of Restricted Stock Awards that are then non Restricted) awarded to her in the Attachment, Husband shall exercise those Options on her behalf by the method made available by his employer. The "method" referred to above is, in brief, that the Company's agent calculates the difference between the price of the Option on the grant date and the price of the exercised Stock on the exercise date, and pays Husband the gross difference between those figures (herein "the Proceeds"), less tax withholding, in good funds. If at any time any other method of exercise becomes necessary, this Agreement shall require modification, and in such circumstance, both parties hereby consent to such future modification.

Wife may request her share of fully vested Restricted Stock Awards at any time they have fully vested and to the extent that this generates taxable income to the Husband, the same method of accounting for taxation as described below shall be applied.

When Wife, in writing, causes Husband to exercise any of "her" Options (or provide her with "her" share of any Restricted Stock Awards that has become non Restricted) Husband shall timely tender to Wife, from the Proceeds of such exercise, the reciprocal percentage of his own estimated average aggregate Federal and State tax rate for that given year (his "Rate", as shall be determined in good faith by Husband at that time) times the Proceeds. (In the case of the Restricted Stock, Husband shall tender the stock itself.)

In any year following a calendar year in which Husband has exercised any of Wife's Options on her behalf, Husband shall make an accounting to Wife, no later than April 30 of the year following such year, of the exact Federal and State Income tax he was required to pay as a result of the exercise of Options assigned to Wife. If, at that time, Husband's tax obligation created by Wife's exercise is determined to have been less than that which was estimated at the time of the exercise of the Options, Husband shall timely pay any excess portion of the proceeds to Wife. If, at that time, Husband's tax obligation is determined to be greater than the amount estimated, Wife shall timely pay to Husband that amount necessary to reimburse Husband for the prior overpayment.

At such time, Wife shall have the right to demand, for the purposes of audit, only, that Husband tender his prior tax returns to Wife's licensed tax professional (Qualified Attorney or

C.P.A.). and such professional shall have the right to examine the return to see if the tax obligation has been calculated correctly. Wife's professional shall keep Husband's tax returns, and their contents, confidential from Wife unless a Court Order is obtained to the contrary or by Stipulation of both Parties.

Husband shall exercise any dominion and control granted by this paragraph of this Order in a Fiduciary manner, and shall be held to such standard. Wife shall keep Husband advised, at all times, of her mailing address. Husband shall keep Wife advised, at all times, of his mailing address, and shall further provide Wife with copies of any and all Plan materials provided to him which might, in any way, affect Wife's rights or opportunities, all in the manner of a prudent fiduciary.

<u>PENALTY CLAUSE:</u> *If at any time any of the Options remaining from those equitably assigned to Wife are due to expire in less than 10 trading days (on the exchange on which such securities are normally traded), and if at that time Wife has failed to notify Husband in writing that she wishes to exercise such Options, Husband may exercise such Options for his own benefit, without recourse or claim from Wife.*

<u>DEATH PROVISION:</u> To the extent permissible by the Plan, if either Party shall die prior to the exercise or expiration of all Stock Options equitably awarded to Wife in the Attachment, the remaining Stock Options equitably awarded to Wife in the Attachment, on the date of such persons death, shall inure to the benefit of the remaining Party, without compensation to the deceased party, their heirs, estate or assigns.

To the extent this Agreement clarifies and may even Amend the Parties' Decree, despite the fact that the Decree has been Entered by the Court, the terms of this Agreement shall prevail in any dispute which may exist subsequent to the date of this Agreement.

The Superior Court of Arizona shall have jurisdiction to resolve any conflict which may arise as a result of this Agreement.

TAB 3

Avoiding QDRO Malpractice

and the

Power of the Time Rule

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QUALIFIED DOMESTIC RELATIONS ORDERS: AVOIDING MALPRACTICE

Legal Malpractice

Legal malpractice involving a QDRO typically occurs when the matrimonial attorney fails to recognize one or both of the following issues:

- Timing
- Notice

Overview of Qualified Domestic Relations Orders ("QDROs"): A QDRO is a court order created by federal law ("ERISA") that assigns retirement benefits or provides support to a *spouse, former spouse, child, or other dependent* ("Alternate Payee") in connection with a state's marital property laws. Congress enacted the QDRO provisions in 1984 under the Retirement Equity Act ("REAct") to protect the rights of an Alternate Payee. Although created by federal law, state law determines the *substance* of the award.

Discovery Rule for Legal Malpractice in Arizona

A malpractice claim against a family law attorney will usually sound in tort. *See* A.R.S. § 12-542, below. Arizona follows a discovery rule for legal malpractice. *See Best Choice Fund, LLC v. Low & Childers,* P.C., 269 P.3d 678 (Ariz.Ct.App. 2011). That means, that a cause of action does *not* accrue until the plaintiff knows, or should have known, of the defendant's conduct.

A.R.S. § 12-542

§ 12-542. Injury to person; injury when death ensues; injury to property; conversion of property; forcible entry and forcible detainer; two year limitation

Except as provided in section 12-551 there shall be commenced and prosecuted **within two years after the cause of action accrues**, and not afterward, the following actions:

1. For injuries done to the person of another including causes of action for medical malpractice as defined in section 12-561.
2. For injuries done to the person of another when death ensues from such injuries, which action shall be considered as accruing at the death of the party injured.
3. For trespass for injury done to the estate or the property of another.
4. For taking or carrying away the goods and chattels of another.

5. For detaining the personal property of another and for converting such property to one's own use.
6. For forcible entry or forcible detainer, which action shall be considered as accruing at the commencement of the forcible entry or detainer.

<u>Legal Malpractice in Nevada and the Discovery Rule</u>

A malpractice claim against a family law attorney will usually sound in contract. *See* Nev. Rev. Stat. Ann. § 11.190, below. That means that a written breach of contract action must be commenced against a Nevada attorney within six (6) years. Importantly, Nevada follows a discovery rule for legal malpractice. That means, that a cause of action does *not* accrue until the plaintiff knows, or should have known, of the defendant's conduct. Fee agreements should be in writing. *See* Rule 1.5. Unfortunately, QDRO issues are rampant with malpractice. *See* Dietrich, *Qualified Domestic Relations Orders: Strategy and Liability for the Family Law Attorney*, §3 (2015 Ed., Matthew Bender).

Compare to No Discovery Rule such as in Virginia and New York: the statute of limitation period begins to run *when the cause of action accrues*, not when the damage is discovered. See CPLR § 214.

I. Operation of Law

Strategic Point: Operation of Law - Following a divorce a former spouse loses his or her ERISA-based retirement benefits, in connection with the marriage, by operation of law. ERISA § 206.

Practice Tip: A QDRO should be filed *concurrently* with the divorce decree. Failure to do so may result in attorney *malpractice* if the client is later denied benefits.

A. Exception: Vesting of Survivor Benefits

Strategic Point: Vesting - Survivor Benefits "ordinarily" irrevocably vest in the current spouse upon the participant's retirement. *Carmona v. Carmona*, 544 F.3d 988 (9th Cir. 2008). *See Carmona* Casenote, attached; *see also Hopkins v. AT&T Global Info. Solutions Co.*, 105 F.3d 153 (4th Cir. 1997).

Carmona Timeline of Events- Atypical

Marriage……….<u>Retirement</u>……*Divorce*………Remarriage……QDRO (current wife)

Hopkins Timeline of Events: Typical

Marriage…….*Divorce*……..Remarriage……..<u>Retirement</u>……..QDRO (former spouse)

B. Exception: Plan Documents Rule

Strategic Point: Plan Documents Rule - The United States Supreme Court recently held that an ERISA plan administrator is required to act in accordance with plan documents when determining beneficiary status. Accordingly, a plan administrator should disregard a waiver of benefits by a former spouse if that waiver conflicts with plan documents. *Kennedy v. Plan Adm'r for DuPont Sav. & Inv. Plan*, 128 S. Ct. 1225 (U.S. 2009). *See Kennedy* Lexis Expert Commentary.

ERISA's plan documents rule also preempts state law. See *Boggs v. Boggs*, 520 U.S. 833 (1997); *see also Egelhoff v. Egelhoff*, 532 U.S. 141 (2001).

Practice Tip: Kennedy reinforces the importance of estate planning following a divorce. Advise the plan participant that he or she should contact the pension plan administrator immediately to make the appropriate beneficiary designation.

II. Notice

A. Risk of Loss is the Issue: Your client must be advised of the *Risk of Loss* of not entering the QDRO concurrently with the Dissolution of Marriage

B. Develop layers of Notice

1. Fee Agreement
2. Decree
3. Closing Letter
4. Notice of Adverse Interest

Practice Tip: File your QDRO <u>concurrently</u> with your divorce decree OR at the minimum provide notice to your client about the *risk of loss*; along with notice to the plan.

Attachment 1

NOTICE OF ADVERSE INTEREST

{Attorney}

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA
IN AND FOR THE COUNTY OF MARICOPA

In re: The Marriage of: CASE NO.: FC2014-$$$$

DON TRUMP

Petitioner,

and

IVANKA TRUMP

Respondent.

____________________________________/

NOTICE OF ADVERSE INTEREST IN THE [*PLAN NAME*]

Respondent, [*NAME*], has retained the undersigned counsel for the entry of a Qualified Domestic Relations Order ("QDRO") in Connection with Participant [*NAME*] and the above identified qualified retirement plan. See attached separate addendum for social security numbers.

Certificate of Service

I HEREBY CERTIFY that a true and correct copy of the foregoing has been furnished via US mail to [p*lan name and address*] and [a*ttorney name and address*] on [*date*].

____

[a*ttorney signature*]

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Coverture Strategy: Amount of the Award

Arizona & Nevada authorize the Time-Rule. The formula is *not mandated*.

Justification for Coverture: Pension rights are contractual obligations between the employer and the employee. *Total number of years* under a pension plan is a substantial factor in computing the accrued benefit. Therefore, the marital interest is entitled to have its share based upon the length of service performed on behalf of the marital interest in proportion to the total length of service necessary to earn those benefits.

Community property states typically use the term “time rule.” Common law states use the term “coverture.” Both terms refer to the same principle. Time rule provides an alternate payee with the potential to *maximize* his or her benefit.

- Typically applies to a Defined Benefit Plan
- Does not apply to a Defined Contribution Plan since the deferrals are not linear

Practice TIP: Use as "last resort" IF you cannot trace separate property OR apply to stock options in *Hugg* and *Nelson* formulas since valuation is difficult to ascertain

Compare: What it's <u>not</u>: D U R A T I ON

- o Separate Interest Vs. Shared Interest

Decreasing Share (%) of a Growing Pie

Example #1 :

5/10 = .50 x 50% = 25%

Example #2:

2/5 = .40 x 50% = 20%

The P O W E R of Coverture

Coverture is a fractional formula that determines the AMOUNT of a Alternate Payee's award under a QDRO.

Formula/Award:

{50%} X Years Married while in
Plan

____

Total Number of Years in the Plan

X Accrued Benefit **@ <u>commencement</u>**

Time Rule Award as Expressed in a QDRO (Example):

Amount of Alternate Payee's Benefit: This Order assigns to the Alternate Payee an amount equal to 50% of the Marital Share of the Participant's vested accrued benefit under the Plan as of the Participant's commencement of benefits. The Marital Share shall be determined by multiplying the Participant's Accrued Benefit by a coverture fraction, the numerator of which is the number of months of the Participant's creditable service in the Plan earned during the marriage (from November 23, 1997 to November 5, 2004), and the denominator of which is the **number of months of service credited to the Participant.**

How to S T O P Coverture

1) Freeze: Structure award as a *frozen interest* in the plan. Allow QDRO to be entered post-decree.

Argument:

1. Plain Meaning; and QDRO is in NONCONFORMITY with the Decree.
2. The Supreme Court neither condoned nor condemed the Time-Rule formula. See *Van Loan v. Van Loan*, 569 P.2d 214, 274-275 (1977).

3. Cite *Koelsch* and use a counter weight to the Time-Rule. *Koelsch v. Koelsch*, 713 P.2d 1234 (1986).
4. Not required to use Time-Rule formula. *In re Marriage of Gray*, 155 Cal. App. 4th 504 (Cal.Ct.App. 2007)

2) PV: Place Present Value on Pension Benefit. *Koelsch.*

How Coverture Looks in a QDRO if Frozen

Frozen Award as Expressed in a QDRO (Example):

Amount of Alternate Payee's Benefit: This Order assigns to the Alternate Payee an amount equal to 50% of the Participant's vested accrued benefit under the Plan *as of* November 5, 2004.

OR (now you are a PRO)

Amount of Alternate Payee's Benefit: This Order assigns to the Alternate Payee an amount equal to 50% of the Marital Share of the Participant's vested accrued benefit under the Plan as of November 5, 2004. The Marital Share shall be determined by multiplying the Participant's Accrued Benefit by a coverture fraction, the numerator of which is the number of months of the Participant's creditable service in the Plan earned during the marriage (from November 23, 1997 to November 5, 2004), and the denominator of which is the number of months of service credited to the Participant as of November 5, 2004.

Other Views

Coverture Presumed

A few states take the middle ground on the time rule issue. Nevada, for example, uses a presumption of time rule approach. Accordingly, Nevada neither completely accepts nor rejects the time rule methodology. Nevada's presumption approach may be the most equitable since it provides relief to a party where benefit enhancements are the result of post-marriage efforts.

#Comment Begins

Strategic Point: Presumption of Time Rule—A court may retain jurisdiction to make adjustments in the assignment of retirement benefits that are a result of post- marriage efforts. *Gemma v. Gemma*, 778 P.2d 429 (Nev.1989); *see also Fondi v. Fondi*, 802 P.2d 1264 (Nev.1990).

FOCUS: In *Gemma*, the Nevada Supreme Court recognized that there are a minority of cases where the time rule would result in an "inequitable" outcome by allowing a nonemployee spouse to receive benefits based on the employee spouse's post-marriage efforts. Such post- marriage efforts include the attainment of an advance degree or unusual promotions. By retaining jurisdiction, the assigned benefit can be recalculated based on the "normal course of events." The burden of proof is on the participant to rebut the presumption of the time rule.

Coverture Prohibited

A minority of states prohibit the use of the time rule. These states reject time rule since it improperly assigns benefits that accrue *after* the divorce.

Strategic Point: Time Rule Prohibited—Retirement benefits should be assigned as of the date of divorce. *Boyett v. Boyett*, 703 So. 2d 451 (Fla.1997); *see also Shill v. Shill*, 765 P.2d 140 (Idaho 1988); *Berrington v. Berrington*, 633 A.2d 589 (Pa. 1993); *Berry* v. Berry, 647 S.W.2d 945 (Tex. 1983).

FOCUS: In *Boyett*, the Florida Supreme Court held that the assignment of retirement benefits should not include any contributions made after the date of the divorce. The Court relied on the statutory definition of marital assets under Fla. Stat. Ann. § 61.075 to support its conclusion. The *Boyett* Court also concluded that a pension plan should be valued without regard to early retirement penalties *citing Trant v. Trant*, 545 So. 2d 428 (Fla. 2nd Dist. Ct. App. 1989).

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Raymond S. Dietrich

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Qualified Domestic Relations Orders: Strategy and Liability for the Family Law Attorney
2015 Edition
Raymond S. Dietrich

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About the Author

Raymond S. Dietrich manages a multi-jurisdictional law practice specializing in the drafting and litigation of Qualified Domestic Relations Orders ("QDROs") and related issues. Mr. Dietrich has created a unique niche law practice that specializes in an area of law that is notoriously mishandled. Mr. Dietrich is licensed and actively practices law in Virginia, the District of Columbia, Florida, Arizona, Nevada, and New York. The firm's website is located at www.galleonnetwork.com.

TAB 4

Creative Ways to Analyze and Structure Settlements

JOURNAL OF THE AMERICAN ACADEMY OF MATRIMONIAL LAWYERS

This issue is devoted to:
CUTTING EDGE ISSUES IN FAMILY LAW

The Use of Trusts to Structure Divorce Settlements

by
Carlyn S. McCaffrey

Volume 27 | 2014-15 | Number 1

The Use of Trusts to Structure Divorce Settlements

by
Carlyn S. McCaffrey*

In General

When spouses divorce, one spouse will often be required to make support payments to the other. In some cases, property settlements will be provided. Funding support payments and property settlements through trusts established for that purpose may be an attractive option to both spouses.

The transferee spouse will generally prefer to look to a trustee for payment rather than to his or her former spouse. A trust will protect the transferee from any future financial problems of the former spouse or any future unwillingness to continue payments. On the other hand, in most cases, the transferor spouse would choose an unfunded obligation to make future support payments over the transfer of any significant property interest into a trust. This arrangement gives the transferor the maximum control over his or her assets. But, if the transferee spouse is demanding a lump sum property settlement as well as support payments, a transfer of property to a trust may represent an acceptable compromise. If the transferee spouse is unskilled in managing investments, a trust will provide a way for the transferor spouse to assure himself or herself that the transferred funds will be professionally managed. It will also give the transferor spouse the assurance that the transferred property (except to the extent consumed during the transferee spouse's lifetime) will ultimately pass to his or her children (or some other appropriate designee) at the death of the transferee spouse. In addition, if the separation has been acrimonious, the transferor may

 Portions of this article are derived from the manuscript of the forthcoming new edition of STRUCTURING THE TAX CONSEQUENCES OF MARRIAGE AND DIVORCE (1995), being prepared by Carlyn S. McCaffrey and John C. McCaffrey.

welcome the separation the trustee provides between him or her and the former spouse.

Part I of this article considers the income tax consequences of transfers into trusts. Part II briefly discusses the taxation of trust income. Part III alerts the reader to various gift tax traps and suggests how these traps might be avoided. Part IV shows the reader how to use trusts to implement estate freezes in connection with a divorce settlement.

I. Income Tax Consequences of Transfers to Trust

A. *In General*

The U.S. Internal Revenue Code ("I.R.C.") § 1041 provides that no gain or loss will be recognized on a transfer of property in trust for the benefit of a spouse or, if the transfer is incident to a divorce, to a trust for the benefit of a former spouse.[1] This will be so even if the transfer is in satisfaction of the transferor spouse's support obligations, his or her other marital obligations, or any other obligations.

When a transferee acquires property in a transfer to which I.R.C. § 1041(a) applies, his or her basis in the transferred property is the same as the adjusted basis in the hands of the transferor immediately before the transfer.[2] This is so whether the transferor's basis is higher than the fair market value at the time of the transfer or whether any gift tax is payable as a result of the transfer.[3]

If the purpose of the trust is to provide support or supplementary payments to the transferor's minor children, the trust may provide for payments directly to or for the benefit of the children rather than to a spouse. Since the transferor's spouse is not a beneficiary of the trust, transfers to the trust will not be protected by § 1041.

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1 References to "I.R.C." are to the Internal Revenue Code of 1986 (26 U.S.C.) (the "Code"), as amended.

2 I.R.C. § 1041(b)(2); Temp. Treas. Reg. § 1.1041-1T(d), Q&A(11).

3 *But see* I.R.C. § 1015(a) (which limits a donee's basis in gifted property to the lower of the donor's basis immediately before the transfer or the value of the property at the time of the transfer).

Arguably, such transfers should be treated as gifts for gift tax purposes, but this may not always be the result. A transfer to a trust for the support of minor children may cause gain recognition to the transferor spouse if the transfer to the trust discharges his or her obligation to support dependent children or if the transfer is to provide a reasonable allowance for the support of minor issue of the marriage within the meaning of I.R.C. § 2516.[4] If the transfer to the trust is a recognition event to the transferor, the trust will receive a fair market value basis in the trust assets.[5]

In the case of a transfer pursuant to a marital settlement agreement, it is likely that the transferee spouse will share beneficiary status with the children of the marriage. Section 1041 draws no distinction between trusts for the sole benefit of the spouse and those that have other beneficiaries, nor does it specify any minimum interest which the spouse must have for I.R.C. § 1041 to apply. The Temporary Regulations offer no clarification.

B. *Negative Basis Property*

I.R.C. § 1041(e) makes subsection (a) of § 1041 inapplicable to the transfer of property in trust to the extent that the sum of the liabilities assumed plus the amount of liabilities to which the property is subject exceeds the adjusted basis of the property transferred. The basis of the property to the transferee is increased by the amount of gain recognized.[6]

Section 1041(e) is limited to § 1041(a). It does not prevent the application of I.R.C. § 1041(b). As a result, the transferee spouse and the trust continue to be treated as having received the transferred property as a gift, and their basis in the property is determined under § 1041 rather than § 1015, adjusted to reflect the amount of gain recognized by the transferor as a result of the transfer.

<u>Example</u> - *Pat owns property having a fair market value of $1,000,000 and an adjusted basis of $10,000. Pat borrows $500,000 using the property as security in contemplation of transferring this property incident to*

---

[4] *See* St. Joseph Bank & Trust Co. v. United States, 716 F.2d 1180 (7th Cir. 1983), Spruance v. Comm'r, 60 T.C. 141 (1973), *aff'd mem.*, 505 F.2d 731 (3d Cir. 1974).

[5] I.R.C. § 1012.

[6] I.R.C. § 1041(e).

a divorce from Quinn. Pat then transfers to the trustees of a trust for Quinn and the trustees take the property subject to the liability to pay the $500,000 debt. Under I.R.C. § 1041(e), Pat recognizes gain of $490,000 on the transfer of the property and Quinn's basis in the property is $500,000.[7]

If the transfer of the interest is made to a trust for the benefit of a spouse rather than a former spouse, and if the transferee spouse's interest in the trust is sufficient to result in the treatment of the entire trust as a so-called grantor trust subject to I.R.C. § 671 (or if other trust provisions would result in the trust being treated as "owned" by the transferor within the meaning of § 671), the transfer would not result in the recognition of gain. This is so because the transferor will continue to be treated as the owner of the transferred property after the transfer.[8] When the trust ceases to be a grantor trust because of the termination of the spouse's interest or upon the spouse's death,[9] the transferor will be treated as having transferred ownership of the interest to a different taxable entity.[10] At that time, the transferor will be treated as having disposed of the interest.[11]

C. *Installment Notes*

I.R.C. § 453B(g) provides that the non-recognition provision of I.R.C. § 1041, which was made generally applicable to the disposition of installment obligations by § 453B, does not apply to the transfer of an installment obligation to a trust. As a result, a transfer of an installment obligation to a trust for the benefit of a transferor's spouse will be treated as a disposition of that obligation for purposes of § 453B.[12]

---

7 See Temp. Treas. Reg. § 1.1041-1T(d) Q&A (12) (The outcome of the example above is different from the outcome in the Temporary Regulation Q&A because in the example above the transfer is made to a trust rather than outright).

8 Rev. Rul. 85-13, 1985-1 C.B. 184. The Second Circuit reached a contrary conclusion in *Rothstein v. United States,* 735 F.2d 704 (2d Cir. 1984). The Internal Revenue Service announced its decision not to follow *Rothstein* in Rev. Rul. 85-13.

9 I.R.C. § 672(e) (Grantor trust status will not terminate merely because of the divorce of the transferor and his or her spouse).

10 Treas. Reg. § 1.1001-2(c), Ex. (5).

11 *See id.* § 1.001-2(c); Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 79-84, 1979-1 C.B. 223; Rev. Rul. 77-402, 1977-2 C.B. 222 (1977).

12 I.R.C. §§ 453B(a), (g)(1).

Unlike § 1041(e), discussed above, no other provision of § 1041 or § 453B provides for a basis adjustment to reflect the gain recognized by the transferor. A basis adjustment is necessary to prevent the imposition of an income tax twice on the same gain—first on the gain recognized by the transferor, and then on that recognized by the trust on disposition of the property.

In the case of a disposition of an installment note by gift to which I.R.C. § 1015 applies, the language of § 1015 seems to provide the necessary adjustment. I.R.C. § 1015 indicates that the transferee's basis will "be the same as it would be in the hands of the [transferor]."[13] The Internal Revenue Service (the "IRS") has ruled that this language requires that the transferor's basis take into account the gain resulting from the transfer because, if he or she held the note after the disposition, the basis would have been increased by the amount of such gain.[14]

I.R.C. § 1041(b), however, not § 1015(a), applies to a transfer of an installment note to a trust for the benefit of the transferor's spouse. The language of § 1041(b) states only that the "basis of the transferee shall be the adjusted basis of the transferor." Unlike § 1015, it does not suggest a test that looks to see what the transferor's basis would be if he or she still held the transferred property. To avoid a double tax on the same gain, the Treasury Regulations should construe § 1041(b) to require the same test as § 1015.[15]

Recognition will be avoided if the transferor transfers the installment note to a trust the terms of which result in the grantor being treated as the "owner" (within the meaning of I.R.C. § 671) of that portion of the trust consisting of the right to receive the principal of the note.[16] Since the original owner continues to be treated as the owner after the transfer, the transfer is not treated as a disposition for purposes of I.R.C. § 453B.

13 I.R.C. § 1015(a).

14 Rev. Rul. 79-371, 1979-2 C.B. 294.

15 *But cf.* Rev. Rul. 87-112, 1987-2 C.B. 207 (in which the IRS allowed the transferee spouse of E- savings bonds to increase his or her basis by the amount of income the transferor spouse recognized on the transfer).

16 Rev. Rul. 81-98, 1981-1 C.B. 40; Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 67-70, 1967-1 C.B. 106.

When the power over or interest in the trust that caused the transferor to be treated as owner is terminated, the termination will be treated as a disposition.[17]

II. Taxation of Trust Income

A. *In General*

There are two principal tax types of trusts that are likely to be used in connection with a property settlement agreement, a standard trust and a grantor trust. A trust may share the characteristics of both a standard trust and a grantor trust. If so, it will be subject to the rules applicable to both types of trusts.

A detailed discussion of the manner in which each of these different kinds of trusts is treated for income tax purposes is beyond the scope of this article. A brief summary is provided below since some knowledge of how the trust tax rules work is necessary to an understanding of the tax consequences of using trusts in connection with a divorce or separation.[18]

B. *Standard Trusts*

1. *Rates*

The tax rates imposed on the income of a standard trust are set forth in the table that appears in I.R.C. § 1(e). The table provides five different brackets, a 15% bracket, a 25% bracket, a 28% bracket, a 33% bracket and a 39.6% bracket. The tax rate table applicable to trusts is the most steeply progressive of the five different tax tables that are provided in I.R.C. § 1. Trust taxable income is subjected to the 39.6% rate on amounts in excess of $12,150.[19] In addition, the net investment income of trusts is subject to the I.R.C. § 1411 Medicare Tax at income levels above $12,150.

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17 *See* Treas. Reg. § 1.1001-2(c), Ex. (5); *Madorin*, 84 T.C. 667; Rev. Rul. 79-84, 1979-1 C.B. 223; Rev. Rul. 77-402, 1977-2 C.B. 222.

18 See BYRLE M. ABBIN, INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES (CCH 2014), for a comprehensive discussion of this subject,

19 *See* I.R.C. § 1(f) (requiring Treasury to prescribe new tables annually to reflect increases in the cost of living); *see also* Rev. Proc. 2013-35, 2013-46 I.R.B. 749 (establishing the $12,150 taxable income level).

2. *Deductions*

In most cases, the deductions allowed to a trust are the same as those allowed to an individual. The principal exception, discussed below, provides the mechanism for allocating trust income between the trust and its beneficiaries.

3. *Allocating Income Between a Trust and its Beneficiaries*

Trust income is allocated between a standard trust and its beneficiaries through the deductions permitted to the trust under I.R.C. §§ 651 and 661 for distributions made to beneficiaries. The deductions remove the income from the trust's taxable income and put it in the beneficiary's gross income.[20] In each case the deduction is limited to the amount of the trust's "distributable net income" ("DNI")[21] regardless of the actual amount of the deduction.[22] If an item of income is not reflected in DNI, it will be taxed to the trust rather than to its beneficiaries. A trust's DNI is its taxable income with several adjustments, the most significant of which are described below.[23]

Capital gains are not included if they are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year."[24] Capital losses are also not taken into account except to the extent that they reduce the amount of gains included under the preceding sentence.[25] Furthermore, the 50% exclusion from gross income under I.R.C. § 1202 for any gain from the sale or exchange of qualified small business stock held for more than five years is not taken into account.[26]

A trust's tax-exempt income is included, reduced by any amounts that would be deductible in connection with this income but for I.R.C. § 265 (which disallows certain deductions relating to tax exempt income).[27]

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20 I.R.C. §§ 651, 652, 661, 662.
21 I.R.C. § 643(a).
22 I.R.C. §§ 651, 661.
23 I.R.C. § 643(a).
24 I.R.C. § 643(a)(3).
25 *Id.*
26 *Id.*
27 I.R.C. § 643(a)(5).

A trust's distribution deduction is added back to taxable income.[28] In calculating its taxable income, the trust is permitted to deduct distributions to beneficiaries actually made and distributions that were required to be made to the extent they do not exceed its DNI.[29] For purposes of calculating the DNI limitation on the deduction, DNI is calculated without including tax-exempt income and the deductions allocable to such income.[30]

I.R.C. §§ 652 and 662 require that amounts distributed (or required to be distributed) to trust beneficiaries from trusts are to be included in the beneficiaries' gross incomes to the extent such distributions do not exceed the trust's DNI.[31] The distributions have the same tax character in the hands of the beneficiaries as they had in the hands of the trustee.[32]

If a trust agreement requires the distribution of a specific sum of money at one time or in not more than three installments, a distribution in satisfaction of this requirement will not be treated as a distribution of trust income.[33] As a result, the distribution will not be deductible to the trust or includible in the gross income of the beneficiary.

The exception for distributions of specific sums does not apply to amounts which can be paid only out of trust income or to annuities or payments of periodic amounts that have the effect of an annuity.[34]

C. *Grantor Trusts*

1. *In General*

The term "grantor trust" is used to describe a trust that is treated as "owned" by its creator, the grantor, or, in some cases, by another individual. The rules governing grantor trusts are described in I.R.C. §§ 671 through 679.

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28 I.R.C. § 643(a)(1).

29 I.R.C. § 651(b).

30 I.R.C. § 661(c).

31 I.R.C. §§ 652(a), 662(a) (DNI is computed without the deduction allowed under § 642(c) for payments to charities); *see also* I.R.C. §§ 651(a)(2), 662(b).

32 I.R.C. §§ 652(b), 662(b).

33 I.R.C. § 663(a).

34 Treas. Reg. § 1.663(a)-1(b)(2).

2. *Consequences of Grantor Trust Treatment*

The primary tax consequence of grantor trust treatment is that the deemed owner of the trust will calculate his or her taxable income and credits by including the trust's income, deductions, and credits.[35] This means that the deemed owner, not the trust, will pay tax on the trust's income. If the trust has losses, or deductions in excess of income, they are usable by the deemed owner. Of particular importance to some clients will be the fact that this means the trust is no longer subject to the highly compressed rate structure imposed by I.R.C. § 1(e).

The IRS's application of the grantor trust rules goes beyond the simple reflection of income, deduction, and credits. In a series of rulings, it has taken the position that the owner of a trust under the grantor trust rules will be treated as owning, for tax purposes, the trust property itself. The effect of this position is to permit the deemed owner to enter into transactions with the trust without any income tax consequence to himself or herself or the trust.[36]

An individual may be the deemed owner of an entire trust or only a portion of the trust.[37] If the individual is treated as the owner of only a portion of a trust, only the items of income, deduction, and credit attributable to that portion are to be reflected in the calculation of his or her taxable income.[38] Items of income, deduction, and credit attributable to a portion of the trust not deemed owned by an individual are subject to the tax rules applicable to standard trusts as discussed above.[39]

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35 I.R.C. § 671.

36 *See* Rev. Rul. 85-13, 1985-1 C.B. 184; *contra* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984). *See also supra* text at notes 6-17, which discusses the transfer to trusts of installment notes and property subject to debt in excess of basis.

37 I.R.C. § 671(a).

38 Treas. Reg. § 1.671-3(a).

39 *Id.*

3. *When the Rules Apply*

a) *In General*

The grantor trust rules apply when the grantor or any person other than an adverse party[40] has retained certain interests in or powers over trust income and assets. For purposes of determining the powers and interests held by a grantor, I.R.C. § 672(e) provides that he or she will be treated as holding any power or interest held by an individual to whom the grantor was married at the time of the creation of the power or interest or whom he or she married after such creation. There is no provision of the Code that causes this treatment to terminate if the spouses divorce.

An individual is an adverse party as to a particular power if he or she is a person who has a "substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of [his or her] power."[41]

b) *Reversionary Interests*

I.R.C. § 673(a) provides that the grantor of a trust will be treated as the owner of any portion of the trust in which he or she has a reversionary interest in either corpus or income if, as of the creation of that portion of the trust, the value of that reversionary interest is more than 5% of the value of the portion.

c) *Power to Control Beneficial Enjoyment*

I.R.C. § 674(a) provides that the grantor will be treated as the owner of any portion of the trust if the beneficial enjoyment of such portion is subject to a power exercisable by the grantor or a nonadverse party without the consent of an adverse party. There are a number of exceptions to this rule.[42] The most significant exception is in § 674(c): Such powers will not cause grantor trust treatment if held by trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the grantor. Because § 672(e) imputes to the grantor any power held by his or her spouse, it is

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40 I.R.C. §672(b) (referring to a person who is not an adverse party as a "nonadverse party").

41 I.R.C. § 672(a).

42 I.R.C. §§ 674(b)-(d).

likely that this exception does not apply if the grantor's spouse is a trustee with any power to control beneficial enjoyment.

d) *Administrative Powers*

I.R.C. § 675 provides that the grantor will be treated as the owner of any portion of a trust if (i) the grantor or a nonadverse party has the power to deal with the trust property for less than a full and adequate consideration in money or money's worth, (ii) the grantor or a nonadverse party enables the grantor to borrow trust corpus or income without adequate interest or without adequate security unless the power is exercisable by a trustee (other than the grantor) under a general lending power that enables the trustee to make loans to any person without regard to interest or security, (iii) the grantor has borrowed corpus or income of the trust and has not completely repaid the loan before the beginning of the year,[43] or (iv) if a power of administration is exercisable in a nonfiduciary capacity without the consent of a fiduciary. For this purpose, the term "power of administration" means (a) a power to vote securities held by the trust when the holdings of the grantor and the trust are significant from the viewpoint of voting control, (b) a power to control the investment of trust funds to the extent that they consist of securities in corporations in which the holdings of the grantor and the trust are significant from the standpoint of voting control, or (c) the power to reacquire the trust corpus by substituting other property of equal value.[44]

e) *Power to Revoke*

I.R.C. § 676(a) provides that the grantor will be treated as the owner of any portion of the trust if he or she or any nonadverse party has the power to revert title to such portion in the grantor.

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[43] I.R.C. § 675(3) (stating this provision does not apply to a loan made for adequate interest and adequate security if made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor within the meaning of § 672(c)).

[44] I.R.C. § 675(4).

f) *Power to Distribute or Accumulate Income to or for the Grantor of the Grantor's Spouse*

Section 677(a) provides that the grantor will be treated as the owner of any portion of the trust if the income from that portion may, without the consent of an adverse party, be distributed to or accumulated for future distribution to the grantor or the grantor's spouse, or used to pay premiums on life insurance policies on the grantor's life or on the life of the grantor's spouse.

Some trust agreements give the trustee the power to use trust property to support a beneficiary whom the grantor may be obligated to support. Such a power could be viewed as a power to distribute trust property to the grantor. I.R.C. § 677(b) prevents this result by providing that income will not be taxable to the grantor under this section (or under any other provision) merely because the income could be used to discharge a support obligation of the grantor unless it is actually used for this purpose. It also provides that if trust property other than income is used to discharge a support obligation of the grantor, the payment is treated as a distribution within the meaning of I.R.C. § 661(a)(2) and will be taxed to the grantor under § 662.[45]

4. *Person Other Than Grantor Treated as Owner*

I.R.C. § 678 provides that an individual other than the grantor of the trust is treated as the owner of a portion of the trust if he or she has the unilateral right to withdraw the corpus or the income.[46] A person other than the grantor will also be treated as the owner the person other than the grantor partially released or modified such a power, and after such partial release or modification he or she or nonadverse parties have the type of power over or interest in the trust that would have resulted in the power holder being treated as the owner if he or she had been the grantor.[47]

45 I.R.C. § 677(b).

46 I.R.C. § 678(a)(1).

47 I.R.C. § 687(a)(2).

5. *Taxation of Trusts Established in Connection with Divorce or Separation*

a) *In General*

If one spouse transfers property to a trust for the benefit of the other spouse in connection with a divorce or separation, the taxation of that trust and of the transferee spouse would generally follow the rules reviewed above.[48] Taxability will depend on the particular characteristics of the trust. If the trust is a standard trust, the spouse rather than the trust would be taxed on trust income to the extent distributed to him or her.

b) *The Grantor Trust Rules*

A trust created in connection with a divorce or separation, however, is likely to be subject to the grantor trust rules for one of several reasons. The transferor spouse may have a reversionary interest the actuarial value of which was more than five percent at the inception of the trust.[49] This might occur, for example, if the transferor spouse retained the right to receive the trust principal on the death or remarriage of the transferee spouse. Or, the transferor may have the right to decide how his or her children will share in the trust property at the death or remarriage of the transferee spouse.[50]

If the transferor spouse's transfer to the trust does not, under state law, completely terminate the obligation to support the other spouse, the trust would be subject to the grantor trust rules to the extent payments were made from the trust to the transferee spouse.[51] Such payments would be treated as having been made for his or her benefit since they would discharge a continuing legal obligation.[52]

If the transferor spouse and the transferee spouse are still married to each other when the trust is created, the grantor trust rules are likely to impose grantor trust status because of the existence of the marital relationship. For example, if trust income is

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48 *See supra* text at notes 18-34.

49 I.R.C. § 673(a).

50 I.R.C. § 674(a).

51 *See* Helvering v. Leonard, 310 U.S. 80, 85 (1940). *See generally*, *Tax Aspects of Alimony Trusts*, 66 YALE L.J. 881 (1957).

52 I.R.C. § 677(b).

or may be distributed or accumulated for future distribution to the grantor's spouse (without the consent of an adverse party), I.R.C. § 677(a) treats the grantor as the deemed owner. If trust income may be allocated among a group of beneficiaries at the discretion of the trustees one of whom is the grantor's spouse, I.R.C. §§ 674(a) and (c) treat the grantor as the deemed owner. If the grantor's spouse has borrowed trust funds, under some circumstances § 675(3) will treat the grantor as the deemed owner. These provisions do not apply after the grantor and the beneficiary or power holder are divorced.[53] As a result, the grantor trust rules would be of concern to individuals who are structuring a marital settlement agreement only in connection with the period of time covered by the agreement that precedes the divorce unless the interests and powers they cover fall within the scope of § 672(e).

I.R.C. § 672(e) is more difficult to avoid. It provides that a trust grantor will be treated as holding any trust interest or power held by an individual to whom the grantor was married at the time of the power's creation.[54] Section 672(e) does not cease to operate after the grantor and spouse are divorced.

If § 672(e) is applicable, the determination of whether the grantor will be treated as the deemed owner of the trust will depend upon whether the grantor would be the deemed owner if he or she held the interest or power held by the spouse.

> Example - *Hugh created a trust to pay his daughter Pat income for fifteen years, remainder to his spouse Winona. The actuarial value of Winona's interest in the trust corpus at the inception of the trust was 10%. Because Hugh is treated as owning the reversionary interest held by Winona and because that reversionary interest is worth more than 5%, Hugh will be treated as the owner of 100% of the trust under I.R.C. § 673(a).*

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53 The portions of I.R.C. §§ 674(c) and 675(3) which treat a power held or a loan made by a grantor's spouse as having been made by the grantor specifically do not apply after a divorce or separation under a decree of separate maintenance. The regulations under I.R.C. § 677 provide that § 677(a)'s provisions affecting income payable to the grantor's spouse apply "solely during the period of the marriage of the grantor to a beneficiary." Treas. Reg. § 1.677(a)-1(b)(2).

54 *See* I.R.C. § 672(e) (applying to interests or powers held by an individual who became the grantor's spouse after the creation of the trust, but only for periods after the marriage).

The result in the preceding example will not change if Hugh and Winona are divorced. Section 672(e)'s test is administered at the time the interest is created. It contains no mechanism for a later retesting to take into account a change in marital status.

It is probable that I.R.C. § 672(e) operates to extend the application of § 677(a) to periods after the divorce. As discussed above, if trust income is or may be distributed or accumulated for future distribution to the grantor's spouse (without the consent of an adverse party), § 677(a) treats the grantor as the deemed owner. If the spouse's status as a mandatory or discretionary recipient of trust income is a trust "interest" within the meaning of § 672(e), then that status would continue to be attributed to the grantor after a divorce and would result in grantor trust status.

> <u>Example</u> - *Wilma, pursuant to the requirements of a marital settlement agreement, transferred $500,000 to a trust to pay her spouse Winnie income for life. The independent trustee had discretion to distribute principal to Winnie if the independent trustee deemed it advisable. At Winnie's death, the remainder was to be paid to Wilma's children. The transfer was made prior to Wilma's divorce from Winnie. I.R.C. § 677(a) applies to treat Wilma as the deemed owner of the entire trust before the divorce and probably after the divorce as well.*

The result suggested by the preceding example seems inappropriate.[55] It will be partially, but not completely, avoided in most cases by the operation of I.R.C. § 682(c), which is discussed below.

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55 This result seems to be required by the language of the statute but is inconsistent with the results obtained under I.R.C. §§ 674(c) and 675(3). Both of these sections disengage the grantor from the spouse's powers and loans upon divorce or legal separation pursuant to a decree of separate maintenance. The IRS in Treas. Reg. § 1.1361-1(k)(1), Ex. 10 (ii), a regulation dealing with Subchapter S rules, takes the position that I.R.C. § 682 will shield a taxpayer from being treated as the grantor-owner of a trust under Code Sec. 677 because of the trustee's power to distribute income to his or her spouse, after the couple divorces. This regulation seems incorrect for two reasons. First it is misreading § 682. I.R.C. § 682 does not eliminate grantor trust status. It simply says that the grantor won't be taxed on income the spouse is entitled to receive even though the trust may be a grantor trust. Second, its conclusion as to § 677 fails to take into account the fact that the spouse's beneficial interest is attributed to the grantor under § 672(e) even after divorce. It is true that the trust is no longer a grantor trust under § 677 because of the possible distributions to the former spouse, but under § 672, the power to distribute to the former spouse is treated as the power to distribute to the grantor. That is what is reached by § 677 after divorce.

Grantor trust status will not be limited to those trusts that are created as part of the divorce or separation negotiations. It will apply also to trusts that one spouse created for the other during their marriage. For example, the trust created by Wilma for Winnie described above might have been an *inter vivos* qualified terminable interest property trust (a so-called "QTIP") originating as part of their combined estate plan. All such trusts should be identified during the negotiation process so that the impact of future taxes on trust income can be taken into account.

6. *I.R.C. § 682 Trusts*

a) *In General*

I.R.C. § 682(a) provides that if spouses are divorced from each other or are separated under a decree of separate maintenance or under a written separation agreement, the amount of any income one of them receives or is entitled to receive from a trust will be included in his or her gross income and will not be included in the gross income of the other spouse. This will be so despite any other provision of the Code such as the grantor trust rules.[56] Section 682(a) does not apply to any part of trust income that the terms of the decree, written separation agreement, or trust agreement fix as payable for the support of minor children of the other spouse. Trusts that are subject to I.R.C. § 682(a) are usually referred to as "Section 682 Trusts."

Before the 1984 Act, I.R.C. § 71 prevented the application of § 682 to trusts that were created at the same time as or in contemplation of a divorce or separation. Instead, such trusts were subjected to the prior version of § 71. Under § 71, all payments to the beneficiary were taxable whether or not they would be taxable to the beneficiary under the rules applicable to standard trusts and their beneficiaries. As a result, distributions of

56 I.R.C. § 682(a). There is at least one regulation and two private letter rulings in which the IRS has taken a position contrary to the one described in the text. In Treas. Reg. § 1.1361-1(k)(1), Ex. 10 (ii), the IRS concludes that § 682 will cause the termination of the grantor trust status of an inter vivos QTIP trust when the grantor and his or her spouse divorce. A similar conclusion is reached in PLR 9235032 (August 28, 1992). The conclusions seem clearly wrong. Nothing in § 682 operates to terminate grantor trust status. It simply protects the grantor, who would ordinarily be taxed on trust income, from taxation on income required to be paid to his or her spouse.

trust principal and distributions of tax exempt income were all included in the transferee spouse's gross income and excluded from the transferor spouse's income. This result occurred because § 71 specifically required gross income inclusion of payments attributable to property transferred in trust.[57]

Section 682(a) was not needed to protect the transferor spouse from tax because the former version of § 71 expressly excluded from one spouse's gross income the income from transferred property that § 71(a) required the other spouse to include. The required inclusion in the gross income of the receiving spouse regardless of the tax character of the payments made these trusts tax inefficient.

b) *Avoiding Possible Application of § 71 to Trust Distributions*

The current version of I.R.C. § 71 contains no similar provision. A literal reading of it, however, could lead to almost the same result. Section 71 does not require that payments to one spouse be made by the other in order to be taxed to the transferee spouse. It seems to apply to any payment received by a spouse under a divorce or separation instrument if all of the other requirements set forth in § 71(b) are met.[58] As a result, if a divorce or separation instrument requires the establishment of a trust to make payments for life to one spouse, § 71(a) may require all payments from the trust to be included in the transferee spouse's gross income whether or not such payments are from trust income.[59]

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57 Treas. Reg. §§ 1.71-1(c)(2), 1.682(a)-1(a)(2); Rev. Rul. 65-283, 1965-2 C.B. 25; *contra* Ellis v. United States, 416 F.2d 894 (6th Cir. 1969); Stewart v. Comm'r, 9 T.C. 195 (1947).

58 The legislative history suggests an intention to prevent this result: "Where . . . a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee will be entitled to the usual . . . treatment as the beneficiary of a trust (by reason of sec. 682), notwithstanding that the . . . payments by the trust qualify as alimony or otherwise discharge a support obligation." H.R. 432, 98th Cong. (1984).

59 In that event, the transferor spouse, if he or she were treated as owner of the trust, would probably be able to deduct the payment under I.R.C. § 215 since the payment would be treated as having been paid by the transferor. Treas. Reg. § 1.671-2(c).

To avoid this result, it is advisable to include a provision in the divorce or separation instrument stating that the distributions to the transferee spouse are not to be included in his or her gross income under § 71(a). The inclusion of this simple statement will prevent the operation of § 71(a)'s inclusion rule.[60]

c) *Tax Treatment of Transferee Spouse Under § 682(a)*

The spouse who receives or is entitled to receive the income from a § 682 Trust is treated as a beneficiary of the trust for purposes of the rules governing the taxation of standard trusts and their beneficiaries.[61] This means that the transferee spouse must include in his or her gross income the amounts allocated to him or her through the DNI mechanism discussed above.

If the divorce decree, marital settlement agreement, or trust agreement fixes, in terms of an amount of money or a portion of trust income, a sum which is payable for the support of the minor children of the transferor spouse, § 682(a) does not apply to such part. The concept of "fix" for I.R.C. § 682 purposes should have the same meaning as it does for I.R.C. § 71(c).

There is an important difference. Section 682 does not include the rules in §§ 71(c)(1) and (2) which treat certain spousal payments as child support because of the timing of payment reductions. Thus, if the terms of a trust require that distributions be made to the spouse of the trust's grantor until the child of the transferor reaches age eighteen, the payments will be income to the spouse to the extent of the trust's DNI. If trust income is less than the amount required to be paid for child support, trust income is allocated first to the child support portion of the amount paid to the transferee spouse.[62]

If a § 682 Trust receives capital gain income and the transferee spouse's distribution exceeds DNI, I.R.C. § 682(a) may require that the transferee spouse include the capital gain income in his or her gross income. Whether this is the correct result is unclear because neither § 682(a) nor its regulations contain a definition of "income."

Subchapter J, the portion of the Code that determines how trusts and their beneficiaries are to be taxed, and its regulations,

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60 I.R.C. § 71(b)(1)(B).

61 I.R.C. § 682(b).

62 I.R.C. § 682(a).

contain two conflicting definitions of "income." I.R.C. § 643(b) provides that the term "income" generally means the amount of accounting income of a trust determined under the trust instrument and local law. Provisions in the trust instrument that differ substantially from traditional principles of income and principal are disregarded.[63] This definition applies for purposes of the standard trust tax rules. If this definition applies to I.R.C. § 682(a), the transferee spouse would not be taxed on capital gain income distributed to him or her since gain from the disposition of assets is not trust accounting income. In contrast, the regulations under the grantor trust rules provide that "income" means income for tax purposes rather than trust accounting income.[64]

Applying this definition to § 682(a), if the transferor spouse is the deemed owner of the entire trust under the grantor trust rules so that the capital gain income would, unless § 682(a) applies, be taxed to him or her, a distribution to the transferee spouse in excess of trust accounting income would be taxed to the transferee spouse to the extent of the trust's capital gain income. Because § 682(a) serves the purpose of overriding the grantor trust rules, these rules are probably the proper source for the definition.

d) *Tax Treatment of Transferor Spouse Under § 682(a)*

The tax treatment of the transferor spouse depends upon whether he or she is deemed to own the trust under the grantor trust rules.[65] If the trust is not treated as owned by the transferor and if no portion of the payments to the transferee spouse are specified for child support, no portion of the trust income would be taxed to the transferor spouse.[66]

If the trust is treated as owned by the transferor spouse, he or she will be taxed, under the grantor trust rules, on all trust income not distributed to the transferee spouse.[67] Defining what

63 Treas. Reg. § 1.643-1(b).
64 Treas. Reg. § 1.671-2(b).
65 I.R.C. § 671(a).
66 I.R.C. § 682(a).
67 I.R.C. § 671(a).

that income is presents the same issue discussed above in connection with determining the transferee spouse's income.[68]

Until this issue is resolved, drafters of trusts that will be subject to § 682(a) should consider providing a tax reimbursement mechanism. For example, if the parties believe that income should include capital gain income, the transferee spouse should agree that he or she will be responsible for the tax on capital gain income to the extent of his or her distributions in excess of ordinary income. To protect the transferor spouse against a possible contrary conclusion by the IRS, the agreement between the spouses should require the transferee spouse to reimburse the transferor spouse for any taxes attributable to the inclusion in his or her gross income of the amount of income the parties had expected to be taxed to the transferor spouse. Additionally, to protect the reimbursement payments from treatment as income under § 71(a), the agreement should contain a statement that the payments are not to be included in the receiving spouse's gross income and are not to be deducted by the paying spouse.[69] If a portion of the trust payments to the transferee spouse is fixed in the divorce decree, separation agreement, or trust instrument as a sum payable for the support of the transferor spouse's minor children, that portion will be included in the transferor spouse's income.[70]

III. Avoiding Gift Tax Traps

A. *In General*

Despite the fact that the parties who are negotiating a marital settlement agreement generally will not have a donative intent toward each other, their agreement and the transfers made pursuant to that agreement may be subject to the federal gift tax. This is so because the application of the gift tax does not depend on the existence of a subjective donative intent. The federal gift tax creates an objective standard for determining whether a gift has occurred. It treats transfers of cash and other property as a

68 *See supra* discussion in text at notes 61-64.

69 I.R.C. § 71(b)(1)(B).

70 Treas. Reg. § 1.682(a)-1(b).

gift except to the extent the transferor received full consideration in money or money's worth for the transfer.[71]

The best method of assuring that the transfer to a spouse or former spouse in connection with a divorce will not be subject to the gift tax is to qualify it for I.R.C. § 2516's special exception for property settlements. To qualify for this exception, the transfer must be made pursuant to a written marital settlement agreement and divorce must occur within either the one-year period before the execution of the agreement or the one-year period after the execution of the agreement.[72]

B. *Special Problems Created by Transfers of Term Interests and Transfers in Trust*

1. *The Problem*

I.R.C. § 2702, which was added to the Code in 1990 as part of Chapter 14, may present significant difficulties for many typical marital settlement patterns.[73] Section 2702 was designed to attack the ordinary method of valuing term interests in property for gift tax purposes. Transferors and the IRS are required to use Treasury valuation tables established under I.R.C. § 7520, which assume a particular rate of return regardless of the actual rate of return expected to be earned on the transferred property. As a result, it was possible for transferors to reduce the gift tax value of transferred remainders by a deemed value of a retained income interest that had little relation to the actual value of the retained interest.

Congress's solution to the problem was simple but draconian. Because it could not be sure that a retained income interest would have any particular value, Congress decided to give it a value of zero when a remainder interest is transferred to certain

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71 I.R.C. § 2512(b).

72 Harris v. Comm'r, 340 U.S. 106 (1950) (discussing how gift tax protection may also be achieved if the transfer of the interest in the qualified personal residence trust ("QPRT") is made pursuant to a court decree); *see also* Rev. Rul. 68-379, 1968-2 C.B. 414 (holding gift tax protection is also achieved if it can be established that the transfer of the interest in the QPRT was made in exchange for the relinquishment of support rights and that those rights had a value equal to the value of the transferred QPRT interest).

73 Pub. L. No. 101-508, 104 Stat. 1388 (1990) (adding I.R.C. § 2702 to the Code as part of the Omnibus Budget Reconciliation Act of 1990).

family members.[74] As a result, the transferor's taxable gift would be the full value of the transferred property.[75]

Section 2702 applies generally to transfers of term or remainder interests in property, in trust or otherwise, to a family member, if the transferor or an applicable family member[76] retains an interest in the transferred property. Unless the transfer is made in one of several qualified forms, the retained interest is deemed to have a zero value.

Because an individual's spouse is a family member, a transfer of property in trust to pay income to the transferor's spouse for a term of years or for life is subject to § 2702 if the transferor retains the remainder.

> *Example* - *Harold transfers $100,000 in trust to pay his spouse, Wanda, income for ten years, and then to pay the trust principal to him. The actuarial value of Harold's retained interest is $45,000. But I.R.C. § 2702 will treat it as having a zero value. The value of the gift, therefore, is $100,000.*

Similarly, a transfer of a term interest in property to a spouse would be subject to § 2702 if the transferor retains a remainder interest in the property. Transfers of term interests in property frequently take place in connection with a divorce or separation. Consider the following example:

> *Example* - *Wendy and Henry own their home as joint tenants. Their marital settlement agreement gives him the right to live in it for five years. At the end of the five-year period, the home will be sold and the proceeds divided equally between them.*

The arrangement described is within the scope of I.R.C. § 2702. As a result, the value of Wendy's retained interest in the residence will be deemed to be zero.

If the transfers described above were part of a marital settlement, § 2702 will be avoided if the requirements of I.R.C. § 2516 are satisfied. Treasury Regulation § 25.2702-1(c)(7) creates an exception for "the transfer of an interest to a spouse [if it] is

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74 For this purpose, other family members include the transferor's spouse, his or her ancestors and issue and the ancestors and issue of his or her spouse, his or her siblings, and the spouses of any such ancestor, issue, or sibling.

75 I.R.C. § 2702(a)(2)(A).

76 The term "applicable family member" means the transferor's spouse, an ancestor of the transferor or his or her spouse, and the spouse of any such ancestor. I.R.C. §§ 2701(e)(2), 2702(a)(1).

deemed to be for full and adequate consideration by reason of section 2516 . . . and the remaining interests in the trust are retained by the other spouse."[77]

The exception contained in the regulations does not apply to transfers that are protected from the gift tax for any reason other than the application of § 2516. As a result, the spouse who makes a gift tax protected transfer of a term interest in trust or otherwise and retains the remainder interest may be treated as having made a taxable gift equal to the value of the remainder interest. Even if the parties are married at the time, the marital deduction will not protect the transfer (unless the trust is eligible for a QTIP election) since the remainder interest will not actually pass to the transferee spouse.

The exception contained in the regulations does not apply if any person other than the two spouses acquires an interest in the trust. If a remainder interest in a trust will pass to the children, which is not uncommon in a § 2516 transfer, the exception will not protect the transfer.

From the standpoint of the actual transferor, the lack of protection is not important. This is so because § 2702 does not reach his or her transfer unless the transferor retains an interest in the trust. If he or she transfers a term interest to the spouse and a remainder interest to their children, § 2702 will not apply to the transferor because neither the transferor nor an applicable family member has retained an interest.

> Example - *Henry transferred $100,000 in trust to pay his spouse Hans income for ten years and then to pay the trust principal to their children. The value of the income interest is $55,000. In exchange, Hans relinquished his right to be supported by Henry. His support rights were worth $55,000. Henry has retained no interest in the trust. His gift to the children will be $45,000. Hans is an applicable family member as to Henry but he has "acquired" rather than "retained" an interest in the trust.*[78]

The joint purchase rule of § 2702, however, is likely to cause a gift tax problem for the transferee spouse. Subsection (c)(2) provides that if two or more family members acquire interests in

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77 Treas. Reg. § 25.2702-1(c)(7).

78 Treas. Reg. § 25.2702-2(c)(3) (defining "retained" for any individual other than the transferor as "held by the same individual both before and after the transfer in trust").

property in the same transaction or in a series of related transactions, and one of them acquires a term interest (i.e., a life interest or an interest for a term of years), the family member who acquired the term interest will be treated as if he or she had acquired the entire property and then transferred to the other family member the interest he or she acquired.[79]

> Example - *John and his daughter Cleo acquired Blackacre from John's father Jim for a total purchase price of $100,000. John acquired a ten-year term interest and Cleo acquired the remainder. John paid Jim $55,000 for his interest, an amount equal to the actuarial value of his ten-year interest, and Cleo paid Jim $45,000. John will be treated under I.R.C. § 2702(c)(2) as having acquired all of Blackacre for $100,000 and as then having transferred the remainder interest to Cleo for $45,000. Since the value of John's retained interest in Blackacre is zero, the net result is a taxable gift to Cleo by John of $55,000.*

The joint purchase rule will treat the full value of any term interest acquired by a transferee spouse in a transfer protected by § 2516 as a taxable gift from him or her if a family member other than the transferor spouse retains or acquires any interest other than a term interest in the transferred property. This will probably be so even if the non-term interests are transferred to provide a reasonable support allowance for minor children. The joint purchase rule recharacterizes the transaction as one made by the transferee spouse.

> Example - *Hank and Winnie entered into a marital settlement agreement that required her transfer of $100,000 into a trust to pay income to Hank for fifteen years and then to pay the remaining trust principal to their adult children. In exchange, Hank relinquished his marital rights. Hank and Winnie were divorced within two years of the date of the agreement. The actuarial value of Hank's interest in the trust is $68,500; the actuarial value of the children's interest, $31,500. Winnie's transfer to the trust was protected from gift tax, to the extent of Hank's interest, by § 2516. She paid a gift tax on the value of the children's remainder interest. Hank will be caught by the joint purchase rule. He will be treated as having acquired the full $100,000 interest in the trust and then as having transferred it in trust to pay himself income for fifteen years, remainder to the children. The value of his retained interest in the trust is zero but the consideration he furnished, marital rights deemed to be worth $68,500, limits the amount of his taxable gift.*

The result in this example would probably be the same even if Winnie's transfer to the children had also been protected by

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79 I.R.C. § 2702(c)(2).

§ 2516. This part of the transfer would have been protected if the children were minors and if the purpose of the transfer to them had been to provide for their support during their minority. The protection afforded by I.R.C. § 2516, however, seems to be limited to Winnie, since she was the one who made the actual transfer. For § 2516 to apply to Hank, his deemed transfer would also have to be treated as having been made for the support of the children. Since the portion of his deemed transfer that consists of the value of the retained interest is clearly not intended for the support of the children, § 2516 seems to be unavailable.

2. *Possible Solutions*

There are several ways of avoiding the impact of I.R.C. § 2702 on a § 2516 transfer in which family members other than spouses acquire remainder interests in trusts or property. The transfer could be structured as a qualified annuity or unitrust interest or as a personal residence trust. These techniques are discussed in further detail below.

If the transferee spouse does not insist on a transfer of a remainder interest to the children, § 2702 can be avoided, if § 2516 is otherwise applicable, by the transferor's retention of the remainder interest. A later transfer of that interest to the children would be unlikely to resurrect the possible application of § 2702 so long as there was no commitment or understanding that the second transfer would be made at the time the spouses entered into the marital settlement agreement.

Finally, the transferee spouse could be given a power of appointment over the remainder of the trust. The power could be limited to a power to appoint to issue. By giving him or her such a power, the gift he or she would be deemed to have made by application of the joint purchase rule will be an incomplete gift. The IRS dealt with such a transfer in Letter Ruling 201116006.[80] That ruling dealt with the consequences to the transferee spouse of the creation of a trust for her benefit for life, remainder to her issue as she appointed by will. The husband's transfer to the trust was protected from gift tax by § 2516. The IRS concluded, without any analysis of the joint purchase rule, that the wife had not made a transfer within the meaning of I.R.C. § 2702. The

80 I.R.S. Priv. Ltr. Rul. 201116006 (Apr. 22, 2011).

IRS's conclusion in that ruling seems clearly incorrect. But, in that case, the application of the joint purchase rule should not have produced any taxable gift because the gift should have been treated as incomplete.

IV. Using Trusts to Implement Estate Freezes in Connection with Divorces

A. *In General*

Divorce and an accompanying property settlement may present an opportunity to accomplish an estate freeze type transaction either outside or within the scope of I.R.C. § 2702. The object is to transfer to the transferee spouse an interest in property that is not likely to appreciate while simultaneously (or shortly thereafter) transferring an interest in the same property that is likely to appreciate to the couple's issue.

One of the most common types of freeze transfers is the transfer of a term interest in property to a spouse and a remainder interest in the same property to issue. If § 2702 can be avoided, this type of transfer is likely to accomplish an estate freeze. Four useful methods of avoiding § 2702 are discussed below.

1. *Causing the Transferee Spouse's Interest to Be Treated as an Incomplete for Gift Tax Purposes*

I.R.C. § 2702 does not apply if no portion of the gift would be treated as a completed gift without regard to any consideration received by the transferor.[81]

Consider the following example:

Example *Waverly, in a transaction protected by § 2516, transfers $1,000,000 to a trust to pay her husband Harlan income for life, remainder to their children. The application of § 2516 results in the treatment of the transfer of the income interest to Harlan as having been made for a full and adequate consideration in money or money's worth. Harlan has now acquired, within the meaning of the joint purchase rule, a term interest in property in the same transaction in which his children have acquired the remainder interest. As a result, he will be treated as having gifted the entire $1,000,000 to his children with an offset for the value of the taxable gift to the children made by Waverly when she made the*

81 Treas. Reg. § 25.2702-1(c)(1).

> *actual transfer to the trust. If the actuarial value of Harlan's income interest were $700,000 and the actuarial value of the children's interest were $300,000, Harlan would be treated as having made a taxable gift to the children of $700,000.*
>
> *Suppose the trust instrument gave Harlan the power to determine how the children would share in the remainder interest of the trust. As a result, his deemed transfer is wholly incomplete for gift tax purposes. It is incomplete as to the income interest because the income interest is his. It is incomplete as to the remainder interest because he controls who will receive it.*[82]

If the approach described in the preceding example is used, care must be taken to ensure that the transferee spouse retains the power for life. Any lapse of the power during life would cause the deemed gift to be complete and would trigger the application of § 2702. Because § 2702 does not apply for estate tax purposes, the trust property should not be included in Harlan's gross estate for estate tax purposes if he dies possessing this power.

2. *Delaying the Transfer*

Section 2702 can also be avoided by delaying the transfer to the junior family members until after the divorce. In addition, the transfer to the children must be unrelated to the transfer to the spouse. If the two transfers were related they would likely be treated as a series of transactions in which the transferee spouse and the children acquired a term and a remainder interest, respectively. If the two transactions were treated as a series of transactions, the joint purchase rules discussed above would apply to treat the transferee spouse as the transferor of the children's interest.[83] The following is an example of a post-divorce transformation of an interspousal transfer into an estate freeze:

> *Example - Homer, pursuant to the terms of a marital settlement agreement entered into between him and his spouse, Wallis, transferred $100,000 in trust to pay her income for life. At her death, the trustees were to return the principal to him. Homer's transfer to the trust was protected from gift tax by § 2516. The actuarial value of Wallis's interest in the trust was $90,000. Two years after Homer's divorce from Wallis, he transferred his remainder interest, then worth $11,000, to his daughters, Jenny and Kate. Section 2702 does not apply to Homer's*

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82 *See* Treas. Reg. § 25.2511-2(c).

83 I.R.C. § 2702(c)(2).

transfer to Wallis since it was protected from the gift tax by § 2516 and because only he and Wallis had interests in the trust after his transfer to it. Because his later transfer to Jenny and Kate was made after his divorce when Wallis was no longer related to him, § 2702 does not apply to Homer's transfer. Section 2702 will not apply to Wallis because her acquisition of an income interest was not part of a series of transactions in which Jenny and Kate acquired an interest.

3. *Using a Qualified Annuity Interest*

In some cases, a spouse who is willing to accept a trust as part of a marital settlement wants to be assured of a fixed return and does not want to rely on trust income, the amount of which will depend to a large extent on the way the trustees choose to invest trust principal. This spouse may accept an annuity trust, one that pays him or her a fixed amount on specified dates each year. This kind of trust will escape the zero valuation rule of I.R.C. § 2702 if it meets certain requirements.

Section 2702's zero valuation rule does not apply to a trust in which the transferor retains a qualified interest.[84] The term "qualified interest" includes an interest "which consists of the right to receive fixed amounts payable not less frequently than annually."[85] The regulations impose several additional requirements. The annuity amount must be paid at least once each year.[86] The annuity amount payable each year must be fixed at the time the trust is created.[87] Although the trustees may be permitted to pay trust income in excess of the required annuity to the annuitant/beneficiary,[88] the annuity must be paid whether or not the trust income is sufficient to permit payment out of income. To the extent income is insufficient, it must be payable out of principal. The amount paid is not required to be the same each year, but the amount payable in any particular year may not exceed 120% of the amount payable in the preceding year.[89] The

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84 I.R.C. § 2702(a)(2).

85 I.R.C. § 2702(b)(1). The term "qualified interest" also includes certain unitrust interests and certain noncontingent remainder interests. I.R.C. § 2702(b)(2)-(3). These interests are not discussed in the text because they do not present particularly attractive methods for structuring an estate freeze.

86 Treas. Reg. § 25.2702-3(b)(1)(i).

87 Treas. Reg. § 25.2702-3(b)(1)(ii).

88 Treas. Reg. § 25.2702-3(b)(1)(iii) (stating the value of the right to receive excess income is not reflected in the value of the retained interest).

89 Treas. Reg. § 25.2702-3(b)(1)(ii).

trust instrument must prohibit payment to any person other than the annuitant/beneficiary until the expiration of the annuity term,[90] prepayment of the annuitant/beneficiary's term interest,[91] and additions to the trust after its initial funding.[92] The term may be for a fixed period of years, for the life of the annuitant/beneficiary or for the shorter of the two.[93] If all of these requirements are met, the value of the retained annuity will be determined using the normal valuation rules described in I.R.C. §7520. A qualified annuity trust may be a viable means of structuring a marital property settlement that both satisfies the transferee spouse's desire for a constant income and the transferor's estate freezing ambitions. Consider the following example:

> Example - *Whitney's fifty year old husband Howard has demanded alimony of $50,000 per year for fifteen years or until his earlier death. Whitney is willing to provide him with this level of support only if he is willing to relinquish any personal claim against her and look only to a trust for payment. She has offered to fund this trust with $625,000. Howard's investment advisors have told him that this amount should be sufficient to fund a fifteen year, $50,000 annuity. Whitney wants the remainder interest in the trust to pass to their child Katy at the end of the fifteen year term.*

If all the requirements set forth in the regulations are met, Howard's interest in the trust will be a qualified annuity interest. If the marital settlement agreement is protected by § 2516, Whitney's transfer to the trust will be subject to gift tax only to the extent of the excess of $625,000 over the value of Howard's qualified annuity interest. Assuming a 2.2% discount rate, the value of his interest will be $604,080.[94] Her taxable gift will be about $20,920.

Because Howard's interest in the trust is a qualified interest, the joint purchase rule will credit him with the full $604,080 in calculating the amount of his gift to Katy. Since this is the total amount of consideration he will be deemed to have furnished, he will not be treated as having made a taxable gift.

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90 Treas. Reg. § 25.2702-3(d)(3).

91 Treas. Reg. § 25.2702-3(d)(5).

92 Treas. Reg. § 25.2702-3(b)(5).

93 Treas. Reg. § 25.2702-3(d)(4).

94 This is the actuarial value of the right to receive a payment of $50,000 per year for the shorter of fifteen years or the life of a fifty-year-old individual.

If the trustees invest the trust fund to achieve a 6% return, the trust will be worth $334,050 when it passes to Katy. Whitney's estate freezing objective will have been accomplished.

If Whitney dies before the end of the annuity term, no portion of the trust will be included in her gross estate because she retained neither an interest in nor control over the trust. If Howard dies before the end of the fifteen year term no portion of the trust should be included in his gross estate because he made no transfer to it. The IRS may challenge the second result on the grounds that he is the real transferor of the trust because of his relinquishment of marital rights. There is some support for such a challenge in the *Gradow v. United States* decision.[95] In that case, the court held that the bona fide sale exception in I.R.C. § 2036 required that the transferor receive consideration equal to the entire value of the property in the trust.[96] *Gradow* may be inapplicable to a situation in which the decedent did not transfer any property to a trust but simply purchased a term interest.

4. *Using a Qualified Personal Residence Trust*

In some cases, one of the spouses will want to retain the use of the marital residence or a family vacation home for a period of time. The qualified personal residence trust may be a useful tool in these cases.

Suppose, for example, that one spouse agrees to let the other retain the marital residence for a period of years, after which the residence will be sold, and the proceeds divided be-

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95 Gradow v. United States, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (1990).

96 *Id.* at 814. In both *Estate of D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir.), *cert. denied*, 520 U.S. 1230 (1997), and *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997), on the other hand, it was held that adequate and full consideration under I.R.C. § 2036(a) is determined with reference to the value of the remainder interest transferred, not the value of the full fee simple interest in the underlying property. The Court in *D'Ambrosio* opined that under the *Gradow* analysis it would be virtually impossible to sell a remainder interest because "the transferor [would] have to find an arms-length buyer willing to pay a fee simple price for a future interest." *D'Ambrosio*, at 316. In Letter Ruling 200408015 (Nov. 12, 2003), the IRS concluded that a trust created to pay an annuity to a former wife of the settlor would not be included in her gross estate at her death because "[w]ife will have no interest that she can transmit to others, upon her death."

tween them. If one or both of them are interested in simultaneously making a gift to their children, this could be accomplished by using a qualified personal residence trust ("QPRT"). The terms of the trust would give one spouse the right to use the residence for the agreed upon period. At the end of the period, all, or a portion of the property, could be distributed to the parties' children. Consider the following example:

> Example - *Wendy and Hank own their marital residence jointly. Their marital settlement agreement gives Wendy the right to live in the marital residence for the rest of her life. At that time, the residence is to be sold. Wendy's estate will receive one-half of the proceeds. Hank would like the other one-half to be paid to their children. The residence is worth $500,000. The § 7520 rate is 4.8%. Wendy is fifty-five years old. Hank's transfer of the right to use his one-half of the residence to Wendy for her life will be protected from gift tax by § 2516. His transfer of the future interest in one-half of the residence to his children will be a taxable gift, but the amount of the gift will be only $89,208 rather than $250,000.*

As discussed above, the joint purchase rules of I.R.C. § 2702, would make Wendy the transferor of Hank's entire one-half of the residence, with an offset only for the value of his $89,208 gift to the children. If, however, the transfer is structured as a QPRT, § 2702 can be avoided.

To qualify for the QPRT exception to § 2702, the trust instrument must meet several governing instrument requirements described in the regulations.[97] For example, it must require the distribution of all trust income to the term holder at least annually and must prohibit principal distributions to anyone other than the term holder during the trust term.[98] With a few exceptions, the trust instrument must prohibit the trust from holding any asset other than the residence.[99] The trust instrument must prohibit commutation, *i.e.,* the prepayment of the term holder's interest at its actuarial value at the date of prepayment.[100] The trust instrument must provide that if the residence held by the trust ceases to be a personal residence of the term holder, the trust ceases to be a QPRT[101] and, within thirty days of the trust's

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97 Treas. Reg. § 25.2702-5.

98 Treas. Reg. § 25.2702-5(c)(3) and (4).

99 Treas. Reg. § 25.2702-5(c)(5)(i).

100 Treas. Reg. § 25.2702-5(c)(6).

101 Treas. Reg. § 25.2702-5(c)(7).

ceasing to be a QPRT with respect to any assets, those asset must be (i) distributed to the term interest holder, or (ii) held fo the balance of the term in a separate share of the trust that meet the requirements of a qualified annuity interest within the meaning of Treas. Reg. § 25.2702-3.[102] The regulations state that th trust instrument can direct either of these results or leave th decision to the discretion of the trustee.

102 Treas. Reg. § 25.2702-5(c)(8)(i).

CREATIVE WAYS TO ANALYZE AND STRUCTURE SETTLEMENTS

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Problems with Asset Allocation in Divorce Where One Spouse Owns a Business

by
Stephen Bravo* and Michael Mattson**

The overall mission of probate and family courts is to provide the public with a fair, equitable and, efficient forum to resolve family and probate legal matters and protect individuals in an impartial manner.[1]

When it comes to marital dissolutions, one of the important jobs of a family court is allocating the marital estate between the two spouses and for the benefit of the children. If all assets in a marital estate were simple, such as bank accounts, residential real estate or mutual funds, or other marketable securities readily traded on established exchanges such as stocks on the New York Stock Exchange, the allocation process would be fairly simple. However, the marital estates of high net worth families often contain assets such as closely held companies, contingent future payments, options, hedge or private funds, and other more esoteric assets. In addition, there is the issue of support – both spousal (if appropriate) and for the children (if any).

The problem in divorce settlements is further exacerbated by the fact that that they can be highly negotiated, and by the time they are finalized, they may have strayed far from the economics the parties had initially hoped to realize. For example, a marital estate might contain a closely held business, limited partnership interests in other businesses, real estate, mutual funds, and various physical assets (such as furniture and automobiles). In this case, there might be valuations of the closely held business, the real estate, and the limited partnership interests. If the

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1 The Massachusetts Court System, Probate and Family Court Department (Sept. 14, 2013), available at http://www.mass.gov/courts/courtsandjudges/courts/probateandfamilycourt/.

ownership stakes are particularly large, there might be more than one valuation for each of the assets.[2]

Where there are multiple appraisals on a particular item, there will often be disagreements on the correct value, and sometimes these value differences can be quite large. Judges and attorneys tend to have limited finance/accounting backgrounds, so when large differences arise, the final settlement might end up being the result of a negotiation among the parties, rather than on economics.

In this article, we will illustrate some of these issues, some of the problems that accompany them (from a financial perspective) and suggest ways of providing settlements that will meet the needs of the parties, or at a least help quantify what the resulting economics are, based on the terms negotiated and agreed to in settlement.

We start with a scenario where Husband is the sole shareholder in a small service business, with revenues of $10 million and operating profit of $740 thousand. His salary is $1.5 million. The business' expected income for the next year is shown below:

Revenues	**10,000,000**
Cost of sales	0
Gross profit	**10,000,000**
Operating expenses	
Depreciation and amortization	10,000
Employee salaries and benefits	6,500,000
Owner's compensation	1,500,000
Other operating expenses	500,000
Rent and utilities	750,000
Operating expenses	9,260,000
Operating income	**740,000**
Other income (expenses)	0
Pretax income	**740,000**
Income taxes	**0**
Net income	**740,000**

2 Each asset class would require an appraisal by an appraiser competent in that particular appraisal discipline, e.g. real property assets would require an accredited real property appraiser and machinery and equipment assets would require an accredited machinery and technical specialties appraiser. One source for identifying multi-discipline appraisers is the American Society of Appraisers (http://www.appraisers.org). *See, e.g.* Brett Turner, Theories and Methods for Valuing Marital Assets, 25 J. Am. Acad. Matrim. Law (2012).

The business has operated profitably for many years and is well recognized in the industry as providing quality services to its customers. The management team (of which Husband is one) expects long-term future profits will grow 5% annually. The business is incorporated and files corporate income tax returns as an S corporation (from inception), so there are no entity taxes imposed.[3]

An appraiser, hired jointly by both parties, has valued the business at $9,559,000. All conceptual valuation approaches were considered (asset, income and market) however the appraiser determined that the income approach was the most appropriate to use in estimating the value of the business. The appraiser used a single year capitalization of income method to derive the business value. The appraiser made one very important normalizing adjustment to income – he reduced the Husband's salary to $500 thousand, based on market rates for top management, non-owner positions in similar companies.[4]

Other assets in the marital estate include the following:

	Value
Primary Residence	1,500,000
Motor Vehicles	75,000
Checking account	250,000
Savings/Money Markets	100,000
Marketable Securities/Mutual Funds	1,500,000
Home Furnishings	100,000
Total	**3,525,000**

This results in a total market value of $13,084,000 for the marital estate. As in many cases, the value of the closely held

3 Corporate income taxes are included in determining the value of the business, and are discussed later in this article.

4 The business value of $9,559,000 (rounded) was arrived at by increasing income $1,000,000 to normalize market value compensation. Pretax income of $1,740,000 was reduced by corporate income taxes of $683,472, decreased by capital expenditures in excess of depreciation of $1,000, and increased by a dividend tax savings of $253,327 to arrive at net cash flow of $1,308,855. This net cash flow figure was divided by a 15% capitalization rate (20% discount rate less 5% long-term growth rate) and then multiplied by a mid-year factor of 1.09545. A discussion about these additional factors is beyond the scope of this article.

business owned by the Husband represents a significant (approximately 73%) amount of the marital estate.

The goal of the parties is to divide the marital estate equally between the Husband and Wife; meaning that Husband is to receive 50% of the value of the marital estate and Wife is to receive 50% of the value of the estate. In addition to this, Wife is to receive 50% of the value of Husband's salary over the next 20 years as support.[5] (Please note that we are not considering child support separate in our analysis.)

Situation 1

The parties accept the appraisal and the underlying assumptions without modification. The parties divide the motor vehicles equally (that is, each spouse keeps his/her own car of equal value); the checking account is divided equally and Wife receives 100% of each of the primary residence, savings/money markets, marketable securities/mutual funds and home furnishings. Wife receives one-third of the value of the business; but this is in the form of a 10-year 8% note, paying principal and interest monthly – similar to the way a mortgage payment works.[6] As a result, Wife will receive almost $39 thousand per month in principal and interest payments on the note for the next 10 years.[7]

Based on this division of property, Husband and Wife each receive 50% of the value of the assets in the marital estate:

[5] An allocation of 50% is for illustration purposes only. We realize state guidelines vary in their determination of alimony.

[6] The 8% rate is what the Company would have to pay its bank to borrow on a long-term basis.

[7] The interest received by Wife is taxable income; however the interest paid by Husband is considered personal interest and is not deductible. We recommend this tax issue be reviewed by qualified tax advisors in advance of final settlement terms.

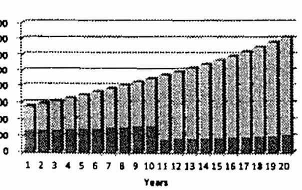
	Value	Husband	Wife
Primary Residence	1,500,000	0	1,500,000
Motor Vehicles	75,000	37,500	37,500
Checking account	250,000	125,000	125,000
Savings/Money Markets	100,000	0	100,000
Marketable Securities/Mutual Funds	1,500,000	0	1,500,000
Home Furnishings	100,000	0	100,000
Business Value	9,559,000	6,372,667	3,186,333
Totals	**13,084,000**	**6,535,167**	**6,548,833**

This is also confirmed if one considers the cash flows the parties could expect to receive over the next twenty years, as shown in Exhibit 1 below.

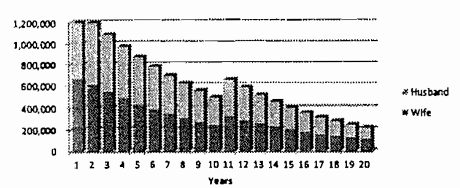
Exhibit 1

	Husband		Wife	
Year	**Cash Flows**	**Present Values**	**Cash Flows**	**Present Values**
1	735,092	671,044	669,880	644,592
2	794,742	604,581	684,579	609,941
3	857,374	543,522	700,250	577,689
4	923,138	487,677	716,963	547,663
5	992,191	436,797	734,789	519,704
6	1,064,696	390,597	753,809	493,663
7	1,140,826	348,772	774,107	469,404
8	1,220,763	311,008	795,773	446,798
9	1,304,696	276,993	818,906	425,728
10	1,392,826	246,420	843,610	406,084
11	1,949,271	328,968	399,134	177,897
12	2,046,435	291,489	411,351	169,762
13	2,148,457	258,277	424,178	162,088
14	2,255,579	228,847	437,647	154,847
15	2,368,058	202,769	451,790	148,010
16	2,486,161	179,661	466,639	141,551
17	2,610,169	159,185	482,231	135,445
18	2,740,378	141,042	498,603	129,670
19	2,877,097	124,966	515,793	124,204
20	3,020,652	110,722	533,843	119,028
End	26,792,189	982,066	3,362,500	749,720
Over 20 Years	**61,720,790**	**7,325,402**	**15,476,376**	**7,353,489**

Annual Cash Flows



Annual Cash Flows - PV



In this illustration, we have assumed Husband's salary (again, this is the market compensation, not the actual compensation) increases at the same rate of the Company's growth – 5%/ year. The rate of return on all assets besides the Company is 8%.[8] Husband and Wife each have a 40% combined state and Federal income tax rate.

In this illustration it is important to note that while Husband's cash flows are higher in every year than Wife's, the *risk* of Husband realizing his cash flows is also much higher, since most are from Company distributions. In the valuation, this risk is included by using a 20% expected rate of return (also known as the "discount rate") on Company cash flows while the expected rates of return on the note and the other assets are only 8%.[9] A consideration of the present value of these cash flows, a measure which incorporates these risks, indicates that over a 20-year period, Husband and Wife are receiving approximately equal cash flows (on a present value basis).[10][11]

A major mistake, which is often made in divorce negotiations, is to focus on equalizing the cash flows each party receives, without regard to their sources and their relative risks. In this case, Wife's assets are in relatively "safe" real estate, bank accounts and market-traded securities and mutual funds. While one could argue whether 8% is the right discount rate to use on these assets, it is fairly certain that the risks related to these assets are less than those of a typical small, closely-held business.

8 This includes the primary residence. Even though the wife plans to stay in the house, it will likely appreciate in value; so this 8% represents this annual value appreciation.

9 We have assumed the discount rate of Husband's salary is the same as the Company's borrowing rate, since salary usually has the similar payment priority (risk) as a company's borrowings. This is a much lower risk than a company's dividends or distributions, which are usually made after all other obligations are met. In other words, distributions have a much higher discount rate than salaries and borrowings.

10 This is not surprising since the value of an asset is equal to the expected cash flows discounted to present value using an appropriate discount rate – one which incorporates both the time value of money and the risk of the asset.

11 The "end" in the above exhibit represents the ending values of the business and the other assets 20 years from now, both on a nominal and a present value basis.

Situation 2

The parties accept the appraisal value and most of the underlying assumptions. The only issue is Husband's salary for spousal support purposes. Wife is to receive half of Husband's salary for the next twenty years; but his current salary of $1.5 million is to be used, rather than the $500 on which the value of the Company is based. The division of the value of the Company and the other assets is the same as that given in Situation 1.

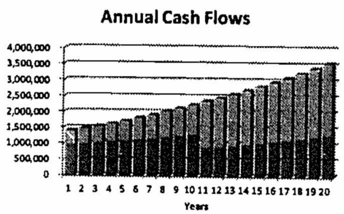
This is a common departure from a carefully constructed valuation analysis, and is known as the classic "double dip;" that is, if the parties agree to this, Wife is getting both her share of the Company explicitly (through the note payments) and through Husband's higher salary. The salary used to determine the business value was only $500 thousand; so, the same cash flows are being used to pay both Wife's portion of Husband's salary as well as the note.[12] This is very clear when considering the cash flows, in Exhibit 2, which show something less than equitable. Husband is only receiving 39% of the present value of the cash flows over the twenty years; while Wife is realizing the other 61%.[13]

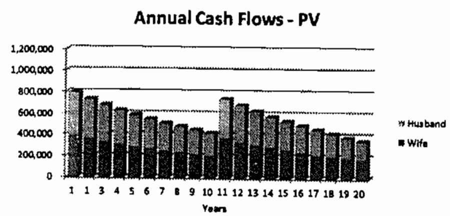
12 Wife continues to receive the almost $39 thousand per month in note payments; but she is also getting $62,500/month in Husband's salary, compared to $20,833 in Situation 1. The difference of almost $42 thousand per month is the amount of the double dip.

13 If the parties wanted to use the $1.5 million salary, then the value of the business would have been much lower, at $4.1 million (versus $9.6 million above). In addition, the distribution of the assets would be much different, with Husband getting 50% of the checking account and the securities/mutual funds along with 100% of the savings/money markets.

Exhibit 2

	Husband		Wife	
Year	Cash Flows	Present Values	Cash Flows	Present Values
1	435,092	397,183	969,880	933,267
2	479,742	366,543	999,579	890,598
3	526,624	339,862	1,031,000	850,549
4	575,851	316,007	1,064,250	812,944
5	627,539	294,447	1,099,441	777,616
6	681,811	274,790	1,136,694	744,411
7	738,797	256,748	1,176,135	713,186
8	798,632	240,095	1,217,903	683,809
9	861,460	224,659	1,262,142	656,155
10	927,428	210,303	1,309,009	630,111
11	1,460,603	371,137	887,803	395,701
12	1,533,333	341,918	924,453	381,515
13	1,609,700	314,997	962,935	367,960
14	1,689,885	290,194	1,003,342	355,000
15	1,774,079	267,344	1,045,769	342,603
16	1,862,483	246,292	1,090,318	330,739
17	1,955,307	226,897	1,137,094	319,377
18	2,052,772	209,029	1,186,208	308,493
19	2,155,111	192,568	1,237,779	298,060
20	2,262,567	177,403	1,291,928	288,055
End	26,792,189	2,100,716	3,362,500	749,720
Over 20 Years	**51,801,004**	**7,659,133**	**25,396,162**	**11,829,868**





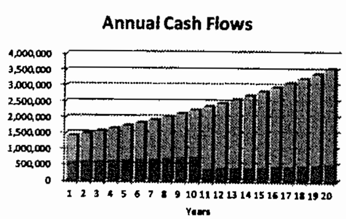
What may compound this situation is where there is more than one appraisal of the Company and the values are quite different from one another. The differences could be due to a variety of factors: discount rates, expected growth rates, owners' compensation, etc. Here, there is a real possibility that both Husband's salary and the value of the business could be subject to negotiation. Because of the high probability that the final settlement will not reflect the economics the parties had hoped to achieve, it is important that a careful long-term cash flow analysis be performed to make sure that the financial objectives are realized.

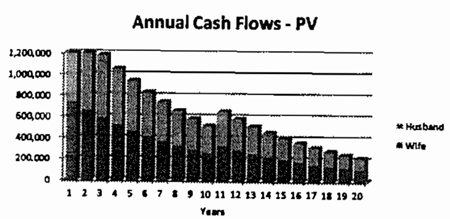
For example, if we assume the same expected income statement shown earlier; but the parties have stipulated to a $500 thousand salary for purposes of support and that the value is stipulated to be $8 million, which is the negotiated value based on the two appraisals. The allocation of the Company's value and other assets will be as shown in Situation 1. The result is a clear advantage for Husband.

The distributions he receives from the Company are no different than before; yet his note payments are much less. Rather than realizing monthly note payments of almost $39 thousand as before, Wife will only get $32 thousand per month. There are no other changes in the cash flows; so, clearly a transfer of assets from Wife to Husband. The cash flow analysis is shown in Exhibit 2a. Since Wife is receiving most of the other assets, the only way to rectify this situation, returning to a 50/50 split of assets is to give Wife a larger share of the business (about 37%). It seems counterintuitive to give the Wife a larger share of the Company, if the Husband's main asset is the Company and its value has been decreased. The problem is that the value of $8 million is completely divorced from the Company's cash flows, so relying on the negotiated value would result in an inequitable settlement. The value of an asset is based on its cash flows and not the other way around.

Exhibit 2a

	Husband		Wife	
Year	**Cash Flows**	**Present Values**	**Cash Flows**	**Present Values**
1	810,752	740,112	610,338	587,298
2	870,402	662,137	623,863	555,845
3	933,034	591,486	638,263	526,551
4	998,798	527,647	653,598	499,261
5	1,067,851	470,105	669,934	473,832
6	1,140,356	418,354	687,338	450,132
7	1,216,486	371,902	705,886	428,036
8	1,296,423	330,284	725,658	407,431
9	1,380,356	293,056	746,739	388,210
10	1,468,486	259,805	769,222	370,276
11	1,949,271	328,968	399,134	177,897
12	2,046,435	291,489	411,351	169,762
13	2,148,457	258,277	424,178	162,088
14	2,255,579	228,847	437,647	154,847
15	2,368,058	202,769	451,790	148,010
16	2,486,161	179,661	466,639	141,551
17	2,610,169	159,185	482,231	135,445
18	2,740,378	141,042	498,603	129,670
19	2,877,097	124,966	515,793	124,204
20	3,020,652	110,722	533,843	119,028
End	26,792,189	982,066	3,362,500	749,720
Over 20 Years	**62,477,389**	**7,672,880**	**14,814,550**	**6,899,096**





Situation 3

The parties accept the valuation and the assets are to be divided as given in Situation 1. The only difference is that Husband's attorney believes that the 8% note rate is much too high; it should be closer to 2%. Of course, this is a very low rate, since it is lower than the borrowing rate of the U.S. Government.

This seemingly small change has a big change on the distribution of assets. Rather than the Wife receiving a note for a one-third interest in the business, with a value of $3.186 million, she is getting an asset worth only $2.416 million ($770 thousand less), with a monthly payment of $29 thousand as opposed to $39 thousand. This can also be seen in the cash flows, in Exhibit 3, where Wife is receiving less. Short of making the interest rate on the note an appropriate market rate, the situation could be remedied by giving Wife a larger share of the business and/or allocating more of the other assets to her.

Exhibit 3

	Husband		Wife	
Year	**Cash Flows**	**Present Values**	**Cash Flows**	**Present Values**
1	847,177	773,364	632,194	608,329
2	906,827	689,847	642,042	572,042
3	969,460	614,578	652,312	538,140
4	1,035,224	546,890	663,023	506,461
5	1,104,276	486,141	674,198	476,849
6	1,176,781	431,717	685,857	449,162
7	1,252,911	383,038	698,023	423,268
8	1,332,848	339,564	710,721	399,044
9	1,416,782	300,789	723,974	376,375
10	1,504,912	266,250	737,809	355,155
11	1,949,271	328,968	399,134	177,897
12	2,046,435	291,489	411,351	169,762
13	2,148,457	258,277	424,178	162,088
14	2,255,579	228,847	437,647	154,847
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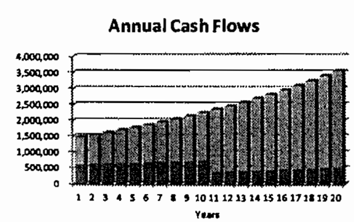
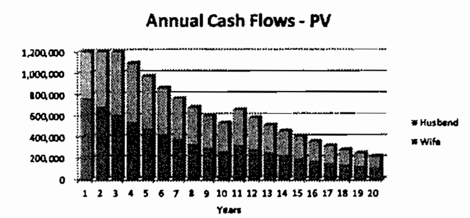
17	2,610,169	159,185	482,231	135,445
18	2,740,378	141,042	498,603	129,670
19	2,877,097	124,966	515,793	124,204
20	3,020,652	110,722	533,843	119,028
End	26,792,189	982,066	3,362,500	749,720
Over 20 Years	**62,841,645**	**7,840,169**	**14,803,862**	**6,917,048**





Conclusion

We have examined several typical situations with respect to divorce negotiations. One common theme is the possibility that a seemingly small change in some of the terms of the settlement could significantly change the economics of the outcome. It is important that any negotiated changes be reexamined, using a careful cash flow analysis to determine whether the goals of the parties are being met by the settlement.

26 U.S. Code § 72 - Annuities; certain proceeds of endowment and life insurance contracts

Current through Pub. L. 114-38 (http://www.gpo.gov/fdsys/pkg/PLAW-114publ38/html/PLAW-114publ38.htm). (See Public Laws for the current Congress (http://thomas.loc.gov/home/LegislativeData.php?n=PublicLaws).)

US Code (/uscode/text/26/72?qt-us_code_temp_noupdates=0#qt-us_
Notes (/uscode/text/26/72?qt-us_code_temp_noupdates=1#qt-us_co
IRS Rulings (/uscode/text/26/72?qt-us_code_temp_noupdates=2#qt-
Authorities (CFR) (/uscode/text/26/72?qt-us_code_temp_noupdates=

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(a) General rules for annuities

(1) Income inclusion

Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

(2) Partial annuitization

If any amount is received as an annuity for a period of 10 years or more or during one or more lives under any portion of an annuity, endowment, or life insurance contract—

(A)such portion shall be treated as a separate contract for purposes of this section,

(B)for purposes of applying subsections (b), (c), and (e), the investment in the contract shall be allocated pro rata between each portion of the contract from which amounts are received as an annuity and the portion of the contract from which amounts are not received as an annuity, and

(C)a separate annuity starting date under subsection (c)(4) shall be determined with respect to each portion of the contract from which amounts are received as an annuity.

(b) Exclusion ratio

(1) In general

Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as

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of the annuity starting date) bears to the expected return under the contract (as of such date).

(2) Exclusion limited to investment

The portion of any amount received as an annuity which is excluded from gross income under paragraph (1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

(3) Deduction where annuity payments cease before entire investment recovered

(A) In general

If—

(i)after the annuity starting date, payments as an annuity under the contract cease by reason of the death of an annuitant, and

(ii)as of the date of such cessation, there is unrecovered investment in the contract,

the amount of such unrecovered investment (in excess of any amount specified in subsection (e)(5) which was not included in gross income) shall be allowed as a deduction to the annuitant for his last taxable year.

(B) Payments to other persons

In the case of any contract which provides for payments meeting the requirements of subparagraphs (B) and (C) of subsection (c)(2), the deduction under subparagraph (A) shall be allowed to the person entitled to such payments for the taxable year in which such payments are received.

(C) Net operating loss deductions provided

For purposes of section 172 (/uscode/text/26/172), a deduction allowed under this paragraph shall be treated as if it were attributable to a trade or business of the taxpayer.

(4) Unrecovered investment

For purposes of this subsection, the unrecovered investment in the contract as of any date is—

(A)the investment in the contract (determined without regard to subsection (c)(2)) as of the annuity starting date, reduced by

(B)the aggregate amount received under the contract on or after such annuity starting date and before the date as of which the determination is being made, to the extent such amount was excludable from gross income under this subtitle.

(c) Definitions

(1) Investment in the contract

For purposes of subsection (b), the investment in the contract as of the annuity starting date is—

(A)the aggregate amount of premiums or other consideration paid for the contract, minus

(B)the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

(2) Adjustment in investment where there is refund feature

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Construction Law, Personal Injury, Nursing Home Abuse & Neglect, If—

(A)the expected return under the contract depends in whole or in part on the life expectancy of one or more individuals;

(B)the contract provides for payments to be made to a beneficiary (or to the estate of an annuitant) on or after the death of the annuitant or annuitants; and

(C)such payments are in the nature of a refund of the consideration paid,

then the value (computed without discount for interest) of such payments on the annuity starting date shall be subtracted from the amount determined under paragraph (1). Such value shall be computed in accordance with actuarial tables prescribed by the Secretary. For purposes of this paragraph and of subsection (e)(2)(A), the term "refund of the consideration paid" includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, but (if part of the consideration was contributed by an employer) does not include that part of any payment to a beneficiary (or to the estate of the annuitant) which is not attributable to the consideration paid by the employee for the contract as determined under paragraph (1)(A).

(3) Expected return

For purposes of subsection (b), the expected return under the contract shall be determined as follows:

(A) Life expectancy

If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary.

(B) Installment payments

If subparagraph (A) does not apply, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

(4) Annuity starting date

For purposes of this section, the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

(d) Special rules for qualified employer retirement plans

(1) Simplified method of taxing annuity payments

(A) In general

In the case of any amount received as an annuity under a qualified employer retirement plan—

(i)subsection (b) shall not apply, and

(ii)the investment in the contract shall be recovered as provided in this paragraph.

(B) Method of recovering investment in contract

(i)In general Gross income shall not include so much of any monthly annuity payment under a qualified employer retirement plan as does not exceed the amount obtained by dividing—

(I)the investment in the contract (as of the annuity starting date), by

(II)the number of anticipated payments determined under the table contained in clause (iii) (or, in the case of a contract to which subsection (c)(3)(B) applies, the number of monthly annuity payments under such contract).

(ii)Certain rules made applicable Rules similar to the rules of paragraphs (2) and (3) of subsection (b) shall apply for purposes of this paragraph.

(iii)Number of anticipated payments If the annuity is payable over the life of a single individual, the number of anticipated payments shall be determined as follows:

If the age of the annuitant on theannuity starting date is:	The number of anticipated payments is:
Not more than 55	360
More than 55 but not more than 60	310
More than 60 but not more than 65	260
More than 65 but not more than 70	210
More than 70	160.

(iv)Number of anticipated payments where more than one life If the annuity is payable over the lives of more than 1 individual, the number of anticipated payments shall be determined as follows:

If the combined ages of annuitants are:	The number is:
Not more than 110	410
More than 110 but not more than 120	360
More than 120 but not more than 130	310
More than 130 but not more than 140	260
More than 140	210.

(C) Adjustment for refund feature not applicable

For purposes of this paragraph, investment in the contract shall be determined under subsection (c)(1) without regard to subsection (c)(2).

(D) Special rule where lump sum paid in connection with commencement of annuity payments

If, in connection with the commencement of annuity payments under any qualified employer retirement plan, the taxpayer receives a lump-sum payment—

(i)such payment shall be taxable under subsection (e) as if received before the annuity starting date, and

(ii)the investment in the contract for purposes of this paragraph shall be determined as if such payment had been so received.

(E) Exception

This paragraph shall not apply in any case where the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than 5 years of guaranteed payments under the annuity.

(F) Adjustment where annuity payments not on monthly basis

In any case where the annuity payments are not made on a monthly basis, appropriate adjustments in the application of this paragraph shall be made to take into account the period on the basis of which such payments are made.

(G) Qualified employer retirement plan

For purposes of this paragraph, the term "qualified employer retirement plan" means any plan or contract described in paragraph (1), (2), or (3) of section 4974 (/uscode/text/26/4974)(c) (/uscode/text/26/usc_sec_26_00004974----000-#c).

(2) Treatment of employee contributions under defined contribution plans

For purposes of this section, employee contributions (and any income allocable thereto) under a defined contribution plan may be treated as a separate contract.

(e) Amounts not received as annuities

(1) Application of subsection

(A) In general

This subsection shall apply to any amount which—

(i)is received under an annuity, endowment, or life insurance contract, and

(ii)is not received as an annuity,

if no provision of this subtitle (other than this subsection) applies with respect to such amount.

(B) Dividends

For purposes of this section, any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2) General rule

Any amount to which this subsection applies—

(A)if received on or after the annuity starting date, shall be included in gross income, or

(B)if received before the annuity starting date—

(i)shall be included in gross income to the extent allocable to income on the contract, and

(ii)shall not be included in gross income to the extent allocable to the investment in the contract.

(3) Allocation of amounts to income and investment

For purposes of paragraph (2)(B)—

(A) Allocation to income

Any amount to which this subsection applies shall be treated as allocable to income on the contract to the extent that such amount does not exceed the excess (if any) of—

(i)the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over

(ii)the investment in the contract at such time.

(B) Allocation to investment

Any amount to which this subsection applies shall be treated as allocable to investment in the contract to the extent that such amount is not allocated to income under subparagraph (A).

(4) Special rules for application of paragraph (2)(B)

For purposes of paragraph (2)(B)—

(A) Loans treated as distributions

If, during any taxable year, an individual—

(i)receives (directly or indirectly) any amount as a loan under any contract to which this subsection applies, or

(ii)assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract,

such amount or portion shall be treated as received under the contract as an amount not received as an annuity. The preceding sentence shall not apply for purposes of determining investment in the contract, except that the investment in the contract shall be increased by any amount included in gross income by reason of the amount treated as received under the preceding sentence.

(B) Treatment of policyholder dividends

Any amount described in paragraph (1)(B) shall not be included in gross income under paragraph (2)(B)(i) to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.

(C) Treatment of transfers without adequate consideration

(i) In general If an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of—

(I)the cash surrender value of such contract at the time of transfer, over

(II)the investment in such contract at such time,

under the contract as an amount not received as an annuity.

(ii) Exception for certain transfers between spouses or former spouses Clause (i) shall not apply to any transfer to which section 1041 (/uscode/text/26/1041)(a) (/uscode/text/26/usc_sec_26_00001041----000-#a) (relating to transfers of property between spouses or incident to divorce) applies.

(iii) Adjustment to investment in contract of transferee If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract of the transferee in such contract shall be increased by the amount so included.

(5) Retention of existing rules in certain cases

(A) In general

In any case to which this paragraph applies—

(i)paragraphs (2)(B) and (4)(A) shall not apply, and

(ii)if paragraph (2)(A) does not apply,

the amount shall be included in gross income, but only to the extent it exceeds the investment in the contract.

(B) Existing contracts

This paragraph shall apply to contracts entered into before August 14, 1982. Any amount allocable to investment in the contract after August 13, 1982, shall be treated as from a contract entered into after such date.

(C) Certain life insurance and endowment contracts

Except as provided in paragraph (10) and except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance or endowment contract.

(D) Contracts under qualified plans

Except as provided in paragraph (8), this paragraph shall apply to any amount received—

(i)from a trust described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a) which is exempt from tax under section 501 (/uscode/text/26/501)(a) (/uscode/text/26/usc_sec_26_00000501----000-#a),

(ii)from a contract—

(I)purchased by a trust described in clause (i),

(II)purchased as part of a plan described in section 403 (/uscode/text/26/403)(a) (/uscode/text/26/usc_sec_26_00000403----000-#a),

(III)described in section 403 (/uscode/text/26/403)(b) (/uscode/text/26/usc_sec_26_00000403----000-#b), or

(IV)provided for employees of a life insurance company under a plan described in section 818 (/uscode/text/26/818)(a)(3) (/uscode/text/26/usc_sec_26_00000818----000-#a_3), or

(iii)from an individual retirement account or an individual retirement annuity.

Any dividend described in section 404 (/uscode/text/26/404)(k) (/uscode/text/26/usc_sec_26_00000404----000-#k) which is received by a participant or beneficiary shall, for purposes of this subparagraph, be treated as paid under a separate contract to which clause (ii)(I) applies.

(E) Full refunds, surrenders, redemptions, and maturities

This paragraph shall apply to—

(i)any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract, and (ii)any amount received under a contract on its complete surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (2)(A) shall not apply.

(6) Investment in the contract

For purposes of this subsection, the investment in the contract as of any date is—

(A)the aggregate amount of premiums or other consideration paid for the contract before such date, minus

(B)the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

[(7) Repealed. Pub. L. 100–647, title I, § 1011A(b)(9)(A),Nov. 10, 1988, 102 Stat. 3474]

(8) Extension of paragraph (2)(b) 1 to qualified plans

(A) In general

Notwithstanding any other provision of this subsection, in the case of any amount received before the annuity starting date from a trust or contract described in paragraph (5)(D), paragraph (2)(B) shall apply to such amounts.

(B) Allocation of amount received

For purposes of paragraph (2)(B), the amount allocated to the investment in the contract shall be the portion of the amount described in subparagraph (A) which bears the same ratio to such amount as the investment in the contract bears to the account balance. The determination under the preceding sentence shall be made as of the time of the distribution or at such other time as the Secretary may prescribe.

(C) Treatment of forfeitable rights

If an employee does not have a nonforfeitable right to any amount under any trust or contract to which subparagraph (A) applies, such amount shall not be treated as part of the account balance.

(D) Investment in the contract before 1987

In the case of a plan which on May 5, 1986, permitted withdrawal of any employee contributions before separation from service, subparagraph (A) shall apply only to the extent that amounts received before the annuity starting date (when increased by amounts previously received under the contract after December 31, 1986) exceed the investment in the contract as of December 31, 1986.

(9) Extension of paragraph (2)(B) to qualified tuition programs and Coverdell education savings accounts

Notwithstanding any other provision of this subsection, paragraph (2)(B) shall apply to amounts received under a qualified tuition program (as defined in section 529 (/uscode/text/26/529)(b) (/uscode/text/26/usc_sec_26_00000529----000-#b)) or under a Coverdell education savings account (as defined in section 530 (/uscode/text/26/530)(b) (/uscode/text/26/usc_sec_26_00000530----000-#b)). The rule of paragraph (8)(B) shall apply for purposes of this paragraph.

(10) Treatment of modified endowment contracts

(A) In general

Notwithstanding paragraph (5)(C), in the case of any modified endowment contract (as defined in section 7702A (/uscode/text/26/7702A))—

(i)paragraphs (2)(B) and (4)(A) shall apply, and

(ii)in applying paragraph (4)(A), "any person" shall be substituted for "an individual".

(B) Treatment of certain burial contracts

Notwithstanding subparagraph (A), paragraph (4)(A) shall not apply to any assignment (or pledge) of a modified endowment contract if such assignment (or pledge) is solely to cover the payment of expenses referred to in section 7702 (/uscode/text/26/7702)(e)(2)(C)(iii) (/uscode/text/26/usc_sec_26_00007702----000-#e_2_C_iii) and if the maximum death benefit under such contract does not exceed $25,000.

(11) Special rules for certain combination contracts providing long-term care insurance

Notwithstanding paragraphs (2), (5)(C), and (10), in the case of any charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract which is part of or a rider on such annuity or life insurance contract—

(A)the investment in the contract shall be reduced (but not below zero) by such charge, and

(B)such charge shall not be includible in gross income.

(12) Anti-abuse rules

(A) In general

For purposes of determining the amount includible in gross income under this subsection—

(i)all modified endowment contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 modified endowment contract, and

(ii)all annuity contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 annuity contract.

The preceding sentence shall not apply to any contract described in paragraph (5)(D).

(B) Regulatory authority

The Secretary may by regulations prescribe such additional rules as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through serial purchases of contracts or otherwise.

(f) Special rules for computing employees' contributions

In computing, for purposes of subsection (c)(1)(A), the aggregate amount of premiums or other consideration paid for the contract, and for purposes of subsection (e)(6), the aggregate premiums or other consideration paid, amounts contributed by the employer shall be included, but only to the extent that—

(1)such amounts were includible in the gross income of the employee under this subtitle or prior income tax laws; or

(2)if such amounts had been paid directly to the employee at the time they were contributed, they would not have been includible in the gross income of the employee under the law applicable at the time of such contribution.

Paragraph (2) shall not apply to amounts which were contributed by the employer after December 31, 1962, and which would not have been includible in the gross income of the employee by reason of the application of section 911 (/uscode/text/26/911) if such amounts had been paid directly to the employee at the time of contribution. The preceding sentence shall not apply to amounts which were contributed by the employer, as determined under regulations prescribed by the Secretary, to provide pension or annuity credits, to the extent such credits are attributable to services performed before January 1, 1963, and are provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services, or to the extent such credits are attributable to services performed as a foreign missionary (within the meaning of section 403 (/uscode/text/26/403)(b)(2)(D)(iii) (/uscode/text/26/usc_sec_26_00000403----000-#b_2_D_iii), as in effect before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001).

(g) Rules for transferee where transfer was for value

Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then—

(1)for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;

(2)for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(3)the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

(h) Option to receive annuity in lieu of lump sum

If—

(1)a contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity in lieu of such lump sum;

(2)the option is exercised within 60 days after the day on which such lump sum first became payable; and

(3)part or all of such lump sum would (but for this subsection) be includible in gross income by reason of subsection (e)(1),

then, for purposes of this subtitle, no part of such lump sum shall be considered as includible in gross income at the time such lump sum first became payable.

[(i) Repealed. Pub. L. 94–455, title XIX, § 1951(b)(1)(A),Oct. 4, 1976, 90

Stat. 1836]

(j) Interest

Notwithstanding any other provision of this section, if any amount is held under an agreement to pay interest thereon, the interest payments shall be included in gross income.

[(k) Repealed. Pub. L. 98–369, div. A, title IV, § 421(b)(1),July 18, 1984, 98 Stat. 794]

(l) Face-amount certificates

For purposes of this section, the term "endowment contract" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 (/uscode/text/15) U.S.C., sec. 80a–2 (/uscode/text/15/80a-2)), issued after December 31, 1954.

(m) Special rules applicable to employee annuities and distributions under employee plans

[(1) Repealed. Pub. L. 93–406, title II, § 2001(h)(2),Sept. 2, 1974, 88 Stat. 957]

(2) Computation of consideration paid by the employee

In computing—

(A)the aggregate amount of premiums or other consideration paid for the contract for purposes of subsection (c)(1)(A) (relating to the investment in the contract), and

(B)the aggregate premiums or other consideration paid for purposes of subsection (e)(6) (relating to certain amounts not received as an annuity),

any amount allowed as a deduction with respect to the contract under section 404 (/uscode/text/26/404) which was paid while the employee was an employee within the meaning of section 401 (/uscode/text/26/401)(c)(1) (/uscode/text/26/usc_sec_26_00000401----000-#c_1) shall be treated as consideration contributed by the employer, and there shall not be taken into account any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is properly allocable (as determined under regulations prescribed by the Secretary) to the cost of life, accident, health, or other insurance.

(3) Life insurance contracts

(A)This paragraph shall apply to any life insurance contract—

(i)purchased as a part of a plan described in section 403 (/uscode/text/26/403)(a) (/uscode/text/26/usc_sec_26_00000403----000-#a), or

(ii)purchased by a trust described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a) which is exempt from tax under section 501 (/uscode/text/26/501)(a) (/uscode/text/26/usc_sec_26_00000501----000-#a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

(B)Any contribution to a plan described in subparagraph (A)(i) or a trust described in subparagraph (A)(ii) which is allowed as a deduction under section 404 (/uscode/text/26/404), and any income of a trust described in subparagraph (A)(ii), which is determined in accordance with regulations prescribed by the Secretary to have been applied to purchase the life insurance protection under a contract described in subparagraph (A), is includible in the gross income of the participant for the taxable year when so applied.

(C) In the case of the death of an individual insured under a contract described in subparagraph (A), an amount equal to the cash surrender value of the contract immediately before the death of the insured shall be treated as a payment under such plan or a distribution by such trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under this section and shall be treated as provided in section 101 (/uscode/text/26/101).

[(4) Repealed. Pub. L. 97–248, title II, § 236(b)(1),Sept. 3, 1982, 96 Stat. 510]

(5) Penalties applicable to certain amounts received by 5-percent owners

(A) This paragraph applies to amounts which are received from a qualified trust described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a) or under a plan described in section 403 (/uscode/text/26/403)(a) (/uscode/text/26/usc_sec_26_00000403----000-#a) at any time by an individual who is, or has been, a 5-percent owner, or by a successor of such an individual, but only to the extent such amounts are determined, under regulations prescribed by the Secretary, to exceed the benefits provided for such individual under the plan formula.

(B) If a person receives an amount to which this paragraph applies, his tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of the amount so received which is includible in his gross income for such taxable year.

(C) For purposes of this paragraph, the term "5-percent owner" means any individual who, at any time during the 5 plan years preceding the plan year ending in the taxable year in which the amount is received, is a 5-percent owner (as defined in section 416 (/uscode/text/26/416)(i)(1)(B) (/uscode/text/26/usc_sec_26_00000416----000-#i_1_B)).

(6) Owner-employee defined

For purposes of this subsection, the term "owner-employee" has the meaning assigned to it by section 401 (/uscode/text/26/401)(c)(3) (/uscode/text/26/usc_sec_26_00000401----000-#c_3) and includes an individual for whose benefit an individual retirement account or annuity described in section 408 (/uscode/text/26/408)(a) (/uscode/text/26/usc_sec_26_00000408----000-#a) or (b) is maintained. For purposes of the preceding sentence, the term "owner-employee" shall include an employee within the meaning of section 401 (/uscode/text/26/401)(c)(1) (/uscode/text/26/usc_sec_26_00000401----000-#c_1).

(7) Meaning of disabled

For purposes of this section, an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require.

[(8) Repealed. Pub. L. 97–248, title II, § 236(b)(1),Sept. 3, 1982, 96 Stat. 510]

[(9) Repealed. Pub. L. 98–369, div. A, title VII, § 713(d)(1),July 18, 1984, 98 Stat. 957]

(10) Determination of investment in the contract in the case of qualified domestic relations orders

Under regulations prescribed by the Secretary, in the case of a distribution or payment made to an alternate payee who is the spouse or former spouse of the participant pursuant to a qualified domestic relations order (as defined in section 414 (/uscode/text/26/414)(p) (/uscode/text/26/usc_sec_26_00000414----000-#p)), the investment in the contract as of the date prescribed in such regulations shall be allocated on a pro rata basis between the present value of such distribution or payment and the present value of all other benefits payable with respect to the participant to which such order relates.

(n) Annuities under retired serviceman's family protection plan or survivor benefit plan

Subsection (b) shall not apply in the case of amounts received after December 31, 1965, as an annuity under chapter 73 (/uscode/text/10/subtitle-A/part-II/chapter-73) of title 10 (/uscode/text/10) of the United States Code, but all such amounts shall be excluded from gross income until there has been so excluded (under section 122 (/uscode/text/26/122)(b)(1) (/uscode/text/26/usc_sec_26_00000122----000-#b_1) or this section, including amounts excluded before January 1, 1966) an amount equal to the consideration for the contract (as defined by section 122 (/uscode/text/26/122)(b)(2) (/uscode/text/26/usc_sec_26_00000122----000-#b_2)), plus any amount treated pursuant to section 101 (/uscode/text/26/101)(b)(2)(D) (/uscode/text/26/usc_sec_26_00000101----000-#b_2_D) (as in effect on the day before the date of the enactment of the Small Business Job Protection Act of 1996) as additional consideration paid by the employee. Thereafter all amounts so received shall be included in gross income.

(o) Special rules for distributions from qualified plans to which employee made deductible contributions

(1) Treatment of contributions

For purposes of this section and sections 402 (/uscode/text/26/402) and 403 (/uscode/text/26/403), notwithstanding section 414 (/uscode/text/26/414)(h) (/uscode/text/26/usc_sec_26_00000414----000-#h), any deductible employee contribution made to a qualified employer plan or government plan shall be treated as an amount contributed by the employer which is not includible in the gross income of the employee.

[(2) Repealed. Pub. L. 100–647, title I, § 1011A(c)(8),Nov. 10, 1988, 102 Stat. 3476]

(3) Amounts constructively received

(A) In general

For purposes of this subsection, rules similar to the rules provided by subsection (p) (other than the exception contained in paragraph (2) thereof) shall apply.

(B) Purchase of life insurance

To the extent any amount of accumulated deductible employee contributions of an employee are applied to the purchase of life insurance contracts, such amount shall be treated as distributed to the employee in the year so applied.

(4) Special rule for treatment of rollover amounts

For purposes of sections 402 (/uscode/text/26/402)(c) (/uscode/text/26/usc_sec_26_00000402----000-#c), 403 (/uscode/text/26/403)(a)(4) (/uscode/text/26/usc_sec_26_00000403----000-#a_4), and 403 (/uscode/text/26/403)(b)(8) (/uscode/text/26/usc_sec_26_00000403----000-#b_8), 408 (/uscode/text/26/408)(d)(3) (/uscode/text/26/usc_sec_26_00000408----000-#d_3), and 457 (/uscode/text/26/457)(e)(16) (/uscode/text/26/usc_sec_26_00000457----000-#e_16), the Secretary shall prescribe regulations providing for such allocations of amounts attributable to accumulated deductible employee contributions, and for such other rules, as may be necessary to insure that such accumulated deductible employee contributions do not become eligible for additional tax benefits (or freed from limitations) through the use of rollovers.

(5) Definitions and special rules

For purposes of this subsection—

(A) Deductible employee contributions

The term "deductible employee contributions" means any qualified voluntary employee contribution (as defined in section 219 (/uscode/text/26/219)(e)(2) (/uscode/text/26/usc_sec_26_00000219----000-#e_2)) made after December 31, 1981, in a taxable year beginning after such date and made for a taxable year beginning before January 1, 1987, and allowable as a deduction under section 219 (/uscode/text/26/219)(a) (/uscode/text/26/usc_sec_26_00000219----000-#a) for such taxable year.

(B) Accumulated deductible employee contributions

The term "accumulated deductible employee contributions" means the deductible employee contributions—

(i)increased by the amount of income and gain allocable to such contributions, and

(ii)reduced by the sum of the amount of loss and expense allocable to such contributions and the amounts distributed with respect to the employee which are attributable to such contributions (or income or gain allocable to such contributions).

(C) Qualified employer plan

The term "qualified employer plan" has the meaning given to such term by subsection (p)(3)(A)(i).

(D) Government plan

The term "government plan" has the meaning given such term by subsection (p)(3)(B).

(6) Ordering rules

Unless the plan specifies otherwise, any distribution from such plan shall not be treated as being made from the accumulated deductible employee contributions, until all other amounts to the credit of the employee have been distributed.

(p) Loans treated as distributions

For purposes of this section—

(1) Treatment as distributions

(A) Loans

If during any taxable year a participant or beneficiary receives (directly or indirectly) any amount as a loan from a qualified employer plan, such amount shall be treated as having been received by such individual as a distribution under such plan.

(B) Assignments or pledges

If during any taxable year a participant or beneficiary assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified employer plan, such portion shall be treated as having been received by such individual as a loan from such plan.

(2) Exception for certain loans

(A) General rule

Paragraph (1) shall not apply to any loan to the extent that such loan (when added to the outstanding balance of all other loans from such plan whether made on, before, or after August 13, 1982), does not exceed the lesser of—

(i)$50,000, reduced by the excess (if any) of—

(I)the highest outstanding balance of loans from the plan during the 1-year period ending on the day before the date on which such loan was made, over

(II)the outstanding balance of loans from the plan on the date on which such loan was made, or

(ii)the greater of

(I) one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan, or

(II) $10,000.

For purposes of clause (ii), the present value of the nonforfeitable accrued benefit shall be determined without regard to any accumulated deductible employee contributions (as defined in subsection (o)(5)(B)).

(B) Requirement that loan be repayable within 5 years

(i) In general Subparagraph (A) shall not apply to any loan unless such loan, by its terms, is required to be repaid within 5 years.

(ii) Exception for home loans Clause (i) shall not apply to any loan used to acquire any dwelling unit which within a reasonable time is to be used (determined at the time the loan is made) as the principal residence of the participant.

(C) Requirement of level amortization

Except as provided in regulations, this paragraph shall not apply to any loan unless substantially level amortization of such loan (with payments not less frequently than quarterly) is required over the term of the loan.

(D) Related employers and related plans

For purposes of this paragraph—

(i)the rules of subsections (b), (c), and (m) ofsection 414 (/uscode/text/26/414) shall apply, and

(ii)all plans of an employer (determined after the application of such subsections) shall be treated as 1 plan.

(3) Denial of interest deductions in certain cases

(A) In general

No deduction otherwise allowable under this chapter shall be allowed under this chapter for any interest paid or accrued on any loan to which paragraph (1) does not apply by reason of paragraph (2) during the period described in subparagraph (B).

(B) Period to which subparagraph (A) applies

For purposes of subparagraph (A), the period described in this subparagraph is the period—

(i)on or after the 1st day on which the individual to whom the loan is made is a key employee (as defined in section 416 (/uscode/text/26/416)(i) (/uscode/text/26/usc_sec_26_00000416----000-#i)), or

(ii)such loan is secured by amounts attributable to elective deferrals described in subparagraph (A) or (C) of section 402 (/uscode/text/26/402)(g)(3) (/uscode/text/26/usc_sec_26_00000402----000-#g_3).

(4) Qualified employer plan, etc.

For purposes of this subsection—

(A) Qualified employer plan

(i) In general The term "qualified employer plan" means—

(I)a plan described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a) which includes a trust exempt from tax under section 501 (/uscode/text/26/501)(a) (/uscode/text/26/usc_sec_26_00000501----000-#a),

(II)an annuity plan described in section 403 (/uscode/text/26/403)(a) (/uscode/text/26/usc_sec_26_00000403----000-#a), and

(III)a plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403 (/uscode/text/26/403)(b) (/uscode/text/26/usc_sec_26_00000403----000-#b).

(ii) Special rule The term "qualified employer plan" shall include any plan which was (or was determined to be) a qualified employer plan or a government plan.

(B) Government plan

The term "government plan" means any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

(5) Special rules for loans, etc., from certain contracts

For purposes of this subsection, any amount received as a loan under a contract purchased under a qualified employer plan (and any assignment or pledge with respect to such a contract) shall be treated as a loan under such employer plan.

(q) 10-percent penalty for premature distributions from annuity contracts

(1) Imposition of penalty

If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Paragraph 1 shall not apply to any distribution—

(A)made on or after the date on which the taxpayer attains age 591/2,

(B)made on or after the death of the holder (or, where the holder is not an individual, the death of the primary annuitant (as defined in subsection (s)(6)(B))),

(C)attributable to the taxpayer's becoming disabled within the meaning of subsection (m)(7),

(D)which is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary,

(E)from a plan, contract, account, trust, or annuity described in subsection (e)(5)(D),

(F)allocable to investment in the contract before August 14, 1982, or [2]

(G)under a qualified funding asset (within the meaning of section 130 (/uscode/text/26/130)(d) (/uscode/text/26/usc_sec_26_00000130----000-#d), but without regard to whether there is a qualified assignment),

(H)to which subsection (t) applies (without regard to paragraph (2) thereof),

(I)under an immediate annuity contract (within the meaning of section 72 (/uscode/text/26/usc_sec_26_00000072----000-)(u)(4) (/uscode/text/26/usc_sec_26_00000072----000-#u_4)), or

(J)which is purchased by an employer upon the termination of a plan described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a) or 403 (/uscode/text/26/403)(a) (/uscode/text/26/usc_sec_26_00000403----000-#a) and which is held by the employer until such time as the employee separates from service.

(3) Change in substantially equal payments

If—

(A)paragraph (1) does not apply to a distribution by reason of paragraph (2)(D), and

(B)the series of payments under such paragraph are subsequently modified (other than by reason of death or disability)—

(i)before the close of the 5-year period beginning on the date of the first payment and after the taxpayer attains age 591/2, or

(ii)before the taxpayer attains age 591/2,

the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(D)) would have been imposed, plus interest for the deferral period (within the meaning of subsection (t)(4)(B)).

(r) Certain railroad retirement benefits treated as received under employer plans

(1) In general

Notwithstanding any other provision of law, any benefit provided under the Railroad Retirement Act of 1974 (other than a tier 1 railroad retirement benefit) shall be treated for purposes of this title as a benefit provided under an employer plan which meets the requirements of section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a).

(2) Tier 2 taxes treated as contributions

(A) In general

For purposes of paragraph (1)—

(i)the tier 2 portion of the tax imposed by section 3201 (/uscode/text/26/3201) (relating to tax on employees) shall be treated as an employee contribution,

(ii)the tier 2 portion of the tax imposed by section 3211 (/uscode/text/26/3211) (relating to tax on employee representatives) shall be treated as an employee contribution, and

(iii)the tier 2 portion of the tax imposed by section 3221 (/uscode/text/26/3221) (relating to tax on employers) shall be treated as an employer contribution.

(B) Tier 2 portion

For purposes of subparagraph (A)—

(i) After 1984 With respect to compensation paid after 1984, the tier 2 portion shall be the taxes imposed by sections 3201 (/uscode/text/26/3201)(b) (/uscode/text/26/usc_sec_26_00003201----000-#b), 3211 (/uscode/text/26/3211)(b) (/uscode/text/26/usc_sec_26_00003211----000-#b), and 3221 (/uscode/text/26/3221)(b) (/uscode/text/26/usc_sec_26_00003221----000-#b).

(ii) After September 30, 1981, and before 1985 With respect to compensation paid before 1985 for services rendered after September 30, 1981, the tier 2 portion shall be—

(I)so much of the tax imposed by section 3201 (/uscode/text/26/3201) as is determined at the 2 percent rate, and

(II)so much of the taxes imposed by sections 3211 (/uscode/text/26/3211) and 3221 (/uscode/text/26/3221) as is determined at the 11.75 percent rate.

With respect to compensation paid for services rendered after December 31, 1983, and before 1985, subclause (I) shall be applied by substituting "2.75 percent" for "2 percent", and subclause (II) shall be applied by substituting "12.75 percent" for "11.75 percent".

(iii) Before October 1, 1981 With respect to compensation paid for services rendered during any period before October 1, 1981, the tier 2 portion shall be the excess (if any) of—

(I)the tax imposed for such period by section 3201 (/uscode/text/26/3201), 3211 (/uscode/text/26/3211), or 3221 (/uscode/text/26/3221), as the case may be (other than any tax imposed with respect to man-hours), over

(II)the tax which would have been imposed by such section for such period had the rates of the comparable taxes imposed by chapter 21 for such period applied under such section.

(C) Contributions not allocable to supplemental annuity or windfall benefits

For purposes of paragraph (1), no amount treated as an employee contribution under this paragraph shall be allocated to—

(i)any supplemental annuity paid under section 2(b) of the Railroad Retirement Act of 1974, or

(ii)any benefit paid under section 3(h), 4(e), or 4(h) of such Act.

(3) Tier 1 railroad retirement benefit

For purposes of paragraph (1), the term "tier 1 railroad retirement benefit" has the meaning given such term by section 86 (/uscode/text/26/86)(d)(4) (/uscode/text/26/usc_sec_26_00000086----000-#d_4).

(s) Required distributions where holder dies before entire interest is distributed

(1) In general

A contract shall not be treated as an annuity contract for purposes of this title unless it provides that—

(A)if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and

(B)if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

(2) Exception for certain amounts payable over life of beneficiary

If—

(A)any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,

(B)such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(C)such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe,

then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin.

(3) Special rule where surviving spouse beneficiary

If the designated beneficiary referred to in paragraph (2)(A) is the surviving spouse of the holder of the contract, paragraphs (1) and (2) shall be applied by treating such spouse as the holder of such contract.

(4) Designated beneficiary

For purposes of this subsection, the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

(5) Exception for certain annuity contracts

This subsection shall not apply to any annuity contract—

(A)which is provided—

(i)under a plan described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a) which includes a trust exempt from tax under section 501 (/uscode/text/26/501), or

(ii)under a plan described in section 403 (/uscode/text/26/403)(a) (/uscode/text/26/usc_sec_26_00000403----000-#a),

(B)which is described in section 403 (/uscode/text/26/403)(b) (/uscode/text/26/usc_sec_26_00000403----000-#b),

(C)which is an individual retirement annuity or provided under an individual retirement account or annuity, or

(D)which is a qualified funding asset (as defined in section 130 (/uscode/text/26/130)(d) (/uscode/text/26/usc_sec_26_00000130----000-#d), but without regard to whether there is a qualified assignment).

(6) Special rule where holder is corporation or other non-individual

(A) In general

For purposes of this subsection, if the holder of the contract is not an individual, the primary annuitant shall be treated as the holder of the contract.

(B) Primary annuitant

For purposes of subparagraph (A), the term "primary annuitant" means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

(7) Treatment of changes in primary annuitant where holder of contract is not an individual

For purposes of this subsection, in the case of a holder of an annuity contract which is not an individual, if there is a change in a primary annuitant (as defined in paragraph (6)(B)), such change shall be treated as the death of the holder.

(t) 10-percent additional tax on early distributions from qualified retirement plans

(1) Imposition of additional tax

If any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974 (/uscode/text/26/4974)(c) (/uscode/text/26/usc_sec_26_00004974----000-#c)), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Except as provided in paragraphs (3) and (4), paragraph (1) shall not apply to any of the following distributions:

(A) In general

Distributions which are—

(i)made on or after the date on which the employee attains age 591/2,

(ii)made to a beneficiary (or to the estate of the employee) on or after the death of the employee,

(iii)attributable to the employee's being disabled within the meaning of subsection (m)(7),

(iv)part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary,

(v)made to an employee after separation from service after attainment of age 55,

(vi)dividends paid with respect to stock of a corporation which are described in section 404 (/uscode/text/26/404)(k) (/uscode/text/26/usc_sec_26_00000404----000-#k),

(vii)made on account of a levy under section 6331 (/uscode/text/26/6331) on the qualified retirement plan, or

(viii)payments under a phased retirement annuity under section 8366a(a)(5) [3] or 8412a (/uscode/text/5/8412a)(a)(5) (/uscode/text/5/usc_sec_05_00008412---a000-#a_5) of title 5 (/uscode/text/5), United States Code, or a composite retirement annuity under section 8366a(a)(1) [3] or 8412a(a)(1) of such title.

(B) Medical expenses

Distributions made to the employee (other than distributions described in subparagraph (A), (C), or (D)) to the extent such distributions do not exceed the amount allowable as a deduction under section 213 (/uscode/text/26/213) to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).

(C) Payments to alternate payees pursuant to qualified domestic relations orders

Any distribution to an alternate payee pursuant to a qualified domestic relations order (within the meaning of section 414 (/uscode/text/26/414)(p)(1) (/uscode/text/26/usc_sec_26_00000414----000-#p_1)).

(D) Distributions to unemployed individuals for health insurance premiums

(i) In general Distributions from an individual retirement plan to an individual after separation from employment—

(I)if such individual has received unemployment compensation for 12 consecutive weeks under any Federal or State unemployment compensation law by reason of such separation,

(II)if such distributions are made during any taxable year during which such unemployment compensation is paid or the succeeding taxable year, and

(III)to the extent such distributions do not exceed the amount paid during the taxable year for insurance described in section 213 (/uscode/text/26/213)(d)(1)(D) (/uscode/text/26/usc_sec_26_00000213----000-#d_1_D) with respect to the individual and the individual's spouse and dependents (as defined in section 152 (/uscode/text/26/152), determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof).

(ii) Distributions after reemployment Clause (i) shall not apply to any distribution made after the individual has been employed for at least 60 days after the separation from employment to which clause (i) applies.

(iii) Self-employed individuals To the extent provided in regulations, a self-employed individual shall be treated as meeting the requirements of clause (i)(I) if, under Federal or State law, the individual would have received unemployment compensation but for the fact the individual was self-employed.

(E) Distributions from individual retirement plans for higher education expenses

Distributions to an individual from an individual retirement plan to the extent such distributions do not exceed the qualified higher education expenses (as defined in paragraph (7)) of the taxpayer for the taxable year. Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), or (D) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B).

(F) Distributions from certain plans for first home purchases

Distributions to an individual from an individual retirement plan which are qualified first-time homebuyer distributions (as defined in paragraph (8)). Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), (D), or (E) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B).

(G) Distributions from retirement plans to individuals called to active duty

(i) In general Any qualified reservist distribution.

(ii) Amount distributed may be repaid Any individual who receives a qualified reservist distribution may, at any time during the 2-year period beginning on the day after the end of the active duty period, make one or more contributions to an individual retirement plan of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to individual retirement plans shall not apply to any contribution made pursuant to the preceding sentence. No deduction shall be allowed for any contribution pursuant to this clause.

(iii) Qualified reservist distribution For purposes of this subparagraph, the term "qualified reservist distribution" means any distribution to an individual if—

(I)such distribution is from an individual retirement plan, or from amounts attributable to employer contributions made pursuant to elective deferrals described in subparagraph (A) or (C) of section 402 (/uscode/text/26/402)(g)(3) (/uscode/text/26/usc_sec_26_00000402----000-#g_3) orsection 501 (/uscode/text/26/501)(c)(18)(D)(iii) (/uscode/text/26/usc_sec_26_00000501----000-#c_18_D_iii),

(II)such individual was (by reason of being a member of a reserve component (as defined in section 101 (/uscode/text/37/101) of title 37 (/uscode/text/37), United States Code)) ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and

(III)such distribution is made during the period beginning on the date of such order or call and ending at the close of the active duty period.

(iv) Application of subparagraph This subparagraph applies to individuals ordered or called to active duty after September 11, 2001. In no event shall the 2-year period referred to in clause (ii) end before the date which is 2 years after the date of the enactment of this subparagraph.

(3) Limitations

(A) Certain exceptions not to apply to individual retirement plans

Subparagraphs (A)(v) and (C) of paragraph (2) shall not apply to distributions from an individual retirement plan.

(B) Periodic payments under qualified plans must begin after separation

Paragraph (2)(A)(iv) shall not apply to any amount paid from a trust described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a) which is exempt from tax under section 501 (/uscode/text/26/501)(a) (/uscode/text/26/usc_sec_26_00000501----000-#a) or from a contract described in section 72 (/uscode/text/26/usc_sec_26_00000072----000-)(e)(5)(D)(ii) (/uscode/text/26/usc_sec_26_00000072----000-#e_5_D_ii) unless the series of payments begins after the employee separates from service.

(4) Change in substantially equal payments

(A) In general

If—

(i)paragraph (1) does not apply to a distribution by reason of paragraph (2)(A)(iv), and

(ii)the series of payments under such paragraph are subsequently modified (other than by reason of death or disability)—

(I)before the close of the 5-year period beginning with the date of the first payment and after the employee attains age 591/2, or

(II)before the employee attains age 591/2,

the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(A)(iv)) would have been imposed, plus interest for the deferral period.

(B) Deferral period

For purposes of this paragraph, the term "deferral period" means the period beginning with the taxable year in which (without regard to paragraph (2)(A)(iv)) the distribution would have been includible in gross income and ending with the taxable year in which the modification described in subparagraph (A) occurs.

(5) Employee

For purposes of this subsection, the term "employee" includes any participant, and in the case of an individual retirement plan, the individual for whose benefit such plan was established.

(6) Special rules for simple retirement accounts

In the case of any amount received from a simple retirement account (within the meaning of section 408 (/uscode/text/26/408)(p) (/uscode/text/26/usc_sec_26_00000408----000-#p)) during the 2-year period beginning on the date such individual first participated in any qualified salary reduction arrangement maintained by the individual's employer under section 408 (/uscode/text/26/408)(p)(2) (/uscode/text/26/usc_sec_26_00000408----000-#p_2), paragraph (1) shall be applied by substituting "25 percent" for "10 percent".

(7) Qualified higher education expenses

For purposes of paragraph (2)(E)—

(A) In general

The term "qualified higher education expenses" means qualified higher education expenses (as defined in section 529 (/uscode/text/26/529)(e)(3) (/uscode/text/26/usc_sec_26_00000529----000-#e_3)) for education furnished to—

(i)the taxpayer,

(ii)the taxpayer's spouse, or

(iii)any child (as defined in section 152 (/uscode/text/26/152)(f)(1) (/uscode/text/26/usc_sec_26_00000152----000-#f_1)) or grandchild of the taxpayer or the taxpayer's spouse,

at an eligible educational institution (as defined in section 529 (/uscode/text/26/529)(e)(5) (/uscode/text/26/usc_sec_26_00000529----000-#e_5)).

(B) Coordination with other benefits

The amount of qualified higher education expenses for any taxable year shall be reduced as provided in section 25A (/uscode/text/26/25A)(g)(2) (/uscode/text/26/usc_sec_26_00000025---A000-#g_2).

(8) Qualified first-time homebuyer distributions

For purposes of paragraph (2)(F)—

(A) In general

The term "qualified first-time homebuyer distribution" means any payment or distribution received by an individual to the extent such payment or distribution is used by the individual before the close of the 120th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is such individual, the spouse of such individual, or any child, grandchild, or ancestor of such individual or the individual's spouse.

(B) Lifetime dollar limitation

The aggregate amount of payments or distributions received by an individual which may be treated as qualified first-time homebuyer distributions for any taxable year shall not exceed the excess (if any) of—

(i)$10,000, over

(ii)the aggregate amounts treated as qualified first-time homebuyer distributions with respect to such individual for all prior taxable years.

(C) Qualified acquisition costs

For purposes of this paragraph, the term "qualified acquisition costs" means the costs of acquiring, constructing, or reconstructing a residence. Such term includes any usual or reasonable settlement, financing, or other closing costs.

(D) First-time homebuyer; other definitions

For purposes of this paragraph—

(i) First-time homebuyer The term "first-time homebuyer" means any individual if—

(I)such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this paragraph applies, and

(II)subsection (h) or (k) ofsection 1034 (/uscode/text/26/1034) [4] (as in effect on the day before the date of the enactment of this paragraph) did not suspend the running of any period of time specified in section 1034 (/uscode/text/26/1034) [4] (as so in effect) with respect to such individual on the day before the date the distribution is applied pursuant to subparagraph (A).

(ii) Principal residence The term "principal residence" has the same meaning as when used in section 121 (/uscode/text/26/121).

(iii) Date of acquisition The term "date of acquisition" means the date—

(I)on which a binding contract to acquire the principal residence to which subparagraph (A) applies is entered into, or

(II)on which construction or reconstruction of such a principal residence is commenced.

(E) Special rule where delay in acquisition

If any distribution from any individual retirement plan fails to meet the requirements of subparagraph (A) solely by reason of a delay or cancellation of the purchase or construction of the residence, the amount of the distribution may be contributed to an individual retirement plan as provided in section 408 (/uscode/text/26/408)(d)(3)(A)(i) (/uscode /text/26/usc_sec_26_00000408----000-#d_3_A_i) (determined by substituting "120th day" for "60th day" in such section), except that—

(i)section 408 (/uscode/text/26/408)(d)(3)(B) (/uscode/text/26 /usc_sec_26_00000408----000-#d_3_B) shall not be applied to such contribution, and

(ii)such amount shall not be taken into account in determining whether section 408 (/uscode/text/26/408)(d)(3)(B) (/uscode/text/26 /usc_sec_26_00000408----000-#d_3_B) applies to any other amount.

(9) Special rule for rollovers to section 457 plans

For purposes of this subsection, a distribution from an eligible deferred compensation plan (as defined in section 457(b)) of an eligible employer described in section 457 (/uscode/text/26/457)(e)(1)(A) (/uscode/text/26 /usc_sec_26_00000457----000-#e_1_A) shall be treated as a distribution from a qualified retirement plan described in 4974(c)(1) to the extent that such distribution is attributable to an amount transferred to an eligible deferred compensation plan from a qualified retirement plan (as defined in section 4974 (/uscode/text/26/4974)(c) (/uscode/text/26 /usc_sec_26_00004974----000-#c)).

(10) Distributions to qualified public safety employees in

governmental plans

(A) In general

In the case of a distribution to a qualified public safety employee from a governmental plan (within the meaning of section 414 (/uscode/text/26/414)(d) (/uscode/text/26/usc_sec_26_00000414----000-#d)) which is a defined benefit plan, paragraph (2)(A)(v) shall be applied by substituting "age 50" for "age 55".

(B) Qualified public safety employee

For purposes of this paragraph, the term "qualified public safety employee" means any employee of a State or political subdivision of a State who provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision.

(u) Treatment of annuity contracts not held by natural persons

(1) In general

If any annuity contract is held by a person who is not a natural person—

(A)such contract shall not be treated as an annuity contract for purposes of this subtitle (other than subchapter L), and

(B)the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year.

For purposes of this paragraph, holding by a trust or other entity as an agent for a natural person shall not be taken into account.

(2) Income on the contract

(A) In general

For purposes of paragraph (1), the term "income on the contract" means, with respect to any taxable year of the policyholder, the excess of—

(i)the sum of the net surrender value of the contract as of the close of the taxable year plus all distributions under the contract received during the taxable year or any prior taxable year, reduced by

(ii)the sum of the amount of net premiums under the contract for the taxable year and prior taxable years and amounts includible in gross income for prior taxable years with respect to such contract under this subsection.

Where necessary to prevent the avoidance of this subsection, the Secretary may substitute "fair market value of the contract" for "net surrender value of the contract" each place it appears in the preceding sentence.

(B) Net premiums

For purposes of this paragraph, the term "net premiums" means the amount of premiums paid under the contract reduced by any policyholder dividends.

(3) Exceptions

This subsection shall not apply to any annuity contract which—

(A)is acquired by the estate of a decedent by reason of the death of the decedent,

(B)is held under a plan described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26/usc_sec_26_00000401----000-#a) or 403 (/uscode /text/26/403)(a) (/uscode/text/26/usc_sec_26_00000403----000-#a), under a program described in section 403 (/uscode/text/26/403)(b) (/uscode/text/26/usc_sec_26_00000403----000-#b), or under an individual retirement plan,

(C)is a qualified funding asset (as defined in section 130 (/uscode /text/26/130)(d) (/uscode/text/26/usc_sec_26_00000130----000-#d), but without regard to whether there is a qualified assignment),

(D)is purchased by an employer upon the termination of a plan described in section 401 (/uscode/text/26/401)(a) (/uscode/text/26 /usc_sec_26_00000401----000-#a) or 403 (/uscode/text/26/403)(a) (/uscode/text/26/usc_sec_26_00000403----000-#a) and is held by the employer until all amounts under such contract are distributed to the employee for whom such contract was purchased or the employee's beneficiary, or

(E)is an immediate annuity.

(4) Immediate annuity

For purposes of this subsection, the term "immediate annuity" means an annuity—

(A)which is purchased with a single premium or annuity consideration,

(B)the annuity starting date (as defined in subsection (c)(4)) of which commences no later than 1 year from the date of the purchase of the annuity, and

(C)which provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.

(v) 10-percent additional tax for taxable distributions from modified endowment contracts

(1) Imposition of additional tax

If any taxpayer receives any amount under a modified endowment contract (as defined in section 7702A (/uscode/text/26/7702A)), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions

Paragraph (1) shall not apply to any distribution—

(A)made on or after the date on which the taxpayer attains age 591/2,

(B)which is attributable to the taxpayer's becoming disabled (within the meaning of subsection (m)(7)), or

(C)which is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his beneficiary.

(w) Application of basis rules to nonresident aliens

(1) In general

Notwithstanding any other provision of this section, for purposes of determining the portion of any distribution which is includible in gross income of a distributee who is a citizen or resident of the United States, the investment in the contract shall not include any applicable nontaxable contributions or applicable nontaxable earnings.

(2) Applicable nontaxable contribution

For purposes of this subsection, the term "applicable nontaxable contribution" means any employer or employee contribution—

(A)which was made with respect to compensation—

(i)for labor or personal services performed by an employee who, at the time the labor or services were performed, was a nonresident alien for purposes of the laws of the United States in effect at such time, and

(ii)which is treated as from sources without the United States, and

(B)which was not subject to income tax (and would have been subject to income tax if paid as cash compensation when the services were rendered) under the laws of the United States or any foreign country.

(3) Applicable nontaxable earnings

For purposes of this subsection, the term "applicable nontaxable earnings" means earnings—

(A)which are paid or accrued with respect to any employer or employee contribution which was made with respect to compensation for labor or personal services performed by an employee,

(B)with respect to which the employee was at the time the earnings were paid or accrued a nonresident alien for purposes of the laws of the United States, and

(C)which were not subject to income tax under the laws of the United States or any foreign country.

(4) **Regulations**

The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this subsection, including regulations treating contributions and earnings as not subject to tax under the laws of any foreign country where appropriate to carry out the purposes of this subsection.

(x) Cross reference

For limitation on adjustments to basis of annuity contracts sold, see section 1021 (/uscode/text/26/1021).

[1] So in original. Probably should be paragraph "(2)(B)".

[2] So in original. The word "or" probably should not appear.

[3] So in original. Probably should refer to section 8336a.

[4] See References in Text note below.

IRS

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Retirement Topics - Exceptions to Tax on Early Distributions

Most retirement plan distributions are subject to income tax and may be subject to an additional 10% tax.

Generally, the amounts an individual withdraws from an IRA or retirement plan before reaching age 59½ are called "early" or "premature" distributions. Individuals must pay an additional 10% early withdrawal tax unless an exception applies.

The distribution will NOT be subject to the 10% additional early distribution tax in the following circumstances:	Exception to 10% Additional Tax		
	Qualified Plans (401(k), etc.)	**IRA, SEP, SIMPLE IRA* and SARSEP Plans**	**Internal Revenue Code Section(s)**
Age			
after participant/IRA owner reaches age 59½	yes	yes	72(t)(2)(A)(i)
Automatic Enrollment			
permissive withdrawals from a plan with auto enrollment features	yes	yes for SIMPLE IRAs and SARSEPs	414(w)(1)(B)
Corrective Distributions			
corrective distributions (and associated earnings) of excess contributions, excess aggregate contributions and excess deferrals, made timely	yes	n/a	401(k)(8)(D), 401(m)(7)(A), 402(g)(2)(C)
Death			
after death of the participant/IRA owner	yes	yes	72(t)(2)(A)(ii)
Disability			
total and permanent disability of the participant/IRA owner	yes	yes	72(t)(2)(A)(iii)
Domestic Relations			
to an alternate payee under a Qualified Domestic Relations Order	yes	n/a	72(t)(2)(C)
Education			
qualified higher education expenses	no	yes	72(t)(2)(E)
Equal Payments			
series of substantially equal payments	yes	yes	72(t)(2)(A)(iv)
ESOP			
dividend pass through from an ESOP	yes	n/a	72(t)(2)(A)(vi)
Homebuyers			
qualified first-time homebuyers, up to $10,000	no	yes	72(t)(2)(F)
Levy			

because of an IRS levy of the plan	yes	yes	72(t)(2)(A)(vii)
Medical			
amount of unreimbursed medical expenses (>7.5% AGI; after 2012, 10% if under age 65)	yes	yes	72(t)(2)(B)
health insurance premiums paid while unemployed	no	yes	72(t)(2)(D)
Military			
certain distributions to qualified military reservists called to active duty	yes	yes	72(t)(2)(G)
Returned IRA Contributions			
if withdrawn by extended due date of return	n/a	yes	408(d)(4)
earnings on these returned contributions	n/a	no	408(d)(4)
Rollovers			
in-plan Roth rollovers or eligible distributions contributed to another retirement plan or IRA within 60 days	yes	yes	402(c), 402A(d)(3), 403(a)(4), 403(b)(8), 408(d)(3), 408A(d)(3)
Separation from Service			
the employee separates from service during or after the year the employee reaches age 55 (age 50 for public safety employees of a state, or political subdivision of a state, in a governmental defined benefit plan)**	yes	no	72(t)(2)(A)(v), 72(t)(10)

Nonqualified 457(b) plans: Governmental 457(b) distributions are not subject to the 10% additional tax except for distributions attributable to rollovers from another type of plan or IRA.

*SIMPLE IRA distributions incur a 25% additional tax instead of 10% if made within the first 2 years of participation

**Qualified public safety employees

Effective for distributions after December 31, 2015, the exception for pubic safety employees who are age 50 or over is expanded to include specified federal law enforcement officers, customs and border protection officers, federal firefighters and air traffic controllers. Also, the restriction that only defined benefit plans qualify for the exemption is eliminated. Thus, an exemption is allowed for distributions from defined contribution plans or other types of governmental plans, such as the TSP. See IRC Section 72(t)(10), as amended by the Defending Public Safety Employees' Retirement Act, P.L. 114-26.

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Retirement Plans FAQs regarding Substantially Equal Periodic Payments

These frequently asked questions and answers provide general information and should not be cited as any type of legal authority. They provide the user with information responsive to general inquiries. Because these answers do not apply to every situation, yours may require additional research.

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Is there an additional income tax on early distributions from retirement plans and IRAs?

An additional 10% tax applies to early distributions (before the participant reaches age 59½) from a retirement plan or IRA under Code §72(t)(1). Section 72(t)(2) lists exceptions to this tax, including distributions received in substantially equal periodic payments.

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Is there an exception to the tax for distributions in substantially equal periodic payments?

Yes. If distributions are made as part of a series of substantially equal periodic payments over your life expectancy or the life expectancies of you and your designated beneficiary, the §72(t) tax does not apply. If these distributions are from a qualified plan, not an IRA, you must separate from service with the employer maintaining the plan before the payments begin for this exception to apply. If the series of substantially equal periodic payments is subsequently modified (other than by reason of death or disability) within 5 years of the date of the first payment, or, if later, age 59½, the exception to the 10% tax does not apply. In that case, your tax for the modification year is increased by the amount that would have been imposed (but for the exception), plus interest for the deferral period.

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Is there guidance on this exception?

Yes. Rev. Rul. 2002-62 lists three methods you may use in determining what are substantially equal periodic payments:

1. the required minimum distribution method,
2. the amortization method, and
3. the annuitization method.

All three methods require the use of a life expectancy or mortality table. The second and third methods require you to specify an acceptable interest rate.

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How are interest rates determined?

You may use any interest rate that is not more than 120% of the federal mid-term rate published in

IRS revenue rulings for either of the two months immediately before distributions begin.

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How is life expectancy determined?

You may use the:

1. uniform life table in Appendix A of Rev. Rul. 2002-62,
2. single life expectancy table in I.T. Regulations §1.401(a)(9)-9, Q&A-1, or
3. joint life and last survivor table in I.T. Regulations §1.401(a)(9)-9, Q&A-3.

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How is the account balance determined?

The account balance may be determined in any reasonable manner based on the facts and circumstances.

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How are payments determined under the three methods?

Example:

Bob, age 50, is the owner of an IRA from which he would like to start taking distributions beginning in 2011. He would like to avoid the §72(t) additional 10% tax imposed on early distributions by taking advantage of the substantially-equal-periodic-payment exception.

- Bob's IRA account balance is $400,000 as of December 31, 2010 (the last valuation prior to the first distribution)
- 120% of the applicable federal mid-term rate is assumed to be 2.98%, and this will be the interest rate Bob uses under the amortization and annuitization methods
- Bob will determine distributions over his own life expectancy only

Required minimum distribution method

The required minimum distribution method consists of an account balance and a life expectancy (single life or uniform life or joint life and last survivor each using attained age(s) in the distribution calculation year). The annual payment is redetermined each year.

For 2011, the annual distribution amount is calculated by dividing the December 31, 2010, account balance ($400,000) by the single life expectancy (34.2) obtained from I.T. Regs. §1.401(a)(9)-9 Q&A-1, using age 50 ($400,000/34.2 = $11,696).

For subsequent years, the annual distribution amount will be calculated by dividing the account balance as of December 31 of the prior year by the single life expectancy. Use the same single life expectancy table used in prior year calculations, but use the current age. For example, if Bob's IRA account balance, after the 2011 distribution has been paid, is $408,304 on December 31, 2011, the annual distribution amount for 2012 ($12,261) is calculated by dividing the December 31, 2011 account balance ($408,304) by the single life expectancy (33.3) obtained from Q&A-1 of I.T Regulations §1.401(a)(9)-9 using age 51 ($408,304/33.3 = $12,261).

Fixed amortization method

The fixed amortization method consists of an account balance amortized over a specified number of years equal to life expectancy (single life uniform life or joint life and last survivor) and an interest rate of not more than 120% of the federal mid-term rate. Once an annual distribution amount is calculated under this method, the same dollar amount must be distributed in subsequent years.

For 2011, the annual distribution amount is calculated by amortizing the account balance ($400,000) over a number of years equal to Bob's single life expectancy (34.2) (obtained from Q&A-1 of I.T. Regs. §1.401(a)(9)-9 using age 50), at a 2.98% interest rate (April 2011 rates). The annual distribution amount is $18,811.

Fixed annuitization method

The fixed annuitization method consists of an account balance, an annuity factor and an annual payment. The annuity factor is calculated based on the mortality table in Appendix B of Rev. Rul. 2002-62 and an interest rate of not more than 120% of the federal mid-term rate. Once an annual distribution amount is calculated under this method, the same dollar amount must be distributed in subsequent years.

Under this method the annual distribution amount is equal to the account balance ($400,000) divided by an annuity factor that would provide one dollar per year over Bob's life, beginning at age 50. The age 50 annuity factor (21.345) is calculated based on the Rev. Rul. 2002-62 Appendix B mortality table and an interest rate of 2.98%. The annual distribution amount is calculated as \$400,000/21.345 = \$18,740.

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Can I change from one method to another in calculating substantially equal periodic payments?

Yes. Rev. Rul. 2002-62 permits a one-time change from either the amortization method or the annuitization method to the required minimum distribution method.

For example, assume Sam started receiving distributions from his IRA in annual substantially equal periodic payments in 2007 at age 50. His annual payment of \$65,809 was originally calculated using the amortization method. Sam would like to use the special rule in Rev. Rul. 2002-62 allowing a one-time change to the required minimum distribution method to determine a new annual distribution amount beginning in 2011. For this one-time change in method, Sam will determine an annual distribution amount for 2011 using his IRA account balance on March 31, 2011 (\$750,000), and a single life expectancy of 30.5 (obtained from Regulations §1.401(a)(9)-9, Q&A-1, using age 54).

Under the new method, the 2011 distribution amount is \$24,590 (\$750,000/30.5). Sam must use the required minimum distribution method to determine the annual distribution amount for subsequent years.

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What is the effect of an account being completely depleted?

If you have no assets remaining in your individual account plan or IRA, you will not be subject to the Code §72(t) tax as a result of not receiving substantially equal periodic payments. In addition, the recapture tax will not apply.

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Are these methods the only acceptable ways of determining substantially equal periodic payments?

No. Another method may be used in a private letter ruling request, but, of course, it would be subject to individual analysis.

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Can I take my substantially equal payments on a monthly basis?

The simple answer is yes. Your monthly payment under the required minimum distribution method would be the calculated annual amount divided by 12. Under the amortization and annuity methods, the choice of a having the payment made monthly should be part of the original calculation.

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When do I fulfill my obligation to take substantially equal periodic payments?

The substantially equal period payments must generally continue for at least five full years, or if later, until age 59 ½. For example, if you began taking payments at age 56 on December 1, 2006, you may not take a different distribution or alter the amount of the payment until December 1, 2011, even though your fifth payment was taken on December 1, 2010.

If you begin taking substantially equal periodic payments on December 1, 2005, and you turn 59 ½ on July 1, 2011, you may not take a different distribution or alter the amount of the payment until July 1, 2011.

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Internal Revenue

bulletin

Bulletin No. 2002–42
October 21, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Notice 2002–66, page 715.
This notice extends through the end of calendar year 2002 the transitional documentation and reporting relief for foreign partnerships, Qualified Intermediaries (QIs), and U.S. withholding agents specified in Notice 2001–4.

Notice 2002–67, page 715.
Gain or loss; payments to peanut quota holders. Information is provided, in a question and answer format, to holders of peanut quotas regarding the tax treatment of federal payments made under section 1309 of the Farm Security and Rural Investment Act of 2002.

Announcement 2002–94, page 727.
This document contains corrections to proposed regulations (REG–136311–01, 2002–36 I.R.B. 485) that explain when a foreign corporation engaged in the international operation of ships or aircraft may exclude its U.S. source income from gross income for U.S. federal income tax purposes.

EMPLOYEE PLANS

Rev. Rul. 2002–62, page 710.
Substantially equal periodic payments; premature distributions. This ruling provides that a change to the required minimum distribution method of calculating substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) of the Code will not generate additional income tax under section 72(t)(1). Notice 89–25 modified.

EXEMPT ORGANIZATIONS

Rev. Proc. 2002–64, page 717.
This procedure provides a modified and supplemented list of Indian tribal governments that are to be treated similarly to states for specified purposes under the Internal Revenue Code. This list has been coordinated with the list of recognized tribes published by the Department of Interior, Bureau of Indian Affairs. Rev. Proc. 2001–15 superseded.

EXCISE TAX

Announcement 2002–95, page 727.
This document contains a notice of public hearing scheduled for February 27, 2003, on proposed regulations (REG–103829–99, 2002–27 I.R.B. 59) relating to the definition of a highway vehicle for purposes of various excise taxes.

ADMINISTRATIVE

Notice 2002–66, page 715.
This notice extends through the end of calendar year 2002 the transitional documentation and reporting relief for foreign partnerships, Qualified Intermediaries (QIs), and U.S. withholding agents specified in Notice 2001–4.

Rev. Proc. 2002–66, page 724.
Penalties; substantial understatement. Guidance is provided concerning when information shown on a return in accordance with the applicable forms and instructions will be adequate disclosure for purposes of reducing an understatement of income tax under section 6662(d) of the Code. Rev. Proc. 2001–52 updated.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I. — 1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Section 72.—Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

Substantially equal periodic payments; premature distributions. This ruling provides that a change to the required minimum distribution method of calculating substantially equal periodic payments within the meaning of section 72(t)(2)(A)(iv) of the Code will not generate additional income tax under section 72(t)(1). Q&A–12 of Notice 89–25 modified.

Rev. Rul. 2002–62

SECTION 1. PURPOSE AND BACKGROUND

.01 The purpose of this revenue ruling is to modify the provisions of Q&A–12 of Notice 89–25, 1989–1 C.B. 662, which provides guidance on what constitutes a series of substantially equal periodic payments within the meaning of § 72(t)(2)(A)(iv) of the Internal Revenue Code from an individual account under a qualified retirement plan. Section 72(t) provides for an additional income tax on early withdrawals from qualified retirement plans (as defined in § 4974(c)). Section 4974(c) provides, in part, that the term "qualified retirement plan" means (1) a plan described in § 401 (including a trust exempt from tax under § 501(a)), (2) an annuity plan described in § 403(a), (3) a tax-sheltered annuity arrangement described in § 403(b), (4) an individual retirement account described in § 408(a), or (5) an individual retirement annuity described in § 408(b).

.02 (a) Section 72(t)(1) provides that if an employee or IRA owner receives any amount from a qualified retirement plan before attaining age 59½, the employee's or IRA owner's income tax is increased by an amount equal to 10-percent of the amount that is includible in the gross income unless one of the exceptions in § 72(t)(2) applies.

(b) Section 72(t)(2)(A)(iv) provides, in part, that if distributions are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and beneficiary, the tax described in § 72(t)(1) will not be applicable. Pursuant to § 72(t)(5), in the case of distributions from an IRA, the IRA owner is substituted for the employee for purposes of applying this exception.

(c) Section 72(t)(4) provides that if the series of substantially equal periodic payments that is otherwise excepted from the 10-percent tax is subsequently modified (other than by reason of death or disability) within a 5-year period beginning on the date of the first payment, or, if later, age 59½, the exception to the 10-percent tax does not apply, and the taxpayer's tax for the year of modification shall be increased by an amount which, but for the exception, would have been imposed, plus interest for the deferral period.

(d) Q&A–12 of Notice 89–25 sets forth three methods for determining whether payments to individuals from their IRAs or, if they have separated from service, from their qualified retirement plans constitute a series of substantially equal periodic payments for purposes of § 72(t)(2)(A)(iv).

(e) Final Income Tax Regulations that were published in the April 17, 2002, issue of the **Federal Register** (T.D. 8987, 2002–19 I.R.B. 852) under § 401(a)(9) provide new life expectancy tables for determining required minimum distributions.

SECTION 2. METHODS

.01 *General rule.* Payments are considered to be substantially equal periodic payments within the meaning of § 72(t)(2)(A)(iv) if they are made in accordance with one of the three calculations described in paragraphs (a) – (c) of this subsection (which is comprised of the three methods described in Q&A–12 of Notice 89–25).

(a) *The required minimum distribution method.* The annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year. If this method is chosen, there will not be deemed to be a modification in the series of substantially equal periodic payments, even if the amount of payments changes from year to year, provided there is not a change to another method of determining the payments.

(b) *The fixed amortization method.* The annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the chosen interest rate. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

(c) *The fixed annuitization method.* The annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the individual and beneficiary). The annuity factor is derived using the mortality table in Appendix B and using the chosen interest rate. Under this method, the account balance, the annuity factor, the chosen interest rate and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

.02 *Other rules.* The following rules apply for purposes of this section.

(a) *Life expectancy tables.* The life expectancy tables that can be used to determine distribution periods are: (1) the uniform lifetime table in Appendix A, or (2) the single life expectancy table in § 1.401(a)(9)–9, Q&A–1 of the Income Tax Regulations or (3) the joint and last survivor table in § 1.401(a)(9)–9, Q&A–3. The number that is used for a distribution year is the number shown from the table for the employee's (or IRA owner's) age on his or her birthday in that year. If the joint and survivor table is being used, the age of the beneficiary on the beneficiary's birthday in the year is also used. In the case of the required minimum distribution method, the same life expectancy table that is used for the first distribution year must be used in each following year. Thus, if the taxpayer uses the single life expectancy table for the required minimum distribution method in the first distribution year, the same table must be used in subsequent distribution years.

(b) *Beneficiary under joint tables.* If the joint life and last survivor table in § 1.401(a)(9)–9, Q&A–3, is used, the survivor must be the actual beneficiary of the employee with respect to the account for the year of the distribution. If there is more than one beneficiary, the identity and age of the beneficiary used for purposes of each of the methods described in section 2.01 are determined under the rules for determining the designated beneficiary for purposes of § 401(a)(9). The beneficiary is determined for a year as of January 1 of the year, without regard to changes in the beneficiary in that year or beneficiary determinations in prior years. For example, if a taxpayer starts distributions from an IRA in 2003 at age 50 and a 25-year-old and 55-year-old are beneficiaries on January 1, the 55-year-old is the designated beneficiary and the number for the taxpayer from the joint and last survivor tables (age 50 and age 55) would be 38.3, even though later in 2003 the 55-year-old is eliminated as a beneficiary. However, if that beneficiary is eliminated or dies in 2003, under the required minimum distribution method, that individual would not be taken into account in future years. If, in any year there is no beneficiary, the single life expectancy table is used for that year.

(c) *Interest rates.* The interest rate that may be used is any interest rate that is not more than 120 percent of the federal mid-term rate (determined in accordance with § 1274(d) for either of the two months immediately preceding the month in which the distribution begins). The revenue rulings that contain the § 1274(d) federal mid-term rates may be found at *www.irs.gov/taxpros/lists/0,,id=98042,00.html.*

(d) *Account balance.* The account balance that is used to determine payments must be determined in a reasonable manner based on the facts and circumstances. For example, for an IRA with daily valuations that made its first distribution on July 15, 2003, it would be reasonable to determine the yearly account balance when using the required minimum distribution method based on the value of the IRA from December 31, 2002, to July 15, 2003. For subsequent years, under the required minimum distribution method, it would be reasonable to use the value either on December 31 of the prior year or on a date within a reasonable period before that year's distribution.

(e) *Changes to account balance.* Under all three methods, substantially equal periodic payments are calculated with respect to an account balance as of the first valuation date selected in paragraph (d) above. Thus, a modification to the series of payments will occur if, after such date, there is (i) any addition to the account balance other than gains or losses, (ii) any nontaxable transfer of a portion of the account balance to another retirement plan, or (iii) a rollover by the taxpayer of the amount received resulting in such amount not being taxable.

.03 *Special rules.* The special rules described below may be applicable.

(a) *Complete depletion of assets.* If, as a result of following an acceptable method of determining substantially equal periodic payments, an individual's assets in an individual account plan or an IRA are exhausted, the individual will not be subject to additional income tax under § 72(t)(1) as a result of not receiving substantially equal periodic payments and the resulting cessation of payments will not be treated as a modification of the series of payments.

(b) *One-time change to required minimum distribution method.* An individual who begins distributions in a year using either the fixed amortization method or the fixed annuitization method may in any subsequent year switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years and the change in method will not be treated as a modification within the meaning of § 72(t)(4). Once a change is made under this paragraph, the required minimum distribution method must be followed in all subsequent years. Any subsequent change will be a modification for purposes of § 72(t)(4).

SECTION 3. EFFECTIVE DATE AND TRANSITIONAL RULES

The guidance in this revenue ruling replaces the guidance in Q&A–12 of Notice 89–25 for any series of payments commencing on or after January 1, 2003, and may be used for distributions commencing in 2002. If a series of payments commenced in a year prior to 2003 that satisfied § 72(t)(2)(A)(iv), the method of calculating the payments in the series is permitted to be changed at any time to the required minimum distribution method described in section 2.01(a) of this guidance, including use of a different life expectancy table.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Q&A–12 of Notice 89–25 is modified.

SECTION 5. REQUEST FOR COMMENTS

The Service and Treasury invite comments with respect to the guidance provided in this revenue ruling. Comments should reference Rev. Rul. 2002–62.

Comments may be submitted to CC:ITA:RU (Rev. Rul. 2002–62, room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8:30 a.m. and 5 p.m. Monday to Friday to: CC:ITA:RU (Rev. Rul. 2002–62), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, D.C. Alternatively, comments may be submitted via the Internet at *Notice.Comments@irscounsel.treas.gov.* All comments will be available for public inspection and copying.

Drafting Information

The principal author of this revenue ruling is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact Mr. Rubin at 1–202–283–9888 (not a toll-free number).

Appendix A
Uniform Lifetime Table

Taxpayer's Age	Life Expectancy	Taxpayer's Age	Life Expectancy
10	86.2	63	33.9
11	85.2	64	33.0
12	84.2	65	32.0
13	83.2	66	31.1
14	82.2	67	30.2
15	81.2	68	29.2
16	80.2	69	28.3
17	79.2	70	27.4
18	78.2	71	26.5
19	77.3	72	25.6
20	76.3	73	24.7
21	75.3	74	23.8
22	74.3	75	22.9
23	73.3	76	22.0
24	72.3	77	21.2
25	71.3	78	20.3
26	70.3	79	19.5
27	69.3	80	18.7
28	68.3	81	17.9
29	67.3	82	17.1
30	66.3	83	16.3
31	65.3	84	15.5
32	64.3	85	14.8
33	63.3	86	14.1
34	62.3	87	13.4
35	61.4	88	12.7
36	60.4	89	12.0
37	59.4	90	11.4
38	58.4	91	10.8
39	57.4	92	10.2
40	56.4	93	9.6
41	55.4	94	9.1
42	54.4	95	8.6
43	53.4	96	8.1
44	52.4	97	7.6
45	51.5	98	7.1
46	50.5	99	6.7
47	49.5	100	6.3
48	48.5	101	5.9
49	47.5	102	5.5
50	46.5	103	5.2
51	45.5	104	4.9
52	44.6	105	4.5
53	43.6	106	4.2
54	42.6	107	3.9
55	41.6	108	3.7
56	40.7	109	3.4
57	39.7	110	3.1
58	38.7	111	2.9
59	37.8	112	2.6
60	36.8	113	2.4
61	35.8	114	2.1
62	34.9	115	1.9

Appendix B
Mortality Table Used to Formulate the Single Life Table in § 1.401(a)(9)–9, Q&A–1

age	q_x	l_x	age	q_x	l_x
0	0.001982	1000000	58	0.004736	941078
1	0.000802	998018	59	0.005101	936621
2	0.000433	997218	60	0.005509	931843
3	0.000337	996786	61	0.005975	926709
4	0.000284	996450	62	0.006512	921172
5	0.000248	996167	63	0.007137	915173
6	0.000221	995920	64	0.007854	908641
7	0.000201	995700	65	0.008670	901505
8	0.000222	995500	66	0.009591	893689
9	0.000241	995279	67	0.010620	885118
10	0.000259	995039	68	0.011778	875718
11	0.000277	994781	69	0.013072	865404
12	0.000292	994505	70	0.014519	854091
13	0.000306	994215	71	0.016139	841690
14	0.000318	993911	72	0.017950	828106
15	0.000331	993595	73	0.019958	813241
16	0.000344	993266	74	0.022198	797010
17	0.000359	992924	75	0.024699	779318
18	0.000375	992568	76	0.027484	760070
19	0.000392	992196	77	0.030582	739180
20	0.000411	991807	78	0.034010	716574
21	0.000432	991399	79	0.037807	692203
22	0.000454	990971	80	0.042010	666033
23	0.000476	990521	81	0.046652	638053
24	0.000501	990050	82	0.051766	608287
25	0.000524	989554	83	0.057392	576798
26	0.000547	989035	84	0.063583	543694
27	0.000567	988494	85	0.070397	509124
28	0.000584	987934	86	0.077892	473283
29	0.000598	987357	87	0.086124	436418
30	0.000608	986767	88	0.095238	398832
31	0.000615	986167	89	0.105068	360848
32	0.000619	985561	90	0.115518	322934
33	0.000622	984951	91	0.126487	285629
34	0.000625	984338	92	0.137876	249501
35	0.000629	983723	93	0.149419	215101
36	0.000636	983104	94	0.161176	182961
37	0.000657	982479	95	0.173067	153472
38	0.000696	981834	96	0.185008	126911
39	0.000749	981151	97	0.196920	103431
40	0.000818	980416	98	0.210337	83063.4
41	0.000904	979614	99	0.224861	65592.1
42	0.001007	978728	100	0.241017	50843.0
43	0.00113	977742	101	0.259334	38589.0
44	0.00127	976637	102	0.280356	28581.6
45	0.001426	975397	103	0.303142	20568.6
46	0.001597	974006	104	0.329482	14333.4
47	0.001783	972451	105	0.359886	9610.80
48	0.001979	970717	106	0.394865	6152.01
49	0.002187	968796	107	0.434933	3722.80
50	0.002409	966677	108	0.480599	2103.63
51	0.002646	964348	109	0.532376	1092.63
52	0.002896	961796	110	0.590774	510.940
53	0.003167	959011	111	0.656307	209.090
54	0.003453	955974	112	0.729484	71.8628
55	0.003754	952673	113	0.810817	19.4400
56	0.004069	949097	114	0.900819	3.67772
57	0.004398	945235	115	1.000000	0.364760

TAX ISSUES IN FAMILY LAW[1]

PRESENTED BY JOHN BOLT
AND PHIL GERARD

A. ARIZONA'S CURRENT STATUTE—§ 25-318(B)—AND RECENT APPELLATE MEMORANDUM DECISIONS.

B. ARIZONA DIVORCE CASES AND POST-2012 APPELLATE MEMORANDUM DECISIONS WITH OTHER TAX ISSUES.

C. STATUTES AND APPELLATE OPINIONS FROM OTHER STATES DEALING WITH TAX ISSUES.

D. INTEREST DEDUCTIBILITY ON DIVORCE SETTLEMENTS.

E. STOCK REDEMPTIONS IN DIVORCE CASES: TREASURY REGULATION § 1041-2.

F. DIVISION OF NON-STATUTORY STOCK OPTIONS: REVENUE RULING 2002-22.

G. U.S. TAX COURT CASES.

H. REVENUE RULINGS.

A. ARIZONA'S CURRENT STATUTE—§ 25-318(B)—AND RECENT APPELLATE MEMORANDUM DECISIONS.[2]

In 2008, A.R.S. § 25-318 was amended to include subsection B., which states, in relevant part, as follows:

> In dividing property, the court may consider all debts and obligations that are related to the property, <u>including accrued or accruing taxes that would become due on the receipt, sale or other disposition of the property</u>.

(Emphasis added.) Though there are no published opinions since this amendment that reference the new language or address tax issues in the context of property division and/or maintenance/support, the following post-2008 memorandum decisions provide useful insight:

***Crane v. Crane*, 2009 WL 4251109 (App. Div. 1 2009)**
Citing *Schock v. Schock*, 19 Ariz. App. 562, 509 P.2d 634 (1973), explained that in determining the amount of spousal maintenance, the fact that spousal maintenance is taxable to the recipient is a factor to be considered, so that wife would require an award higher than her needs. The appellate court also accepted the propriety of the trial court's consideration of the real estate taxes wife would have to pay on an out-of-state condominium in setting the spousal maintenance award.

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[1] Phil Gerard wishes to acknowledge the contributions of Colin Jared, Timea Hargesheimer, and Nelson Mixon, whose research significantly contributed to this presentation.
[2] Copies of the following cases are assembled at Tab 1.

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***In re Marriage of Avila*, 2010 WL 358847 (App. Div. 2 2010)**
The husband, in a post-trial motion, argued that the division of property "created an inequitable division by giving the petitioner post-tax assets and the respondent pre-tax assets." The appellate court explained that § 25-318(B) is permissive rather than mandatory, and in any event, neither party presented evidence at trial on the tax consequences related to the property division.

***Schreiner v. Schreiner*, 2011 WL 5289266 (App. Div. 1 2011)**
The appellate court affirmed the trial court's determination that the husband's post-petition liquidation of a community IRA constituted waste as liquidation resulted in a 10% early withdrawal penalty and immediate taxation under the husband's higher tax bracket. The decision referenced the trial court's recognition that the "tax consequences would have been different if applied to the wife's lower tax bracket, after retirement, and spread out over a period of time."

***Stizza v. Stizza*, 2011 WL 198656 (App. Div. 1 2011)**
The appellate court affirmed a spousal maintenance award that took into consideration wife's obligation to pay 33% of the spousal maintenance payments in income tax. Again, the appellate court noted that if husband was going to dispute the tax rate, he had presented no evidence and no citation to any legal authority to indicate what different rate would apply. The court also noted that the parties' joint federal income tax returns for the two preceding years reflecting a payment of federal income taxes at approximately 27%, and that with Arizona income tax and FICA, 33% was a "reasonable estimate." In a footnote, the court explained that the rule that only tax consequences in the near future are to be considered was inapplicable, as the wife would owe taxes immediately upon receiving the spousal maintenance payments.

***In re Marriage of Starr*, 2012 WL 432832 (App. Div. 2 2012)**
The appellate court noted that the trial court was not required to make findings on the spousal maintenance issue with respect to the tax rate for a single individual/payor spouse and the tax implications of the recipient's business, as these were not § 25-319 "statutory factors." Furthermore, husband did not argue at trial that his income should be considered in light of the tax rate for a single individual.

B. ARIZONA DIVORCE CASES AND POST-2012 APPELLATE MEMORANDUM DECISIONS WITH OTHER TAX ISSUES.

The following are excerpts from various Arizona cases starting in 1960 and appellate memorandum decisions starting in 2012, where the discussion of the facts and/or issues presented involve tax or tax-related issues. The cases are presented chronologically as opposed to any subset of tax issues or the substantive issues to which the tax issues may have applied. Whether all of the comments or any analysis contained in these decisions is still compelling in view of more recent developments (even if the opinions have not been questioned or challenged), remains to be seen.

***Smith v. Smith*, 89 Ariz. 84, 358 P.2d 183 (1960)**
In its disposition of the spousal maintenance issue, the Supreme Court made reference to the husband's adjusted gross income, a portion of which was "the net capital gain from sale of land" and the "net income" from farming. The opinion also refers to depreciation expense as "purely a book figure," which was added back to reflect husband's "cash income."

***Ashton v. Ashton*, 89 Ariz. 148, 359 P.2d 400 (1961)**
The parties entered into a Property Settlement Agreement, which provided for the deferred payment to wife of one-half of the value as of a future date of the community interest in several companies, to the extent the future value exceeded the agreed-upon value at the time of the settlement, or in the event of a sale of these interests, one-half of the amount in excess of the same agreed-upon value, "after payment of any capital gain tax thereon." Before the valuation

date, husband entered into an exchange for stock of a public company, and attempted to use the value at the time of the exchange as the value for purposes of the above calculation. The Supreme Court explained that the exchange transaction was not a sale, and that the value of the stock obtained in the exchange, as of the agreed-upon date, was controlling. Furthermore, husband was not entitled to deduct from that value the potential capital gain tax before computing the amount due his former wife. Since there was no sale, there was no capital gain, and since there was no capital gain, the capital gain clause in the event of a sale became ineffective. The opinion states as follows: "That the stock would at some future time possibly be subject to tax after the appellant's interest in same had been satisfied and that the appellant should be liable for it was clearly not within the intention of the parties." The analysis is based primarily on contract principles, in view of the parties' Property Settlement Agreement.

***Spector v. Spector*, 94 Ariz. 175, 382 P.2d 659 (1963)**
The Supreme Court, in its discussion of the factual background, stated as follows: "The bulk of the community property was not liquid. As its cost basis is considerably less than its worth at the time of trial, a liquidation of the property would make necessary the payment of a considerable amount of income taxes." This language seems to indicate that the potential income taxes resulting from the division of community property is a proper consideration by the court, particularly when the sale of assets necessary to liquidate the estate will cause the parties to owe income taxes.

***Babnick v. Babnick*, 94 Ariz. 338, 385 P.2d 216 (1963)**
The Supreme Court's recitation of the facts references husband's gross income, and net income after taxes, implicitly recognizing that income taxes are a reality.

***Armer v. Armer*, 105 Ariz. 284, 463 P.2d 818 (1970)**
Wife transferred a 5-acre parcel of property to her husband in order to take advantage of his veteran's exemption from property taxation under the Arizona Constitution. The Supreme Court recognized that this transaction was "merely undertaken for tax purposes," and did not eliminate wife's community property interest.

***Schock v. Schock*, 19 Ariz. App. 562, 509 P.2d 634 (App. 1973)**
The court of appeals stated as follows with respect to the appropriate amount of spousal maintenance awarded to the wife in a separate maintenance proceeding: "Additionally, since appellee would have to pay income tax on the support payments received by her, her need for sufficient funds to pay such taxes was an additional factor to be considered. *Spackman v. Spackman*, 183 A.2d 199 (1962); *Cohn v. Cohn*, 121 A.2d 704 (1956)."

***Gilbert v. McGhee*, 111 Ariz. 121, 524 P.2d 157 (1974)**
The Supreme Court's opinion, dismissing a special action previously granted, discusses the limits of the husband's right to assert the 5th amendment privilege when confronted with evidence of undisclosed assets that apparently were maintained outside the United States. Even though one of the basis for the assertion of the privilege was the potential exposure to criminal prosecution with respect to tax evasion, the Supreme Court found that the husband's prior testimony with respect to the existence of the assets constituted a waiver of his right to assert the privilege, when the previously offered testimony led to the need to further explore the subject.

***In re: Marriage of Goldstein*, 120 Ariz. 23, 583 P.2d 1343 (1978)**
The Supreme Court rejected husband's contention that the corporation's checking account, accounts receivable, and the pension and profit sharing plans should have been valued in light of his tax bracket, stating as follows: "This is not a case where the publication of the dissolution decree causes immediate taxable consequences. Rather, these assets may or may not eventually filter down into appellant's personal coffers sometime in the future. Whether they do and thus at which level he will then be are all factors largely within the accountant's control. Only then

would appellant encounter any tax consequences." The opinion quotes at length from the California decision of *In re: Marriage of Fonstein*, 552 P.2d 1169 (Cal. 1976), and then adds the following from *Fonstein*: "In short, '[r]egardless 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.'" The opinion notes that the New Jersey opinion of *Stern v. Stern*, 331 A.2d 257 (1975), the Wisconsin opinion of *Wahl v. Wahl*, 159 N.W.2d 651 (1968), and the Indiana opinion in *Burkhart v. Burkhart*, 349 N.E.2d 707 (1976) are in accord.

***Mori v. Mori*, 124 Ariz. 193, 603 P.2d 85 (1979)**
Wife's transfer of property to husband in order to permit husband to claim a veteran's tax exemption did not prevent the trial court from concluding that the real property was still community in nature.

***Bowart v. Bowart*, 128 Ariz. 331, 625 P.2d 920 (App. 1980)**
The trial court rejected husband's contention that the tax savings that resulted from the marriage (apparently the filing of joint returns) should have been treated as a marital asset. The opinion reflects that the husband presented evidence on this issue, and that the trial court had "considered all the evidence presented including the effect of certain tax deductions." However, the court of appeals did not agree with husband's assertion that "tax benefits should be treated like retirement benefits and profit sharing funds, i.e., deemed community property."

***Johnson v. Johnson*, 131 Ariz. 38, 638 P.2d 705 (1981)**
In dealing with the division of the community's interest in pension and profit sharing plans, which were in the nature of defined contribution plans, the Supreme Court rejected husband's contention that the valuation should be reduced by the taxes that he would eventually have to pay. [It should be remembered that this opinion was before QDROs were created by the 1984 amendments to the tax code.] The opinion relies on the California cases of *Marx*, 97 Cal. App. 3d 552 (1979), and *Fonstein*, 552 P.2d 1169 (1976), which contain the rationale that the tax consequences are too speculative for present determination. A footnote to the opinion, relying on language from *Marx*, acknowledges that "if the future maturity date were close to the trial date, the tax consequences could be immediately and specifically determined. In such a case, the court should consider the effects of taxation of the valuation."

***Garrett v. Garrett*, 140 Ariz. 564, 683 P.2d 1166 (App. 1983)**
Though husband's appeal primarily focused on his contention that the contingency fees which he would receive as an attorney should not have been characterized as community property, he argued alternatively that if "the wife has an interest in the fees to be received under these contracts the trial court erred in not considering the tax liabilities flowing to the parties." The court of appeals responded to the latter point as follows: "We touch briefly on the husband's contention that the trial court ignored the tax consequences that will flow to the husband by receiving income after dissolution, that is, that the entire fee will be taxable to him as separate property. We disagree. In our opinion, under existing tax decisions, each party must report and pay taxes upon the income we have declared under this opinion to be community property. *See Johnson v. United States*, 135 F.2d 125 (9th Cir. 1943)." It is somewhat debatable as to whether the summary resolution of the tax issue properly analyzed certain aspects of this situation, or similar situations, including the assignment of income doctrine.

***Thomas v. Thomas*, 142 Ariz. 386, 690 P.2d 105 (App. 1984)**
The court of appeals recitation of the facts includes references to capital gains taxes that had to be paid with respect to the disposition of the parties' residence, and also that wife's income, as well as a retirement distribution, were before tax numbers. It appears that expert testimony was provided concerning wife's monthly after-tax income.

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***Mitchell v. Mitchell*, 152 Ariz. 312, 732 P.2d 203 (App. 1985), *vacated in part* 152 Ariz. 317, 732 P.2d 208**
The court of appeals rejected husband's contention that the value of the Pinetop property should be reduced by the tax consequences to be incurred upon a future sale of the property. The opinion states that "the potential tax consequences which may result from a sale of the property should not be considered by the court when valuing the community equity in the property." The opinion does not reflect whether any evidence was offered with respect to the amount of any potential tax consequences.

***Biddulph v. Biddulph*, 147 Ariz. 571, 711 P.2d 1244 (App. 1985)**
The trial court ordered a redemption of corporate stock, pursuant to which the corporation was to redeem shares from the wife at a particular price. The opinion indicates that the court apparently realized that the equalizing note from husband to wife, as well as the corporate redemption, would result in the imposition of a capital gains tax, so additional provisions of the decree addressed these tax liabilities. [It is unclear from the opinion why the equalization note would have resulted in a capital gains tax.] The opinion notes that husband, in response to the rule announced in *Goldstein*, did not request that the court reduce the fair market value of the assets awarded to him to reflect the tax consequences of converting those assets to cash. [Ironically, the rule announced in *Goldstein* would seem to permit the court to tax effect this situation, if the conversion of the assets to cash was necessary in order to implement the settlement.]

Husband also argued that the provision of the decree requiring that the tax liabilities on the corporate redemption be split equally among the parties in effect meant that he was paying one-half of wife's tax obligation and all of the obligation on the taxes that he would incur should he subsequently sell his shares. Wife argued that only the immediate tax consequences resulting from the decree should be considered and the tax consequences that husband might incur in the future from the disposition of his shares should not be considered. The court of appeals agreed that husband's future tax liability was contingent and speculative and that the capital gain taxes that the court had ordered that the parties equally divide was nothing more than the cost of dividing the community estate. In rejecting husband's contention, the court said as follows: "Costs which necessarily result from dividing the community estate in an otherwise equal manner should be borne equally by the parties. However, the spouse having ownership and control over an item of property should bear the risks associated with its future disposition. The tax consequences of the husband's future activity regarding the stock are completely speculative. *See Johnson v. Johnson*, 131 Ariz. 38, 638 P.2d 705 (1981). He may never sell the stock; he may donate it to charity; he may place it in trust for another."

Having rejected husband's position, it is interesting that the opinion then contains the following: "Furthermore, the husband presented no evidence to the trial court concerning his potential tax liability. He cannot now claim the fault lies with the trial court." The opinion also notes that husband failed to provide the court with the entire transcript on appeal, and since husband's argument was essentially an attack on the sufficiency of the evidence, under basic appellate substantive law, the appellate court was required to presume that the evidence supported the actions of the trial court.

If the law on the tax issue was so clear, why did the court comment on the absence of evidence as to the "potential" tax liability? Nonetheless, *Biddulph* is frequently cited by family lawyers, even though other redemption cases, including the 9th Circuit decision in *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992), as well as a 1994 Private Letter Ruling, seem to create significant uncertainty with respect to the tax treatment of stock redemptions that are part of divorce settlements. The January 2003 adoption of treasury regulation § 1041-2 concerning the redemption of closely held stock in a divorce case may help to clarify the situation. *See* discussion at p. 13.

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***Rowe v. Rowe*, 154 Ariz. 616, 744 P.2d 717 (App. 1987)**
The court of appeals rejected husband's contention that the valuation of the pension plan that he was receiving should have considered any tax consequences, before calculation of the equalization or offset payment. Citing the Arizona Supreme Court's opinion in *Johnson v. Johnson*, 131 Ariz. 38, 638 P.2d 705 (1981), the court noted that trial courts "need not consider the speculative future effects of taxes or inflation in valuing pension plans." However, the opinion notes that "if the future maturity date is close to trial, and the tax consequences can be immediately and specifically determined, the court should consider such effects of taxation. *Koelsch v. Koelsch*, 148 Ariz. 176, 713 P.2d 1234 (1986), and *Johnson*." The opinion points out that husband did not testify that he would "definitely be taking the money on a specific date, in a specific manner, bearing specific costs," and that the record therefore did not support his contention that the valuation of the pension plan should be adjusted for taxes.

***Martin v. Martin*, 156 Ariz. 452, 752 P.2d 1038 (1988)**
Dealing with the appropriateness of an equalization payment for funds that husband had allegedly expended during the parties' separation, the Supreme Court accepted the trial court's determination that the "net" community income would include deductions for state and federal income tax payments, as well as other expenses. Though footnote 2 to the opinion notes that the methodology used by the trial court in determining allowable expenses was not part of the issue accepted for review, it seems unlikely that income taxes would not be part of the acceptable explanation in these circumstances.

***Baker v. Baker*, 183 Ariz. 70, 900 P.2d 764 (1995)**
The resolution of the appropriate amount of child support in a modification proceeding includes a discussion of certain tax issues, which are affected by the pretax approach of the Child Support Guidelines. The opinion discusses three different approaches to the adjustment of accelerated depreciation, accepted the trial court's treatment of the I.R.C. § 179 $10,000 capital contribution deduction as an additional type of accelerated depreciation, and also sustained the trial court's refusal to deduct federal and state income taxes from the corporation's gross profits. With respect to the latter point, the opinion states as follows: "If appellant had paid the corporate profits to himself as salary, there would have been no corporate income tax, and the full amount of the profits would be charged to appellant as gross income for child support purposes. His decision to pay taxes inside the corporation (instead of outside on a personal basis) should not alter the amount of gross income charged to him for child support purposes. We find the Guidelines definition of gross income broad enough to include the income from a wholly owned corporation without regard to the payment of taxes. Our conclusion is supported by Guideline 5(h), which states that the payment of income taxes has been considered in the support schedule."

***Toth v. Toth*, 190 Ariz. 218, 946 P.2d 900 (1997)**
In the briefest of references, the majority opinion indicates that whether property is treated as separate or community has consequences beyond the dissolution of the marriage, "particularly with respect to tax liability and the rights of creditors. *See* Charles Marshall Smith, Arizona Community Property Law §§ 4:4, 4:5 (1995)."

***Pearson v. Pearson*, 190 Ariz. 231, 946 P.2d 1291 (App. 1997)**
Husband's corporation paid $12,000 for a Harley Davidson motorcycle titled in his name. Husband "never produced any notes payable, tax returns or other documents" to establish his claim that the $12,000 was a loan from the corporation.

***Muchesko v. Muchesko*, 191 Ariz. 265, 955 P.2d 21 (App. 1998)**
The fact that the parties filed separate income tax returns for three years considered evidence of their belief that they were dealing with their separate property for purposes of determining whether the parties had actually entered into a settlement agreement.

***Mead v. Holzmann*, 198 Ariz. 219, 8 P.3d 407 (App. 2000)**
Husband's sole income consisted of non-taxed disability benefits. Trial court refused to impute a "pre-tax" income to husband for child support purposes. The appellate court discussed the interpretation of "gross income" under the Child Support Guidelines and noted that its position avoided the problem of calculating and imputing pre-tax income to other scenarios involving differing tax treatments, such as capital gains, personal injury awards, tax-free municipal bond interest, unemployment benefits, etc.

***McNutt v. McNutt*, 203 Ariz. 28, 49 P.3d 300 (App. 2002)**
Trial court abused its discretion in not allocating the federal income tax dependency exemptions for the minor children, as Section 25 of the Arizona Child Support Guidelines' use of the word "should" required the Court to allocate the dependency exemptions.

***Hamblen v. Hamblen*, 203 Ariz. 342, 54 P.3d 371 (App. 2002)**
It was error for the trial court to allocate the federal income tax exemptions for the parties' children other than in proportion to the amount of child support paid by the respective parties, as required by Section 25 of the Arizona Child Support Guidelines.

***Jenkins v. Jenkins*, 215 Ariz. 35, 156 P.3d 1140 (App. 2007)**
Father's decision to reinvest proceeds from the sale of land via a tax-exempt I.R.C. § 1031 exchange, rather than invest the money so as to have an additional stream of income, would not result in income being imputed to father for purposes of child support calculation.

***MacMillan v. Schwartz*, 226 Ariz. 584, 250 P.3d 1213 (App. 2011)**
In spousal support modification proceeding, trial court determined wife's pre-tax annual income and when compared to reasonable expenses, downward modification of wife's spousal support payments was appropriate.

***Sammons v. Sammons*, 2012 WL 1899557 (App. Div. 1 2012)**
Trial court ordered wife to pay husband $2,000 from her 2009 tax refund because wife's refund was $8,035 and Husband only received a $1,500 refund. Wife contended the allocation was inequitable since the court did not order husband to share his. The appellate court found no abuse of discretion in the trial court's allocation and affirmed.

***Davis v. Davis*, 2012 WL 1932615 (App. Div. 1 2012)**
The parties' total tax obligation for the 2008 tax year was $82,568, of which husband paid $61,274 from the parties' community business account. Husband argued the funds in the business account were his sole and separate property because the funds were deposited after the date of service and the business was awarded to him in the divorce; he argued he was entitled to the entire refund and that wife should be ordered to pay half of the amount he paid towards their 2008 tax obligation. The appellate court found "no error in the family court's implicit determination that Father paid the community's remaining 2008 tax obligation in April 2009 with community funds and therefore (1) he was not entitled to a credit from Mother for one-half of the payment amount and (2) the refund he received was a community asset he was required to share with Mother."

***Merrill v. Merrill*, 230 Ariz. 369, 284 P.3d 88 (App. 2012)**
Former husband who, after divorce, unilaterally waived his military retirement pay in favor of a [CRSC tax benefit, which allows veterans injured in combat to choose to receive tax-free benefits in exchange for a dollar-for-dollar reduction in their retirement pay] was required to make former wife whole by paying her an amount equal to the resulting decrease in her one-half share of former husband's military retirement pay, which had been awarded to her in divorce as her sole and separate property; former husband's unilateral decision to receive the tax benefit resulted in a reduction in former wife's monthly share of retirement pay from $1,116 to $133.

***Leas v. Leas*, 2013 WL 3514599 (App. Div. 1 2013)**
Wife argued that the parties should share the tax burden accruing between January and August 31, 2010—the date of service. The appellate court found that it was indisputable that income tax was accruing on community funds during the first eight months of 2010, and interest deductions for the parties' mortgages also were being earned, and requiring husband to pay tax on the parties' business-related earnings through August 31, 2010 was further warranted because husband received a community share of wife's interest in the business. Accordingly, the appellate court remanded and directed the trial court to determine an appropriate allocation of the 2010 tax liability and should consider whether any portion of the tax liability on Wife's bonus, paid in December 2010, may be appropriately allocated to Husband.

***Grow v. Grow*, 2013 WL 5746215 (App. Div. 1 2013)**
After being informed that both parents claimed one of the children in 2010, and one party would be required to refile, the family court ordered former wife to modify her return to correct the error and delete the tax credit for child, as she had admitted improperly claiming the child. The minute entry from the proceeding ordered that former husband would be entitled to claim both children for tax purposes in 2011, and noted that former wife agreed to file an amended tax return for 2010. The appellate court found that allowing such an outcome would produce an inequitable result that conflicts with the Decree's clear provision on child support stating that former husband shall claim the child in question as a dependent every year and former wife shall claim the other child every year for tax purposes, and therefore, remanded to the family court to revisit the order and take appropriate action to comport with the Decree.

***Beasley-Rodriquez v. Rodriguez*, 2014 WL 4781854 (App. Div. 1 2014)**
Trial court's division of property failed to take into account tax benefits husband received from payment of mortgage and real estate taxes. Appellate court vacated and remanded and directed trial court to make equitable division of marital residence by awarding some interest to wife.

***Bollerman v. Nowlis*, 2015 WL 3470516 (App. Div. 1 2015)**
Appellate court vacated trial court's order that husband be allowed to claim all eligible dependents in each tax year because husband only provided 4/5 of the combined adjusted gross income, and therefore, wife was entitled to claim 1/5 of applicable tax exemptions.

C. STATUTES AND APPELLATE OPINIONS FROM OTHER STATES DEALING WITH TAX ISSUES.[2]

The chart provided below identifies the property division statutes from all 51 jurisdictions. There are no statutes which contain the specific "may consider" language of A.R.S. § 25-318(B). Rather, the statutes fall within two categories: 1) express inclusion of tax consequences as a factor to be considered in the property division (eighteen states and Washington D.C.); and 2) tax consequences not expressly included as a factor for consideration in the property division, but case law interpreting "any and all relevant factors" statutory provisions to nevertheless permit consideration of tax consequences (twenty-nine states). Annotations for both categories of these marital property division statutes provide extensive case law addressing consideration of tax consequences under various circumstances, and general rules to be applied in determining the appropriateness and/or extent of consideration to be afforded. Additionally, three states where property division is entirely based on case law have included consideration of tax consequences as a factor.

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[2] Relevant secondary sources were also reviewed, including:

- 9 A.L.R.5th 568, "Divorce and separation; consideration of tax consequences in distribution of marital property"
- 24 Am.Jur.2d Divorce and Separation § 525, "Tax consequences"
- 27B C.J.S. Divorce § 890, "Taxes and other consequences of distribution; attorneys fees"

Themes appearing throughout the jurisdictions, and reflected in Arizona case law both prior to and after the 2008 amendment to A.R.S. § 25-318(B), include the following:

- The court should consider those tax consequences that are immediate, imminent and specific and/or that consequentially flow from the property division (i.e., if a taxable event, such as a sale of property, is required by the property distribution or is certain to occur shortly thereafter, tax consequences should be considered).
- The court should not consider tax consequences of the property division when to do so would require speculation (i.e., court is not required to consider theoretical tax consequences of transactions that are not necessary or probable but merely conjectural).
- Where the parties have not requested the court to consider potential tax consequences or do not introduce reasonably instructive evidence, the court is not bound to identify and decipher tax issues (i.e., failure to present evidence on tax issues justifies non-recognition of tax consequences).

Various case law summaries from these states reflecting the court's consideration of tax consequences are assembled beginning at p. 9.

State	**Statutory Citation**	**Notes**
Alabama	No statute	Case law permits consideration of tax consequences
Alaska	A.S. § 25.24.160	Case law permits consideration of tax consequences
Arizona	A.R.S. § 25-318	Tax consequences an express statutory factor
Arkansas	A.C.A. § 9-12-315(a)(1)(A)	Tax consequences an express statutory factor
California	Cal.Fam.Code § 550	Case law permits consideration of tax consequences
Colorado	C.R.S.A. § 14-10-113	Case law permits consideration of tax consequences
Connecticut	C.G.S.A. § 46b-81	Case law permits consideration of tax consequences
Delaware	13 Del.C. § 1513(a)(11)	Tax consequences an express statutory factor
D.C.	D.C. ST § 16-910(b)(10) and (11)	Tax consequences an express statutory factor
Florida	F.S.A. § 61.075	Case law permits consideration of tax consequences
Georgia	Ga. Code Ann. § 19-5-13	Case law permits consideration of tax consequences
Hawaii	H.R.S. § 580-47	Case law permits consideration of tax consequences
Idaho	I.C. § 32-712	Case law permits consideration of tax consequences
Illinois	750 I.L.C.S. 5/503(d)(12)	Tax consequences an express statutory factor
Indiana	I.C. 31-15-7-4	Case law permits consideration of tax consequences
Iowa	I.C.A. § 598.21(5)(j)	Tax consequences an express statutory factor
Kansas	K.S.A. 23-2802(c)(9)	Tax consequences an express statutory factor
Kentucky	K.R.S. § 403.190	Case law permits consideration of tax consequences
Louisiana	LSA-R.S. 9:2801	Case law permits consideration of tax consequences
Maine	19-A M.R.S.A. § 953	Case law permits consideration of tax consequences
Maryland	MD Code § 8-205	Case law permits consideration of tax consequences
Massachusetts	M.G.L.A. 208 § 34	Case law permits consideration of tax consequences
Michigan	M.C.L.A. § 552.23	Case law permits consideration of tax consequences
Minnesota	M.S.A. § 518.58	Case law permits consideration of tax consequences
Mississippi	No statute	Case law permits consideration of tax consequences
Missouri	V.A.M.S. § 452.330	Case law permits consideration of tax consequences
Montana	M.C.A. 40-4-202	Case law permits consideration of tax consequences
Nebraska	Neb.Rev.Stat. § 42-365	Case law permits consideration of tax consequences
Nevada	Nev.Rev.Stat. § 125.150	Case law permits consideration of tax consequences
New Hampshire	N.H.Rev.Stat. § 458:16-a(j)	Tax consequences an express statutory factor
New Jersey	N.J.Stat. § 2A:34-23.1(j)	Tax consequences an express statutory factor
New Mexico	N.M.Stat.Ann. § 40-4-7	Case law permits consideration of tax consequences
New York	McKinney's D.R.L. § 236(B)(5)(d)(11)	Tax consequences an express statutory factor

North Carolina	N.C.G.S.A. § 50-0(c)(11)	Tax consequences an express statutory factor
North Dakota	N.D. Cent. Code § 14-05-24	Case law permits consideration of tax consequences
Ohio	Ohio Rev. Code Ann. § 3105.171(F)(6)	Tax consequences an express statutory factor
Oklahoma	Okla.Stat. tit. 43, § 121	Case law permits consideration of tax consequences
Oregon	O.R.S. § 107.105(1)(f)(G) and (2)	Tax consequences an express statutory factor
Pennsylvania	23 Pa. Cons. Stat. § 3502(a)(10.1)	Tax consequences an express statutory factor
Rhode Island	R.I. Gen. Laws § 15-5-16.1	Case law permits consideration of tax consequences
South Carolina	S.C. Code § 20-3-620(B)(11)	Tax consequences an express statutory factor
South Dakota	S.D. Codified Laws § 25-4-44	Case law permits consideration of tax consequences
Tennessee	Tenn. Code § 36-4-121(c)(9)	Tax consequences an express statutory factor
Texas	Tex. Fam. Code § 7.008(1) and (2)	Tax consequences an express statutory factor
Utah	Utah Code § 30-3-5	Case law permits consideration of tax consequences
Vermont	Vt. Stat. title 15, § 751	Case law permits consideration of tax consequences
Virginia	Va. Code § 20-107.3(E)(9)	Tax consequences an express statutory factor
Washington	Rev. Code of Washington § 26.09.080	Case law permits consideration of tax consequences
West Virginia	W.Va. Code § 48-7-101	Case law permits consideration of tax consequences
Wisconsin	W.S.A. 767.61(3)(k)	Tax consequences an express statutory factor
Wyoming	Wyo.Stat. 20-2-114	Case law permits consideration of tax consequences

ALABAMA

No statute.

A property division was "unequitable and unjust" where husband was awarded no assets from which he could pay the property settlement ordered to the wife within the time ordered, except from an investment account, the liquidation of which would have caused him to incur substantial tax liability virtually negating the award of the investment account to him. *Robinson v. Robinson*, 795 So.2d 729 (2001).

ALASKA

AS § 25.24.160

Court can order spouse to waive federal income tax dependency exemption, and rejects argument that IRS Form 8332 (releasing right to claim exemption) must be voluntary. Court adopted majority rule and rationale of California Supreme Court decision of *Monterey County v. Cornejo*, 812 P.2d 586 (1991). *Dodge, f/k/a Sturdevant v. Sturdevant*, 335 P.3d 510 (2014).

Tax consequences of provision of divorce decree which ordered former husband to exercise option to purchase stock in his employer if market price exceeded option price during period of option were speculative, rather than immediate and specific, and thus, court was not required to consider consequences in making division of marital property; only evidence concerning taxation was testimony by parties' personal accountant, which did not address possibility that husband could avoid taxes altogether. *Broadribb v. Broadribb*, 956 P.2d 1222 (1998).

ARKANSAS

A.C.A. § 9-12-315

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Requirement that former wife pay one-half of additional tax liability due to husband's failure to report income for prior year was proper, as chancellor required former husband to pay interest and penalties, and had husband properly reported income previously, wife would have been responsible for paying one-half of tax. *Killough v. Killough*, 32 S.W.3d 57 (2000).

CALIFORNIA

Cal.Fam. Code § 2550

Though the community was found liable for the settlement reimbursing the employer for embezzled funds used by the community, the embezzling spouse was solely liable for income taxes and penalties on the undeclared income. *In re: Marriage of Bell*, 56 Cal.Rptr.2d 623 (1996).

Where wife's capital gains tax obligation as result of award of stock shares as community property was known and certain based upon increased value of corporate shares she received from husband, and such tax would thereby reduce her share of community property, trial court erred in failing to take account of capital gains tax consequences of distribution of stock to wife. *In re: Marriage of Sharp*, 192 Cal.Rptr. 97 (1983).

Trial court did not abuse its discretion in failing to make a tax adjustment in ordering husband to execute promissory note in favor of wife to equalize division of community assets, where there was no evidence of an immediate and specific capital gain tax liability to the wife resulting from the decree. *In re: Marriage of Slater*, 160 Cal.Rptr. 686 (1979).

COLORADO

C.R.S.A. § 14-10-113

Trial court did not abuse its discretion in awarding former husband entire passive activity loss carry-forward, as trial court found that origin of passive activity loss carry-forward of $981,412 reported on parties' tax return was not clear and that neither party had cited authority concerning tax entry. Trial court concluded that it would treat asset as economic circumstance to be dealt with in an equitable division of property, and, in the absence of evidence to the contrary, distribution of asset was consistent with court's allocation of marital tax liabilities. *In re Marriage of Lafaye*, 89 P.3d 455 (2003).

Failure of trial court to take into account tax consequences in making division of proceeds from sale of insurance agency which had been marital property was abuse of discretion where proceeds were ultimately found to be partially separate property. *In re Marriage of Goldin*, 923 P.2d 376 (1996).

CONNECTICUT

C.G.S.A. § 46b-81

Payor/husband's gross income for child support purposes is to be distinguished from gross income of the LLC of which he is the sole member. The LLC "is a distinct legal entity whose existence is separate from its members." *Yomtov v. Yomtov*, 98 A.3d 110 (2014).

Fact that retained earnings of Subchapter S corporation may be taxable income to shareholder does not resolve question of whether such "income" is "available" to shareholder in determining alimony and child support, and must therefore be resolved on case-by-case basis. Court referenced the Massachusetts Supreme Judicial Court decision of *J.S. v. C.C.*, 912 N.E.2d 933 (2009) for factors for ascertaining portion of undistributed earnings that may be available to shareholder for support purposes. *Tuckman v. Tuckman*, 61 A.3d 449 (2013).

Evidence regarding wife's tax rates for 1995 and 1996, the years in which she received settlement proceeds from employment lawsuit, was sufficient to determine husband's after tax equitable share of settlement. *Smith v. Smith* 752 A.2d 1023 (1999).

DISTRICT OF COLUMBIA

DC ST § 16-910

Taxes payable on a large severance entitlement of the husband was appropriated, so that wife received one-half of the severance payment after taxes. *Lake v. Lake*, 756 A.2d 917 (2000).

Portion of order conditioning wife's receipt of her share of marital property upon her filing an amended joint federal income tax return with husband for two years of their marriage, being unquestionably coercive, was erroneous as exceeding both the mandates of the Internal Revenue Code governing joint returns and bounds of trial court's equitable powers. *Leftwich v. Leftwich*, 442 A.2d 139 (1982).

DELAWARE

13 Del.C. § 1513

Dividing tax liability for disallowed tax shelter investment equally between husband and wife in division of marital property was proper, even though the tax shelter investment had been made after spouses separated, where spouses were awarded roughly equivalent amounts of liquid assets from which to satisfy tax liability, wife indirectly benefited from tax shelter in that more funds were available for husband to pay wife, and wife signed tax return on which tax shelter was included. *Gregg v. Gregg*, 510 A.2d 474 (1986).

Court was required to give consideration to capital gains taxes which could reduce cash value of husband's payout from corporate stock ownership and thrift plans. *Donovan v. Donovan*, 494 A.2d 1260 (1985).

FLORIDA

West's F.S.A. § 61.075

Trial court erred in declining to characterize for federal tax purposes payments that wife received from ex-husband under marital settlement agreement. A non-modifiable provision titled "lump sum alimony and equitable distribution" in post-reconciliation marital settlement agreement required husband to pay wife for ten year half of his salary after payment of child support, to be followed by yearly payments of $10,000. The marital settlement agreement was silent as to whether payments would be deductible by husband or includible in wife's income. Court explained that payments are not deductible by payor as alimony if they are part of a property settlement, and also noted that if payments qualify as lump sum alimony, they remain payable to wife's estate in the event of her death, and thus generally will not be deductible. In a footnote the court observed that the non-modifiability of the payments suggest they are not deductible for income tax purposes. *Kuchera v. Kuchera*, 123 So.3d 631 (2013).

Income can be imputed to wife based on amounts that could be withdrawn without penalty from IRAs and annuities, pursuant to I.R.C. § 72(t). The court also noted that this approach "works both ways", and that income could likewise be imputed to an obligor spouse pursuant to an I.R.C. § 72(t) withdrawal plan. § 72(t) permits a taxpayer to withdraw money from an IRA or an annuity without penalty, utilizing substantially equal payments over a period of at least five years, based on the life expectancy of the participant and a reasonable rate of return. Relying on two earlier Florida cases, the court reasoned that failure to impute this income from the annuities and IRAs would require the husband to pay additional alimony, and would constitute an impermissible "savings component" in the alimony award. *Niederman (Kleinman) v. Niederman*, 60 So.3d 544 (2011).

Trial court abused its discretion by requiring ex-husband to reimburse ex-wife for taxes deducted from her share of ex-husband's benefit restoration plan; effect of order was to require ex-husband to bear entire tax liability of plan. *Hall v. Hall*, 833 So.2d 305 (2002).

Wife could be required to pay portion of back taxes owed to IRS on husband's salary for period during which parties were married, even though husband and wife filed separate tax returns for period in question; though wife contended that husband was more capable of paying for taxes, monies earned by husband were used to support family, debt could be considered marital, and wife had sufficient assets to contribute. *Barner v. Barner*, 716 So.2d 795 (1998).

The trial court abused its discretion in equally dividing between the parties the 1996 federal income tax liability. The evidence supported that wife was excluded from the family business and husband had taken significant sums of money during 1996 without any satisfactory explanation and without any benefit to the wife. *Pierre-Lewis v. Pierre-Lewis*, 715 So.2d 1073 (1998).

"It cannot be said that valuation of assets without taking into account the tax consequences is fairly reflective of the market value of the assets to the parties." (Citation omitted.) "We are concerned that, for purposes of evaluating marital assets, trial counsel failed to take into consideration the affect of income taxes. Consideration of the consequences of income tax laws on the distribution of marital assets and alimony is required and failure to do so is ordinarily reversible error." (Citations omitted.) "Tax consequences are often ignored. On remand, we encourage the parties to present competent evidence regarding the income tax consequences of the distribution of the marital property and of any award of alimony." *Miller v. Miller*, 625 So.2d 1320 (1993).

"A trial court is required to consider the consequences of income tax laws on the distribution of marital assets and alimony ordered by it, and failure to do so is ordinarily reversible error. Citations omitted. Accordingly, the trial court should consider all tax consequences, including contingent tax liabilities, that affect the value of the properties distributed to husband and wife as in this case. The trial court's failure to do so in this case requires reversal and reconsideration thereof on remand." *Nicewonder v. Nicewonder*, 602 So.2d 1354 (1992).

GEORGIA

Ga. Code Ann. § 19-5-13

Addressing division of stock options, the Court noted that the "[k]ey to the trial court's underlying factual inquiry and any decision it may make as to equitable distribution, if any, is consideration of a multitude of factors including, but not limited to: whether the marital or premarital funds were used to exercise the options; the employer's purpose for granting the option (i.e., for past, present or future service); the best formula for apportioning the marital share of the options based on the purpose and timing of the options in relation to the time of the marriage; a method of distribution to appellee; and the parties' tax obligations resulting from distribution" (footnotes omitted). *Newman v. Patton,* 692 S.E.2d 322 (2010).

HAWAII

HRS § 580-47

Court failed to adequately consider tax consequences associated with its implicit order that husband cause his corporations to sell marital partnership property to generate funds to pay wife, its order giving husband option of causing equalization to wife by giving her shares in any of his corporations which corporations would redeem amount awarded to wife, and failure to allocate to wife any liability for percentage of income taxes actually paid by husband's corporation which could be directly related to sale of assets. *Jackson v. Jackson*, 933 P.2d 1353 (1997).

IDAHO

I.C. § 32-712

In ordering sale of community business to effectuate property disposition, trial court should consider tax consequences to spouses resulting from differing treatment, for tax purposes, of goodwill and of covenants not to compete. *Carr v. Carr*, 701 P.2d 304 (1985).

ILLINOIS

750 ILCS 5/503

Proportionate share of retained earnings of sub-S corp., in which father has majority ownership, should not be imputed to him as income in calculating child support payments. Mother failed to rebut father's claim that it was necessary to reinvest earnings in company rather than distribute earnings. Also, amounts sent directly to taxing agency from S corp. to pay taxes on S corp. income did not constitute disbursements for purposes of child support calculation. *Moorthy and Arjuna*, 29 N.E.3d 604 (2015).

Court did not abuse discretion in considering tax consequences of unequal division of retirement accounts, utilizing ordinary income tax rate of approximately 28%. Illinois statute (503(d)(12)) requires court "to consider the tax consequences of the property division upon the respective economic circumstances of the parties." *In re: Marriage of Bradley*, 993 N.E.2d 25 (2013).

Former wife was not entitled, under marital settlement agreement (MSA) incorporated into marriage dissolution judgment, which agreement granted to former husband the right to file amended joint tax returns after entry of dissolution judgment, to a share of refunds from amended federal and state joint income tax returns filed after dissolution; MSA provided no express right to share in refunds arising from post-dissolution filings of amended returns, in contrast to MSA's provision giving former wife the right to share in any refund up to $100,000 from amended tax returns pending at time of MSA, and MSA expressly protected former wife from any additional tax liability arising from amended joint tax returns filed after entry of dissolution judgment, confirming that it was foreseeable that amended returns might be filed after dissolution. *In re Marriage of Goldsmith*, 962 N.E.2d 517 (2011).

INDIANA

IC 31-15-7-4

Even though tax deficiency notice was received after filing for separation, tax debt arose. "The IRS notice represented the underpayment of taxes during the marriage. Thus, the tax debt is a marital liability and should have been considered in fashioning an equitable property division." Court cited to *Moore vs. Moore*, 695 N.E.2d 1004 (App. 1998), in which post-filing tax refund was determined to be divisible marital asset because refund represented return of taxes overpaid during marriage. *Crider vs. Crider*, 26 N.E.3d 1045 (App. 2015).

On remand, the court was directed to value the unexercised options, and to consider the tax consequences attributed to each party. *Henry v. Henry*, 758 S.E.2d 991 (2001).

Though the Indiana statute requires a trial court to consider tax consequences related to the disposition of marital property, this requirement relates only to the "direct or inherent and necessarily incurred tax consequences of the property disposition." The court determined that future tax consequences incident to the disposition of stock awarded to one party were not properly to be reduced by future tax consequences. *Knotts v. Knotts*, 693 N.E.2d 962 (1998).

The trial court deducted an anticipated tax liability that would arise from the sale of two Laundromats. However, the appellate court reversed because only tax consequences necessarily arising from the plan of distribution are to be taken into account. The court explained that a taxable event must occur as a direct result of the court ordered disposition of the marital estate for the resulting tax to reduce the value of the marital estate. *Granger v. Granger*, 579 N.E.2d 1319 (1991).

IOWA

I.C.A. § 598.21

Decree ordered parties to file joint tax returns, with husband to pay any tax. Husband failed to sign or file returns wife submitted to him. Trial court found husband in contempt and sentenced him to jail. Husband argued that automatic stay from his post-decree bankruptcy filing protected him from the contempt charge. Appellate Court found order requiring him to sign tax returns did not implicate protections of bankruptcy stay "since it was not an action to collect a debt or create financial insecurity," even though signing of tax returns would create a tax liability. *Cathers v. Iowa Dist. Court for Greene County*, 860 N.W.2d 343 (2014).

"[I]t is appropriate to consider the tax consequences when one party is awarded a disparate amount of the marital assets that have a reduced tax basis because the parties have taken excess depreciation even though a sale might not be anticipated. It is particularly appropriate to do so when the excess depreciation has augmented the parties' apparent marital assets." Husband asked court to order sale of assets so that significant debts could be paid with proceeds, with each party paying tax due on their share of proceeds. Noting that when no sale of the assets is anticipated the tax consequences of potential sale are not be considered in property division, trial court should nonetheless have considered tax consequences in this situation. The parties agricultural assets were primarily machinery and equipment, § 1231 property under the federal tax code. As the parties had taken advantage of the code's allowance for accelerated depreciation, this in turn had increased parties' net worth. A sale of the assets, to the extent sale proceeds exceeded remaining basis, would be recaptured as ordinary income. Since husband might have to sell the assets in order to make equalizing payment, taxes ($250,000 per expert testimony) would be due on liquidation of depreciated assets. Appellate court observed that even if liquidation were avoided, husband would be left with assets that had very little basis to depreciate. Whether assets were sold or retained, husband would be repaying depreciation previously taken, either through a current loss of depreciation if assets were retained, or on recaptured depreciation if assets were sold. *In re: the Marriage of Johnston*, 860 N.W.2d 342 (2014).

Former husband was not entitled to additional amount of KSOP deferred compensation plan to take into account income tax consequences resulting from his higher income than that of former wife; the former spouses were in mid-forties and about twenty years from retirement, no withdrawal was ordered or necessary to effectuate property division, their income tax rates at the time of retirement were highly speculative, and each party received property with a value of over one-half million dollars. *In re Marriage of Swalley,* 680 N.W.2d 377 (unreported) (2004).

Liquidation of capital assets awarded to husband for which he would incur tax consequences in order to make $400,000 equalizing payment to wife was not relatively certain, and thus, trial court's failure to reduce equalizing payment to wife by estimated tax consequence for sale of farm or house was not reversible error; husband was also awarded other property for which liquidation would not result in tax consequences, and husband had option of borrowing against property for which interest would be tax deductible for him. *In re Marriage of Lenz*, 715 N.W.2d 770 (unreported) (2006).

KANSAS

K.S.A. 23-2802

Trial court erred in failing to consider tax consequences of its division of property and, thus, case remanded for limited purpose of receiving evidence and making findings on alternative methods of payment giving consideration to tax consequences, interest on and security for unpaid balance. *Bohl v. Bohl*, 657 P.2d 1106 (1983).

KENTUCKY

KRS § 403.190

Man who agreed to judgment of paternity so he could claim twins as his dependents for income tax purposes was equitably estopped from setting aside paternity judgment, even though mother acknowledged man was not biological father. Court found that man knew or should have known that he was not the twins' father, and had benefitted from being able to claim them on his taxes, and had only entered into the judgment in order to gain tax benefit. K.W. v. J.S., 459 S.W.3d 399 (2015).

Trial court's decision to uphold non-wage garnishment writs against husband's tax-deferred accounts, after husband failed to pay sums due to wife by dates set forth in divorce judgment, was not justified as, in upholding writs, trial court subjected husband to a penalty which was far in excess of his breach in failing to make payments to wife by court-imposed deadlines, garnishment writs converted a deferred distribution of marital assets into a present-value distribution, and penalties and taxes imposed on husband fundamentally altered the underlying allocation of marital assets. *Atkisson v. Atkisson*, 298 S.W.3d 858 (2009).

Federal "economic stimulus" check received by husband was generated from the marital estate and thus, was either marital property or joint property of both parties, where the check was payable to both parties, and was based on the prior year's income tax return, which the husband and wife had filed jointly. *Wilder v. Wilder*, 294 S.W.3d 449 (2009).

IRS's granting innocent spouse relief to wife did not bar divorce court from allocating to wife part of tax liability arising from disallowed deductions for husband's S-corp. *Dobson v. Dobson*, 159 S.W.3d 335 (2004).

LOUISIANA

LSA-R.S. 9:2801

Trial court should have considered income taxes which would have to be paid when ex-husband's stock options would be exercised in partitioning community property, and, thus, date of trial would be used to determine what tax liability would have been had all options been exercised at that time and ex-husband would be entitled to appropriate credit, where rate of taxation was no more speculative than value of options and ex-husband submitted evidence that he was subject to maximum applicable tax rate. *Hansel v. Holyfield*, 779 So.2d 939 (2000).

MAINE

19-A M.R.S.A. § 953

Decree required wife's share of stock option account to be reduced by half of any taxes resulting from the options vesting and liquidation. Parties had filed joint return during marriage, which included tax effect of the vesting. Sale of the stock occurred post-divorce, and entire capital gains tax was reported on former husband's return. Court explained that there were two taxable events, and both were addressed by divorce judgment, so that post-decree sale, which resulted in capital gains tax, required wife to reimburse husband for one-half of those additional taxes. *Bonner v. Emerson*, 105 A.3d 1023 (2014). **[PRACTICE TIP – WHEN DEALING WITH TAX ASPECTS OF STOCK OPTION ISSUES, REVIEW REVENUE RULING 2002-22.]**

Trial court's determination that money husband inherited from mother and briefly placed in parties' joint account remained non-marital property was not clear error, where money was placed in joint account for a brief period of time with the understanding that it would be used to pay taxes of estate of husband's mother. *Murphy v. Murphy*, 816 A.2d 814 (2003).

The court is required to consider tax consequences when the sale of marital property is part of the division of the marital estate. *Dubord v. Dubord*, 687 A.2d 647 (1997).

MARYLAND

MD Code, Family Law, § 8-205

Evidence of husband's financial resources was sufficient to support conclusion that he was not compelled to withdraw funds from his retirement account to satisfy a lump-sum marital property award to wife, and thus, tax liability of such withdrawal of retirement funds was properly not considered, as too speculative, as an "other factor" pursuant to statute governing monetary awards in making equitable distribution of marital property; trial court did not order $550,000 lump-sum award to be paid from specific source, and husband had annual income in excess of $1 million and access to several proven lending sources. *Solomon v. Solomon*, 857 A.2d 1109 (2004).

Husband's potential tax liabilities from disputes with IRS concerning his corporation's Subchapter S status and its 401(k) plan could be treated as too speculative to affect wife's monetary award of half of appreciation in corporation. *Innerbichler v. Innerbichler*, 752 A.2d 291 (2000).

MASSACHUSETTS

M.G.L.A. 208 § 34

Court has authority to allocate dependency exemption between divorcing parents. *Iv v. Hang*, 988 N.E.2d 1 (2013).

Trial court should weigh potential tax consequences, if presented with evidence regarding tax consequences, in creating or modifying an alimony order. Husband attempted to obtain modification of payments due under decree that placed him at risk of having alimony re-characterized as child support because of reduction in payments within six months before or after a child obtained age of majority. "Our conclusion that a judge should consider the tax consequences of a judgment when creating or modifying divorce instruments comports with the statutory mandate to consider the parties' income and liabilities" in determining alimony. "When as here, the tax consequences are uncertain, the judge must take that uncertainty into account and consider whether there are alternatives that will accomplish the judge's purpose but avoid the potential that his decision will trigger adverse and unwanted tax consequences." *L.J.S. v. J.E.S.*, 982 N.E.2d 1160 (2013).

Wife's interest in joint tax return refund depends on whether wife would have been entitled to refund if she filed separately. *Hundley v. Marsh*, 459 Mass. 78, 944 N.E.2d 127 (2011).

Trial court gave adequate consideration to tax consequences of property division, where court's findings made clear that even if husband had offered testimony from tax expert, which he consciously failed to do, property division would have been the same, given contentious nature of litigation and possibility that husband might attempt to transfer to wife those stocks and equities having basis least favorable to wife. *D.L. v. G.L.*, 811 N.E.2d 1013 (2004).

MICHIGAN

M.C.L.A. 552.23

Divorce court has broad discretion to order signing of joint tax return for tax year occurring during marriage. Opinion cautions that such discretion should be exercised "as a last resort", as general default rule is for court to first redistribute property to make up for any additional tax liability. (Opinion contains significant discussion of other states' approach to this issue.) *Butler v. Simmons–Butler*, 863 N.W.2d 677 (2014).

For purposes of calculating child support, funds distributed by S corp. to pay taxes of sole shareholder should not be included as income under the Michigan guidelines. Court noted that decision was consistent with case law from Kansas and Indiana, holding that such funds did not increase the parent's ability to pay support. Court also rejected testimony of expert that claimed that portion of corporation's excess working capital should be considered as additional income for child support purposes as Michigan guidelines do "not mandate the pursuit of one reasonable business model over another," and do "not necessitate the revamping of a parent's reasonable and historical business practices in favor of alternative methods in which a corporation *could* theoretically be run in order to make additional funds available." *Diez v. Davey*, 861 N.W.2d 323 (2014).

Abuse of discretion does not occur per se when trial court declines to consider tax consequences in distribution of marital assets; however, if trial court concludes on basis of evidence presented by parties that it would not be speculating in doing so, court may consider effects of taxation, stock brokerage and realtor fees, and other inchoate expenses in distributing assets. *Nalevayko v. Nalevayko* 497 N.W.2d 533 (1993).

MINNESOTA

M.S.A. § 518.58

The court acted within its broad discretion when it considered future tax consequences in valuing retirement and deferred compensation plans held by husband. Husband provided expert testimony through an accountant, who testified as to methodology, professional standards, and generally accepted accounting principles, and utilized the present lowest federal and state tax rates to value the plans. *Maurer v. Maurer*, 623 N.W.2d 604 (2001).

Record did not support trial court's finding that husband could avoid income tax consequences of court's division of marital property, which granted wife an equalizing cash award, by financing the cash payment rather than selling stored grain, and thus matter had to be remanded for determination of whether husband had absolute need to sell the grain. If so, value of marital estate would be significantly reduced by tax costs, as there was no evidence of credit available to husband, no evidence of security he could provide for credit, and no evidence of any source of funds from which he could repay loans. *Lund v. Lund*, 615 N.W.2d 860 (2000).

The trial court may consider the tax consequences after the neutral expert has evaluated the tax shelter assets, even though this is no qualification that a sale is required or likely to occur in the near future. *Pekarek v. Pekarek*, 362 N.W.2d 394 (App. 1985).

MISSISSIPPI

No statute – factors identified via case law.

Alimony payments by means of mortgage payments on house until ex-wife remarried or her child from another relationship graduated from high school were reversed, as ex-husband owed no legal duty to provide for child, and payments designated as alimony but terminating on child-related event are treated as child support by IRS, and therefore not deductible. (*See* IRC §71(c)(2).) *Pierce v. Pierce*, 42 So.3d 658 (Miss.Ct.App. 2010).

When equitably dividing marital property, the Court "is required to analyze the following factors: (5) tax and other economic consequences, and contractual or legal consequences to third parties, of the proposed distribution; and (8) any other factor which in equity should be considered". *Hammer v. Hammer*, 890 So.2d 944 (2004).

MISSOURI

V.A.M.S. 452.330

Lack of evidence of alleged tax refund and tax liability due for year precluded trial court from considering refund and liability when equalizing assets as part of dissolution of marriage proceeding, although it would have been proper to consider tax liabilities and/or refunds accrued during the marriage. *Pickering v. Pickering*, 314 S.W.3d 822 (2010).

Evidence supported trial court's acknowledgement that a potential tax consequence could attach to sale of "rolling stock" assets awarded to husband; although not precisely determinable until each asset was sold, assets carried a potential tax burden that reduced their value in husband's hands, and tax burden resulted from accelerated appreciation taken during marriage, which reduced tax liability of both husband and wife. *Elrod v. Elrod,* 192 S.W.3d 738 (2006).

Tax consequences are a factor to consider in dividing marital assets, and the trial court is deemed to know the tax law. *Brown v. Brown*, 14 S.W.3d 704 (2000).

Passive loss carry forward was treated as marital asset, subject to division. *Silverstein v. Silverstein*, 943 S.W.2d 300 (1997).

The trial court reduced the appraised value of a commercial building by a hypothetical real estate commission and the capital gains tax in the event of a sale. Though wife argued that there was no evidence that the property was going to be sold, the court explained that the experts' opinions were based on fair market value, and "the concept of fair market value assumes the sale of the property to an interested buyer. Thus, we are reluctant to find any error by the trial court in presuming a sale of the real estate with its attendant tax consequences in order to value that marital asset." *Hogan v. Hogan*, 796 S.W.2d 400 (1990).

MONTANA

MCA 40-4-202

Court did not abuse its discretion in ordering husband, sole shareholder of S corp., to undertake a divisive reorganization under I.R.C. §368(a)(1)(D), to accomplish division of marital property, as the "D Reorg" would allow corporation to transfer certain assets to wife with least amount of taxes or costs. *In re: Marriage of Edwards*, 340 P.3d 1237 (2015).

Trial court was not required to consider possible tax implications to husband if he sold marital assets awarded to him in order to make court-ordered equalization payment to wife as part of property division, since making that payment would not require husband to sell assets that would give rise to tax liability. *In re Marriage of DeBuff*, 50 P.3d 1070 (2002).

NEBRASKA

Neb.Rev.Stat. § 42-365

Federal tax law does not prevent a state court from exercising its discretion and ordering a divorcing couple to file a joint federal income tax return. The court included in its rationale the fact that court's have the authority to allocate dependency tax exemptions between divorcing parents. *Bock v. Dalbey*, 19 Neb.App. 210, 809 N.W.2d 785, (2011).

In assigning a value to a business, trial court should not consider the tax consequences of the sale of the business unless there is a finding that the sale of the business is reasonably certain to occur in the near future; however, the court may consider such tax consequences if it finds that the property division award will, in effect, force a party to sell the business in order to meet the obligations imposed by the court. *Schuman v. Schuman*, 658 N.W.2d 30 (Neb. 2003).

Life insurance policies were properly valued at their cash surrender value without considering income tax liability upon surrender of policies; no expert testimony was offered on income tax penalty and husband stated that he did not plan to surrender policies in foreseeable future. *McGuire v. McGuire*, 652 N.W.2d 293 (2002).

For purposes of determining an equitable distribution, former husband was substantially responsible for creating problematic federal tax liability and parties' resulting financial difficulties; consequently, an equitable division of the $27,001.63 net marital estate would result in awarding $18,010 to the former wife and $8,991 to the former husband. *Meints v. Meints*, 608 N.W.2d 564 (2000).

For a court to force one or both parties to a dissolution action to incur substantial income tax liability by a forced sale is unreasonable, unless the sale is necessary to accomplish a reasonable and necessary division. *Kellner v. Kellner*, 593 N.W.2d 1, (1999).

NEVADA

Nev.Rev.Stat. § 125.150

Trial court should have considered future tax liability upon maturity of note when valuing the note for purposes of dividing community property, where there was testimony by certified public accountant that the tax liability would accrue when the note was paid off on a particular date, just over a year from trial. *Ford v. Ford*, 782 P.2d 1304 (1989).

NEW HAMPSHIRE

N.H.Rev.Stat. § 458:16-a

While capital gains realized by sub S corporation are includible in sole shareholder's gross income for child support purposes, "proper measure of 'gross income' is to deduct legitimate business expenses from business profits," since "calculating a parent's ability to pay child support necessitates determining an actual ability to pay." Court observed that other jurisdictions have held that sole shareholder of sub-S corporation is considered to be self-employed. *In re: Matter of Maves and Moore*, 101 A.3d 1 (2014).

Failure of master to order filing of a joint income tax return was not abuse of discretion where there was no demonstration that a joint return would result in significant savings. *Wheaton-Dunberger v. Dunberger*, 629 A.2d 812 (1993).

NEW JERSEY

N.J.Stat. § 2A:34-23.1

Trial court did not abuse its discretion by compelling parties to file joint federal and state income tax returns for subject years; there was a significant financial benefit to filing joint returns, trial court had statutory obligation to consider tax implications of its decision, filing separately would have unnecessarily depleted funds available to support family, ex-husband was source of all income to be reported, and, because large majority of marital assets were required to pay marital debts, there was little means by which court could alter equitable distribution in order to compensate ex-husband for the adverse tax consequences of filing separate returns. *Bursztyn v. Bursztyn*, 879 A.2d 129 (2005).

Hypothetical tax consequences upon future sale or transfer of marital assets should not be deducted from present value for equitable distribution purposes, even though hypothetical consequences may be considered as a factor in determining distributive share of each party. *Orgler v. Orgler*, 568 A.2d 67 (1989).

NEW MEXICO

N.M.Stat.Ann. § 40-4-7

Court required to attribute sub-S corp. funds actually distributed to shareholder husband as income for spousal maintenance calculation unless husband could demonstrate what portion of distribution was used for business purposes or payment of income taxes resulting from any pro-rated share of S corp. net income or loss. Clark v. Clark, 320 P.3d 991 (App. 2013).

Court has obligation to consider tax implications of its division of marital property, and trial judge will usually assign recognized tax liability when dividing the property. *Schueller v. Schueller*, 117 N.M. 197, 870 P.2d 159 (1997).

NEW YORK

McKinney's DRL § 236

Wife's share of husband's bonus under open-court stipulation providing that wife would receive 25 percent of "after-tax amount" of bonus was 25 percent of bonus reduced by husband's actual tax liability, and not 25 percent of bonus reduced by amount of taxes withheld, given that court expressly indicated, when parties' settlement agreement was placed on the record, that calculation of exact amount of wife's share would have to await review of bonus statement and determination of tax rate, and also stated that wife would get 25 percent of bonus amount minus federal, state, and city tax liabilities. *Sood v. Sood*, 858 N.Y.S.2d 539 (2008).

Wife was liable for one-half of the parties' tax obligation arising out of a failure to pay proper income taxes during their marriage; since the wife shared equally in the benefits derived from the failure to pay, she had to share in the financial liability arising out of tax liability. *Conway v. Conway,* 815 N.Y.S.2d 233 (2006).

When equitably distributing marital property, husband was entitled to credit for his proportionate share of capital gains taxes resulting from gains in wife's separately-owned mutual fund. *Hendershott v. Hendershott*, 750 N.Y.S.2d 210 (2002).

A tax loss carry forward accumulated by a divorcing couple is a divisible marital asset. *Finkelstein v. Finkelstein*, 701 N.Y.S.2d 52 (App. 2000).

Credit for capital loss carry forward was not type of "property" addressed in domestic relations law section for determination of equitable disposition of property; while statute does list tax consequences as factor in distribution, such consideration relates only to consequences of distribution. *Cerretani v. Cerretani*, 634 N.Y.S.2d 228 (1995).

NORTH CAROLINA

N.C.G.S.A. § 50-20

Though the trial court was authorized by statute to consider the tax consequences of the distribution, there was no evidence presented that the distribution would not qualify as a tax-exempt exchange between former spouses, and, because it was error for trial court to consider hypothetical tax consequences as a distributive factor, case would be remanded. *Plummer v. Plummer*, 680 S.E.2d 746 (2009).

Where a party is required to pay the distributive award from a non-liquid asset or by obtaining a loan, the equitable distribution award must be recalculated to take into account any adverse financial ramifications such as adverse tax consequences. *Robertson v. Robertson*, 605 S.E.2d 667 (2004).

Trial court improperly considered tax consequences to parties if rental properties were liquidated; these tax consequences were hypothetical and speculative, absent finding that, as direct result of the distribution, parties would have to liquidate the rental properties or that there would be any actual tax consequences. *Dolan v. Dolan*, 558 S.E.2d 218 (2002), affirmed 562 S.E.2d 422.

NORTH DAKOTA

N.D. Cent. Code § 14-05-24

Trial court did not abuse its discretion in directing parties to file joint income tax returns for year in which judgment of divorce entered, where joint filing was more beneficial than separate filing with respect to tax consequences. *Oldham v. Oldham*, 677 N.W.2d 196 (2004).

Phantom tax consequences are not relevant basis on which to divide marital property; while properly informed trial court must consider tax effects in divorce, tax consequences should only be considered when liability is certain to occur within short time following dissolution. *Linrud v. Linrud*, 574 N.W.2d 875 (1998).

OHIO

Ohio Rev. Code Ann. § 3105.171

Court erred in failing to consider the potential tax consequences of equalization payment when husband was to pay wife property equalization payment from his 401(k) account. Ohio statute requires court to consider "tax consequences of the property division upon the respective awards to be made to each spouse," and court failed to consider tax consequences wife would incur when she withdraws transferred funds as cash from her own 401(k) account. *Lanzillotta v. Lanzillotta*, 2013 WL 5312430 (2013).

Husband who took money out of retirement account without wife's consent must pay her half of those funds as well as tax penalty for early withdrawal. *Robinson v. Robinson*, 2013 WL 5533083 (2013).

Divorce court should not have allocated dependency exemptions for parties' emancipated children. *Kent v. Kent*, 2010 WL 5548591 (2010).

Wife was found in contempt for failure to sign an amended joint tax return, as she had agreed to do in the decree incorporated property distribution agreement. Since the joint tax return would substantially reduce the tax liability, and Wife refused to sign the return, she was ordered to pay husband the difference between the amount owed on his actual separate return and the proposed amended joint return. The issues seems to have been controlled by the fact that wife had agreed to file an amended return when the settlement agreement was negotiated. *Ahmad (Hornsby) v. Ahmad*, 2010 WL 4703072 (2010).

Tax consequences of marital property division, which required wife who retained $9 million business to pay $4.5 million to husband as his share of the value of the business, were speculative and did not render marital property division inequitable, notwithstanding expert testimony presented by wife as to those consequences, where argument was premised upon contention that division essentially ordered a sale of one-half of the business or that business would have to generate millions in additional taxable profits to cover the division. Nothing in the trial court's order actually required wife to sell half the business or to pay the money out of dividend income, and she would have to pay taxes on income in any event. *Thomas v. Thomas*, 171 Ohio App.3d 272, 870 N.E.2d 263 (2007).

In valuing rental property awarded to husband, trial court was not required to consider estimated taxes which husband would incur by selling property, as tax liability was speculative where property was subject to option contract and husband failed to show that option was likely to be exercised. *James v. James*, 656 N.E.2d 399 (1995).

OKLAHOMA

Okla.Stat. Title 43, § 121

OREGON

O.R.S. § 107.105

Trial court properly took into account former husband's tax liability in setting the amount of spousal support to be awarded. Where the amount of tax consequence or the potential for tax liability is too speculative, an appellate court will not take into account the possible effects of taxation in dividing the property. *Mallorie and Mallorie*, 113 P.3d 924 (2005).

It was not appropriate for court to consider tax consequences of compensating judgment requiring husband to pay wife one-third of valuation of husband's discount brokerage firm, even though husband would be required to pay the judgment from proceeds of a sale of the company, where it was not certain that husband would sell the company and there was no evidence of what the tax consequences would be if husband sold the company. *In re Marriage of Bidwell*, 12 P.3d 76 (2000).

The value of husband's retirement account was discounted by 40% for future tax liability, based on expert testimony, as future tax was "virtual certainty". *In re: Marriage of Drews*, 956 P.2d 246 (1998).

PENNSYLVANIA

23 Pa. Cons. Stat. § 3502

(a) General rule. – Upon the request of either party in an action for divorce or annulment, the court shall equitably divide, distribute or assign, in kind or otherwise, the marital property...Factors which are relevant to the equitable division of marital property include the following:

***

(10.1) The Federal, State and local tax ramifications associated with each asset to be divided, distributed or assigned, which ramifications need not be immediate and certain.

Master erred in reducing, by 20% capital gains tax, the value of wife's non-marital stock awarded to husband; nothing in the record cited by either party or the master indicated that a sale or other transfer would create a tax liability that could reasonably be ascertained, and therefore, the master incorrectly subtracted 20% from the gross value of wife's non-marital stock awarded to husband. *Anzalone v. Anzalone*, 835 A.2d 773 (2003).

RHODE ISLAND

R.I. Gen. Laws § 15-5-16.1

Trial court was not required to consider possible capital gains tax of husband selling commercial property to satisfy equitable distribution; husband failed to submit any evidence to guide court in assessing tax implications of any property distribution. *Koutroumanos v. Tzeremes*, 865 A.2d 1091 (2005).

SOUTH CAROLINA

S.C. Code § 20-3-620

Court should not have allocated solely to husband income tax liability for income earned by husband during the marriage. Even though wife had filed separate tax returns, and husband had failed to file state and federal income tax returns during the marriage, husband's greater income gave rise to a greater tax liability, and wife, benefiting from at least 50% of the marital income, was responsible for an equal amount of the tax liability, apparently aside from late fees and penalties. *Barrow v. Barrow*, 394 S.C. 603, 716 S.E.2d 302 (2011.)

Trial court was not required to consider the tax consequences to husband if he was forced to liquidate his retirement account in order to purchase a new residence, since its order neither contemplated nor required, either explicitly or implicitly, the sale of the marital home by wife or the liquidation of retirement funds by husband. *Wooten v. Wooten*, 615 S.E.2d 98 (2005).

Though the South Carolina statutes concerning the division of marital property require the court to consider tax consequences resulting from an equitable apportionment, it was an abuse of discretion for the court to consider tax consequences where the apportionment order did not contemplate sale or liquidation of the asset. *Ellerbe v. Ellerbe*, 473 S.E.2d 881 (1996).

SOUTH DAKOTA

S.D. Codified Laws § 25-4-44

It was not necessary to consider theoretical tax consequences on transactions which are not probable, but merely conjectural. *Grode v. Grode*, 543 N.W.2d 795 (1996).

Trial court adequately considered tax consequences when it decided to disregard "joint venture" between husband and children and include assets of "joint venture" in marital estate subject to division; though husband claimed that setting aside joint venture would result in tax and potential criminal liability, trial court found that there would be no deferred income tax if property were transferred in overall setting of divorce proceeding. *Strickland v. Strickland*, 470 N.W.2d 832 (1991).

<u>TENNESSEE</u>

Tenn. Code § 36-4-121

Filing of joint tax return does not transmute refund into joint property when refund arose from separate property of husband. Court pointed out that income tax returns "lack any operative words of conveyance." *Estate of Hunt v. Hunt*, 389 S.W.3d 755 (2012).

Trial court's failure to consider tax consequences of liquidation of some assets did not make division of assets inequitable. *Watters v. Watters*, 959 S.W.2d 585 (1997).

<u>TEXAS</u>

Tex. Fam. Code § 7.008. Consideration of Taxes

In ordering the division of the estate of the parties to a suit for dissolution of marriage, the court may consider:

(1) whether a specific asset will be subject to taxation, and

(2) if the asset will be subject to taxation, when the tax will be required to be paid.

Prior to the 2005 enactment of Tex. Fam. Code § 7.008, various Texas cases addressed taxation issues relating to property division.

In dividing community property, trial court can appropriately consider existing tax liability for sale of capital assets that has been realized by parties at time of divorce. *Grossnickle v. Grossnickle*, 935 S.W.2d 830 (1996).

Allowing husband offset for potential future tax consequences in event of sale of property awarded husband was abuse of discretion, where likelihood of property being subject to capital gains tax could only be answered by engaging in speculation or surmise. *Harris v. Holland*, 867 S.W.2d 86 (1993).

Tax consequences stemming from division of community property, as well as any unpaid tax liabilities, are proper factors to be considered in deriving fair and just division of community assets; indeed, it is reversible error for court to refuse to consider tax liability, particularly when this liability is substantial and one of spouses is without means to pay it. *Baccus v. Baccus*, 808 S.W.2d 694 (1991).

Ordering a certain division of property without giving consideration to spouses' probable tax liability with regard to husband's earnings during prior two years and wife's lack of resources to discharge such liability was error. *Cole v. Cole* 532 S.W.2d 102 (1975).

UTAH

Utah Code § 30-3-5

Trial court could refuse to speculate about hypothetical future tax consequences of property division pursuant to divorce. *Howell v. Howell*, 806 P.2d 1209 (1991).

Trial court may decline to consider speculative future effect of tax consequences associated with sale, transfer or disbursement of marital property. *Morgan v. Morgan*, 795 P.2d 684 (1990).

VERMONT

Vt. Stat. title 15, § 751

Potential costs such as taxes or commissions cannot affect the valuation of a marital asset, but the trial court has the discretion to consider such costs in establishing the amount and method of payment of any monetary award. *Hayden v. Hayden*, 838 A.2d 59 (2003).

Trial court properly reduced value of certain marital assets to reflect potential tax consequences of sale of those assets, when assigning value to marital property, where primary marital asset was husband's investment account with market value of approximately $4 million, parties funded their lifestyle during marriage by borrowing against that account such that downturn in market could force husband to sell investments to repay debt thereby incurring substantial tax liability, and wife received cash award as her share of marital property with no need to worry about future tax problems, while husband retained investment account and bore risk that market downturn would force him to sell some investments and pay taxes on gain. *Cabot v. Cabot*, 697 A.2d 644 (1997).

Though trial court may consider potential tax when establishing amount and method of any monetary award in property division, thereby allocating burden of payment of tax, court does not consider basis in property when determining value of asset. *Mabee v. Mabee*, 617 A.2d 162 (1992).

VIRGINIA

Va. Code § 20-107.3

Federal and state income tax refunds, utilizing loss on husband's separately owned property, should be divided on basis of refunds traceable to separate income, with balance of refunds equally divided, as refunds were not entirely attributable to losses from husband's separate property. *King v. King*, 621 S.E.2d 159 (2005).

Trial court's failure to adjust equitable distribution award to reflect that a future sale of husband's stock in closely held corporation would trigger capital gains taxes, was not an abuse of discretion; trial court understood the relevance of tax consequences as statutory factor for adjusting equitable distribution, but accepted wife's argument that the potential tax liability was too conjectural to warrant adjustment. *Owens v. Owens*, 589 S.E.2d 488 (2003).

Every capital asset has basis and, thus, potential liability for capital gain tax upon sale; such potential liability is proper consideration in determination of property division, if potential liability is not speculative. Value of husband's dental practice which was marital property should not have been reduced based on consideration of tax consequences of hypothetical sale of practice; tax consequences of hypothetical sale were too speculative to be considered by trial court in determining present value of practice, as husband did not intend to sell his dental practice, and no evidence established that sale would occur in near future. *Arbuckle v. Arbuckle*, 470 S.E.2d 146 (1996).

WASHINGTON

Rev. Code of Washington § 26.09.080

Because sale of real estate partnership was not imminent, trial court erred in considering capital gains tax consequence when valuing parties' interest in partnership. This opinion discusses numerous decisions from courts throughout the country, and also references an ALR annotation, Divorce and Separation: Consideration of Tax Consequences Distribution of Marital Property, 9 ALR 5th 568. *In re Marriage of Hay*, 907 P.2d 334 (1995).

Trial court erred in deducting arbitrary amount from value of husband's deferred compensation plan for income taxes; reduction for taxes was only appropriate based on substantial evidence as to amount and evidence that taxes would become payable in immediate future. *In re Marriage of Hurd*, 848 P.2d 185 (1993).

Trial court could award husband his separate inheritance and deduct 25% for taxes and social security in valuing husband's Financial Security Plan, even though husband did not specifically testify as to percentage of taxes that would be deducted from that plan. *In re Marriage of Sheffer*, 802 P.2d 817 (1990).

WEST VIRGINIA

W.Va. Code § 48-7-101

Definite and readily ascertainable tax consequences may be considered in valuing property for equitable distribution purposes. *Michael v. Michael*, 469 S.E.2d 14 (1996).

In valuing husband's medical practice for equitable distribution purposes, husband had to be given credit for taxes ultimately payable on receipt of accounts receivable, since unpaid taxes were valid lien or encumbrance against accounts receivable, or would become such lien or encumbrance as soon as accounts receivable were collected. *Durnell v. Durnell*, 460 S.E.2d 710 (1995).

Court should have considered tax consequences in determining division of husband's stock between parties; stock was acquired at different times with different costs, and cost would be used to determine capital gain or loss for tax purposes when stock was subsequently sold. *Kapfer v. Kapfer*, 419 S.E.2d 464 (1992).

For purposes of equitable distribution, husband could be entitled to a deduction for tax liability on sale proceeds of billboards if tax liability could be definitively ascertained. *Hudson v. Hudson*, 399 S.E.2d 913 (1990).

Former husband was not entitled to deduct from payment due wife under divorce decree an amount representing an estimate of the tax he would be required to pay upon sale of assets allegedly necessary in order to raise funds to make payment; tax implications were too remote. *Bettinger v. Bettinger*, 396 S.E.2d 709 (1990).

WISCONSIN

W.S.A. 767.61

Allocating parties' future tax liability was unwarranted. Since IRS had not made final determination of amount of tax liability, exact amount of tax liability was matter of speculation. *Steinmann v. Steinmann*, 749 N.W.2d 145 (2008).

Husband's culpable failure to satisfy tax obligations fell within definition of "marital waste" justifying deviation from equal division of marital assets, where husband admitted that he was being audited for his failure to satisfy sales tax obligations, wife played no role in operation of husband's business and testified that she had not signed tax returns for previous three years, and husband exercised complete control over business and made all business decisions. *Covelli v. Covelli*, 718 N.W.2d 260 (2006).

WYOMING

Wyo.Stat. 20-2-114

Potential tax liability should be considered only upon proof that a specific taxable event will occur in connection with the division of marital property within a time frame that such tax liability can be reasonably calculated. Trial court would not consider the potential tax consequences of husband's future equalizing payments to wife, given the speculative nature of any potential tax liability; husband effectively was asking trial court to consider tax implications of theoretical future liquidation of assets, it would be the basest form of speculation to attempt to determine tax consequences of voluntary liquidation of assets at an unknown future time, and the voluntary and theoretical nature of impact of potential future tax consequences was exemplified by husband's failure to identify with specificity assets he allegedly would be forced to liquidate. *Hall v. Hall*, 125 P.3d 284 (2005).

D. INTEREST DEDUCTIBILITY ON DIVORCE SETTLEMENTS.

In *Armacost v. Commissioner of Internal Revenue*, 75 T.C.M. (CCH) 2177 (1998), the Tax Court concluded that portions of the interest payable by husband to wife, pursuant to a promissory note which was part of the parties' separation agreement, was deductible so long as it met the requirements of §163(h)(2)(A)-(E), to the effect that the interest would not be excluded as personal interest. The opinion contains both an historical and technical analysis of the issue, including the obligation to allocate the interest among deductible and nondeductible aspects of the settlement. *See* also *Seymour v. Commissioner of Internal Revenue*, 109 T.C. No.14 (1997). Copies of both cases are attached.

Articles from 1) the November 1998 *Journal of Taxation*, "Interest Paid to an Ex-Spouse Incident to Divorce – Yes, it Can be Deductible," 2) *Tax Lawyer*, Volume 51 #4 at pp. 829 – 834 "§ 1041 Does Not Require Interest Paid to an Ex-Spouse to be Treated as Personal Interest: *Seymour v. Commissioner*," and 3) *Taxation for Accountants,* June 1989. "Qualifying for Non-Recognition on Transfers Between Spouses or as Part of a Divorce," provide additional guidance on this situation.

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T.C. Memo. 1998-150
United States Tax Court.

Ronald R. ARMACOST and Cathy L. Armacost, Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

No. 19616–96. | April 27, 1998.

Attorneys and Law Firms

Richard P. Algeo, for petitioners.

Julie L. Payne, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DEAN, *Special Trial Judge:*

***1** This case was heard pursuant to section 7443A(b)(3) and Rules 180, 181, and 182.[1] Respondent determined a deficiency in Ronald and Cathy Armacost's Federal income taxes for the taxable year 1992 in the amount of $5,470. The sole issue for decision is whether interest payments on a promissory note made by Ronald Armacost (petitioner) to his exwife are deductible.

Some of the facts have been stipulated and are so found. The stipulation of facts and the attached exhibits are incorporated herein by reference. Petitioners resided in Liberty Lake, Washington, at the time their petition was filed.

FINDINGS OF FACT

Petitioner married Linda L. Armacost in 1963. During their marriage, petitioner and Linda Armacost accumulated numerous assets, including stocks, bonds, a personal residence, vacation properties, and other liquid assets. They also acquired several commercial properties on which they developed, constructed, and operated gas stations and convenience stores.

Petitioner and Linda Armacost resided only in the community property States of Washington or Idaho during their marriage; therefore most of their assets were owned in undivided one-half interests.

In January 1985, petitioner and Linda Armacost legally separated. They agreed to divide their property equally and executed a Separation Agreement designating which property would be allocated to whom. All their property, along with its "value at date of dissolution", was divided as follows:

Ronald Armacost

1. Lake home at Priest Lake, Idaho ($50,000);
2. All boats, boat motors and trailers, and motorcycles plus

household furnishings	($25,000);
3. Hawaiian condominium at Kihei, Maui	($61,000);
and	
4. Debt on family home	(-$49,000).
5. All capital stock in Budget Oil Co., Inc.	($101,000);
6. One-half of all investment stocks	($0);
7. One-half of all royalty rights in Procto–Therm	($0);
8. One-half of all limited partnership interests in oil well,	
rotator, and handlebar	($0);
9. One-half of existing partnership interests in Cable Marque	
and Dinestalon	($0);
10. Individual retirement accounts	($4,800);
11. One-half interest in Ronald Armacost's Budget Oil Co., Inc.	
pension and profit sharing plan	($40,000);
12. Commercial property located at N. 7902 Division	(-$38,000);

13. Commercial property located at Division and Augusta	($128,000);
14. Commercial property located at University City	($195,000);
15. Commercial property located on Pines Road	($400,000);
16. Commercial property located in Moscow, Idaho	($145,000);
17. Building at Third and Maple	($50,000);
18. Commercial property located at Liberty Lake	($247,000);
and	
19. Bank Note—McDonald's Property	(-$135,000).
20. Ranch Land located in Adams County, Idaho	($20,000).
Total Assets	$1,244,800

Linda Armacost

1. Family Home	($70,000);

2. Vehicles and household furnishings	($25,000);
and	
3. Account balances	($4,000).
4. McDonald's property	($580,000);
5. Miller real estate contract	($16,000);
6. Lang real estate contract	($5,000);
7. One-half of all investment stocks	($0);
8. One-half royalty rights in Procto–Therm	($0);
9. One-half partnership interest in Cable Marque and Dinestalon	($0)
10. One-half of all limited partnership interests in oil well,	
rotator, and handlebar	($0);
11. One-half interest in Ronald Armacost's Budget Oil Co., Inc.	
pension and profit-sharing plan	($40,000).
Total Assets	$740,000

Linda Armacost 1. Family Home ($70,000); 2. Vehicles and household furnishings ($25,000); and 3. Account balances ($4,000). 4. McDonald's property ($580,000); 5. Miller real estate contract ($16,000); 6. Lang real estate contract ($5,000); 7. One-half of all investment stocks ($0); 8. One-half royalty rights in Procto"Therm ($0); 9. One-half partnership interest in Cable Marque and Dinestalon ($0)10. One-half of all limited partnership interests in oil well, rotator, and handlebar ($0);11. One-half interest in Ronald Armacost's Budget Oil Co., Inc. pension and profit-sharing plan ($40,000). ------------ Total Assets $740,000

***2** Petitioner received more property upon dissolution of the marriage than did Linda Armacost, so he signed a promissory note in the amount of $250,000 payable to Linda Armacost to equalize the distribution of assets. The note was payable for 20 years, at 10 percent interest. Linda Armacost also was granted a security interest in the properties transferred to petitioner.

Petitioner made payments to Linda Armacost under the note, and deducted the interest paid on his Federal income tax return for taxable year 1992. Respondent disallowed the deduction on the ground that the interest was nondeductible personal interest under section 163(h)(2).

OPINION

Respondent contends that the interest on the note was incurred for purposes of dividing community property incident to divorce. Section 1041 provides that no gain or loss shall be recognized on the transfer of property incident to divorce, and the property is treated as having passed to the transferee by gift. Respondent argues that the interest here is nondeductible because the underlying debt is traced back to the divorce, a personal purpose. This is essentially the same argument respondent made in *Seymour v. Commissioner*, 109 T.C. 279, 1997 WL 686244 (1997).

In the *Seymour* case, the taxpayer incurred indebtedness to his ex-spouse upon his divorce. Respondent disallowed his interest deduction on the ground that section 1041 characterized the taxpayer's interest as personal interest under section 163(h). In that case, the taxpayer prevailed because we concluded that section 1041 does not require indebtedness to a former spouse incident to divorce to be characterized as personal interest for purposes of section 163(h)(1). *Seymour v. Commissioner, supra* at 286. If the taxpayer can satisfy the requirements of section 163(h)(2)(A) through (E), the interest will be properly deductible under section 163(a). *Id.*

Generally, section 163 provides that interest on indebtedness is deductible by the taxpayer in the year it is paid. Sec. 163(a). However, substantial limitations are placed on this general rule which may limit or prohibit the taxpayer from deducting indebtedness interest at all.

Section 163(h) provides that for an individual taxpayer, personal interest is nondeductible. Personal interest is defined in section 163(h)(2) as the residual of what remains after considering five enumerated exceptions. These exceptions are as follows:

> (A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),
>
> (B) any investment interest (within the meaning of subsection (d)),
>
> (C) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,
>
> (D) any qualified residence interest (within the meaning of paragraph (3)), and
>
> (E) any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163 or 6166 or under section 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

***3** Sec. 163(h)(2). The exception relating to investment interest is the basis for petitioner's claim.

Interest on indebtedness must be allocated in the same manner as its underlying debt. Sec. 1.163–8T, Temporary Income Tax Regs., 52 Fed.Reg. 24999 (July 2, 1987). Underlying debt is allocated by tracing specific disbursements of the proceeds to specific expenditures. *Id.* If the underlying debt is incurred as a personal expenditure, the interest on that debt may not be deducted under section 163 except to the extent such interest is qualified residence interest. Sec. 1.163–8T(a)(4)(ii), *Example (1)*, Temporary Income Tax Regs., 52 Fed.Reg. 25000 (July 2, 1987).

But if the underlying debt is incurred to acquire investment property, the interest on that debt is deductible under section 163 as investment interest. Sec. 163(h)(2)(B). Investment interest is defined as any interest paid on indebtedness properly allocable to investment property. Sec. 163(d). Investment property includes property producing gross income from interest, dividends, annuities or royalties not derived in the taxpayer's trade or business, or property held in the course of the taxpayer's trade or business which is neither a passive activity nor an activity in which the taxpayer materially participates. Sec. 163(d)(5)(A), 469(e)(1).

To determine whether the promissory note signed by petitioner is indebtedness traceable to investment property, we look at the nature of the underlying assets acquired by petitioner as a result of the divorce. To the extent the note was made to acquire Linda Armacost's community interest in their investment property, the interest paid on that note will be properly characterized as investment interest and will be deductible under section 163. To the extent, however, the note was made to acquire her interest in noninvestment property, the interest will not be deductible as investment interest under section 163. Respondent's determinations are presumed correct, and petitioner has the burden of proving them erroneous. Rule 142(a); *Welch v. Helvering,* 290 U.S. 111, 115, 54 S.Ct. 8, 78 L.Ed. 212 (1933).

The Separation Agreement is silent as to which properties received by petitioner are attributable to the $250,000 note. But the lack of such designation in the Settlement Agreement does not affect the underlying character of the assets. The value differential between what petitioner received and what Linda Armacost received may appear to be equal to the total property distribution upon the divorce. However, examination of the total property values is not the end of our analysis. Based on the record, we are able to classify each property as either investment property or noninvestment property.

Petitioner received personal property, a condominium in Maui, and a lake house in Idaho. He also assumed the outstanding debt on the family home. Petitioner testified that these assets are noninvestment properties, and the record supports such a finding.

***4** The evidence also shows that petitioner's stock, partnership interests and royalty rights, IRA, pension and profit plan and commercial real estate are investment property.[2]

Linda Armacost received the family home, cash, and personal property, which we find is noninvestment property. For her share of investment property, Linda Armacost kept the McDonald's property, two land sale contracts, her interest in investment stocks and partnership interests, and one-half of their pension and profit sharing plan. The character of these assets is reflected in the record, and the parties do not dispute such a designation.

There is some dispute, however, as to the ranch located in Adams County, Idaho, and a condominium unit located in Liberty Lake, Washington. Respondent contends that the ranch land allocated to petitioner is noninvestment community property. Petitioner, however, testified that he inherited the ranch from his father. In addition, section 7, paragraph 11 of the Settlement Agreement states that the ranch land is the "sole and separate property" of the petitioner. Property acquired by bequest or devise is ordinarily that spouse's separate property. See *In re Estate of Salvini,* 65 Wash.2d 442, 397 P.2d 811 (Wash.1964). Therefore, the ranch is not community property, and Linda Armacost had no right to receive payment for any interest in the property. See *Poe v. Seaborn,* 282 U.S. 101, 51 S.Ct. 58, 75 L.Ed. 239 (1930); *Hansen v. Blevins,* 84 Idaho 49, 367 P.2d 758 (Idaho 1962); *In re Estate of Salvini, supra.* Because petitioner already owned the ranch in its entirety, we find that no part of the $250,000 note is attributable to the acquisition of this property.

Next, we look at the condominium unit situated in Liberty Lake. Respondent argues that a condominium unit valued at $247,000 was allocated to petitioner as noninvestment property. Petitioner, however, contends that the property located in Liberty Lake was not actually a condominium, but was one of his commercial convenience stores. After careful review of the record, we agree with petitioner that the property the parties valued at $247,000 is not a condominium unit and should be characterized as commercial investment property.

The parties submitted Joint Exhibit 4–D, Schedule of Assets Received Upon Marital Dissolution (Schedule of Assets), which refers to a commercial property in Liberty Lake valued at $247,000. The Schedule of Assets only refers to one property in Liberty Lake. The Separation Agreement, however, refers to two properties in Liberty Lake. A condominium is described in section 7, paragraph 18 of the Separation Agreement, and commercial real estate abutting Liberty Lake Road is found in section 7, paragraph 20.

For reasons unknown, a condominium in Liberty Lake is not listed on the Schedule of Assets. Petitioner testified, however, that the only noninvestment property he received outside of the personal property was the condominium in Maui and the house on the lake in Idaho. Everything else, petitioner claims, is commercial investment property. His testimony is supported by the Schedule of Assets, which categorizes the Liberty Lake property valued at $247,000 as commercial property.

***5** Respondent's argument that the Liberty Lake property valued at $247,000 is a noninvestment property is unsupported by the record. We do not know the nature of the condominium in Liberty Lake, but its character does not affect our finding that the commercial property in Liberty Lake valued at $247,000 is includable in petitioner's acquisition of investment property from Linda Armacost.

Based on our findings above, we draw the following conclusions regarding the value of properties distributed:

	NonInvestment	Investment
Ronald Armacost	[1] $87,000	[2] 51,137,800
Linda Armacost	[3] 99,000	[4] 641,000

Petitioner received $12,000 less than Linda Armacost in noninvestment property value, and $496,000 more than Linda Armacost in investment property value. This means that petitioner is entitled to his one-half community interest of $6,000 from Linda Armacost for noninvestment property, and Linda Armacost is entitled to her one-half community interest of $248,000 from petitioner for investment property. Linda Armacost's deficit in investment property nearly equals the $250,000 promissory note signed by petitioner. Thus we conclude that the debt is attributable to the acquisition of Linda Armacost's community share of investment property, and the interest on that indebtedness is deductible pursuant to section 163(d).

To reflect the foregoing,

Decision will be entered for petitioners.

All Citations

T.C. Memo. 1998-150, 1998 WL 221025, 75 T.C.M. (CCH) 2177, T.C.M. (RIA) 98,150, 1998 RIA TC Memo 98,150

Footnotes

1 Includes lake home in Idaho ($50,000), personal property and household furnishings ($25,000), condominium in Maul ($61,000) and debt on the family home (-$49,000).

2 Includes all capital stock in Budget Oil Co., Inc. ($101,000), one-half of all investment stocks, royalty rights, and partnership interests ($0), IRA ($4,800), one-half interest in pension and profit sharing plan ($40,000), commercial property located at N. 7902 Division (-$38,000), commercial property located at Division and Augusta ($128,000), commercial property located at University City ($195,000), commercial property located on Pines Road ($400,000), commercial property located in Moscow, Idaho ($145,000), commercial property located at Liberty Lake ($247,000), real estate at Third and Maple ($50,000), and a bank note on the McDonald's property (-$135,000).

3 Includes the family home ($70,000), vehicles and household furnishings ($25,000), and account balances ($4,000).

4 Includes McDonald's property ($580,000), Miller real estate contract ($16,000), Lang real estate contract ($5,000), one-half interest in investment stocks, royalty rights and partnership interests ($0), one-half interest in pension and profit sharing plan ($40,000).

1 Section references are to the Internal Revenue Code in effect for the year at issue. Rule references are to the Tax Court Rules of Practice and Procedure.

2 The value of petitioner's investment property is reduced by his liability on the bank note on Linda Armacost's McDonald's property.

End of Document

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United States Tax Court.
John L. SEYMOUR, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

No. 2575–96.
Nov. 05, 1997.

*279 Thomas J. Thomas, for petitioner.

Leonard T. Provenzale, for respondent.

RUWE, *Judge:*

P deducted the amount of interest paid to his former spouse on an indebtedness which he incurred incident to their divorce. P claimed that the indebtedness was properly allocable to investment, passive activity, and qualified residence indebtedness based on certain assets acquired pursuant to a decree of divorce. R disallowed such deduction on the ground that sec. 1041, I.R.C., requires P's interest expense to be characterized as personal interest under sec. 163(h)(1), I.R.C.

Held: Sec. 1041, I.R.C., has no relevance to the proper characterization of interest on indebtedness incurred incident to divorce.

Respondent determined deficiencies in petitioner's Federal income taxes and additions to tax as follows:

		Additions to Tax	
Year	Deficiency	Sec. 6651(a)(1)	Sec. 6654(a)
1992	$116,819	$926	$2,910
1993	100,290	—	1,749

After concessions, the issues for decision are: (1) Whether interest petitioner paid to his former spouse pursuant to a decree of divorce is nondeductible personal interest under section 163(h)(1); [FN1] and (2) whether petitioner is liable for the ***280** additions to tax under section 6654(a) for the taxable years 1992 and 1993.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, supplemental stipulation of facts, and stipulation of settled issues are incorporated herein by this reference. Petitioner resided in Palm Beach Gardens, Florida, at the time-he filed his petition.

By Final Judgment of Dissolution of Marriage dated July 20, 1987 (the divorce decree), the Florida Circuit Court of the Fifteenth Judicial Circuit, in and for Palm Beach County, dissolved the marriage between petitioner and Katherine S. Seymour. In connection with their divorce, petitioner and Mrs. Seymour entered into a Separation and Property Settlement Agreement on July 17, 1987 (the property settlement agreement), which was subsequently incorporated into the divorce decree.

The property settlement agreement required that Mrs. Seymour convey to petitioner the following assets:

A. The wife's Class A and Class B stock in Pepsi–Cola Bottling Company of Selma, Inc.;

B. The wife's interest in the Pepsi–Cola land and building located in Selma, Alabama;

C. The wife's interest in the marital homeplace located at 14732 Palmwood Road, Palm Beach Gardens, Florida.

Under the terms of the property settlement agreement, petitioner was required to pay to Mrs. Seymour the sum of $925,000,[FN2] payable as follows:

A. $300,000 within thirty (30) days of the date of the execution of this agreement in current funds;

B. The balance of $625,000 over a period of ten (10) years bearing interest at the rate of 10%. The first three (3) years shall be payable interest only in equal semi-annual payments payable June 30 and December ***281** 31 each year. The first payment shall be due December 31, 1987. The remaining seven (7) years of the term of the note will be paid by the husband in equal semiannual payments payable June and December each year of principal and interest. * * *

On January 1, 1988, petitioner executed a promissory note naming Mrs. Seymour as the holder and containing payment provisions similar to those reflected in the property settlement agreement.[FN3] To secure the promissory note, petitioner conveyed to Mrs. Seymour a mortgage deed on the residence located in Palm Beach Gardens, Florida. The mortgage deed conveyed to Mrs. Seymour was subordinate to a preexisting mortgage on the property.

During the years in issue, petitioner made the following payments (consisting of principal and interest) to Mrs. Seymour:

Date	Principal	Interest	Total Payment
06/30/92	$44,642.86	$26,785.71	$ 71,428.57
12/31/92	44,642.86	24,553.57	69,196.43
Total	$89,285.72	$51,339.28	$140,625.00
06/30/93	$44,642.86	$22,321.43	$ 66,964.29
12/31/93	44,642.86	20,089.29	64,732.15
Total	$89,285.72	$42,410.72	$131,696.44

Petitioner failed to file timely Federal income tax returns for the taxable years 1992 and 1993. On November 13, 1995, respondent issued separate notices of deficiency to petitioner for the 1992 and 1993 taxable years. On February 9, 1996, petitioner submitted Federal income tax returns (Forms 1040) for the taxable years 1992 and 1993. On Schedules A of the Forms 1040, petitioner deducted $51,339.28 and $42,410.72 as investment interest for 1992 and 1993, respectively.

OPINION

After concessions, the principal issue in this case involves the application of sections 163 and 1041 to interest that petitioner paid in 1992 and 1993 on indebtedness to his former spouse. Section 163(a) provides the general rule that there ***282** shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. However, as an exception to this general rule, section 163(h)(1) provides that in the case of a taxpayer other than a corporation, no deduction shall be allowed for personal interest which is paid or accrued during the taxable year. Pursuant to section 163(h)(2), personal interest does not include interest which is investment interest, interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer (passive activity interest), or qualified residence interest.[FN4]

The term "investment interest" is defined to mean interest "which is paid or accrued on indebtedness properly allocable to property held for investment." Sec. 163(d)(3)(A). However, investment interest does not include any qualified residence interest or any interest taken into account under section 469 in computing income or loss from a passive activity of the taxpayer. Sec. 163(d)(3)(B). In general, the deduction for investment interest is limited to the noncorporate taxpayer's net investment income for the taxable year. Sec. 163(d)(1).

Interest allocated to a passive activity within the meaning of section 469 will be taken into account in determining the income or loss from such activity and, therefore, is not subject to the limitations of section 163(h). Sec. 163(h)(2)(C). However, the interest expense will be subject to possible disallowance under the passive activity loss limitation of section 469.

For the purposes of applying the passive loss limitation of section 469 and the nonbusiness interest limitations of section 163(d) and (h), section 1.163–8T, Temporary Income Tax Regs., 52 Fed.Reg. 24999 (July 2, 1987), prescribes rules for the proper allocation of an interest expense. In general, an ***283** interest expense is allocated in the same manner as the related debt is allocated; i.e., tracing the proceeds of the debt. Sec. 1.163–8T(a)(3), Temporary Income Tax Regs, *supra.* Section 1.163–8T(c)(1), Temporary Income Tax Regs., 52 Fed.Reg. 25000 (July 2, 1987), provides:

> Debt is allocated to expenditures in accordance with the use of the debt proceeds and, except as provided in paragraph (m) of this section, interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period. Except as provided in paragraph (m) of this section, debt proceeds and related interest expense are allocated solely by reference to the use of such proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest. * * *

If the taxpayer incurs a debt in consideration for the sale or use of property, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated as if the taxpayer used an amount of the debt proceeds equal to the balance of the outstanding debt to make an expenditure for such property. Sec. 1.163–8T(c)(3)(ii), Temporary Income Tax Regs., 52 Fed.Reg. 25001 (July 2, 1987).

Petitioner contends that the interest he paid to Mrs. Seymour is properly allocable to the assets he received from her incident to their divorce. Respondent contends that because the assets were transferred incident to a divorce, the treatment of the transaction under section 1041 prevents the allocation of petitioner's indebtedness to such assets, and the interest should be allocated to his personal obligation and, thus, characterized as nondeductible personal interest under section 163(h)(1).

Section 1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse, or former spouse, if the transfer is incident to divorce. See *Balding v. Commissioner*, 98 T.C. 368, 370, 1992 WL 62026 (1992); *Gibbs v. Commissioner*, T.C. Memo.1997–196. In the case of such a transfer, section 1041(b) provides that the property shall be treated as acquired by the transferee by gift and the basis of the property shall be the adjusted basis of the transferor. Respondent appears to argue that, since section 1041(b) provides that transfers incident to a divorce are to be treated as gifts, any debt incurred with respect to ***284** such transfers cannot be allocated to the property acquired. We do not agree.

In *Gibbs v. Commissioner, supra,* the taxpayer failed to include as income the amount of interest she received from her former spouse pursuant to a decree of divorce. Although the taxpayer conceded that a portion of each payment she received represented interest, she argued that the payments received from her former spouse were in exchange for her interest in certain property transferred incident to divorce and, thus, excludable from her income under section 1041. In *Gibbs v. Commissioner, supra,* we stated that the interest portion of the payments the taxpayer received pursuant to the divorce decree, and any gain she might have realized upon the transfer of the property to her former spouse, "are two distinct items that give rise to separate Federal income tax consequences." Consequently, we held that section 1041 has no application to the interest portion of the payments received by the taxpayer and that such interest must be included in the taxpayer's income in the year received. *Id.*

In Notice 88–74, 1988–2 C.B. 385, the Internal Revenue Service (IRS) announced that for debt incurred to acquire an interest in a residence incident to divorce or legal separation, regulations will provide that, in general, such debt will be eligible to be treated as debt incurred in acquiring a residence for purposes of section 163, without regard to the treatment of the transaction under section 1041.[FN5]

Although regulations concerning this issue have not been adopted,[FN6] further indication of the IRS's position may be found in Private Letter Rulings. [FN7] In Priv. Ltr. Rul. 89–28–010 (Apr. 6, 1989), the taxpayer incurred a debt, the proceeds of which were paid to the taxpayer's former spouse pursuant ***285** to a marital settlement agreement. In return, the taxpayer received the principal residence which, in turn, was used as security for the debt. Citing Notice 88–74, *supra,* the IRS concluded that the interest on the debt will be qualified residence interest for purposes of section 163(h) and that the taxpayer may deduct such amount subject to the limitations of section 163(h)(3) and the provisions of section 1.163–8T, Temporary Income Tax Regs., 52 Fed.Reg. 24999 (July 2, 1987), to the extent applicable. Priv. Ltr. Rul. 89–28–010 (Apr. 6, 1989); see also Priv. Ltr. Rul. 90–31–022 (May 7, 1990) (concluding that section 1041 does not apply to characterize interest expense on loan proceeds allocable to investment expenditures as personal interest for purposes of section 163(h)).

Finally, the historical language of section 163(h) reveals that section 1041, and its treatment of gain or loss on the transfer of property incident to divorce, is disregarded in allocating an interest expense. Prior to the amendments made by the Omnibus Budget Reconciliation Act of 1987 (OBRA–87), Pub.L. 100–203, 101 Star. 1330, 1330–384, that apply to the present case, section 163(h)(3)(B) limited qualified residence interest, in general, to an amount incurred on a debt that did not exceed the taxpayer's basis in the residence. See Tax Reform Act of 1986, Pub.L. 99–514, sec. 511(b), 100 Stat.2085, 2246.

The OBRA–87 amended the definition of qualified residence interest that is treated as deductible. The provisions of the OBRA–87 apply to taxable years beginning after December 31, 1987 and thus apply here. However, for any taxable year beginning in 1987, section 1005(c)(14) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub.L. 100–647, 102 Stat. 3342, 3392, provided that in certain circumstances involving a transfer of a qualified residence between spouses incident to a divorce or legal separation, the basis limitation on debt contained in section 511(b) of the Tax Reform Act of 1986 may be increased by the amount of secured indebtedness incurred by a spouse in connection with the acquisition of the other spouse's interest in the residence.[FN8] Although enacted subsequent to the OBRA–87, the provisions ***286** of this subsection of TAMRA were treated as having been enacted immediately before the enactment of the OBRA–87. TAMRA sec. 1005(c)(13), 102 Star. 3392. Therefore, this amendment had only limited application. However, it is apparent that Congress did not view section 1041 as requiring the characterization of interest on indebtedness incurred incident to divorce as personal interest.

Based on the foregoing, we hold that section 1041 does not require petitioner's indebtedness to his former wife to be characterized as personal interest for purposes of section 163(h)(1). Nevertheless, our resolution of this issue does not determine whether petitioner is entitled to deduct the interest payments on such indebtedness. Unless the interest is properly characterized as investment interest, passive activity interest, or qualified residence interest, petitioner's interest expense may still be personal under section 163(h)(1) and thus not deductible. Sec. 1.163–9T, Temporary Income Tax Regs., 52 Fed.Reg. 48409 (Dec. 22, 1987).

Petitioner contends that the indebtedness to Mrs. Seymour was secured by a mortgage on his residence and that a portion of the interest arising from that indebtedness was qualified residence interest and properly deductible. [FN9] Section 1.163–8T(m)(3), Temporary Income Tax Regs., 52 Fed.Reg. 25005 (July 2, 1987), provides:

> Qualified residence interest (within the meaning of section 163(h)(3)) is allowable as a deduction without regard to the manner in which such interest expense is allocated under the rules of this section. In addition, qualified residence interest is not taken into account in determining the ***287** income or loss from any activity for purposes of section 469 or in determining the amount of investment interest for purposes of section 163(d). * * *

Because qualified residence interest is not taken into account in determining passive interest or investment interest, we must first determine what amount, if any, of petitioner's interest expense is properly characterized as qualified residence interest under section 163(h)(3).

Section 163(h)(3)(A) defines qualified residence interest as any interest which is paid or accrued during the taxable year on acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer. The term acquisition indebtedness includes any indebtedness which is secured by a qualified residence and which is incurred in acquiring, constructing, or substantially improving such residence. Sec. 163(h)(3)(B). The total amount treated as acquisition indebtedness may not exceed $1 million or $500,000 for married taxpayers filing separately. Sec. 163(h)(3)(B)(ii).

In addition to stating that section 1041 will be disregarded in determining the eligibility of acquisition indebtedness, Notice 88–74, 1988–2 C.B. 385, also provides guidance concerning what is meant by acquisition indebtedness. Notice 88–74, 1988–2 C.B. at 385–386, states:

> Regulations will provide for purposes of section 163 that a debt may be treated as incurred in acquiring, constructing, or substantially improving a residence of the taxpayer to the extent that the proceeds of the debt are used, within the meaning of section 1.163–8T, to acquire, construct or substantially improve the residence.
>
> Notwithstanding the tracing rules of section 1.163–8T, in the case of the acquisition of a residence, debt may be treated as incurred to acquire the residence to the extent of expenditures to acquire the residence made within 90 days before or after the date that the debt is incurred.
>
> The total amount of debt which may be treated as debt incurred in acquiring, constructing or substantially improving a residence may not exceed the cost of the residence (including the cost of any improvements)

Therefore, debt secured by the residence will be treated as acquisition indebtedness either under the normal tracing rules of section 1.163–8T, Temporary Income Tax Regs., 52 Fed.Reg. 24999 (July 2, 1987), or, as an alternative, any ***288** debt may be treated as incurred to acquire the residence to the extent of expenditures to acquire the residence made within 90 days before or after the date the debt was incurred.

In addition, Notice 88–74, *supra,* provides that a single debt may qualify as partially acquisition and partially home equity indebtedness. In general, home equity indebtedness is any indebtedness, other than acquisition indebtedness, secured by a qualified residence to the extent that the total debt does not exceed the fair market value of the residence less the acquisition indebtedness associated with such residence. Sec. 163(h)(3)(C). The limit on home equity indebtedness is $100,000 or $50,000 for married taxpayers filing separately. *Id.*

With these rules in mind, we turn now to the proper allocation of petitioner's interest expense. Petitioner contends that the interest should be allocated among the assets received from his former spouse in proportion to the fair market value of each asset at the time of transfer.[FN10] Petitioner suggests in his brief that the interest be characterized and allocated in the following pro rata manner:

Asset	Character of Interest	Percent of FMV of each asset in 1987 divided by FMV of total assets	1992 Interest	1993 Interest
Class A stock[1]	Investment	41.0%	$21,049.10	$17,388.40
Class B stock[2]	Investment	15.0	7,700.89	6,361.61
Palm Beach house[3]	Qualified residence	13.2	6,776.76	5,598.22
Rental real estate in Selma, Alabama[4]	Passive activity	15.4	7,906.25	6,531.25
Rental real estate in Denver, Colorado'[5]	Passive activity	15.4	7,906.25	6,531.25
Total		100.0%	$51,339.27	$42,410.73

FN1. The Class A stock consisted of 160 shares in Pepsi–Cola Bottling Co. of Selma, Inc., which petitioner valued at $466,720.

FN2. The Class B stock consisted of 73 shares in Pepsi–Cola Bottling Co. of Selma, Inc., which petitioner valued at $170,382.

FN3. The residence located in Palm Beach Gardens, Florida, was valued at $300,000. This residence was encumbered by a mortgage securing a preexisting debt with a remaining balance of $47,878.

FN4. The land and building located in Selma, Alabama, was valued at $350,000 and leased to the Pepsi–Cola Bottling Co. of Selma, Inc. According to the property settlement agreement, this land was encumbered by a mortgage securing a debt in the amount of $87,356.

FN5. Petitioner testified that he purchased a rental house in Denver, Colorado, in 1984 for $354,000. This property was titled in petitioner's name prior to his divorce.

***289** We have several concerns regarding petitioner's proposed allocation. First, petitioner does not allocate the interest among all assets he received from Mrs. Seymour in accordance with section 1.163–8T, Temporary Income Tax Regs., 52 Fed.Reg. 24999 (July 2, 1987). According to the property settlement agreement and financial statements provided by petitioner, he received assets including certain household furnishings, Mrs. Seymour's interest in two automobiles, and her interest in a tax refund for 1985. Petitioner's proposed allocation does not allocate indebtedness to any of these assets. Second, we find petitioner's allocation of part of the indebtedness to the Denver, Colorado, rental real estate inappropriate. The financial statements petitioner submitted, as well as petitioner's own testimony, indicate that Mrs. Seymour had no interest in this asset prior to their divorce. In addition, the property settlement agreement does not provide for, or even refer to, any property located in Denver, Colorado. Consequently, no amount of indebtedness or interest should be allocated to this asset under section 1.163–8T(c)(3)(ii), Temporary Income Tax Regs., 52 Fed.Reg. 25001 (July 2, 1987). Finally, petitioner's suggested allocation disregards the provisions of section 163(h)(3) and the guidance provided by Notice 88–74, 1988–2 C.B. 385, concerning the characterization of qualified residence interest. We determine that the proper allocation of petitioner's indebtedness to his residence must be made in accordance with this guidance. The remaining indebtedness must be allocated among all other assets petitioner received incident to the property settlement agreement pursuant to section 1.163–8T, Temporary Income Tax Regs., 52 Fed.Reg. 24999 (July 2, 1987). We believe that the proper allocation of petitioner's interest expense can be mutually resolved and expect the parties to enter a stipulated computation to that effect.

Respondent also determined that petitioner is liable for additions to tax under section 6654(a) for failure to pay estimated income tax. Section 6654(a) provides for an addition to tax "in the case of any underpayment of estimated tax by an individual". Subject to certain exceptions provided by statute, this addition to tax is otherwise automatic if the amounts of the withholdings and estimated tax payments do not equal statutorily designated amounts. *Niedringhaus v. Commissioner*, 99 T.C. 202, 222, 1992 WL 190129 (1992); *Grosshandler v. Commissioner*, 75 T.C. 1, 20–21, 1980 WL 4621 (1980).

Petitioner failed to produce any evidence that would tend to showthat any of the statutory exceptions should apply or that respondent's determination of petitioner's liability for the addition to tax under section 6654(a) is in error. Consequently, because petitioner failed to make any estimated tax payments during the years in issue, we hold that he is liable for the additions to tax under section 6654(a) for 1992 and 1993.

An appropriate order will be issued.

FN1. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the taxable years in issue, and all Rule references are to the Tax Court Rules on Practice and Procedure.

FN2. The property settlement agreement also required petitioner to convey 30 percent of his 25–percent beneficial interest in the Seymour Trust. Petitioner's 25–percent beneficial interest in the Seymour Trust had a current value of not less than $563,302. The property settlement agreement also required petitioner to assume Mrs. Seymour's debts which, according to petitioner's calculations, totaled $121,899. Finally, the property settlement agreement required that petitioner pay $75,000 in attorney's fees and accounting service fees incurred by Mrs. Seymour incident to their divorce.

FN3. The first payment on the promissory note was not due until June 30, 1988.

FN4. Sec. 163(h)(2) provides:

For purposes of this subsection, the term "personal interest" means any interest allowable as a deduction under this chapter other than—

(A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),

(B) any investment interest (within the meaning of subsection (d)),

(C) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(D) any qualified residence interest (within the meaning of paragraph (3)), and

(E) any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163 or 6166 or under section 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

FN5. Notice 88-74, 1988-2 C.B. 385, 386 further states: "This announcement serves as an administrative pronouncement' as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure."

FN6. See sec. 1.163-10T(k)(1)(ii), Temporary Income Tax Regs., 52 Fed.Reg. 48414 (Dec. 22, 1987). Sec. 1.163-LOT, Temporary Income Tax Regs., 52 Fed.Reg. 48410 (Dec. 22, 1987), addresses the issue of what portion of an interest expense on an indebtedness secured by a qualified residence constitutes qualified residence interest. However, this regulation does not reflect the amendments of the 1987 Revenue Act, nor does it address circumstances involving a transfer of a qualified residence between spouses incident to a divorce.

FN7. Although private letter rulings are not precedent, sec. 6110(j)(3), they "do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws." *Hanover Bank v. Commissioner,* 369 U.S. 672, 686, 82 S.Ct. 1080, 8 L.Ed.2d 187 (1962); see *Rowan Cos. v. United States,* 452 U.S. 247, 259, 101 S.Ct. 2288, 68 L.Ed.2d 814 (1981); *Estate of Cristofani v. Commissioner,* 97 T.C. 74, 84 n. 5, 1991 WL 137858 (1991); *Estate of Jalkut v. Commissioner,* 96 T.C. 675, 1991 WL 64935 (1991).

FN8. Sec. 1005(c)(14) of the Technical and Miscellaneous Revenue Act of 1988, Pub.L. 100-647, 102 Stat. 3342, 3392, provides:

(A) For purposes of applying section 163(h) of the 1986 Code to any taxable year beginning during 1987, if, incident to a divorce or legal separation—

(i) an individual acquires the interest of a spouse or former spouse in a qualified residence in a transfer to which section 1041 of the 1986 Code applies, and

(ii) such individual incurs indebtedness which is secured by such qualified residence, the amount determined under paragraph (3)(B)(ii)(I) of section 163(h) of the 1986 Code (as in effect before the amendments made by the Revenue Act of 1987) with respect to such qualified residence shall be increased by the amount determined under subparagraph (B).

(B) The amount determined under this subparagraph shall be equal to the excess (if any) of—

(i) the lesser of the amount of the indebtedness described in subparagraph (A)(ii), or the fair market value of the spouse's or former spouse's interest in the qualified residence as of the time of the transfer, over

(ii) the basis of the spouse or former spouse in such interest in such residence (adjusted only by the cost of any improvements to such residence).

FN9. Respondent does not contest that the mortgage deed securing the indebtedness satisfies the definition of "secured debt" under sec. 1.163-10T(o), Temporary Income Tax Regs., 52 Fed.Reg. 48417 (Dec. 22, 1987), or that petitioner's residence meets the definition of "qualified residence" under sec. 1.163-10T(p), Temporary Income Tax Regs., 52 Fed.Reg. 48418 (Dec. 22, 1987).

FN10. Petitioner appears to rely upon Notice 89-35, 1989-1 C.B. 675, which provides special interest allocation rules for investors who own shares in partnerships or corporations. Notice 89-35, 1989-1 C.B. at 676, provides:

Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of

> the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.
>
> For purposes of this notice, the determination of whether a particular method of allocating debt proceeds used to purchase an interest in or to make a capital contribution to a passthrough entity is reasonable depends on the facts and circumstances including, without limitation, whether the taxpayer consistently applies the method from year to year.

U.S.Tax Ct.,1997.
Seymour v. C.I.R.
109 T.C. No. 14, 109 T.C. 279, Tax Ct. Rep. (CCH) 52,336, Tax Ct. Rep. Dec. (RIA) 109.14

END OF DOCUMENT

E. STOCK REDEMPTIONS IN DIVORCE CASES: TREASURY REGULATION § 1041-2.

Treasury Department Regulation § 1041-2 concerns the redemption of corporate stock owned by a spouse or former spouse, when the redemption occurs during marriage or incident to the divorce. The Regulation outlines circumstances in which the transferor spouse may be responsible for the applicable tax, as well as circumstances in which the transferee spouse may be treated as having received a constructive dividend. Most importantly, the Regulation provides in subsection (c) special rules which permit the parties to agree as to how the distribution will be taxable. The election must be made in the divorce or separation instrument, or in a valid written agreement. This document must expressly provide that i) both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as a redemption distribution to the transferor spouse; and ii) such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption. A copy of the Regulation is attached.

Code of Federal Regulations
Title 26. Internal Revenue
Chapter I. Internal Revenue Service, Department of the Treasury
Subchapter A. Income Tax
Part 1. Income Taxes (Refs & Annos)
Normal Taxes and Surtaxes
Gain or Loss on Disposition of Property
Common Nontaxable Exchanges

26 C.F.R. § 1.1041–2, Treas. Reg. § 1.1041–2

§ 1.1041–2 Redemptions of stock.

Currentness

(a) **In general--(1) Redemptions of stock not resulting in constructive distributions.** Notwithstanding Q&A–9 of § 1.1041–1T(c), if a corporation redeems stock owned by a spouse or former spouse (transferor spouse), and the transferor spouse's receipt of property in respect of such redeemed stock is not treated, under applicable tax law, as resulting in a constructive distribution to the other spouse or former spouse (nontransferor spouse), then the form of the stock redemption shall be respected for Federal income tax purposes. Therefore, the transferor spouse will be treated as having received a distribution from the corporation in redemption of stock.

(2) **Redemptions of stock resulting in constructive distributions.** Notwithstanding Q&A–9 of § 1.1041–1T(c), if a corporation redeems stock owned by a transferor spouse, and the transferor spouse's receipt of property in respect of such redeemed stock is treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the redeemed stock shall be deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock shall be deemed first to be transferred by the corporation to the nontransferor spouse in redemption of such spouse's stock and then to be transferred by the nontransferor spouse to the transferor spouse.

(b) **Tax consequences--(1) Transfers described in paragraph (a)(1) of this section.** Section 1041 will not apply to any of the transfers described in paragraph (a)(1) of this section. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(2) **Transfers described in paragraph (a)(2) of this section.** The tax consequences of each deemed transfer described in paragraph (a)(2) of this section are determined under applicable provisions of the Internal Revenue Code as if the spouses had actually made such transfers. Accordingly, section 1041 applies to any deemed transfer of the stock and redemption proceeds between the transferor spouse and the nontransferor spouse, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041, however, will not apply to any deemed

transfer of stock by the nontransferor spouse to the redeeming corporation in exchange for the redemption proceeds. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(c) **Special rules in case of agreements between spouses or former spouses--(1) Transferor spouse taxable.** Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, and shall not be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that--

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as a redemption distribution to the transferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(2) **Nontransferor spouse taxable.** Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, and shall not be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that--

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(3) Execution of agreements. For purposes of this paragraph (c), a divorce or separation instrument must be effective, or a valid written agreement must be executed by both spouses or former spouses, prior to the date on which the transferor spouse (in the case of paragraph (c)(1) of this section) or the nontransferor spouse (in the case of paragraph (c)(2) of this section) files such spouse's first timely filed Federal income tax return for the year that includes the date of the stock redemption, but no later than the date such return is due (including extensions).

(d) Examples. The provisions of this section may be illustrated by the following examples:

Example 1. Corporation X has 100 shares outstanding. A and B each own 50 shares. A and B divorce. The divorce instrument requires B to purchase A's shares, and A to sell A's shares to B, in exchange for $100x. Corporation X redeems A's shares for $100x. Assume that, under applicable tax law, B has a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption results in a constructive distribution to B. Also assume that the special rule of paragraph (c)(1) of this section does not apply. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for $100x in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the $100x to A in a transfer to which section 1041 applies.

Example 2. Assume the same facts as Example 1, except that the divorce instrument provides as follows: "A and B agree that the redemption will be treated for Federal income tax purposes as a redemption distribution to A." The divorce instrument further provides that it "supersedes all other instruments or agreements concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption." By virtue of the special rule of paragraph (c)(1) of this section and under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X and shall not be treated as resulting in a constructive distribution to B. See section 302.

Example 3. Assume the same facts as Example 1, except that the divorce instrument requires A to sell A's shares to Corporation X in exchange for a note. B guarantees Corporation X's payment of the note. Assume that, under applicable tax law, B does not have a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption does not result in a constructive distribution to B. Also assume that the special rule of paragraph (c)(2) of this section does not apply. Accordingly, under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X. See section 302.

Example 4. Assume the same facts as Example 3, except that the divorce instrument provides as follows: "A and B agree the redemption shall be treated, for Federal income tax purposes, as resulting in a constructive distribution to B." The divorce instrument further provides that it "supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption." By virtue of the special rule of paragraph (c)(2) of this section, the redemption is treated as resulting in a constructive distribution to B for purposes of paragraph (a)(2) of this section. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for a note in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the note to A in a transfer to which section 1041 applies.

(e) **Effective date.** Except as otherwise provided in this paragraph, this section is applicable to redemptions of stock on or after January 13, 2003, except for redemptions of stock that are pursuant to instruments in effect before January 13, 2003. For redemptions of stock before January 13, 2003 and redemptions of stock that are pursuant to instruments in effect before January 13, 2003, see § 1.1041–1T(c), A–9. However, these regulations will be applicable to redemptions described in the preceding sentence of this paragraph (e) if the spouses or former spouses execute a written agreement on or after August 3, 2001 that satisfies the requirements of one of the special rules in paragraph (c) of this section with respect to such redemption. A divorce or separation instrument or valid written agreement executed on or after August 3, 2001, and before May 13, 2003 that meets the requirements of the special rule in Regulations Project REG–107151–00 published in 2001–2 C.B. 370 (see § 601.601(d)(2) of this chapter) will be treated as also meeting the requirements of the special rule in paragraph (c)(2) of this section.

Credits

[T.D. 9035, 68 FR 1536, Jan. 13, 2003]

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

Current through Oct. 23, 2014; 79 FR 63335.

End of Document

F. <u>DIVISION OF NON-STATUTORY STOCK OPTIONS: REVENUE RULING 2002-22</u>.

This Revenue Ruling applies I.R.C. § 1041 to the transfer between spouses of <u>vested</u> non-statutory stock options, which transfer occurs as part of the divorce. The § 1041 treatment results in non-recognition upon the transfer between spouses, and avoids the application of the assignment of income doctrine, which is discussed in the Revenue Ruling. As the Revenue Ruling points out in its conclusion at p. 5, the Ruling does not apply to transfers between spouses other than in connection with a divorce, and "this ruling also does not apply to transfers of non-statutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer." A copy of the ruling is attached.

David S. Rosettenstein's article in *Family Law Quarterly*, volume 37, Summer 2003, entitled "Options on Divorce: Taxation, Compensation Accountability, and the Need to Look for Holistic Solutions," should be read by anyone interested in the subject of divorce and stock options.

H

Rev. Rul. 2002-22, 2002-19 I.R.B. 849, 2002-1 C.B. 849, 2002 WL 881644 (IRS RRU)

Internal Revenue Service (I.R.S.)
IRS RRU

Revenue Ruling
GROSS INCOME; TRANSFERS OF PROPERTY INCIDENT TO DIVORCE

Released: May 08, 2002
Published: May 13, 2002

Section 83.--Property Transferred in Connection With Performance of Services, 26 CFR 1.83-7: *Taxation of nonqualified stock options.*

A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

Section 1041.--Transfers of Property Between Spouses or Incident to Divorce, 26 CFR 1.1041-1T: *Treatment of transfer of property between spouses or incident to divorce.*

A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

Section 61.--Gross Income Defined, 26 CFR 1.61-1: *Gross income.*

Gross income; transfers of property incident to divorce.A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse. Rev. Rul. 87-112 clarified.

Gross income; transfers of property incident to divorce.A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

ISSUES
(1) Is a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce required to include an amount in gross income upon the transfer?

(2) Is the taxpayer or the former spouse required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse?

FACTS
Prior to their divorce in 2002, *A* and *B* were married individuals residing in State *X* who used the cash receipts and disbursements method of accounting.

A is employed by Corporation *Y*. Prior to the divorce, *Y* issued nonstatutory stock options to *A* as part of *A*'s compensation. The nonstatutory stock options did not have a readily ascertainable fair market value within the meaning of § 1.83-7(b) of the Income Tax Regulations at the time granted to *A*, and thus no amount was included in *A*'s gross income with respect to those options at the time of grant.

Y maintains two unfunded, nonqualified deferred compensation plans under which *A* earns the right to receive post-employment payments from *Y*. Under one of the deferred compensation plans, participants are entitled to payments based on the balance of individual accounts of the kind described in § 31.3121(v)(2)-1(c)(1)(ii) of the Employment Tax Regulations. By the time of *A*'s divorce from *B*, *A* had an account balance of $100x under that plan. Under the second deferred compensation plan maintained by *Y*, participants are entitled to receive single sum or periodic payments following separation from service based on a formula reflecting their years of service and compensation history with *Y*. By the time of *A*'s divorce from *B*, *A* had accrued the right to receive a single sum payment of $50x under that plan following *A*'s termination of employment with *Y*. *A*'s contractual rights to the deferred compensation benefits under these plans were not contingent on *A*'s performance of future services for *Y*.

Under the law of State *X*, stock options and unfunded deferred compensation rights earned by a spouse during the period of marriage are marital property subject to equitable division between the spouses in the event of divorce. Pursuant to the property settlement incorporated into their judgment of divorce, *A* transferred to *B* (1) one-third of the nonstatutory stock options issued to *A* by *Y*, (2) the right to receive deferred compensation payments from *Y* under the account balance plan based on $75x of *A*'s account balance under that plan at the time of the divorce, and (3) the right to receive a single sum payment of $25x from *Y* under the other deferred compensation plan upon *A*'s termination of employment with *Y*.

In 2006, *B* exercises all of the stock options and receives *Y* stock with a fair market value in excess of the exercise price of the options. In 2011, *A* terminates employment with *Y*, and *B* receives a single sum payment of $150x from the account balance plan and a single sum payment of $25x from the other deferred compensation plan.

LAW AND ANALYSIS

Section 1041 and the assignment of income doctrine

Section 1041(a) provides that no gain or loss is recognized on a transfer of property from an individual to or for the benefit of a spouse or, if the transfer is incident to divorce, a former spouse. Section 1041(b) provides that the property transferred is generally treated as acquired by the transferee by gift and that the transferee's basis in the property is the adjusted basis of the transferor.

Section 1041 was enacted in part to reverse the effect of the Supreme Court's decision in *United States v. Davis*, 370 U.S. 65 (1962), which held that the transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims was a taxable event resulting in the recognition of gain or loss to the transferor. *See*H.R. Rep. No. 432, 98th Cong., 2d Sess. 1491 (1984). Section 1041 was intended to "make the tax laws as unintrusive as possible with respect to relations between spouses" and to provide "uniform Federal income tax consequences" for transfers of property between spouses incident to divorce, "notwithstanding that the property may be subject to differing state property laws."*Id.* at 1492.Congress thus intended that § 1041 would eliminate differing federal tax treatment of property transfers and divisions between divorcing taxpayers who reside in community property states and those who reside in non-community property states.

The term "property" is not defined in § 1041. However, there is no indication that Congress intended "property" to have a restricted meaning under § 1041. To the contrary, Congress indicated that § 1041 should apply broadly to transfers of many types of property, including those that involve a right to receive ordinary income that has accrued in an economic sense (such as interests in trusts and annuities).*Id.* at 1491.Accordingly, stock options and unfunded deferred compensation rights may constitute property within the meaning of § 1041. *See also Balding v. Commissioner*, 98 T.C. 368 (1992) (marital rights to military pension treated as property under § 1041).

Although § 1041 provides nonrecognition treatment to transfers between spouses and former spouses, whether income derived from the transferred property and paid to the transferee is taxed to the transferor or the transferee depends upon the applicability of the assignment of income doctrine. As first enunciated in *Lucas v. Earl*, 281 U.S. 111 (1930), the assignment of income doctrine provides that income is ordinarily taxed to the person who earns it, and that the incidence of income taxation may not be shifted by anticipatory assignments. However, the courts and the Service have long recognized that the assignment of income doctrine does not apply to every transfer of future income rights. *See, e.g.*, *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970); *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974), *cert. denied*, 419 U.S. 826 (1974); Rev. Rul. 80-198 (1980-2 C.B. 113). Moreover, in cases arising before the effective date of § 1041, a number of courts had concluded that transfers of income rights between divorcing spouses were not voluntary assignments within the scope of the assignment of income doctrine. *See* *Meisner v. United States*, 133 F.3d 654 (8th Cir. 1998); *Kenfield v. United States*, 783 F.2d 966 (10th Cir. 1986); *Schulze v. Commissioner*, T.C.M. 1983-263; *Cofield v. Koehler*, 207 F. Supp. 73 (D. Kan. 1962).

In *Hempt Bros., Inc. v. United States*, the court concluded that the assignment of income doctrine should not apply to the transfer of accounts receivable by a cash basis partnership to a controlled corporation in a transaction described in § 351(a), where there was a valid business purpose for the transfer of the accounts receivable together with the other assets and liabilities of the partnership to effect the incorporation of an ongoing business. The court reasoned that application of the assignment of income doctrine to tax the transferor in such circumstances would frustrate the Congressional intent reflected in the nonrecognition rule of § 351(a). Accordingly, the transferee, not the transferor, was taxed as it received payment of the receivables. In Rev. Rul. 80-198, the Service adopted the court's position in *Hempt Bros.*, but ruled that the assignment of income doctrine would nonetheless apply to transfers to controlled corporations where there was a tax avoidance purpose.

Similarly, applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as *Meisner* that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.

Specific provisions governing nonstatutory stock options

Section 83(a) provides, in general, that if property is transferred to any person in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property is included in the gross income of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. In the case of nonstatutory stock options that do not have a readily ascertainable fair market value at the date of grant, § 83 does not apply to the grant of the option, but applies to property received upon exercise of the option or to any money or other property received in an arm's length disposition of the option. *See* § 83(e) and § 1.83-7(a).

Although a transfer of nonstatutory stock options in connection with a marital property settlement may, as a factual matter, involve an arm's length exchange for money, property, or other valuable consideration, it would contravene the gift treatment prescribed by § 1041 to include the value of the consideration in the transferor's income under § 83. Accordingly, the transfer of nonstatutory stock options between divorcing spouses is entitled to nonrecognition treatment under § 1041.

When the transferee exercises the stock options, the transferee rather than the transferor realizes gross income to the extent determined by § 83(a). Since § 1041 was intended to eliminate differing federal tax treatment for property transferred or divided between spouses in connection with divorce in community property states and in non-community property states, § 83(a) is properly applied in the same manner in both contexts. Where compensation rights are earned through the performance of services by one spouse in a community property state, the portion of the compensation treated as owned by the non-earning spouse under state law is treated as the gross income of the non-earning spouse for federal income tax purposes. *Poe v. Seaborn*, 282 U.S. 101 (1930). Thus, even though the non-employee spouse in a non-community property state may not have state law ownership rights in nonstatutory stock options at the time of grant, § 1041 requires that the ownership rights acquired by such a spouse in a marital property settlement be given the same federal income tax effect as the ownership rights of a non-employee spouse in a community property state. Accordingly, upon the subsequent exercise of the nonstatutory stock options, the property transferred to the non-employee spouse has the same character and is includible in the gross income of the non-employee spouse under § 83(a) to the same extent as if the non-employee spouse were the person who actually performed the services.

The same conclusion would apply in a case in which an employee transfers a statutory stock option (such as those governed by § 422 or 423(b)) contrary to its terms to a spouse or former spouse in connection with divorce. The option would be disqualified as a statutory stock option, see §§ 422(b)(5) and 423(b)(9), and treated in the same manner as other nonstatutory stock options. Section 424(c)(4), which provides that a § 1041(a) transfer of stock acquired on the exercise of a statutory stock option is not a disqualifying disposition, does not apply to a transfer of the stock option. *See*H.R. Rep. No. 795, 100th Cong., 2d Sess. 378 (1988) (noting that the purpose of the amendment made to § 424(c) is to "clarif[y] that the transfer of stock acquired pursuant to the exercise of an incentive stock option between spouses or incident to divorce is tax free").

CONCLUSION

Under the present facts, the interests in nonstatutory stock options and nonqualified deferred compensation that *A* transfers to *B* are property within the meaning of §1041. Section 1041 confers nonrecognition treatment on any gain that *A* might otherwise realize when *A* transfers these interests to *B* in 2002. Further, the assignment of income doctrine does not apply to these transfers. Therefore, *A* is not required to include in gross income any income resulting from *B*'s exercise of the stock options in 2006 or the payment of deferred compensation to *B* in 2011. When *B* exercises the stock options in 2006, *B* must include in income an amount determined under § 83(a) as if *B* were the person who performed the services. In addition, *B* must include the amount realized from payments of deferred compensation in income in the year such payments are paid or made available to *B*. The same conclusions would apply if *A* and *B* resided in a community property state and all or some of these income rights constituted community property that was divided between *A* and *B* as part of their divorce.

This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer. *See* Kochansky v. Commissioner, 92 F.3d 957 (9th Cir. 1996). Transfers of certain types of property incident to divorce, the tax consequences of which are governed by a specific provision of the Code or regulations (for example, § 402, 408, 414, 424, or 453B) are not affected by this ruling.

HOLDINGS

(1) A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer.

(2) The former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

PROSPECTIVE APPLICATION

The Service will apply § 7805(b) and assignment of income principles to treat income as gross income of the transferor and not of the transferee if--

(i) The income is attributable to an interest in nonstatutory stock options, unfunded deferred compensation rights, or other similar intangible property rights;

(ii) The options or rights were transferred from one party to a divorce to the other party to the divorce;

(iii) The transfer was required by a provision of an agreement or court order;

(iv) The provision was contained in the agreement or order before November 9, 2002; and

(v) (a) The agreement or court order specifically provides that the transferor must report gross income attributable to the transferred interest, or

(b) It can be established to the satisfaction of the Service that the transferor has reported the gross income for federal income tax purposes.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 87-112 (1987-2 C.B. 207) which deals with the treatment of transfers of United States savings bonds between spouses or former spouses, is clarified by eliminating references to assignment of income principles. As so clarified, the ruling is reaffirmed respecting the application of § 454 and the regulations thereunder to the transfer and the determination of the transferee's basis.

FURTHER INFORMATION

For further information or questions regarding § 61 or 1041, contact Edward Schwartz of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622-4960. For further information or questions regarding § 83, 402, 408, 414, 422, 423, 424, or 453B, contact Erinn Madden of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622-6030. These are not toll-free calls.

Rev. Rul. 2002-22, 2002-19 I.R.B. 849, 2002-1 C.B. 849, 2002 WL 881644 (IRS RRU)

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G. <u>U.S. TAX COURT CASES</u>.

I.R.C. § 152(a)(2) authorizes non-custodial parent to claim exemption for child if custodial parent has signed written declaration (typically Form 8332) that custodial parent will not claim the child. Though court order or decree entered before July 3, 2008 can serve as a "written declaration", it must be signed by custodial parent. Court rejected argument that decree, signed by judge, constituted a signing by custodial parent in order to meet the requirements of § 152(a)(2), even though decree allocated exemptions between parents. Court noted that statutory requirement sometimes imposes harsh results on tax payers, when ex-spouse claims dependency exemption deductions in violation of decree. *Porter v. C.I.R.*, T.C. Memo 2015-141.

<u>Pre</u>-July 2, 2008 divorce judgment permitting non-custodian father to claim exemption for tax purposes is not sufficient because parties never signed decree – "signing requirement" for non-custodial parent to claim exemption is to be strictly construed. *Hendricks v. C.I.R.*, T.C. Memo. 2014-192. **(PRACTICE TIP – <u>POST</u>-JULY 2, 2008 DECREE, OR SEPARATION AGREEMENT, DOES <u>NOT</u> MET "WRITTEN DECLARATION" REQUIREMENT OF FORM 8332.)**

Even though decree provided specific separate monthly child support payments and provided spousal maintenance payments were deductible, requirements of I.R.C. § 71 control, husband cannot deduct spousal maintenance payments when decree provides payments terminate upon ex-wife's remarriage, death of either party, or <u>high school graduation of the youngest child</u>, as this implicates I.R.C. § 71(c)(2) (any payment that is subject to a child related contingency is considered child support and not alimony). *Johnson v. C.I.R.*, T.C. Memo. 2014-67.

Divorced husband denied innocent spouse relief from liability for taxes on early withdrawal of retirement funds because he could not show that funds, later taken by former wife, had been set aside for payment of taxes. *Hammernik v. C.I.R.*, T.C. Memo. 2014-170.

Husband agreed under divorce settlement agreement to pay all tax liabilities incurred during marriage, but failed to do so. Wife sought innocent spouse relief, which was denied by IRS, but granted by Tax Court, under § 6015(f). Among reasons cited by Tax Court – former wife was receiving food assistance, caring for two minor children, and not receiving alimony or child support, and ex-husband had an obligation under divorce settlement to pay the income tax liability. Court noted that even though ex-wife should have known that husband would not be able to get a loan to pay the taxes, this was not a sufficient basis to make her ineligible for innocent spouse relief. *Demeter v. C.I.R.*, T.C. Memo. 2014-238.

Mother's failure to give father Form 8332 precludes him from claiming dependency exemption even though their divorce judgment entitled him to claim exemption. *Shenk v. C.I.R.*, 140 T.C. 200 (2013).

$5,000 per month payments made by husband during pendency of divorce case were not deductible, as there was no written separation agreement. *Faylor vs. Commissioner*, TC Memo. 2013 – 143.

Private Letter Ruling 201434030 –Division of IRA assets and subsequent transfer of approximately half to former wife's IRA under terms of divorce decree was not disqualifying distribution that modified 72T pre-divorce distributions from IRA pursuant to series of substantially equal period payments, as permitted by IRC § 72T.

11th Circuit decides husband's exercise of stock option arrangement in divorce settlement was taxable as ordinary income. IRS § 1041 did not apply to husband's option to reacquire shares transferred to wife as part of settlement. *Davis v. C.I.R.*, 716 F.3d 560 (2013).

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H. REVENUE RULINGS.

Revenue Ruling 2013-17 – Treasury Department and IRS announced in August of 2013 that same-sex married couples will be recognized as legally married for all federal tax purposes, regardless of where they live, so long as they were married in jurisdiction that recognized such marriages as legal.

Internal Revenue Service's Office of Chief Counsel provides advice that the proceeds of insurance policies on the life of divorced decedent were not includible in his gross estate, because at time of death he held only right to receive policy's dividends, as his obligation was to maintain life insurance policies having an aggregate death benefit of fixed amount for sole benefit of ex-wife. **[PRACTICE TIP – IF OWNERSHIP OF POLICIES IS NOT CHANGED BY SETTLEMENT, FACTORS SUCH AS RIGHT TO CHANGE BENEFICIARY, SURRENDER OR CANCEL POLICY, ASSIGN OR PLEDGE POLICY, OR OBTAIN LOANS MAY IMPLICATE 'INCIDENT OF OWNERSHIP', AND CAUSE POLICY PROCEEDS TO BE INCLUDED IN DEDEDENT'S ESTATE.]**

TAB 1

2009 WL 4251109
Only the Westlaw citation is currently available.
NOTICE: THIS DECISION DOES NOT CREATE LEGAL PRECEDENT AND MAY NOT BE CITED EXCEPT AS AUTHORIZED BY APPLICABLE RULES. See Ariz. R. Supreme Court 111(c); ARCAP 28(c); Ariz. R.Crim. P. 31.24
Court of Appeals of Arizona,
Division 1, Department B.

In re the Marriage of John H. CRANE, Petitioner/Appellant,
v.
Mary Karen S. CRANE, Respondent/Appellee.

No. 1 CA-CV 08-0701. | Nov. 24, 2009.

West KeySummary

1 **Divorce**
Standard of living and station in life
Divorce
Multiple factors

An indefinite spousal maintenance award of $4,000 per month for a former wife was permissible, even though the spouses lived frugally during the marriage and even if the wife's post-decree lifestyle did not precisely mirror marital financial decisions. The goal of spousal maintenance was not to replicate the exact marital lifestyle, but to reach a reasonable approximation of the standard of living established during the marriage. The wife's overall post-decree standard of living reasonablyapproximated the marital standard of living. Moreover, the marital standard of living was only one relevant consideration in setting spousal maintenance. The family court properly considered other factors, including the lengthy duration of the marriage, husband's admitted ability to pay maintenance, and the likelihood that the wife's earnings would not increase before her retirement. A.R.S. § 25-319(B).

Cases that cite this headnote

Appeal from the Superior Court in Maricopa County; Cause No. FN 2007-000057; The Honorable Hugh E. Hegyi, Judge. AFFIRMED.

Attorneys and Law Firms

Mariscal, Weeks, McIntyre & Friedlander PA By Leonce A. Richard, III, Phoenix, Attorneys for Petitioner/Appellant.

Burch & Cracchiolo PA By Melissa Iyer, Daryl Manhart, Phoenix, Attorneys for Respondent/Appellee.

MEMORANDUM DECISION

DOWNIE, Judge.

*1 ¶ 1 John Crane ("Husband") appeals from spousal maintenance and attorneys' fees awarded in favor of Mary Karen Crane ("Wife"). For the following reasons, we affirm.

FACTS AND PROCEDURAL BACKGROUND

¶ 2 Husband and Wife were married in 1982. Husband filed a dissolution petition in January 2007. At the time the final decree was entered, Wife was fifty-six years old, and Husband was fifty-two.

¶ 3 Wife worked as a nurse throughout the marriage. Husband was initially in the military and later held civilian jobs. For relatively brief periods of time, Wife's salary was the sole or chief source of income, including a few months in 1994, when Husband established J.H. Crane & Associates ("the company"), which sells equipment and materials to semi-conductor companies. The company soon became profitable and was the primary source of income for the remainder of the marriage.

¶ 4 The parties accumulated approximately $3.2 million in assets during their marriage and had no debt at the time of trial. They agreed to divide their assets equally, but could not agree on spousal maintenance. Wife requested

$6072 per month until she was paid for her interest in the company and $5865 per month indefinitely thereafter. Husband argued Wife was "entitled to rehabilitative spousal maintenance in an amount of *no more than* **$2,000** per month for a period of not more than 4 years."

¶ 5 The case proceeded to trial on April 3, 2008, regarding only spousal maintenance. The family court ordered Husband to make spousal maintenance payments of $4000 per month indefinitely. It also awarded Wife $30,000 in attorneys' fees. After Husband's motion for new trial was denied, this timely appeal followed. We have jurisdiction pursuant to Arizona Revised Statutes ("A.R.S.") sections 12-120(A)(1) (2003) and -2101(B), (F)(1) (2003).

DISCUSSION

1. Spousal Maintenance

¶ 6 We review the family court's award of spousal maintenance for an abuse of discretion. *Gutierrez v. Gutierrez*, 193 Ariz. 343, 348, ¶ 14, 972 P.2d 676, 681 (App.1998). We view the evidence in the light most favorable to the party awarded maintenance and will affirm the judgment if there is any reasonable evidence to support it. *Id.* We also accept the family court's findings of fact unless they are clearly erroneous. *Hrudka v. Hrudka*, 186 Ariz. 84, 91, 919 P.2d 179, 186 (App.1995).

¶ 7 An award of spousal maintenance is governed by A.R.S. § 25-319 (2007).[1] Generally, we apply a two-step process, considering first whether the spouse meets the eligibility requirements of A.R.S. § 25-319(A).Gutierrez, 193 Ariz. at 348, ¶ 15, 972 P.2d at 681.Second, we consider the family court's application of the factors enumerated in A.R.S. § 25-319(B) in setting the amount and duration of spousal maintenance. *Id.* Trial courts have substantial discretion within this two-step framework. *Rainwater v. Rainwater*, 177 Ariz. 500, 502, 869 P.2d 176, 178 (App.1993).

***2** ¶ 8 Husband admits Wife qualified for spousal maintenance. Thus, her eligibility under A.R.S. § 25-319(A) is not at issue. Husband has also acknowledged that he can pay Wife $4000 per month while still meeting his own financial needs. He contends, however, that the family court erred in: (1) interpreting and applying the marital standard of living factor; (2) awarding maintenance in excess of Wife's reasonable needs; and (3) failing to consider Wife's retirement assets when setting the duration of spousal maintenance. We consider each argument in turn.

a. Marital Standard of Living

¶ 9 In determining the amount and duration of a spousal maintenance award, the family court is required to consider the following factors:

1. The standard of living established during the marriage.

2. The duration of the marriage.

3. The age, employment history, earning ability and physical and emotional condition of the spouse seeking maintenance.

4. The ability of the spouse from whom maintenance is sought to meet that spouse's needs while meeting those of the spouse seeking maintenance.

5. The comparative financial resources of the spouses, including their comparative earning abilities in the labor market.

6. The contribution of the spouse seeking maintenance to the earning ability of the other spouse.

7. The extent to which the spouse seeking maintenance has reduced that spouse's income or career opportunities for the benefit of the other spouse.

8. The ability of both parties after the dissolution to contribute to the future educational costs of their mutual children.

9. The financial resources of the party seeking maintenance, including marital property apportioned to that spouse, and that spouse's ability to meet that spouse's own needs independently.

10. The time necessary to acquire sufficient education or training to enable the party seeking maintenance to find appropriate employment and whether such education or training is readily available.

11. Excessive or abnormal expenditures, destruction, concealment or fraudulent disposition of community, joint tenancy and other property held in common.

12. The cost for the spouse who is seeking maintenance to obtain health insurance and the reduction in the cost of health insurance for the spouse from whom maintenance is sought if the

spouse from whom maintenance is sought is able to convert family health insurance to employee health insurance after the marriage is dissolved.

13. All actual damages and judgments from conduct that results in criminal conviction of either spouse in which the other spouse or child was the victim.

A.R.S. § 25-319(B).

¶ 10 Although the family court must consider all statutory factors, *Leathers v. Leathers*, 216 Ariz. 374, 377, ¶ 10, 166 P.3d 929, 932 (App.2007), it is required to make findings only as to those factors relevant to the particular case and on which the parties have presented evidence.*Cullum v. Cullum*, 215 Ariz. 352, 355, ¶ 15, 160 P.3d 231, 234 (App.2007) (citation omitted); *Rainwater*, 177 Ariz. at 502, 869 P.2d at 178.Here, the court made detailed findings regarding the relevant statutory factors.

***3** ¶ 11 Husband argues the family court erred in defining and applying the first statutory factor: the "standard of living established during the marriage."According to Husband, this factor refers to the marital lifestyle as measured by actual expenditures, not "a hypothetical, more opulent standard of living that the parties had the 'potential to live' but chose not to."The family court viewed the standard of living factor more broadly than Husband, stating:

> Husband argues the Court should look only to expenses consistent with the parties' expenses while living together in order to determine Wife's "reasonable needs" pursuant to A.R.S. § 25-319(A)(1) and the parties' "standard of living established during the marriage" pursuant to A.R.S. § 25-319(B)(1).... He argues, in effect, that because the parties lived a minimalist lifestyle during marriage, the Court should consider only the amounts the parties *spent* during their community, and not the amounts they had the *potential* to spend in making these determinations.
>
> The Court does not agree. The fact that Wife chose to live a particular lifestyle while the couple lived together-whether the choice was of her own volition, as the result of a compromise with Husband, or simply as a matter of acquiescing to Husband's desires-does not negate the fact that the parties' "standard of living" included their *potential* to live much more opulently, and that Wife's "reasonable needs" should be viewed from this vantage point.

¶ 12 The goal of spousal maintenance is not to replicate the *exact* marital lifestyle, but to reach "a reasonable approximation of the standard of living established during the marriage."*Rainwater*, 177 Ariz. at 503, 869 P.2d at 179 (citation omitted); *Thomas v. Thomas*, 142 Ariz. 386, 391, 690 P.2d 105, 110 (App.1984). The notion that Wife's post-decree lifestyle must precisely mirror marital financial decisions, as Husband seems to suggest, is an overly restrictive interpretation of the statutory factor.

¶ 13 On the other hand, we find the family court's iteration of the standard to be overly broad. We review the trial court's interpretation of a statute *de novo*. *See Sheehan v. Flower*, 217 Ariz. 39, 40, ¶ 9, 170 P.3d 288, 289 (App.2007). We first consider the statute's language as the best and most reliable index of the statute's meaning. *Zamora v. Reinstein*, 185 Ariz. 272, 275, 915 P.2d 1227, 1230 (1996).

¶ 14 The family court must consider "the standard of living *established* during the marriage."A.R.S. § 25-319(B)(1). Use of the word "established" reflects that courts are to consider how spouses actually lived during their time together, not how they conceivably might have lived based on available financial resources. This interpretation is consistent with Arizona caselaw, which provides that spousal maintenance should allow a "reasonable approximation of the standard of living established during the marriage."*Rainwater*, 177 Ariz. at 503, 869 P.2d at 179.*See also Bender v. Bender*, 123 Ariz. 90, 94, 597 P.2d 993, 997 (App.1979) ("A wife is not entitled to be provided a standard of living beyond her customary one.") (citation omitted); *Kamrath v. Kamrath*, 17 Ariz.App. 394, 395, 498 P.2d 468, 469 (1972) ("The most important function of alimony is to provide support for the wife as nearly as possible at the standard of living she enjoyed during marriage.").

***4** ¶ 15 Although the family court's view of the marital standard of living factor was overly expansive, this determination does not end our inquiry. We may affirm a trial court's ruling if it is correct for any reason. *Univ. Mech. Contractors of Ariz., Inc. v. Puritan Ins. Co.*, 150 Ariz. 299, 300, 723 P.2d 648, 649 (1986); *Wertheim v. Pima County*, 211 Ariz. 422, 424, ¶ 10, 122 P.3d 1, 3 (App.2005); *State v. Swanson*, 172 Ariz. 579, 585, 838 P.2d 1340, 1346 (App.1992). Thus, we consider whether, properly applying the marital standard of living factor, the record supports the spousal maintenance award.

¶ 16 Our review of this issue (as well as the next) is hampered by Husband's failure to file an affidavit of financial information ("AFI"), as directed in the family court's October 1, 2007 minute entry and as required by Rule 76(C)(2)(a), Arizona Rules of Family Law Procedure.[2]In determining the marital standard of living, Husband's claimed expenses would have been relevant and also could have shed light on the reasonableness of Wife's post-decree expenses.

¶ 17 Viewing the evidence in the light most favorable to Wife, the record reflects that her post-dissolution lifestyle and expenses are "a reasonable approximation of the standard of living established during the marriage."*Rainwater,* 177 Ariz. at 503, 869 P.2d at 179.The record supports the family court's finding that, while married, the parties enjoyed a "very comfortable" standard of living, though they lived "frugally." For the year immediately preceding trial, Husband's income was $362,750, and Wife earned $66,924. The parties resided in a debt-free home valued at $850,000 on a one-acre lot in Carefree. Wife traveled to visit family two or three times per year, and the parties occasionally took other vacations.

¶ 18 Wife's post-decree expenses for a housekeeper, financial manager, and Mini-Cooper automobile may not precisely mirror marital financial choices in these specific categories, but her overall expenses reasonably approximate the marital standard of living. Wife testified she needs a financial manager because Husband exclusively handled the finances throughout the twenty-six year marriage. As for the vehicle, this is not a case of a spouse who has gone to extremes in postdecree spending. The record reflects Wife chose to purchase a new fuel-efficient car (for daily commuting) with monthly payments of $516, not a luxury vehicle wholly out of keeping with the parties' "comfortable," yet "frugal" standard of living.[3]

¶ 19 Moreover, it is inappropriate to consider such items in a vacuum. Admittedly, a new car is nicer than the used vehicles Husband and Wife historically drove. On the other hand, as the family court found, Wife's new residence will be a "much more modest home (that will not be debt free, as was her marital home)." Additionally, these parties directed significant income toward capital acquisitions while married, versus immediate expenditures on items like new cars and vacations. Although Wife benefited from such decisions when the assets were split, it is also proper to consider the parties' savings in evaluating the marital standard of living. *Accord Wikel v. Wikel,* 168 Wis.2d 278, 483 N.W.2d 292, 294 (Wis.Ct.App.1992) (rejecting Husband's contention that, because Wife was frugal during the marriage, spousal maintenance gave her "a grander lifestyle than that to which she was accustomed," and noting that "[i]ncome provides more than tangible possessions; it provides present and future security as well.").

*5 ¶ 20 Courts should examine the totality of post-dissolution living circumstances rather than parsing individual line items to see whether they fit precisely within the marital standards for those same items. *See, e.g., Oppenheimer v. Oppenheimer,* 22 Ariz.App. 238, 242, 526 P.2d 762, 766 (1974) (measuring standard of living does not require mathematical precision). Viewed from this perspective, we find Wife's overall post-decree standard of living *reasonably* approximates the marital standard of living. It is also important to note that marital standard of living is only one relevant consideration in setting spousal maintenance. The family court properly considered other § 25-319(B) factors, including the lengthy duration of the marriage, Husband's admitted ability to pay maintenance, and the likelihood Wife's earnings will not increase before her retirement.

b. Wife's Expenses

¶ 21 Husband contends that, even accepting the expense figures listed in Wife's January 15, 2008 AFI, her needs exceed her income by only $2433 per month.[4]He also argues that, if certain monthly expenses are reduced or eliminated as unreasonable, the deficit is further reduced.

¶ 22 We have addressed vehicle and financial advisor expenses in the preceding section. Husband also challenges Wife's claimed expenses for animals (including cat rescue activities), a personal trainer, a housekeeper, travel and recreation, and taxes on a Michigan condominium.

¶ 23 Husband admits the animal and personal trainer expenses were also incurred during the marriage. We fail to see how these same expenses have now become unreasonable such that it is an abuse of discretion not to reduce or eliminate them.[5]As for the housekeeper, Wife testified she works full time and, now that she lives alone, has no help with household duties. Husband does not deny that Wife incurs taxes on the Michigan condominium, so they are valid expenses for the court to consider. Finally, based on Wife's testimony and exhibits, the family court could have found her travel and recreation expenses to be reasonable under the circumstances.

¶ 24 Viewing the facts in the light most favorable to Wife, we find adequate support in the record for the determination that Wife's claimed expenses are reasonable.[6]

c. Duration of Spousal Maintenance

¶ 25 The family court has "discretion to award indefinite maintenance when it appears from the evidence that independence is unlikely to be achieved."*Rainwater,* 177 Ariz. at 503, 869 P.2d at 179 (citations omitted). Husband argues that, in finding Wife will not likely achieve independence, the family court failed to consider future income from retirement funds and the Michigan condominium.

¶ 26 At trial, Husband testified Wife could "draw upon retirement" in four years, so he argues four years of spousal maintenance is appropriate. Although courts should consider non-income producing property when resolving spousal maintenance, "a court need not require a spouse to exhaust a retirement account to support himself or herself."*Gutierrez,* 193 Ariz. at 348, ¶ 18, 972 P.2d at 681 (citation omitted). Moreover, there is no evidence Wife plans to retire in four years. Courts will not typically look very far into the future to address a probable change in income that may affect spousal maintenance, but will instead delay consideration of the issue until it actually occurs.*Chaney v. Chaney,* 145 Ariz. 23, 26-27, 699 P.2d 398, 401-02 (App.1985).

***6** ¶ 27 Wife's income from the Michigan condominium is speculative at this point. She currently receives no income from the property because her mother has a life estate interest in it. Although Wife's mother is eighty years old, it is unknown whether the condominium will produce income for Wife in the near future. *See Gutierrez,* 193 Ariz. at 349, ¶ 23, 972 P.2d at 682 ("A maintenance award 'cannot be based on mere hopes and speculative expectations.'") (citation omitted).

¶ 28 The record does not support Husband's contention that the family court failed to consider sources of income available to Wife in the future. Neither party requested findings of fact and conclusions of law. We assume that a trial judge has considered evidence presented before making a decision. *Fuentes v. Fuentes,* 209 Ariz. 51, 55-56, 97 P.3d 876, 880-81 (App.2004); *Bender,* 123 Ariz. at 92, 597 P.2d at 995 ("Where there is no request made for express findings of fact and conclusions of law, this Court will assume that the trial court found every controverted fact necessary to sustain the judgment, and, if there is reasonable evidence to support such finding, we must sustain the judgment."). Given the family court's detailed ruling and its obvious attention to the evidence presented, we cannot accept the speculative assertion that it ignored significant financial information.

¶ 29 Finally, the modifiable nature of spousal maintenance is a factor that supports the family court's order. An award of lifetime maintenance "does not lock long-term maintenance irrefutably into place."*Rainwater,* 177 Ariz. at 504, 869 P.2d at 180.Absent agreement of the parties, spousal maintenance awards are modifiable. A.R.S. § 25-319(C).*See also Rainwater,* 177 Ariz. at 504, 869 P.2d at 180.An award of lifetime maintenance may later be shortened if the obligor demonstrates a continuing and substantial change in circumstances. *Rainwater,* 177 Ariz. at 504, 869 P.2d at 180.The same is true of the amount of the award. *Schroeder v. Schroeder,* 161 Ariz. 316, 322, 778 P.2d 1212, 1218 (1989). The family court did not abuse its discretion in ordering indefinite spousal maintenance.[7]

2. Attorneys' Fees

¶ 30 Finally, Husband claims the family court erred by ordering him to pay $30,000 of Wife's attorneys' fees. "The trial court has discretion to award attorneys' fees, and we will not disturb that finding absent an abuse of discretion."*Gutierrez,* 193 Ariz. at 351, ¶ 32, 972 P.2d at 684 (citation omitted).

¶ 31 Pursuant to A.R.S. § 25-324(A) (2007) the family court has discretion to award reasonable attorneys' fees "after considering the financial resources of both parties and the reasonableness of the positions each party has taken throughout the proceedings."In determining attorneys' fees, "relative financial disparity between the parties is the benchmark for eligibility."*Breitbart-Napp v. Napp,* 216 Ariz. 74, 84, ¶ 37, 163 P.3d 1024, 1034 (App.2007).

*7 ¶ 32 Based on 2007 figures, Husband's income after adjusting for spousal maintenance payments, would have been $314,750. Adjusting Wife's income in 2007 to include spousal maintenance, results in income of $168,000. The difference is substantial. Wife's ability to pay her own fees does not limit the court's discretion. *Id.* ("A party may be able to pay and still receive an award of fees.") (citation omitted). We reject the contention that Wife's fees were unreasonably high. The court awarded $30,000 of the $48,452.38 Wife requested. Husband himself incurred attorneys' fees exceeding $36,000.

¶ 33 We find no merit to Husband's argument that Wife took unreasonable positions that should have prevented a fee award in her favor. As a threshold matter, we only consider this claim in conjunction with spousal maintenance-the only litigated issue. Although Husband contends Wife was unreasonable in setting the value of the marital business, that issue was not litigated, and we have no basis for determining the reasonableness (or lack thereof) of the parties' positions on that issue. As for spousal maintenance, neither Wife nor Husband prevailed entirely, and the final decision fell somewhere between their respective positions. We cannot conclude either side took patently unreasonable positions regarding spousal maintenance.

CONCLUSION

¶ 34 We affirm the family court's orders. Wife has requested her attorneys' fees incurred on appeal pursuant to A.R.S. § 25-324. We award Wife her costs and reasonable attorneys' fees incurred on appeal upon compliance with Arizona Rule of Civil Appellate Procedure 21.

CONCURRING: PATRICIA K. NORRIS, Presiding Judge and SHELDON W. WEISBERG, Judge.

All Citations

Not Reported in P.3d, 2009 WL 4251109

Footnotes

1 We cite the current version of this statute because no revisions material to this decision have since occurred.

2 At the outset of trial, counsel and the court discussed Husband's failure to file an AFI. Husband's counsel argued no AFI was necessary, notwithstanding the court order and rule, because Husband was not denying his ability to pay spousal maintenance.

3 Husband's position was that a car payment of $400 per month would be reasonable.

4 Husband assumes after-tax income to Wife of $6700 per month. However, because spousal maintenance payments are taxable to Wife, she would actually require more than $2433 to meet this assumed shortfall. *See Schock v. Schock,* 19 Ariz.App. 562, 565-66, 509 P.2d 634, 637-38 (1973) (income tax on support payments is a factor to consider in determining amount of spousal maintenance) (citations omitted).

5 The record reflects the personal trainer's rates increased by $50 per month after the parties separated.

6 At trial, Husband challenged the expenses as listed in Wife's January 15, 2008 AFI. Wife, however, testified about her expenses based on the AFI filed March 4, 2008. The family court's ruling refers to the expenses in "Trial Exhibit 3" (the January affidavit) and finds them to be "reasonable and likely." In terms of the objections raised by Husband, the two AFI's provide:

housekeeper: $100 (January); $323 (March)
Mini-Cooper: $677 (January); $516 (March)
recreation: $1150 (January); $468 (March)
vacation: $666 (January); $0 (March)
animal expenses: $400 (January); $400 (March)
personal trainer: $400 (January); $450 (March)
Michigan condo taxes: $350 (January); $350 (March)
financial manager: $1000 (January); $1000 (March)

Admittedly, some of the other expenses in Wife's March AFI are higher than the January AFI, including food costs, mortgage, yard and pest control services, and utilities. Husband, however, has not challenged the reasonableness of these expenses. We find no reversible error regarding the AFI's.

7 In his motion for new trial and opening brief, Husband states, without elaboration, that the family court failed to set forth specific reasons for an indefinite spousal maintenance award. He did not cite or discuss *Hughes v. Hughes,* 177 Ariz. 522, 869 P.2d 198 (App.1993), until the reply brief. Although we could consider this argument waived, *see, e.g., Anderson v. Country Life Ins. Co.,* 180 Ariz. 625, 636, 886 P.2d 1381, 1392 (App.1994) (arguments not presented until the reply brief may not be considered); *State v. Moody,* 208 Ariz. 424, 452 n. 9, ¶ 101, 94 P.3d 1119, 1147 (2004) (merely mentioning an argument is insufficient; opening briefs must present significant arguments, supported by authority, or they may be considered waived), we find Hughes distinguishable. It involved a marriage of "relatively short duration," there was no evidence the parties' standard of living increased "through their common efforts or otherwise," and Wife was unemployed, despite having a college degree.*Hughes,* 177 Ariz. at 522, 525, 869 P.2d at 199, 201.This

Court could find no explanation in the record for the trial court's "failure to require some 'effort toward independence' " by the Wife. *Id.* at 524, 869 P.2d at 200.In the case at bar, on the other hand, there is no contention Wife is underemployed or failing to use her best efforts to achieve independence. The family court found that, even with her full time job, Wife could not approximate the marital standard of living. It is difficult to envision terms the court could have fashioned to encourage further efforts toward financial independence. Also unlike *Hughes,* the family court here discussed several factors under A.R.S. § 25-319(B) that are relevant to the maintenance decision.

End of Document

2010 WL 358847
Only the Westlaw citation is currently available.
NOTICE: THIS DECISION DOES NOT CREATE LEGAL PRECEDENT AND MAY NOT BE CITED EXCEPT AS AUTHORIZED BY APPLICABLE RULES. See Ariz. R. Supreme Court 111(c); ARCAP 28(c); Ariz. R.Crim. P. 31.24
Court of Appeals of Arizona,
Division 2, Department A.

In re the MARRIAGE OF Gina Noel AVILA, Petitioner/Appellee,
and
Albert Avila, Respondent/Appellant.

No. 2 CA-CV 2009-0108. | Feb. 1, 2010.

West KeySummary

1 **Divorce**
Nature of act or expenditure in general

In dividing a divorcing couple's assets, trial court did not fail to account for $3,502.00 transferred by wife to an account in her sole possession. Husband introduced "on-line" banking records showing that amount had been withdrawn from the couple's money market account. However, the court's first amended accounting chart for the division of assets included an entry of $12,295.00 which equaled the total of two withdrawals by the wife from the couple's two joint accounts. Wife testified, and a bank statement introduced at trial showed, that she had deposited 12,000 from these withdrawals into her sole account. The court's division of assets charged wife with all of the money she withdrew from the two joint accounts and included husband's share in the equalization payment the trial court ordered.

Cases that cite this headnote

Appeal from the Superior Court of Pima County; Cause No. D-20074225; Honorable K.C. Stanford, Judge Pro Tempore. AFFIRMED.

Attorneys and Law Firms

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DiCampli, Elsberry & Hunley, L.L.C. By Anne Elsberry, Tucson, Attorneys for Respondent/Appellant.

MEMORANDUM DECISION

KELLY, Judge.

***1** ¶ 1 Appellant Albert Avila appeals from the trial court's order dissolving his marriage to appellee Gina Avila. He argues the trial court abused its discretion in dividing the couple's assets because it failed to consider "the tax consequences of liquidating the assets" and miscalculated the division of a certain account. Finding no error, we affirm.

Background

¶ 2"[W]e consider the evidence in the light most favorable to upholding the superior court's ruling and will sustain the ruling if it is reasonably supported by the evidence."*Boncoskey v. Boncoskey,* 216 Ariz. 448, ¶ 13, 167 P.3d 705, 708 (App.2007); *see also Gutierrez v. Gutierrez,* 193 Ariz. 343, ¶ 5, 972 P.2d 676, 679 (App.1998). Albert and Gina Avila were married in 1993 and have three minor children. In November 2007, Gina petitioned for dissolution of the marriage. After a trial, the court dissolved the marriage, awarded sole custody of the minor children to Gina, scheduled "reasonable parenting time" for Albert, and divided the couple's assets and liabilities.

¶ 3 A month later, Albert filed a motion to correct a mistake or to alter or amend the judgment, arguing the trial court had, inter alia, "created an inequitable division by giving the petitioner post-tax assets and the respondent pre-tax assets."The trial court ordered briefing on the question of "post-tax and pre-tax impacts." It then concluded that although it could consider "tax consequences" in dividing community property under

A.R.S. § 25-318(B), such consideration was discretionary. And, because "[n]either party presented evidence at trial on the tax consequences, if any, related" to the couple's property, it "decline[d] to consider the tax consequences to each party" from Discussion liquidating the divided property. The court subsequently entered a decree of dissolution and this appeal followed.

Discussion

¶ 4 Albert first contends the trial court did not equitably divide the community's assets because it awarded him two 401(k) accounts,[1] which would be taxed if liquidated, and awarded Gina a home, which, according to Albert, would not be subject to taxation, even if sold. "In apportioning community property between the parties at dissolution, the superior court has broad discretion to achieve an equitable division, and we will not disturb its allocation absent an abuse of discretion."*Boncoskey,* 216 Ariz. 448, ¶ 13, 167 P.3d at 708.We address questions of statutory interpretation de novo.*Farmers Ins. Co. of Ariz. v. Young,* 195 Ariz. 22, ¶ 5, 985 P.2d 507, 509 (App.1998).

¶ 5 Albert raised this issue after trial in his motion to alter or amend the judgment. "An issue raised for the first time after trial is deemed to have been waived."*Medlin v. Medlin,* 194 Ariz. 306, ¶ 6, 981 P.2d 1087, 1089 (App.1999). Even if not waived, however, his argument lacks merit. Section 25-318(B) states: "In dividing property, the court may consider all debts and obligations that are related to the property, including accrued or accruing taxes that would become due on the receipt, sale or other disposition of the property."Thus, based on the plain language of the statute, a trial court *may* consider "accruing taxes that would become due on the ... disposition of the property."*Id.* Albert argues, however, that the trial court is required to consider potential tax ramifications, at least when "taxes that will become due upon the disposition of the property will affect its value to such an extent that it would render the division of the property inequitable."We disagree.

***2** ¶ 6"In interpreting statutes, our central goal 'is to ascertain and give effect to the legislature's intent." *Yarbrough v. Montoya-Paez,* 214 Ariz. 1, ¶ 12, 147 P.3d 755, 759 (App.2006), *quoting Washburn v. Pima County,* 206 Ariz. 571, ¶ 9, 81 P.3d 1030, 1034 (App.2003). "To determine legislative intent, we look first to the language the legislature has used as providing 'the most reliable evidence of its intent." *Id., quoting Walker v. City of Scottsdale,* 163 Ariz. 206, 209, 786 P.2d 1057, 1060 (App.1989). "If a statute's meaning is clear and unambiguous, we give effect to its plain language without resorting to other rules of construction." *Ariz. Dep't of Revenue v. Salt River Project Agric. Improvement & Power Dist.,* 212 Ariz. 35, ¶ 15, 126 P.3d 1063, 1067 (App.2006).

¶ 7 Here the statute's language is clear and unambiguous and provides that a trial court *may* consider taxes that will become due upon disposition of an item of property. By using permissive rather than mandatory language, the legislature gave trial courts discretion to decide whether to consider such tax consequences. Thus, the trial court here correctly acknowledged that it had the discretion to consider tax consequences in distributing property. Had the legislature intended to require trial courts to consider tax consequences to the parties in the distribution of property, it could have so provided in the statute. *See Padilla v. Indus. Comm'n,* 113 Ariz. 104, 106, 546 P.2d 1135, 1137 (1976). In this case, we cannot say the trial court abused its discretion in the division of marital property, particularly in the absence of any evidence at trial about potential tax consequences.

II. Money market account

¶ 8 Albert also alleges the trial court erred by failing to account for certain money he alleges was taken by Gina. According to Albert, the couple previously had a jointly held money market account from which Gina had transferred $3,502.00 to an account in her sole control in December 2007. At trial, Albert introduced a computergenerated document attributed to the Tucson Federal Credit Union's (TFCU) "on-line" banking records showing that this amount had been withdrawn from that account on December 12, 2007. He testified he had not withdrawn the funds. "The trial court has broad discretion to allocate assets and obligations and its decision will not be disturbed absent a clear abuse of discretion."*Nelson v. Nelson,* 164 Ariz. 135, 138, 791 P.2d 661, 664 (App.1990).

¶ 9 We note that the court's first amended accounting chart for the division of assets includes an entry of $12,295.00. This amount equals the total of two withdrawals by Gina from the couple's two joint accounts with TFCU. A credit union document, dated December 12, 2007, shows a balance of $8,793.00 in the regular savings account and a balance of $3,502.00 in the money market checking account. The TFCU documents Albert introduced show the sum of $8,793 .00 was withdrawn from the couple's regular savings account on December 12, 2007, and the sum of $3,502.00 was withdrawn from the couple's money market checking account on the same day. Gina testified, and a bank statement introduced at trial showed, that she had deposited $12,000.00 from these withdrawals into an account solely in her name at Pima Federal Credit Union on December 14, 2007. The court's division of assets charged Gina with all of the money she withdrew from their two TFCU accounts and included Albert's share in the equalization payment the trial court ordered. Therefore, the trial court did not fail to account for the $3,502.00 withdrawn by Gina and did not abuse its discretion.

Disposition

***3** ¶ 10 The judgment of the trial court is affirmed. Gina has requested an award of attorney fees on appeal pursuant to A.R.S. § 25-324. In the exercise of our discretion, and in view of the reasonableness of the parties. positions, we award Gina fees and costs pending her compliance with Rule 21, Ariz. R. Civ.App. P.

CONCURRING: JOSEPH W. HOWARD, Chief Judge and PHILIP G. ESPINOSA, Judge.

All Citations

Not Reported in P.3d, 2010 WL 358847

Footnotes

1 A 401(k) account is a retirement savings account established pursuant to 26 U.S.C.A. § 401(k).

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2011 WL 5289266
Only the Westlaw citation is currently available.
Court of Appeals of Arizona,
Division 1, Department D.

In re the Marriage of Sandra SCHREINER,
Petitioner/Appellee,
v.
Dennis W. SCHREINER, Respondent/Appellant.

No. 1 CA–CV 10–0732. | Nov. 3, 2011.

Appeal from the Superior Court of Mohave County; Cause No. DO 2009–07178; The Honorable Randolf A. Bartlett, Judge; AFFIRMED IN PART; REVERSED AND REMANDED IN PART.

Attorneys and Law Firms

Caldwell, Padish & Wells, PLLC By James E. Padish, and Kellie N. Wells, Scottsdale, Attorneys for Respondent–Appellant.

Slaton Law Office, P.C. By Sandra Slaton and Mary Bystricky, Scottsdale, Attorney for Petitioner–Appellee.

MEMORANDUM DECISION

THOMPSON, Presiding Judge.

***1** ¶ 1 Dennis W. Schreiner (husband) appeals from the trial court's divorce decree. We reverse and remand to the trial court for a re-determination of the duration of the spousal maintenance awarded to wife. As to all other claims, we affirm.

BACKGROUND

¶ 2 Husband and wife were married in August 1980 in Ohio. The two separated in the summer of 2006. Wife moved to Lake Havasu, Arizona, where her mother was and husband continued to live in the marital residence in Ohio. Wife filed for divorce in Arizona in June 2009. The parties have two grown sons. Wife at the time of trial was 54 and husband was 58. Neither testified to significant health issues.

¶ 3 Husband is a senior consultant working at a nuclear power station. Husband's salary is approximately $104,000 annually plus the potential for annual bonuses which generally range from $12,000–16,000; for 2009 his bonus was $22,380. It is undisputed that, throughout the early marriage, husband was the primary bread winner and wife primarily a homemaker and stay-at-home mother. When the youngest son was in middle school, wife started working part-time and soon thereafter started teaching. She obtained a masters degree in teaching in 2004. Her annual teaching salary prior to the separation was between $19,000–24,000. After moving to Arizona, wife obtained substitute teaching work eventually earning $11,000 for the 2006–2007 school year. At the time of trial in June 2010 wife was the district's most recent hire as regular teacher; her contract rate was $38,000.

¶ 4 The evidence at trial was that nearly from the time of the separation, husband and wife's finances were separate. Other than $3,100 that she received from husband, wife supported herself and did not use community accounts or credit; husband paid all community obligations such as the mortgage, consumer credit and auto insurance .[1]Wife testified that since the separation she had lived frugally, with about $100 remaining after the payment of necessary bills.

¶ 5 In May 2009, husband unilaterally liquidated their community property Wachovia IRA totaling $165,179.40. He applied $49,646.15 to essentially eliminate the outstanding community consumer debt; taxes in the amount of $94,137.43 were automatically taken out of the distribution. He additionally purchased a new vehicle which was divided as part of the community property.

¶ 6 At trial, husband and wife agreed to an allocation of certain property and debt including the Ohio home to husband ($38,521.69 in equity), an IRA to wife of $36,018.08, and agreed to split equally the pension from his employer (which will pay $3,667.39 per month if husband retires at age sixty-five) and an employer based savings plan valued at $141,637.77. The parties allocated some personal property, including several vehicles, and a small amount of outstanding debt (under $300). Husband was awarded all personal property in his possession and control, including a tool collection, guns and some Amish heirloom furniture valued collectively at $25,000; wife's personal property in her control was valued at approximately $2,500.

***2** ¶ 7 The trial court awarded wife $2,000 per month in spousal maintenance for a period of fifteen years starting in September 2010, found two Bank of America accounts in wife's name to be her sole and separate property, awarded wife an equalization payment of $24,683.82. The trial court found "troubling" husband's unilateral decision to liquidate the community IRA account of $165,179.40. Of that, the court stated:

> The Respondent's decision to liquidate the Wachovia IRA, which resulted in early withdrawal penalty and state and federal tax liabilities is troubling. While the community did benefit by the payment of $49,646.15 in community debt, the community lost $94,137.43 ($82,576.72 federal income tax and $11,560.71 state income tax) and the court considers this to be a waste of the community asset to the Petitioner's detriment. However, Respondent's incurring of the significant tax liability is tempered by Respondent solely paying all community obligations from the parties' physical separation in the amount of $48,127.86, and his representation that he will pay the ten percent (10%) early withdrawal penalty [ ]. Nonetheless, the Court concludes that petitioner should be compensated by an award of $33,702.70 (165,179.40–49,646.15–48,127.86 = 67,405.30 divided by 2).

Neither party was awarded attorneys' fees or costs. Husband timely appealed.

ISSUES ON APPEAL

¶ 8 Husband asserts on appeal that:

1. Wife failed carry her burden of proof to show two Bank of America accounts the trial court awarded her were her sole and separate property.

2. The trial court abused its discretion in determining the amount and duration of wife's spousal maintenance.

3. The trial court erred finding a portion of the liquidation of a community retirement account in the amount of $165,179.40 to be waste.

DISCUSSION

A. Wife's Bank of America Accounts

¶ 9 Husband asserts the trial court erred in awarding wife two Bank of America accounts valued at approximately $18,024.54 as her sole and separate property. We view the evidence in the light most favorable to sustaining the trial court's findings and determine whether there was evidence that reasonably supports those findings. *Mitchell v. Mitchell,* 152 Ariz. 317, 323, 732 P.2d 208, 214 (1987). An inheritance is generally the sole and separate property of the spouse who received it. Arizona Revised Statutes (A.R.S.) § 25–213(A) (2007).

¶ 10 Wife testified that the accounts were opened in her name in February 2009 after her mother died and she received an inheritance. Wife testified the source of the funds were her inheritance. Husband testified he had never had access to those accounts and did not know the source of the funds. Although he requested the accounts be treated as community property, he testified that he had no reason to believe wife was lying about the source of the funds or where she could have otherwise gotten that amount of money. Therefore, we find the evidence does reasonably support the trial court's determination that the two Bank of America accounts were wife's sole and separate property.

B. Spousal Maintenance

***3** ¶ 11 Husband next asserts that the trial court abused its discretion in determining the amount and duration of spousal maintenance due to wife. We review an award of spousal maintenance under an abuse of discretion standard. *See In re Marriage of Berger,* 140 Ariz. 156, 167, 680 P.2d 1217, 1228 (App.1983) (citation omitted). Therefore, we will view the evidence in the trial court in the light most favorable to sustaining wife's spousal maintenance award and will affirm if there is any reasonable evidence to support it. *See Thomas v. Thomas,* 142 Ariz. 386, 390, 690 P.2d 105, 109 (App.1984) (citation omitted).

¶ 12 The amount and duration of spousal maintenance is determined pursuant to A.R.S. § 25–319 (2007). The trial court must consider thirteen factors, as each may be relevant in the particular case, including the standard of living during the marriage, the duration of the marriage, each spouse's age, employment history and earning ability, and the financial abilities and resources of each spouse. *Id.* The minute entry stated the trial court found one factor under A.R.S. § 25–319(A) to support an award of maintenance: that the parties had a marriage of long duration and wife is of an age that may preclude the possibility of gaining employment adequate to be self sufficient. Under A.R.S. § 25–319(B), the determination of amount and duration, the trial court stated that he considered all relevant factors including standard of living during the marriage and relative financial resources at the time of trial before arriving at $2,000 per month for a period of fifteen years.

¶ 13 We find no abuse of discretion in either the trial court's award of maintenance or in the amount awarded. However, under the facts of this case, the trial court did abuse its discretion in ordering spousal maintenance to last fifteen years. *See Hughes v. Hughes,* 177 Ariz. 522, 525, 869 P.2d 198, 201 (App.1993). We note that although the parties did not request findings of fact and conclusions of law, the duration of fifteen years was far in excess of what wife requested and our independent review of the record failed to support a maintenance award lasting until husband is nearly 74 years of age. It does not appear from this record the trial court took into account the natural diminution of income husband would experience at retirement or what the parties' relative financial status' would be at that time.[2]

¶ 14 During the trial, most of the focus was on spousal maintenance until husband retired. Testimony was vague as to whether husband had definitive plans to retire at age 62 or age 65. The projections as to husband's pension and social security were focused on age 65, although husband alluded to the fact he might retire before that. When asked by her counsel what maintenance she was seeking, wife testified "I think $2,000 until Dennis retires" because once he did their income would be "somewhat equal" although she asked to "keep it open, you know, if I may if that's a possibility."On cross-examination, the following exchange occurred with wife:

***4** Q: And when do you hope to retire?

A: Probably 65, I suppose. I don't know.

Q: Well, I really need to know.

A: 62.

Q: Do you think that it's fair that Dennis should be able to retire when he's 62 as well?

A: Yes.

Wife's counsel in closing stated, regarding maintenance "She's asking for at least $2,000 until the time that Mr. Schreiner retires ."

¶ 15 Given the evidence presented regarding husband's retirement, this award might not be modifiable upon that event. *See Reeves v. Reeves,* 146 Ariz. 471, 472–73, 706 P.2d 1238, 1239–40 (App.1985) (husband's retirement was contemplated in the maintenance award and therefore was an insubstantial basis for modification); *Linton v. Linton,* 17 Ariz.App. 560, 563, 499 P.2d 174, 177 (App.1972) (finding in spousal maintenance case involving husband's retirement, "[i]n our opinion no substantially changed circumstances can be made out of the appellee's decrease in income because all of these facts were available to the parties at the time"). These case authorities indicate that the court was obliged to take into account the different financial circumstances that will occur upon a party's retirement in awarding maintenance for a period well into the normal retirement period. For the above stated reasons, the trial court's spousal maintenance award as to the duration of maintenance is reversed for further proceedings consistent with this decision.

C. Wachovia IRA Liquidation

¶ 16 Husband asserts that the trial court abused its discretion determining a portion of the liquidation of the Wachovia IRA was waste. We disagree.

¶ 17 The trial court is specifically authorized to consider excessive or abnormal expenditures when apportioning community property. A.R.S. § 25–318(A) (2007). Again, we view the evidence in the light most favorable to sustaining the trial court's findings. *Mitchell,* 152 Ariz. at 323, 732 P.2d at 214. The evidence was that the IRA was liquidated without wife's knowledge or permission and resulted in tax penalty that significantly trumped the immediate gain. The trial court found husband's liquidation a troubling devaluation of a community asset. The trial court noted that the tax consequences would have been different if applied to wife's lower tax bracket, after retirement, and spread out over a period of time. The trial court took care to not charge the entire $165,179.40 against husband, but rather deducted the amount spent on community debts and amount husband paid toward other community obligations during the separation. The waste determination is affirmed.

D. Attorneys' Fees on Appeal

¶ 18 Wife requests attorneys' fees and costs on appeal pursuant to A.R.S. § 12–341.01(C) and 25–324 (2005), and Rule 21 of the Arizona Rules of Civil Appellate Procedure. Section 25–341.01(C) is inapplicable as we have reversed on one of the grounds raised by husband. Section 12–324 requires us to examine both the financial resources and the reasonableness of the positions of each party. After doing so, we find that the parties should bear their own fees and costs on appeal.

CONCLUSION

*5 ¶ 19 For the foregoing reasons, we reverse the judgment of the trial court on the issue of the duration of spousal maintenance. In all other matters, the trial court is affirmed.

CONCURRING: MAURICE PORTLEY and JOHN C. GEMMILL, Judges.

All Citations

Not Reported in P.3d, 2011 WL 5289266

Footnotes

1 Wife also cashed out a small community property pension plan she had from teaching in Ohio valued at approximately $3,000.

2 We note that husband, of course, could not attempt to reduce his spousal maintenance obligations by voluntarily and prematurely leaving the workforce. *See Shaughnessy v. Shaughnessy,* 164 Ariz. 449, 451, 793 P.2d 1116, 1118 (App.1990).

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2011 WL 198656
Only the Westlaw citation is currently available.
NOTICE: THIS DECISION DOES NOT CREATE LEGAL PRECEDENT AND MAY NOT BE CITED EXCEPT AS AUTHORIZED BY APPLICABLE RULES. See Ariz. R. Supreme Court 111(c); ARCAP 28(c); Ariz. R.Crim. P. 31.24
Court of Appeals of Arizona,
Division 1, Department B.

Cathy Louise STIZZA, Petitioner/Appellee,
v.
Denis Michael STIZZA, Respondent/Appellant.

No. 1 CA-CV 10-0188. | Jan. 13, 2011.

Appeal from the Superior Court in Maricopa County; Cause No. FN2009-000678; The Honorable Andrew G. Klein, Judge. AFFIRMED.

Attorneys and Law Firms

Mark Cord, Scottsdale, Attorney for Respondent/Appellant.

Fromm Smith & Gadow, P.C. By Stephen R. Smith, Phoenix, Attorney for Petitioner/Appellee.

MEMORANDUM DECISION

KESSLER, Presiding Judge.

***1** ¶ 1 Respondent-Appellant Denis Michael Stizza ("Husband") appeals from the superior court's decree of dissolution, alleging that the superior court's order of spousal maintenance to his wife Cathy Louise Stizza ("Wife") is excessive. For the following reasons, we affirm the decree of the superior court.

FACTUAL AND PROCEDURAL HISTORY

¶ 2 Husband and Wife married in 1983. Wife filed a petition for dissolution of marriage in February 2009. The parties agreed to a temporary spousal maintenance settlement of nine thousand dollars per month, to continue until the decree finally determined spousal maintenance. Husband would be responsible for the tax implications of the temporary maintenance payments. The parties agreed on the resolution of all issues except final spousal maintenance and attorneys' fees, which the superior court resolved after trial.

¶ 3 At trial, the parties stipulated that Husband's income was $45,000 per month. Wife was not working full time when the divorce occurred, however she had previously been a registered nurse and was near completion of a review course that would allow her to obtain entry level employment as a nurse. Entry level employment as a nurse is generally available and Wife could expect to earn between fifty-three and fifty-five thousand dollars per year, plus employer-provided health insurance.

¶ 4 During the marriage, the parties enjoyed a lifestyle that was elaborate enough to consume the vast majority of Husband's substantial earnings. Wife testified that receiving nine thousand tax-free dollars per month left her living below the standard of living she was accustomed to during the marriage. She testified that if she received less than eight thousand dollars (net of taxes) per month, her income would be so inadequate to support her lifestyle that she would be forced to sell her residence. Based on Wife's affidavit of financial information, she needs to spend approximately thirteen thousand dollars per month to maintain her standard of living.

¶ 5 At trial, the superior court heard testimony on the tax consequences of a potential order. Wife testified that she would have to pay forty percent of any spousal maintenance award in taxes. Husband objected to Wife's testimony based on competence. The superior court allowed her to testify based on her "knowledge and perception" of her tax situation and stated that it would "give [it] the weight ... it deserves."The superior court later determined that approximately thirty-three percent of the income Wife receives would be collected in taxes. The only part of the minute entry relying on this figure is the superior court's calculation of support due for the period between the petition and the decree. The superior court concluded that payments made pursuant to the temporary settlement agreement were worth fifty percent more than the amount paid to Wife because of Husband's agreement to bear the taxes on those payments. Therefore, the superior court offset $13,500 in maintenance for each of the $9,000 payments Husband made before the decree.

***2** ¶ 6 The superior court initially ordered that Wife receive $13,500 in spousal maintenance per month, but reduced the award to $12,750 after Husband filed a motion for a new trial. Husband filed a timely notice of appeal. This Court has jurisdiction pursuant to Article 6, Section 9 of the Arizona Constitution and Arizona Revised Statutes ("A.R.S.") section 12-2101(B) (2003).

ANALYSIS

¶ 7 On appeal, we review the superior court's award of spousal maintenance for an abuse of discretion. *Leathers v. Leathers*, 216 Ariz. 374, 376, ¶ 9, 166 P.3d 929, 931 (App.2007) (citation omitted). We view all evidence in the light most favorable to affirming the order. *Id.* The superior court acts within its discretion when its decision is supported by evidence and not plainly contrary to law. *Dowling v. Stapley*, 221 Ariz. 251, 266, ¶ 45, 211 P.3d 1235, 1250 (App.2009) (citation omitted).

I. Substantial Evidence Supports the Superior Court's Award of Spousal Maintenance.

¶ 8 The superior court did not abuse its discretion in awarding Wife $12,750 per month in spousal maintenance. Husband's argument on the amount of maintenance is that Wife failed to present reasonable evidence of her need for spousal maintenance because all of her evidence was not credible. Specifically, he argues that 1) the superior court expressed skepticism about the amount of certain expenses, 2) Wife submitted two affidavits of financial information which indicated different expense amounts, and 3) Wife failed to corroborate her testimony with additional extrinsic evidence. We decline to reverse on this ground because we do not reexamine the superior court's credibility determination on appeal. *See Valento v. Valento*, 225 Ariz. 477, 483, ¶ 19, 240 P.3d 1239, 1245 (App.2010) (accepting fact-finding regarding property valuation based on one spouse's testimony).

¶ 9 The superior court's written findings of fact indicate that elaborate expenses were part of the lifestyle that both spouses had grown accustomed to during the marriage. The court reasoned that the parties had enjoyed a combined annual income of over half a million dollars for years and had little to show for it other than an expensive house and expensive vehicles and the remainder of the money must have been spent supporting a lavish lifestyle. Husband contends that we should reverse the superior court's award because it expressed skepticism about some of Wife's expenses. The court found that the parties had lived a lavish lifestyle during marriage and that some of Wife's claimed expenses needed to be reduced. Ultimately, the court balanced these two points and awarded maintenance that would compel her to reduce her expenditures below the amount she claimed but enable her to continue living with some of the luxury she experienced during marriage.[1]The superior court's award of $12,750 in monthly spousal maintenance is less than thirty percent of the monthly income that Wife and Husband spent together during marriage. The superior court did not erroneously allow expenses in excess of the lifestyle the parties established during marriage.

*3 ¶ 10 We additionally decline to contradict the superior court's credibility determination regarding the discrepancy between Wife's two affidavits. Generally, we do not disturb the superior court's finding when it results from weighing contradictory evidence. *Id.* In this case, Wife explained that the discrepancy between her two affidavits was because she completed the first affidavit without having any experience living on her own, and the second was a more accurate reflection of the expenses necessary to preserve her in the marital standard of living after the divorce. The superior court did not grant maintenance based on all the expenses Wife claimed. To the extent it accepted her some of the expenses she claimed, the record does not reflect that the superior court abused its discretion.

¶ 11 In sum, Husband's stipulated monthly income is $45,000 while Wife's assumed income from maintenance and employment is approximately $17,250. Given the evidence of the parties' marital lifestyle, we find no abuse of discretion in the order awarding Wife $12,750 in permanent monthly maintenance, almost forty percent less than she requested. Additionally, the combined income from maintenance and employment is over sixty percent less than the parties' marital income.

¶ 12 We decline to reexamine the superior court's apparent acceptance of Wife's credibility without corroborating evidence. This Court does not second-guess the superior court's decision to find testimony credible. *Id.* The superior court accepted some of Wife's testimony about her expenses. To the extent it did, we find no abuse of discretion.

II. The Superior Court's Order Is Not Tainted by an Improper Consideration of Tax Issues.

¶ 13 Husband contends that we should reverse the superior court's award of spousal maintenance because it is allegedly based on an assumption that Wife's maintenance will be subject to taxation of thirty-three percent.[2]Specifically, Husband argues that the thirty-three percent figure is based on the allegedly erroneous admission of Wife's testimony that forty percent of her income would be collected in taxes and that the superior court's finding is unsupported by the evidence. We disagree. We will not reverse the decree based on either of these alleged errors because Husband's opening brief fails to demonstrate prejudice. *See* Ariz. R. Fam. L.P. 86. Nowhere in the opening brief does Husband contend that thirty-three percent is the wrong amount of taxes, nor does he state what amount would have been collected in taxes.[3] Without a showing that the amount the superior court relied on is substantively erroneous, we cannot find the requisite prejudice to reverse. Additionally, the superior court's decision not to adopt Wife's testimony that she would pay forty percent of her maintenance in taxes clearly shows that admission of that evidence was not prejudicial.

¶ 14 The superior court's reliance on an estimate that Wife would pay thirty-three percent of her award in taxes is not an abuse of discretion. The only portion of the superior court's analysis that refers to the tax rate is the portion crediting Husband for payments made pursuant to the pre-decree temporary settlement and concluding that a $9,000 tax free payment entitles Husband to an offset of $13,500 in final maintenance.[4] The parties' joint federal income tax returns for the two years preceding the divorce reflect payment of federal income tax approximately equal to twenty-seven percent of their total income. Accounting for Arizona income tax and FICA, thirty-three percent is a reasonable estimate of Wife's tax expenses. Husband presented no evidence in the superior court and no citation to any legal authority indicating that a different amount would apply, so we affirm the superior court's estimate of Wife's tax liability.

III. The Superior Court Did Not Base Its Award of Maintenance on the Temporary Maintenance Settlement.

***4** ¶ 15 The superior court did not improperly consider the temporary maintenance settlement. The superior court explained the reason it awarded the amount of maintenance it did in light of each statutory factor in A.R.S. § 25-319(B) (2007). The minute entry does not indicate that the court relied on the temporary settlement to set maintenance. The only mention of the temporary settlement in the superior court's minute entry is a brief reference on the last page. The court merely referred to it in offsetting maintenance paid pursuant to the settlement against maintenance owed for the period between the filing of the petition and the judgment. Additionally, when Husband raised this issue in a motion for new trial, the superior court's subsequent order specifically stated that the mere fact that Wife's award was approximately equal in value to the amount in the pretrial settlement was "coincidental." We decline Husband's unsubstantiated invitation to impute an erroneous reasoning to the superior court when its minute entry expressly denies that reasoning.

CONCLUSION

¶ 16 For the foregoing reasons, we affirm the superior court's decree of dissolution. Both parties have requested attorneys' fees on appeal pursuant to A.R.S. § 25-324 (Supp.2010). Having considered the relative financial resources of the parties and the reasonableness of their positions on appeal, we grant Wife her costs and reasonable attorneys' fees on appeal upon timely compliance with ARCAP 21.

CONCURRING: SHELDON H. WEISBERG, and DIANE M. JOHNSEN, Judges.

All Citations

Not Reported in P.3d, 2011 WL 198656

Footnotes

1 The superior court's award of $12,750 in maintenance is far below the $20,000 Wife requested in her separate pretrial statement. The superior court found a substantial reduction in Wife's maintenance request sufficient to assuage its concern about Wife's expenses. Nothing in the record indicates that this was an abuse of discretion.

2 Husband relies on *Rowe v. Rowe,* 154 Ariz. 616, 744 P.2d 717 (App.1987) and *Mitchell v. Mitchell,* 152 Ariz. 312, 732 P.2d 203 (App.1985)*vacated in part on other grounds*152 Ariz. 317, 732 P.2d 208 (1987) to contend that the superior court should not consider tax issues because taxation is inherently speculative. *Rowe* held that ascertainable tax consequences of events which will occur soon after trial should be considered by a family court, and condemned only speculative consideration of distant consequences of potential future transactions. 154 Ariz. at 624, 744 P.2d at 725 (citations omitted).*Mitchell* rejected an argument that the court should consider tax consequences of a potential sale of

a property and made no reference to any immediate future transaction, so it is consistent with the rule in *Rowe.* 152 Ariz. at 316, 732 P.2d at 207. In contrast to those cases, income awarded to Wife pursuant to the decree was immediately subject to taxation. Therefore, the superior court could properly consider the tax ramifications of the decree based upon the evidence presented.

3 Husband contends that the superior court's tax calculation is erroneous for the first time in his reply brief. We do not consider issues raised for the first time in a reply brief. *Canyon Ambulatory Surgery Ctr. v. SCF Ariz.,* 225 Ariz. 414, 422 n. 17, ¶ 27, 239 P.3d 733, 741 n. 17 (App.2010).

4 The superior court also referred to the tax rate in its decision on the motion for new trial and stated that it relied on the thirty-three percent figure to calculate what Husband could afford to pay in maintenance. This does not affect our analysis because Husband conceded in his reply brief that his challenge is exclusively to the court's determination of Wife's expenses and not to any other statutory factor impacting the proper amount of maintenance.

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2012 WL 432832
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NOTICE: THIS DECISION DOES NOT CREATE LEGAL PRECEDENT AND MAY NOT BE CITED EXCEPT AS AUTHORIZED BY APPLICABLE RULES. See Ariz. R. Supreme Court 111(c); ARCAP 28(c); Ariz. R.Crim. P. 31.24.
Court of Appeals of Arizona,
Division 2, Department B.

In re the MARRIAGE OF David STARR,
Petitioner/Appellant,
and
Kimberly Starr, Respondent/Appellee.

No. 2 CA–CV 2011–0095. | Feb. 10, 2012.

Appeal from The Superior Court of Pima County; Cause No. D20091402; Honorable K.C. Stanford, Judge. AFFIRMED IN PART REVERSED AND REMANDED IN PART.

Attorneys and Law Firms

Pahl & Associates By Danette R. Pahl, Tucson, Attorneys for Petitioner/Appellant.

Solyn & Lieberman, PLLC By Scott Lieberman and Melissa Solyn, Tucson, Attorneys for Respondent/Appellee.

MEMORANDUM DECISION

VÁSQUEZ, Presiding Judge.

***1** ¶ 1 David Starr appeals from the trial court's decree of dissolution of his marriage to appellee Kimberly Starr. David argues the court abused its discretion in determining the amount and duration of spousal maintenance it awarded to Kimberly because the court failed to consider all relevant factors under A.R.S. § 25–319(B), and the factors the court specified it had considered do not support the award. For the reasons stated below, we affirm the order in part, and reverse and remand in part.

Factual and Procedural Background

¶ 2 We view the record in the light most favorable to upholding the trial court's decision. *Cullum v. Cullum,* 215 Ariz. 352, ¶ 9, 160 P.3d 231, 233 (App.2007). After thirty years of marriage, David filed a petition for dissolution of marriage in April 2009. He was forty-eight years old and Kimberly was forty-nine, and the parties had two children, the younger of which turned eighteen years old while the dissolution was pending. David had been employed with Empire Southwest as a truck engineer product support manager since November 1993. With the exception of two relatively brief periods, Kimberly was self-employed, providing daycare from her home since 1986.[1]

¶ 3 Because the parties were unable to resolve issues of spousal maintenance, community waste, and attorney fees, the matter proceeded to trial. Before trial, David filed a motion for findings of fact and conclusions of law, pursuant to Rule 82, Ariz. R. Fam. Law P. Kimberly joined in that request. Following trial, the court issued an underadvisement ruling in January 2011, awarding Kimberly monthly spousal maintenance in the amount of $2,100 indefinitely. The court attached to its ruling a "summary sheet" that contained a detailed description of the parties' income and expenses. But, asserting that "the [r]uling did not include Rule 82 findings," David asked the court to enter an order that contained specific findings of fact and conclusions of law with respect to spousal maintenance and community waste. He also objected on the same ground to the proposed decree of dissolution of marriage that Kimberly had lodged with the court.

¶ 4 In February 2011, the trial court issued a second ruling that addressed David's "request for Rule 82 findings." In it, the court "confirm[ed] the financial findings in the summary sheet attached to the" first ruling and made "additional findings" concerning spousal maintenance and community waste. At a hearing in March on David's objection to the proposed decree, at David's request the court stated it would include the additional findings from its second ruling in the final decree. David did not request additional or different findings of fact. In May 2011, the court signed the decree, and this appeal followed.

Discussion

¶ 5 David challenges the amount and duration of spousal maintenance awarded to Kimberly,[2] arguing the trial court failed to consider all relevant statutory factors in making its determination and the amount awarded was not supported by the factors the court did consider. We review an award of spousal maintenance for an abuse of discretion. *Gutierrez v. Gutierrez,* 193 Ariz. 343, ¶ 14, 972 P.2d 676, 681 (App.1998)."For an abuse of discretion to exist, the record must be devoid of competent evidence to support the decision."*Platt v. Platt,* 17 Ariz.App. 458, 459, 498 P.2d 532, 533 (1972).

***2** ¶ 6 Section 25–319(B) provides that courts shall determine the amount and duration of spousal maintenance without considering marital misconduct and after considering all relevant factors listed therein. The factors include the following: "the standard of living during the marriage, the duration of the marriage, each spouse's age, employment history and earning ability, and the financial abilities and resources of each spouse."*Leathers v. Leathers,* 216 Ariz. 374, ¶ 10, 166 P.3d 929, 932 (App.2007), *citing*A.R.S. § 25–319(B). This determination requires a case-by-case analysis, and all of the factors may not apply in each case. *Rainwater v. Rainwater,* 177 Ariz. 500, 502, 869 P.2d 176, 178 (App.1993).

¶ 7 David argues the trial court failed to consider his ability to meet both his and Kimberly's needs, the comparative financial resources of the parties, and Kimberly's ability to meet her own needs pursuant to § 25–319(B)(4), (5), and (9), respectively. Kimberly responds that David has waived this issue on appeal and that, in any event, the court actually considered these factors in making its determination.

¶ 8 "In all family law proceedings tried upon the facts, the court, if requested before trial, shall find the facts specially and state separately its conclusions of law thereon...." Ariz. R. Fam. Law P. 82(A). When a party makes a timely request pursuant to Rule 82, "the trial court must make findings concerning *all* of the ultimate facts."*Elliott v. Elliott,* 165 Ariz. 128, 134, 796 P.2d 930, 936 (App.1990). With respect to spousal maintenance, the court must make findings on all § 25–319(B) factors that are supported by the evidence presented by the parties. *Id.* at 134, 796 P.2d at 936. However, parties must object to inadequate findings of fact and conclusions of law so the court has an opportunity to correct them, and "[f]ailure to do so constitutes waiver."*Id.; see also Trantor v. Fredrikson,* 179 Ariz. 299, 300–01, 878 P.2d 657, 658–59 (1994). Although David initially challenged the sufficiency of the court's findings below, the record reflects the court addressed his concerns, both in its second ruling and at the hearing on David's objection to the decree lodged by Kimberly. Because David did not challenge the sufficiency of the findings in the final decree or make the same arguments below that he raises on appeal, he has waived the arguments on appeal. *Id.*

¶ 9 David's claims lack merit in any event because the trial court made findings pursuant to § 25–319(B)(4), (5), and (9) in the summary sheet attached to its first ruling and confirmed those findings in its second ruling. With respect to David's ability to meet both his and Kimberly's needs under § 25–319(B)(4), the court found he had a net monthly income of $5,996 and monthly expenses in the amount of $4,238, leaving a surplus of $1,758 per month. As to § 25–319(B)(5), the comparative financial resources of the spouses, the court conducted a side-by-side comparison of the parties' incomes, finding that Kimberly earned twenty-one percent of their combined net income. And, as to § 25–319(B)(9), Kimberly's ability to meet her own needs, the court attributed her with gross monthly income of $2,000, presumably based on her earning capacity.[3]Thus, the court considered § 25–319(B)(4), (5), and (9) in determining the amount of spousal maintenance to award Kimberly.

***3** ¶ 10 David suggests that under § 25–319(B)(9), the trial court also should have considered the proceeds from the sale of the residence and the retirement account proceeds Kimberly was awarded as part of the property division.[4]The record shows the court divided the community property evenly, a substantial amount of the property awarded to Kimberly consisted of retirement funds, and both parties planned to use part of the funds to purchase new homes. Although § 25–319(B)(9) lists as a relevant factor the marital property apportioned to the party seeking spousal maintenance, that party "should not be expected to live off both the principal, and interest, exhausting whatever financial reserves [he or] she possesses."*Thomas v. Thomas,* 142 Ariz. 386, 391, 690 P.2d 105, 110 (App.1984).

¶ 11 David also argues the trial court failed to consider his income based on the tax rate for a single individual and the tax implications of Kimberly's business in determining spousal maintenance. First, to the extent David is suggesting the court was required to make findings on these matters, we disagree. Although there may be tax consequences arising from statutory factors, the tax consequences are not, standing alone, statutory factors. *Cf. Elliott,* 165 Ariz. at 134, 796 P.2d at 936 (court required to make findings regarding all statutory factors on which evidence was presented). Second, David did not argue at trial that his income should be considered in light of the tax rate for a single individual. This issue is therefore waived on appeal. *See Trantor,* 179 Ariz. at 300, 878 P.2d at 658. Moreover, the court heard conflicting testimony regarding the tax implications of Kimberly's business and implicitly rejected David's position on this issue. *See Imperial Litho/Graphics v. M.J. Enters.*, 152 Ariz. 68, 72, 730 P.2d 245, 249 (App.1986) (trier of fact weighs evidence and determines credibility of witnesses).

¶ 12 David next argues the amount of the spousal maintenance the trial court awarded Kimberly was not supported by the § 25–319(B) factors the court specified in its second ruling.[5]But, as we explained above, the court actually considered and made findings on several other § 25–319(B) factors in its first ruling. Because David's contention that the court's determination was based on only a few factors mentioned in the second ruling is incorrect, we necessarily reject this argument. We review the record, however, to determine whether sufficient evidence supports the court's indefinite spousal maintenance award of $2,100 per month.

¶ 13 The trial court awarded spousal maintenance based on "the thirty year marriage duration with adult children, the age of the parties and the limited possibility of [Kimberly] gaining adequate employment to be fully self-sufficient, contribute to deferred compensation, purchase medical insurance and retire."The record supports these findings and the court's determination that the award should continue indefinitely. The parties' marriage undeniably was of long duration—nearly thirty years. *See Schroeder v. Schroeder*, 161 Ariz. 316, 320 n. 5, 778 P.2d 1212, 1216 n. 5 (1989); *see also*§ 25–319(B)(2). At the time the marriage was dissolved, David was fifty years old and Kimberly was fifty-two years old. *See*§ 25–319(B)(3). Kimberly spent most of her adult life as an in-home daycare provider, and as a result, she has not developed other employment skills. *See*§ 25–319(B)(3), (5). Moreover, the court ordered that the duration of spousal maintenance was "modifiable." *See Schroeder*, 161 Ariz. at 323, 778 P.2d at 1219 (absent contrary language in decree, spousal maintenance awards may be modified on showing of substantial and continuing changed circumstances). Thus, we conclude the record supports the duration of the court's award of spousal maintenance.

***4** ¶ 14 We reach a different conclusion concerning the amount of spousal maintenance—$2,100 per month. The trial court stated it determined the amount as follows: "spousal maintenance is based on an estimate of a split of combined net income less Petitioner's net, rounded down to the nearest hundred."[6]According to the court, David had a net income of $5,996 per month and monthly expenses of $4,238, while Kimberly had a net income of $1,620 per month and monthly expenses of $3,569. The court's findings are supported by the record, including the parties' trial testimony and financial affidavits. And according to those findings, David had a monthly net surplus of $1,758, whereas Kimberly had a monthly shortfall of $1,949. But, the $2,100 award resulted in David having a monthly deficit of $342 and Kimberly having a monthly surplus of $151. David argues this result is "unjust" because it exceeds both Kimberly's needs and his ability to pay. We agree.

¶ 15 In awarding spousal maintenance, trial courts should strike a balance between "[t]he ability of the spouse from whom maintenance is sought to meet that spouse's needs while meeting those of the spouse seeking maintenance."§ 25–319(B)(4); *see also In re Marriage of Foster*, 125 Ariz. 208, 211, 608 P.2d 785, 788 (App.1980).Section 25–319(B)(9) also provides "[t]he financial resources of the party seeking maintenance, ... and that spouse's ability to meet that spouse's own needs independently" should be taken into consideration. Read together, these two factors suggest an award of spousal maintenance should not exceed the payee spouse's needs if the payor spouse cannot afford the excess amount. *See also MacMillan v. Schwartz*, 226 Ariz. 584, ¶ 30, 250 P.3d 1213, 1220 (App.2011) (when modifying spousal maintenance, husband's increased income is not dispositive and court first should consider whether wife needs additional support to meet her needs); *Millington v. Millington*, 67 Cal.Rptr. 128, 146 (Ct .App.1968) (award exceeding wife's needs can be justified only if husband "has income in excess of the sum of his needs and the basic amount necessary to meet those of the wife").

¶ 16 Despite having considered § 25–319(B)(4) and (9), the trial court awarded Kimberly more spousal maintenance than its calculations indicated she needed and more than David was capable of paying. We recognize that "[m] arital standard of living has long been listed by our legislature among the factors pertinent to the duration and amount of spousal maintenance."*Rainwater*, 177 Ariz. 500, 503, 869 P.2d 176, 179 (App.1993). And although courts try to maintain the standard of living established during the marriage, this is limited by the payor spouse's ability to meet the needs of both parties. *See id.* at 503–04, 869 P.2d at 179–80. As a result, divorce often requires both spouses to maintain a lower standard of living than they enjoyed during the marriage. *Id* . Because the $2,100 spousal maintenance award exceeds both Kimberly's needs and David's ability to pay, we conclude the trial court abused its discretion. We therefore reverse the portion of the court's decree relating to the amount of spousal maintenance and remand for further proceedings consistent with this decision.

Attorney Fees

*5 ¶ 17 We decline Kimberly's request for attorney fees on appeal because she does not provide a legal basis for such an award. *Bed Mart, Inc. v. Kelley*, 202 Ariz. 370, ¶ 24, 45 P.3d 1219, 1224 (App.2002).

Disposition

¶ 18 For the reasons stated, we affirm in part, and reverse and remand in part.

CONCURRING: VIRGINIA C. KELLY, Judge and PHILIP G. ESPINOSA, Judge.

All Citations

Not Reported in P.3d, 2012 WL 432832

Footnotes

1 In 1990, Kimberly worked at a daycare facility for about a year, and in 1998, she was employed at an elementary school for less than a year.

2 In reviewing an award of spousal maintenance, we generally apply a two-part test: first, we determine if the requesting party meets one of four criteria in A.R.S. § 25–319(A), and second, we review the amount and duration of the award to determine whether the trial court properly applied the factors in § 25–319(B). *See Gutierrez v. Gutierrez*, 193 Ariz. 343, ¶ 15, 972 P.2d 676, 681 (App.1998). Because David challenges only the amount and duration of the award, we do not address the court's determination under § 25–319(A).

3 Courts may consider the ability to earn, rather than actual earnings, in determining spousal maintenance. *Williams v. Williams*, 166 Ariz. 260, 266, 801 P.2d 495, 501 (App.1990). Based on Kimberly's testimony that she provided daycare for six children, not including her two grandchildren, and charges $20 or $25 per day, the court reasonably could have concluded she had the ability to earn $2,000 per month.

4 Although in his opening brief David relied on subsection (B)(5), he clearly was referring to (B)(9).

5 In support of his argument, David claims the trial court improperly cited community waste as a basis for the award of spousal maintenance when it already granted a separate judgment on that issue. David requested findings of fact and conclusions of law on both spousal maintenance and community waste. The trial court addressed both issues in the same ruling, but it did not actually cite community waste as a factor for the award of spousal maintenance. Therefore, we find no merit in this argument.

6 Although the language of the court's mathematical basis is not clear, we presume the court (1) equally divided the parties' combined net incomes, (2) subtracted Kimberly's net income, and (3) rounded down to the nearest hundred.

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TAB 5

Cross-Examining the Financial Expert

SURE-FIRE TECHNIQUES IN CROSS EXAMINING THE FINANCIAL EXPERT

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ventrellisimon.com

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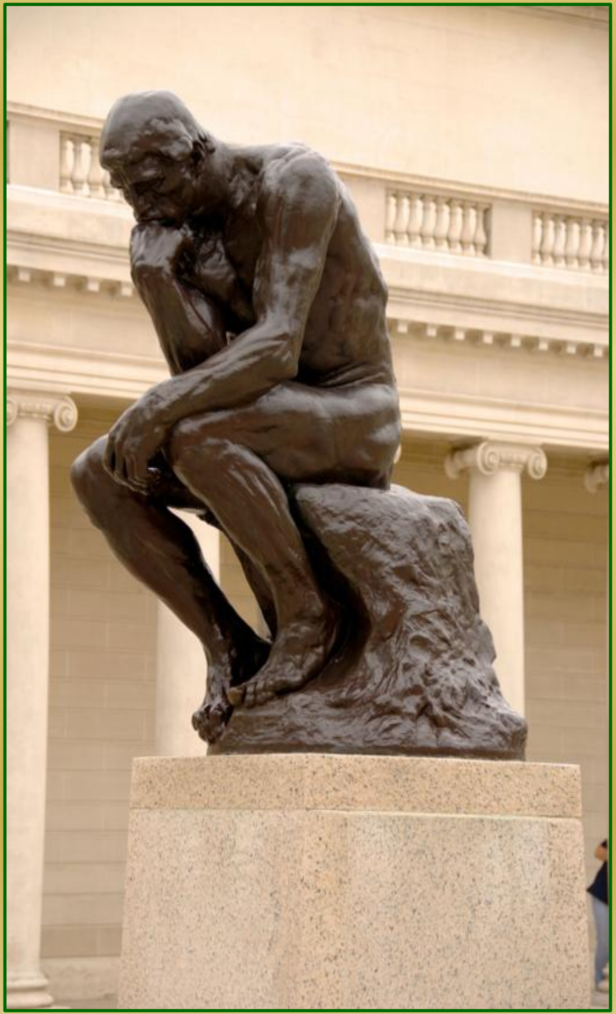
Schiller DuCanto & Fleck LLP
200 N. LaSalle Street, 30th Floor
Chicago, Illinois 60601
sdflaw.com

YOU HAVE DONE YOUR DISCOVERY OK, SO WHAT NOW??



THE PURPOSE …
(KNOW WHAT YOU WANT TO DO BEFORE YOU START)

- Bolster/undermine expert credibility
  - Battle of credentials
- Show what the expert did & Why it’s right or wrong
- Bolster/Undermine weak/less conservative parts of the report
- Have your expert’s conclusion accepted by the court

ANALYSIS: THE METHOD

SUBJECT	PETITIONER'S EXPERT	RESPONDENT'S EXPERT
Party	David Allen	Lynne Allen
Expert	Jaime A. Johnson , CPA,	Chris Ernst, MBA, CPA
Valuation Date	December 31, 2014	December 31, 2014
Interest Valued	100% and 25% Capital Stock, Power Diagnostics	100% and 25% Capital Stock, Power Diagnostics
Conclusion for 100% Value	$4,403,106	$8,670,000
Conclusion for Interest Valued	$660,000	$1,960,000
Standard of Value	Fair Market Value	Fair Market Value

ANALYSIS: THE INFORMATION SOURCES …

SUBJECT	PETITIONER	RESPONDENT
DOCUMENTS REVIEWED	1. Federal and state tax returns of Power Diagnostics, PA for the period Year 5 to Year 1 2. Financial statements of Power Diagnostics, PA for the period Year 5 to Year 1 3. Salary information from Medical Group Management Association (MGMA) 4. Risk Management Association (RMA) 5. Goodwill Registry 6. Account receivable and collection reports provided by management 7. Written offers from Dr. Jones and Dr. Smith 8. Shareholder agreement, employment agreements and other business records	1. Federal and status Sub S (1120S) income tax returns for the years ended December 31, Year 6 through December 31, Year 1 2. Externally-prepared financial statements for the years ended December 31, Year 5 through December 31, Year 1 3. Internally-prepared financial data (general ledgers, trial balances, etc.) for the year ended December 31, Year 6 4. Interviews and depositions of Dr. Allen 5. Interview with the office manager 6. Shareholder agreement as of Year 5 7. Medical Group Management Association 8. Accounts receivable and accounts payable data provided by management

ANALYSIS: THE INFORMATION SOURCES (cont.)…

SUBJECT	PETITIONER	RESPONDENT
DOCUMENTS REVIEWED	9. Various discussions with David Allen, MD 10. Complete tour of the medical facility 11. General ledgers for the period Year 5 to Year 1 12. Ibbotson Stocks Bonds Bills and Inflation Valuation Edition Year 1 13. Federal Reserve Statistical Release, the Federal Reserve 14. Year 1 Tax Rate Schedule, Internal Revenue Service (IRS) 15. Various restricted stock and IPO studies 16. Mergerstat Review 17. Hitchner, et. al, Financial Valuation Applications and Models	9. Curriculum Vitae of Dr. Allen as of December 31, Year 1 10. Discussions with Mr. Johnson (corporate attorney) 11. Financial data from the Wall Street Journal and Ibbotson Associates YR-1 Year book 12. Various restricted stock and IPO studies 13. Mergerstat Review 14. Hitchner, et al. Financial Valuation Applications and Models 15. Ibbotson Stocks Bonds Bills and Inflation Valuation Edition Year 1

More Information Sources

SUBJECT	PETITIONER	RESPONDENT
Interviews	David Allen, M.D.	David Allen, M.D. interview and deposition. Office Manager Interview Corporate Attorney Discussion
Site Visit	Tour of Medical Facility	None Mentioned

ANALYSIS: THE EXPERTS' FINANCIAL ANALYSIS

SUBJECT	PETITIONER	RESPONDENT
# Years of Data Used	5	5
Adjustments to Income	Automobile Expenses Life Insurance Charitable Contributions Non-recurring Equipment Sales Includes Estimated Taxes on Sale Salaries	Owner's Compensation Charitable Contributions Norma Starks' Salary Life Insurance Perquisites Non-recurring Equipment Sales
Adjustments to Balance Sheet	Accounts Receivable Allowance for Uncollectible Deferred Taxes Shareholder Loans (Eliminate)	Accounts Receivable Uncollectible Allowance Equipment Adj. Value Upward Eliminate Building Depreciation Deferred Taxes Eliminate Shareholder Loan

MARKET APPROACHES

SUBJECT	PETITIONER	RESPONDENT
Application	Yes	No
Conclusion	$4,481,819	Not Used
Method		
Guideline Public Companies		
Companies Used		
Which Multipliers		
Guideline Transactions		
Guideline Transaction Companies		
Guideline Transaction Multipliers		

ASSET BASED APPROACHES NOT USED

SUBJECT	PETITIONER	RESPONDENT
Date		
Method		
Outside Appraisals		
Adjustments		
Conclusion		

INCOME BASED APPROACH: Capitalization of Excess Earnings

SUBJECT	PETITIONER	RESPONDENT
Base Economic Earnings	$1,533,579 Weighted	$2,280,821 Straight Line
Capitalization Rate	8% for Tangible Assets 41% for Excess Earnings	8% for Tangible Assets 31% for Excess Earnings
Value	100% $4,339,500 Total	100% $8,268,659 Total

INCOME BASED APPROACH: Capitalized Net Earnings

SUBJECT	PETITIONER	RESPONDENT
After Tax Income	$1,533,579 (1 Year) Weighted	$2,280,821 (1 Year) Straight Line
Capitalization Rate	36%	26%%
Control Premium	20%	25%
Value 100%	$4,388,000	$9,070,488

INCOME BASED APPROACH: DISCOUNTED FUTURE EARNINGS NOT USED

SUBJECT	PETITIONER	RESPONDENT
Earnings Period		
Growth Rate		
Base Year Earnings		
Discount Rate(s)		
Value Before Discounts/Premiums		
Control Premium		
Value		

WEIGHTING & DISCOUNTS

SUBJECT	PETITIONER	RESPONDENT
Weight of Approaches	33.33% Capitalization of Excess Earnings 33.3% Capitalization of Net Income 33.3% Market Approach	50% Capitalized Net Income 50% Capitalized Excess Earnings
Discount Lack of Control/ Premium for Control	20% Discount	5% Discount
Marketability	20% Discount	5% Discount

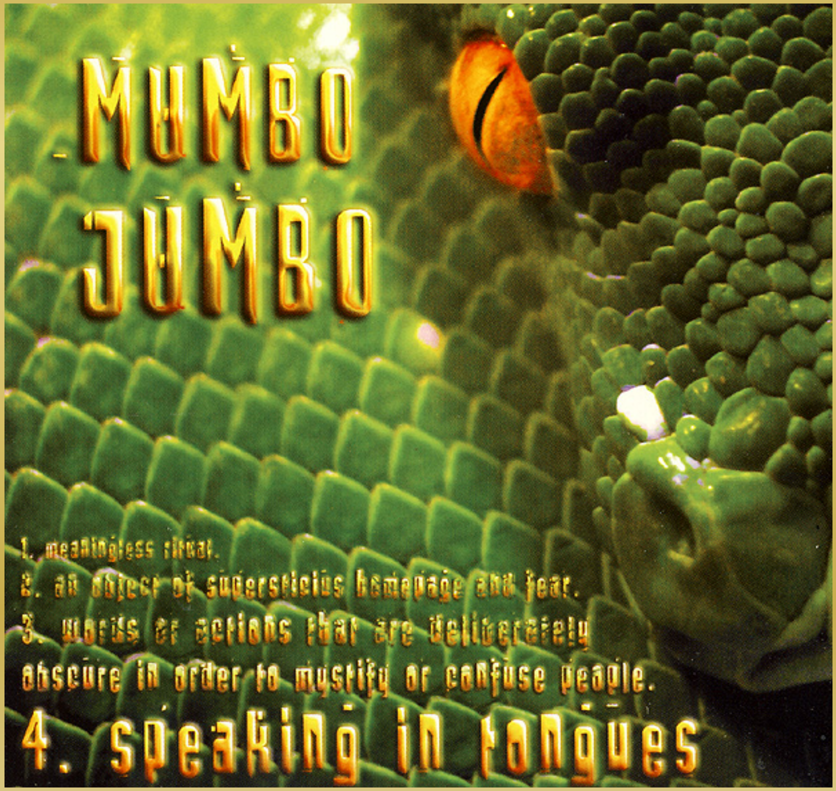
WHY DID WE DO ALL THAT??

- Highlight differences in selected methods
- Highlight the differences in adjustments to financial data
- Highlight the differences in assumptions
- Figure out which differences have most impact on value
- These areas we bolster on direct & undermine on cross

THE EXAMINATION

(Prior Planning Prevents Poor Performance)

- Remember, there are not bad witnesses, only bad questions
- Experts have a language of their own, and they speak it better than the lawyers!



THIS IS NOT ABOUT DIRECT BUT KNOWING THE DIFFERENCES HELPS: DIRECT EXAM FEATURES

- Accredit as Qualified Expert
- Get the opinion/report into evidence
- Showcase the expert with:
  - explaining the basis and conclusions
  - value judgments they made to get there.
- Use open questions to explain terms of art/acronyms

CROSS

- Follow the Rules of Cross Examination
- Use the right terms of art
- Highlight the commonalities this expert and your expert's work
- Challenge bias or impartiality if appropriate
- Substitute information
  - Change assumptions and/or varying facts
  - Move the conclusion closer your expert's

POINTS COMMON TO DIRECT & CROSS

- Use chapters or headnotes for each topic
- Watch the Judge/Jury for Comprehension
- Direct the Judge/Jury to pertinent report pages
- Demeanor: appropriate to direct/cross

SURE-FIRE TECHNIQUES IN CROSS EXAMINING THE FINANCIAL EXPERT

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Background Facts

The following background facts are known to attorneys for David and Lynne Allen and are stipulated to be true (*see* Course Stipulations *infra*). In October YR-1, David Allen filed for divorce from his wife, Lynne Allen.

The trial will include the following disputed issues:

1. primary parenting responsibility and primary residential parent;
2. child support;
3. valuation of 25 percent interest in Power Diagnostics, a subchapter S corporation.

Lynne (Grant) Allen's Family History

Lynne Grant grew up in Northern County, Nita, as the only child of an upper-middle-class couple. During Lynne's childhood, her father successfully expanded a modest family general contracting business. Lynne's mother attended college, but never worked. Instead, she devoted herself to civic and club activities—and not caring for Lynne. Lynne was raised as a Presbyterian, although her family was not especially religious. She attended private schools in preparation for college.

Lynne attended Bennington College, majoring in English. She was a slightly better than average student, but she had trouble directing herself towards a career goal. She dated while in college, but did not have a steady boyfriend. She was outgoing and vivacious, but more interested in campus activities than in academics or romantic relationships. She enjoyed being with other people and working in groups.

During her junior year at Bennington, still uncertain about her career goals, Lynne approached her father about joining him in the family construction business. Her father felt that the construction business was no place for his daughter and discouraged her involvement. Frustrated by this rebuff, and even less decided about her future, Lynne decided to take time off from college. After completing her junior year, she moved to Nita City to share an apartment with a college friend who was studying architecture at Nita University. Lynne got a job as a patient representative at Nita Medical Center to cover her expenses while she sorted out her future.

David Allen's Family History

David Allen was born and raised in a middle-class family in Lawrence, Nita, the second of three children. His father was in the garment business, manufacturing children's clothing. David's mother helped David's father by keeping the books and running the office. David's mother was not heavily involved in her children's day-to-day lives. An aunt, now deceased, and different housekeepers largely raised David. David's mother was comfortable in a traditional role and rarely challenged her husband's authority.

David was always considered to be the studious one in the Allen family. He was an obedient child and a leader in school. He was shy about dating, however, and was selfconscious about his looks. David worked hard while attending Lawrence High School and was awarded a substantial scholarship to attend Tufts University as a premed student.

After completing his premed studies at Tufts University, David attended Nita Medical School. David interned at Nita Presbyterian and then became a resident and radiological fellow at Nita Medical Center. During the course of his training, he developed an interest in and demonstrated considerable talent for radiological research and treatment. During his residency, David had one relationship with a nurse. This relationship did not work out, however, because she felt that David put his medical career before everything.

The Allens' Marriage and Children

In the summer of YR-16, about seven months after that relationship ended, David met Lynne, who was a patient representative. They began meeting for coffee to discuss the progress of his patients. The conversations soon turned to more general discussions of medicine and of David's research in particular. David was very charmed by Lynne and flattered by her attention to his research. They would spend long hours going over his research results. Lynne helped edit his research reports and his first articles. Lynne also helped write and edit his application for a National Radiological Association (NRA) grant.

In the fall of YR-16, David asked Lynne to marry him. He felt that since his career seemed to be going very well, he was ready to settle down. Lynne and David married in February of YR-15. When they married, both David and Lynne assumed they would have children. David felt that they should begin their family only when they were on secure financial footing.

In the summer of YR-14, David finished his residency and fellowship. He was then fortunate enough to receive a research grant funded by the NRA. In YR-14, David joined a group practice with two other radiologists. He thus supplemented his relatively low research salary (continuing renewals of his NRA grant).

Both David's research work and his group practice flourished. For the first two years, David was a salaried employee, and in YR-12 he was invited to buy into the Power Diagnostics group practice and become an equal partner with the other two radiologists. He made his practice his first priority, investing most of his time at work.

David and Lynne decided they were financially secure enough to begin their family. Their first child, Jane, was born in YR-13. In YR-11, a second child, Joey, was born. Lynne agreed to stay home with the children until they reached school age. She did this somewhat reluctantly, as she feared the social isolation and lack of adult and community contact that might result from staying at home full time. However, she found great satisfaction in motherhood. Lynne, following in her mother's footsteps, became very active in a variety of community affairs.

By YR-10, with Jane approaching preschool and Joey about to start toddling, Lynne and David decided to leave their Nita City apartment and move to the suburbs. They purchased a large older home in Huntington, Nita (an attractive suburb), close to where David's parents lived, which Lynne began fixing up.

David Allen's Career

David is also at a career crossroads. Through his years of receiving National Radiological Association research grants, David became actively involved with the association. David has presented at numerous conferences over the years, has been fundamental in planning several symposia, has served on a number of the association's committees, and three years ago chaired the association's National Committee on Ethics in Radiology Research.

Three months ago, the NRA, which is headquartered in Nita City, learned that it would lose its current executive vice president and chief administrator. Following a series of interviews with multiple candidates, including David, the association offered David the post. The compensation is generous for such a position ($400,000 annually). Due to potential conflicts of interest and time, David would have to give up his practice to accept the post.

With the Association's sizeable staff and over $500 million in research grants to award annually, David believes he would be making a greater contribution to the field than he currently does through his practice. The current executive vice president has agreed to remain with the association until a replacement is found. David wants very much to accept the position, but has not yet made a commitment. He has, however, mentioned the possibility to Lynne and discussed it with his partners at Power Diagnostics.

David's Interest in Power Diagnostics

In YR-14, David joined a group practice with two other radiologists. For the first two years, he was a salaried employee. In YR-12, he was invited to become an equity partner in Power Diagnostics, PA, a subchapter S corporation. He purchased an equal share for $100,000, payable over six years. In YR-6, the medical group accepted a fourth shareholder who was required to pay $200,000 over the next five years to purchase a 25 percent share of the practice. All four shareholders hold equal rights at 25 percent each. By agreement, each has the right to purchase the others' shares before they are offered to an outsider at a formula equal to one times (1×) net earnings of the exiting shareholder's last full year.

According to the shareholders' agreement, the shareholders share equally the profits of the practice. Each shareholder plays a specified role in the practice, which was equally allocated based on agreement by each shareholder. Although David has decided to work less in the practice and spend more time with research, David believes that his contribution to the practice is greater than simply the hours he puts in. He believes that many patients are referred to Power Diagnostic because he does a lot of lecturing to primary care physicians and hospitals about innovative radiology procedures. He considers this important in the success of the practice's revenue.

During the past three years, each shareholder experienced a decline due to: 1) declining third-party insurance reimbursement rates, 2) greater use of less invasive procedures, 3) increasing malpractice insurance, and 4) increased competition from a new radiology practice, which competes with them at their primary hospital. Over the past few years, Power's gross income has decreased from $9.4 million (in YR-5) to $5.9 million (in YR-1). Even though competition has increased, many patients continue to be referred to Power Diagnostic due to David's frequent presentations to primary care physicians and other hospital staff. These audiences often refer their patients to his practice.

David's belief is practice revenues will continue to decline. He finds the prospect of working for NRA quite appealing. He is tired of his group practice, with its on-call demands, and he worries that as he ages the stress will take an increasing toll on his health. He also feels that he has been very successful in the past. Given the $1.2 million in his profit-sharing plan, the $2,000,000 home (with a mortgage of $200,000), and the $3.4 million he has in his stocks, bonds, and cash, he feels he can live on less income and have a less stressful life.

The Power Diagnostics shareholder agreement provides that in the event of death of a shareholder, the practice will purchase the deceased shareholder's stock at a formula equal to one times (1×) net earnings of the deceased shareholder's last full year. In the event a shareholder leaves the practice the other shareholders may buy him out at a formula equal to one times (1×) net earnings of the exiting shareholder's last full year. A shareholder cannot sell his shares without approval of the other shareholders. Given the drop in revenues over the past few years, David's partners are reluctant to buy him out.

They are willing to have David sell his shares to a new potential shareholder. Dr. Jones, a radiologist in solo practice, has offered to purchase David's shares for a very generous price of six times (6×) the shareholders share of YR-1 pre-tax net income reflected on the financial statement. However, the shareholders won't approve of Dr. Jones due to some malpractice problems that Dr. Jones has had in the past. They fear that his bad reputation and less than perfect practice will reduce the number of referrals and also possibly lead to higher malpractice insurance premiums. The other shareholders have found Dr. Smith, a young radiologist, whom they would approve; however, Dr. Smith is being recruited by another practice and is only willing to pay three times (3×) the shareholders share of YR-1 pre-tax net income reflected on the financial statement.

Business Valuation Dispute

David and Lynne each hired appraisers to value David's 25 percent ownership interest in Power Diagnostics, P.A., a professional radiology medical practice and a subchapter S corporation. The conclusion of each appraiser is dramatically different, which fall into the following categories:

- discount rates for lack of control and lack of marketability;
- capitalization rate for earnings;
- application of weighted average vs. simple average;
- utilization of three methods vs. two methods to determine the value
- reasonable compensation;
- adjustments to profit and loss (excluding reasonable compensation);
- adjustments to balance sheet.

In addition, David's appraiser reduced his value for capital gain on a potential sale based on the fact David's career is at a turning point. The National Radiological Association's offer to David for the position of executive vice president means David will have to give up his private radiology practice. David is yet to make a commitment, but he feels that managing the $500 million annual research grant awards by the Association would allow him to make a greater contribution to radiology than his current position.

The office condominium owned by the practice was appraised at $2 million during refinancing in YR-1. It has a net value of $1,006,204 after its outstanding mortgage is paid. The book value of the office furniture and equipment is $82,802. Lynn's appraiser, Ross and Ernst, PA, obtained and utilized a fair market value of $331,916 for the medical equipment, as set forth by an outside medical equipment appraiser. David's appraiser uses the book value for the medical equipment. With both appraisals, commercial goodwill is being considered as a factor in establishing the value of David's professional radiology medical practice. It was determined that the majority of the patients are either referred by hospitals, members of various health plans at which Power Diagnostics is affiliated, or responding to local radio and newspaper advertising.

David Allen

Memorandum Regarding Financial Issues

The Allen's disagree on the valuation of Dr. Allen's practice.

(a) Summary of the Dispute

Dr. Allen's income as a shareholder in Power Diagnostics has decreased significantly over the past three years. In YR-4, the practice grossed $9.2 million. This year that number was cut by over a third, down to $5.9 million.

Dr. Allen holds a 25 percent share in the practice, which he will sell to a qualified buyer. Under the terms of the shareholding agreement, the three other shareholders in the practice must approve Dr. Allen's selection of a radiologist. Dr. Jones made a generous offer to purchase Dr. Allen's 25 percent share for six times (6×) YR-1 pre-tax net income. The shareholders do not approve of Dr. Jones because of his negative reputation in the medical community. They fear that his negative personal reputation will further detract from their already ailing business. The only other offer is for three times (3×) YR-1 pre-tax net income.

Ms. Allen was promoted to assistant programming director after being employed for only a short time at the local radio station. She has enjoyed considerable success there, especially with a show she devised that attained success in a difficult time slot. Ms. Allen is contemplating taking a new job should the show become nationally syndicated. This will likely mean a substantial increase in salary for Ms. Allen. Right now she makes $30,000. The new job could increase her salary to $50,000/year.

(b) Previous Settlement Attempts

Previous settlement attempts of other financial issues were successful, however, to this point, the parties have been at an impasse regarding the price of the practice and the amount child support due.

(c) What Dr. Allen Wants

Dr. Allen's radiological practice has been failing for some time. The gross income of the practice has decreased considerably over the past few years, from $9.2 million in YR-4 to just $5.9 million in YR-1. He believes that the value of his practice should be as low as possible and based on the assumption that revenues will continue to decline.

No one has been found to purchase Dr. Allen's share of the radiological group, and therefore he believes that it should not be factored into the equation. Dr. Jones is unacceptable to the three partners who must approve the selection of a new radiologist. This is reflected by his inflated offer of six times (6×) Dr. Allen's 25 percent share in YR-1 pre-tax net income (last full year) to purchase the practice. A radiologist who cannot obtain a share in another practice due to a negative reputation in the medical community is much more likely than a competent radiologist to make such an overly generous offer. The only willing buyer left in the equation is Dr. Smith, and therefore if Dr. Allen's 25 percent share is to be valued, it should be at three times (3×) YR-1 pre-tax net income (last full year) offered by Dr. Smith.

Lynne Allen

Memorandum Regarding Financial Issues

All of the critical financial issues between the parties have been settled except for the valuation of Dr. Allen's practice.

(a) Summary of the Dispute

Dr. Allen is a radiologist, and Ms. Allen works at a radio station. Three months ago, Dr. Allen was offered a position with the National Radiological Association. In order to take this job, Dr. Allen must give up his radiological practice. If Dr. Allen accepts the NRA job, he will be making only $400,000/year.

Ms. Allen, in stark contrast to Dr. Allen, recently earned her college degree and is working for a local radio station. Although she has been promoted to assistant programming director, the salary is small for the position. Ms. Allen only makes $30,000/year. There have been no monetary benefits arising from her recent programming success with a regional baseball show. There is a remote possibility Ms. Allen will get a new job, but there have been no discussions regarding compensation for such a position.

(b) Previous Settlement Attempts

The Allens have been unable to resolve the issues surrounding the value of the practice and the amount of child support that should be paid to Ms. Allen. They were able to settle their other financial disputes without court intervention.

(c) What Ms. Allen Wants

Ms. Allen is fully aware of the value of her husband's business. In valuing the business, Ms. Allen wants the dollar amount to be as high as possible. Under commercial goodwill, she has a stake in the valuation of the business. The radiological group has an excellent reputation and many contacts with hospitals and practice groups. Ms. Allen believes that it will not be difficult to replace Dr. Allen with another radiologist if he leaves the practice.

She is adamant that Dr. Allen is the one fueling the concerns over the addition of Dr. Jones to the practice. Dr. Jones is well regarded in the medical community. Although he was recently sued for malpractice, this instance was not any different from what many physicians encounter. Ms. Allen has her suspicions that Dr. Allen and his colleagues are purposefully lowering the revenues of the company to protect themselves in divorce actions with their wives. In addition to the business, there is the value of the building the shareholders own, along with thousands of dollars in advanced radiological equipment.

CURRICULUM VITAE

Smith, Jones and Johnson, LLP
Jaime A. Johnson, CPA
423 Main Street
Nita City, Nita 99990

Graduate of Wharton School, University of Pennsylvania, with Bachelor of Science in Economics

A Certified Public Accountant in the Commonwealth of Pennsylvania, State of New Jersey, and State of Nita, and accredited in business valuation and financial forensics.

Member: American Institute of Certified Public Accountants (AICPA)
New Jersey Society of Certified Public Accountants (NJSCPA)
Pennsylvania Institute of Certified Public Accountants (PICPA)
Litigation Services Committee of the New Jersey Society of Certified Public Accountants
New Jersey Supreme Court Special Committee on Matrimonial Litigation

Jaime Johnson has represented companies and stockholders in mergers, acquisitions, and sales of business. He has negotiated buy-ins, buy-outs, dissolutions, purchases, and sales of professional practices, and he has advised individuals and attorneys in the formulation of partnership and stockholder agreements. Jaime Johnson was a director of a publicly traded corporation for fourteen years and was active in the sale of the company.

Jaime Johnson has prepared numerous business valuation reports and damage studies for use in partnership and stockholder disputes, matrimonial litigation, and damage claim cases. He has been qualified as an expert witness in federal court and by courts in New Jersey and Pennsylvania, and he has received a variety of court-appointed engagement in business disputes and divorce litigation matters. He has served as a mediator, and he has been active in negotiations and settlements in a variety of litigation matters.

Jaime Johnson was engaged as an expert by the State of New Jersey Agricultural Development Committee and the Department of Environmental Protection.

Jaime Johnson has taught a variety of courses to judges at the New Jersey Judicial College and has lectured at conferences sponsored by the Institute for Continuing Legal Education. He has written a variety of text material for seminars on forensic examinations, federal tax issues, business and professional practice valuations, and other litigation support services by CPAs.

Jaime Johnson has been a contributing author to *Today in Business Valuations* and *Blueprint to Start-Up Businesses*, and has co-authored *Guide to Divorce Practice*, all of which are written for use by Certified Public Accountants throughout the United States. In addition, Jaime Johnson has contributed to courses on accountant's activities in divorce cases and how to perform business valuations sponsored by the American Institute of Certified Public Accountants, which are presented to CPAs throughout the United States. He has written articles for the *ABA Journal* and has written a variety of text material for seminars on forensic examinations, federal tax issues, business and professional practice valuations, and other litigation support services by CPAs.

Jaime Johnson has been a speaker and conducted tax, business, and financial seminars for various organizations, including the AICPA, the NJSPCA, and PICPA, He was a member of the faculty of the Temple University Law School tax forum and a speaker at the AICPA's National Tax Conference in Washington, DC. He has taught courses and lectured on taxation, business, and professional practice valuations, forensic accounting, and damage measurement for the AICPA, NJSCPA, and PICPA. He has lectured at the AICPA's National Conference on Litigation Support Services and National Business Valuation Conference.

CURRICULUM VITAE

Chris Ernst, MBA, CPA

OFFICE ADDRESS	500 Oak Street Nita City, Nita 99997 (721) 555-1234
POSITION	Senior Partner, Ross and Ernst, PA
EDUCATION	University of Nita (YR-8) MBA University of Nita (YR-10) BA
PROFESSIONAL AFFILIATIONS	Certified Public Accountant (CPA), State of Nita Certified Business Appraiser (CBA) Certified Financial Planner (CFP) Member, Institute of Business Appraisers, Inc. Member, Nita Institute of Certified Public Accountants
PROFESSIONAL AND BUSINESS HISTORY	Ross and Ernst, PA Senior Partner, YR-2–Present Managing Director, YR-6–YR-2 Partner, YR-8–YR-6 Staff Accountant (Ross and Associates, PA), YR-10–YR-8
EXPERIENCE	Experience includes forensic accounting and business valuation, business damages, as well as extensive advising to clients in real estate matters, divorce extensive consulting work and testimony in the accounting, financial, economic, and business litigation issues. Served as Expert Witness on many occasions since YR-6.
PUBLICATIONS	"Income Tax Deductibility of Attorney's Fees in Divorce," *The Nita Bar Journal* (December, YR-6) "A Practical Guide to Business Valuation in Divorce," *The Nita Bar's Inn of Court Presentation* (YR-5) "Income Tax Deductibility of Attorney's Fees in Divorce," *The Nita Matrimonial Law Monthly,* (YR-4) "Innocent Spouse Provision is Becoming More User-Friendly," *The Family Law Commentator*, (December, YR-2) "Where's the Money: Challenging Issues in Equitable Distribution," *The Nita Family Law Review*, (YR-2)

APPRAISAL REPORT
DR. DAVID ALLEN'S INTEREST IN
POWER DIAGNOSTICS, PA
AS OF DECEMBER 31, 2014

Smith, Jones and Johnson, LLP
Certified Public Accountants

April 18, 2015

Frank B. Chance, Esq.
Tinkers, Evers & Chance, LLP
411 Main Street
Nita City, Nita 99990

Re: Marriage of Allen
Appraisal Report—Power Diagnostics, PA, as of December 31, YR-1

Dear Mr. Chance,

We prepared the accompanying appraisal report of Power Diagnostics, PA ("Power"). The purpose of our engagement was to determine the fair market value of Dr. Allen's interest in Power, including goodwill, as of December 31, YR-1.

For the purpose of this appraisal, fair market value is defined by the American Institute of Certified Public Accountants ("AICPA") Statement on Standards for Valuation Services ("SSVS-1") as the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Our report is intended solely for the use in the Allen dissolution of marriage proceedings presently before the Superior Court of the State of Nita, County of Darrow. We have not audited, reviewed, or compiled the appraisal report; accordingly, it may contain departures from generally accepted accounting principles and should not be used for any other purpose.

We have considered whether any discounts or premiums should be applied to the value of Power. The most important discounts and premiums would be a lack of control discount and a discount for lack of marketability. In this matter, we have been asked to determine the fair market value of a 25 percent interest in Power. There are four shareholders, with Dr. Allen owning a 25 percent of the common stock outstanding. The concept of lack of control deals with the relationship between the interest being valued and the total enterprise. The primary factor bearing on the value of the minority interest in relation to the value of the total entity is how many of the prerogatives of control, if any, the minority interest enjoys. The interest subject to valuation does not have the ability to unilaterally control the company's policies. The subject company lacks the marketability of similar interest in a publicly traded company. Simply stated, a 25 percent interest in a closely held business is not as readily marketable as an interest in a public company. Therefore, the consideration for discount for lack of marketability is necessary.

After considering all relevant facts, we have selected a 20 percent discount for lack of control and a 20 percent discount for lack of marketability. The application of the discounts to arrive at a 25 percent interest in Power is shown on Schedule 1 of our appraisal report.

It is our opinion, as shown in Schedule 1 of our appraisal report, the fair market value of Dr. David Allen's interest in Power Diagnostics, PA, as of December 31, YR-1, in rounded amount, was:

SIX HUNDRED AND SIXTY THOUSAND DOLLARS

$660,000

Our engagement and compensation for this report and its conclusions are not contingent on the value reported or the outcome of the court proceedings. We have no interest, either present or contemplated, in the business or individual on which this report is based.

Respectfully submitted,

Smith, Jones and Johnson, LLP
Certified Public Accountants

APPRAISAL REPORT
POWER DIAGNOSTICS, PA
CONCLUSION AS TO VALUE
As of December 31, Year 1

		VALUE	WEIGHTING FACTORS	WEIGHTED VALUE
1	CAPITALIZATION OF NET INCOME METHOD [1]	$ 4,388,000	33.3%	$ 1,462,667
2	CAPITALIZATION OF EXCESS EARNINGS METHOD [2]	4,339,500	33.3%	1,446,500
3	MARKET APPROACH [3]	4,481,819	33.3%	1,493,940
4	Total fair market value of 100% interest in Power Diagnostics, PA, Rounded		100%	$ 4,403,106
5	Dr. David Allen's 25% pro-rata interest		25%	$ 1,100,777
6	Less: Discount for Lack of Control (at 20%)		20%	(220,155)
7	Value before consideration of Lack of Marketability Discount			880,621
8	Less: Discount for Lack of Marketability (at 20%)		20%	(176,124)
9	Fair Market Value of 25% interest in Power			704,497
10	Less: taxes on assumed sale [4]			(40,899)
11	**Conclusion of fair market value after discounts and tax effecting (rounded)**			**$ 660,000**

Notes:
[1] See Schedule 2.
[2] See Schedule 3.
[3] See Schedule 9.
[4] Since a sale of Dr. Allen's 25% interest in Power Diagnostics is being actively pursued by Dr. Jones, it is appropriate to consider the tax impact on a potential transaction. Taxes were calculated as follows:

Assumed sales price (Dr. Allen 25% interest)	$ 704,497
Dr. Allen's tax basis	500,000
Gain on sale	$ 204,497
Tax at 20%	$ 40,899

Smith, Jones and Johnson, LLP
Certified Public Accountants

SCHEDULE 1

APPRAISAL REPORT
POWER DIAGNOSTICS, PA
CAPITALIZATION OF NET INCOME METHOD
As of December 31, Year 1

		12 Months Ended					
		Year 5	Year 4	Year 3	Year 2	Year 1	TOTAL
1	Adjusted net income [1]	$ 2,949,554	$ 2,831,619	$ 2,200,149	$ 923,478	$ 819,307	
2	Times: Weighting factors [2]	1.0	2.0	3.0	4.0	5.0	
3	Weighted adjusted net income	$ 2,949,554	$ 5,663,238	$ 6,600,446	$ 3,693,913	$ 4,096,536	$ 23,003,687
4	Divided by: Sum of weighting factors						15.0
5	Normalized net income after taxes						1,533,579
6	Long-term growth rate						3%
7	Normalized net income after taxes						1,579,587
8	Divided by: Capitalization rate for earnings [3]						36%
9	Indicated fair market value						$ 4,387,740
10	Indicated fair market value, rounded						$ 4,388,000

Notes:
[1] See Schedule 5.
[2] The weighting factors reflect the weight given to each historical year's results in determining the normalized earnings.
Based on an estimate of the combined federal and state income tax rate.
[3] See Schedule 8.

APPRAISAL REPORT
POWER DIAGNOSTICS, PA
CAPITALIZATION OF EXCESS EARNINGS METHOD
As of December 31, Year 1

		12 Months Ended					
		Year 5	Year 4	Year 3	Year 2	Year 1	TOTAL
1	Adjusted net income [1]	$ 2,949,554	$ 2,831,619	$ 2,200,149	$ 923,478	$ 819,307	
2	Times: Weighting factors [2]	1.0	2.0	3.0	4.0	5.0	
3	Weighted adjusted net income	$ 2,949,554	$ 5,663,238	$ 6,600,446	$ 3,693,913	$ 4,096,536	$23,003,687
4	Divided by: Sum of weighting factors						15.0
5	Normalized net income after taxes						1,533,579
6	Long-term growth rate						3%
7	Normalized net income after taxes						1,579,587
8	Return on net tangible assets						
9	Net tangible assets as of December 31, Year 1 [3]					$ 604,487	
10	Times: Rate of return on net tangible assets [4]					8.00%	
11	Return on net tangible assets						(48,359)
12	Excess earnings						1,531,228
13	Divided by: Capitalization rate for excess earnings [5]						41%
14	Indicated goodwill of the business						$ 3,734,701
15	Rounded value of goodwill						$ 3,735,000
16	Rounded value of net tangible assets						604,500
17	Indicated fair market value, rounded						$ 4,339,500

Notes:
[1] See Schedule 5.
[2] The weighting factors reflect the weight given to each historical year's results in determining the normalized earnings.
[3] See Schedule 4.
[4] Represents the rate of return on net tangible assets based on rates of return at the date of value.
[5] See Schedule 8.

APPRAISAL REPORT
POWER DIAGNOSTICS, PA
ADJUSTED BALANCE SHEET
As of December 31, Year 1

		Balance Sheet per Financial Statement	Appraisal Adjustments	Adjusted Balance Sheet
1	Assets:			
2	Cash	$ 11,476	$ -	$ 11,476
3	Accounts receivable [1]	-	1,387,770	1,387,770
4	Allowance for uncollectible accounts [2]	-	(677,232)	(677,232)
5	Total other assets	11,476	710,538	722,014
6	Equipment	92,964	-	92,964
7	Office furnishings	37,846	-	37,846
8	Accumulated depreciation	(48,008)	-	(48,008)
9	Net fixed assets	82,802	-	82,802
10	Office building	2,000,000	-	2,000,000
11	Less accum. Depreciation	(305,620)	305,620	-
12	Net building	1,694,380	305,620	2,000,000
13	Other assets	-	-	-
14	Total other assets	-	-	-
15	Total assets	$ 1,788,658	$ 1,016,158	$ 2,804,816
16	Liabilities:			
17	Accounts payable	$ 136,516	$ -	$ 136,516
18	Credit line	785,802	-	785,802
19	Deferred taxes payable [4]	-	284,215	284,215
20	Total current liabilities	922,318	284,215	1,206,533
21	Mortgage	993,796	-	993,796
22	Shareholder loans [3]	195,924	(195,924)	-
23	Total long-term liabilities	195,924	(195,924)	-
24	Capital:			
25	Shareholder's capital	(323,380)	-	(323,380)
26	APPRAISAL ADJUSTMENT	-	927,867	927,867
27	Total equity	(323,380)	927,867	604,487
28	Total liabilities and equity	$ 1,788,658	$ 1,016,158	$ 2,804,816

Smith, Jones and Johnson, LLP
Certified Public Accountants

SCHEDULE 4

APPRAISAL REPORT
POWER DIAGNOSTICS, PA
ADJUSTED BALANCE SHEET
As of December 31, Year 1

Notes:

[1] Amount represents Power Diagnostics accounts receivable balance as of December 31, Year 1 based on the Power Diagnostics accounts receivable aging report as of December 31, Year 1.

[2] Amount represents our estimate of Power Diagnostics allowance for uncollectible accounts balance based on the historical average percentage of collections to charges of 51.2%, as reflected on the Power Diagnostics Charges by Month and payments by Month Reports for the years Year 2 and Year 1.

[3] We eliminated the shareholder loans as of December 31, Year 1.

[4] We estimated deferred income taxes based on 40%.

APPRAISAL REPORT
POWER DIAGNOSTICS, PA
ADJUSTMENTS TO NET INCOME
For the Years Ended December 31, Year 5 through December 31, Year 1

		Year 5	Year 4	Year 3	Year 2	Year 1
1	Net pretax income [1]	$ 4,209,824	$ 4,127,469	$ 3,243,612	$ 1,590,763	$ 1,584,448
2	Adjustments to net income:					
3	Salary [2]	2,400,000	2,300,000	1,950,000	1,700,000	1,700,000
4	Perquisites					
5	Automobile expenses (50%)	112,049	107,558	131,686	113,309	128,945
6	Promotions (100%)	75,328	116,177	255,486	159,050	115,226
7	Travel/medical meetings (100%)	306,549	275,828	343,333	355,863	138,892
8	Life insurance (0%) [3]	-	-	-	-	-
9	Charitable contributions (100%) [4]	188,840	184,000	119,464	21,811	8,000
10	Non-recurring ownership interest sale [5]	(66,667)	(66,667)	(66,667)	(66,667)	-
11	Non-recurring sale of equipment [5]	-	(15,000)	-	(25,000)	-
12	Total adjustments to net income	3,016,099	2,901,896	2,733,302	2,258,367	2,091,064
13 14	Adjusted net income before market compensation and taxes	7,225,923	7,029,365	5,976,915	3,849,131	3,675,512
15	Less: Market compensation [2]	(2,310,000)	(2,310,000)	(2,310,000)	(2,310,000)	(2,310,000)
16	Adjusted net income before taxes	4,915,923	4,719,365	3,666,915	1,539,131	1,365,512
17	Less: Estimated income taxes (40%)	(1,966,369)	(1,887,746)	(1,466,766)	(615,652)	(546,205)
18	ADJUSTED NET INCOME	$ 2,949,554	$ 2,831,619	$ 2,200,149	$ 923,478	$ 819,307

Notes:
[1] See Schedule 7.
[2] Based on our analysis of the financial statements and tax returns for Power Diagnostics for the years Year 5 through Year 1 and our analysis of market compensation for a diagnostic (non-invasive) radiologist utilizing the 90th percentile.
[3] Based on discussions with Dr. Allen, the life insurance is a keyman policy.
[4] Charitable contributions are eliminated as a non-business expenses. Business contributions are deemed to be business related.
[5] We made an adjustment for this category since it represents non-recurring income.

POWER DIAGNOSTICS, PA
FINANCIAL STATEMENT SPREADSHEETS
As of December 31, Year 5 through December 31, Year 1

BALANCE SHEET

		Year 5	Year 4	Year 3	Year 2	Year 1
1	Assets:					
2	Cash	$ 93,967	$ 289,052	$ 621,437	$ 113,137	$ 11,476
3	Accounts receivable	-	-	-	-	-
4	Total other assets	93,967	289,052	621,437	113,137	11,476
5	Furniture and equipment	170,141	152,696	152,696	130,811	130,810
6	Less accum. depreciation	(154,250)	(65,850)	(75,650)	(48,009)	(48,008)
7	Net fixed assets	15,891	86,846	77,046	82,802	82,802
8	Office building	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
9	Less accum. Depreciation	(100,500)	(151,780)	(203,060)	(254,340)	(305,620)
10	Net building	1,899,500	1,848,220	1,796,940	1,745,660	1,694,380
11	Other assets	-	13,600	13,600	-	-
12	Total other assets	-	13,600	13,600	-	-
13						
14	Total assets	$ 2,009,358	$ 2,237,718	$ 2,509,023	$ 1,941,599	$ 1,788,658
15	Liabilities:					
16	Accounts payable	$ 166,964	$ 179,682	$ 189,134	$ 145,253	$ 136,516
17	Credit line	566,072	540,636	521,666	559,496	785,802
18	Total current liabilities	733,036	720,318	710,800	704,749	922,318
19	Mortgage	1,166,464	1,127,902	1,086,140	1,040,912	993,796
20	Shareholder loans	107,858	387,498	609,387	193,938	195,924
21	Total long-term liabilities	1,274,322	1,515,400	1,695,527	1,234,850	1,189,720
22	Capital:	-	-	-	-	-
23	Shareholder's capital	2,000	2,000	102,697	2,000	(323,380)
24	Total liabilities & capital	$ 2,009,358	$ 2,237,718	$ 2,509,024	$ 1,941,599	$ 1,788,658

Source: Financial statements

Smith, Jones and Johnson, LLP
Certified Public Accountants

SCHEDULE 6

POWER DIAGNOSTICS, PA
FINANCIAL STATEMENT SPREADSHEETS
FOR THE YEARS ENDED DECEMBER 31, YEAR 5 THROUGH DECEMBER 31, YEAR 1

INCOME STATEMENT

		Year 5	Year 4	Year 3	Year 2	Year 1
1	Ordinary Income/Expense:					
2	Income:					
3	Revenue	$ 9,358,834	$ 9,182,451	$ 8,269,243	$ 6,050,254	$ 5,864,285
4	Expense:					
5	Advertising	3,360	3,184	2,771	-	-
6	Auto expenses	-	-	-	-	-
7	Rental	7,064	15,660	6,744	3,064	1,996
8	Gasoline	20,312	20,190	20,902	15,789	15,336
9	Insurance	16,551	16,288	16,336	16,245	16,501
10	Lease	144,000	144,000	144,000	144,000	144,000
11	Registration	6,384	6,112	6,168	4,128	3,752
12	Repairs	26,427	9,682	66,452	43,392	76,306
13	Total auto expenses	224,097	215,116	263,373	226,618	257,890
14	Bank charges	200	368	3,184	856	288
15	Books & journals	3,136	4,179	14,181	8,926	3,008
16	Business contributions	144,952	149,440	139,600	132,800	122,000
17	Computer maintenance	11,384	9,510	-	-	8,967
18	Depreciation	57,800	80,200	61,080	82,656	51,280
19	Dues & subscriptions	65,347	72,304	78,592	63,876	83,392
20	Education/Training	46,512	44,752	2,760	2,544	1,432
21	Officer salary and benefits					
22	Officer salary	2,400,000	2,300,000	1,950,000	1,700,000	1,700,000
23	Officer medical	7,280	6,290	11,339	5,696	13,595
24	Officer health insurance	-	-	-	-	76,339
25	Insurance	419,352	422,369	361,402	374,284	308,734
26	Medical supplies	117,873	109,278	107,561	109,508	157,484
27	Legal & accounting	44,200	27,746	41,470	15,026	70,134
28	Meals & entertainment	77,019	72,812	191,366	139,186	33,454
29	Medical meeting	306,549	275,828	343,333	355,863	138,892

POWER DIAGNOSTICS, PA

FINANCIAL STATEMENT SPREADSHEETS

FOR THE YEARS ENDED DECEMBER 31, YEAR 5 THROUGH DECEMBER 31, YEAR 1

INCOME STATEMENT

		Year 5	Year 4	Year 3	Year 2	Year 1
30	Mortgage interest	125,239	123,980	117,113	112,538	107,583
31	Office supplies	31,687	49,299	48,214	41,845	6,327
32	Employee salary	708,462	706,066	807,991	819,090	847,371
33	Postage	2,787	3,864	5,285	3,471	1,379
34	Promotion	75,328	116,177	255,486	159,050	115,226
35	Records storage	-	11,624	31,696	30,968	32,960
36	Repairs & maintenance	-	2,040	-	1,312	4,493
37	Taxes, licenses & fees	21,559	3,000	8,200	9,602	10,835
38	Telephone/Answering service	44,742	55,074	55,900	42,298	27,439
39	Corporate tax (State)	95,330	95,180	79,960	74,080	56,000
40	Total expense	5,030,834	4,956,495	4,979,085	4,512,093	4,236,504
41	Net Ordinary Income	$ 4,328,000	$ 4,225,955	$ 3,290,158	$ 1,538,161	$ 1,627,781
42	Interest income	$ -	$ -	$ 17,624	$ -	$ -
43	Ownership interest sale	66,667	66,667	66,667	66,667	-
44	Sale of equipment	-	15,000	-	25,000	-
45	Other expenses					
46	Disability insurance	51,333	51,333	51,333	51,333	51,333
47	Life insurance	40,000	40,000	40,000	40,000	40,000
48	Charitable contributions	188,840	184,000	119,464	21,811	8,000
49	Total other expense	280,173	275,333	210,797	113,144	99,333
50	Net other income / (expenses)	(213,506)	(193,666)	(126,506)	(21,477)	(99,333)
51	Net Income	$ 4,114,494	$ 4,032,289	$ 3,163,652	$ 1,516,683	$ 1,528,448
52	Corporate tax (State)	95,330	95,180	79,960	74,080	56,000
53	Net pretax income	$ 4,209,824	$ 4,127,469	$ 3,243,612	$ 1,590,763	$ 1,584,448

Source: Financial statements

APPRAISAL REPORT
POWER DIAGNOSTICS, PA
ANALYSIS OF CAPITALIZATION RATES
As of December 31, Year 1

1	Market risks:	
2	Risk-Free Rate [1]	2.54%
3	Equity Risk Premium [2]	6.70%
4	Small Stock Risk Premium [3]	4.70%
5	Total market risk	13.94%
6	Add: Additional non-market risks:	
7	Company Specific Risk [4]	15.0%
8	Professional Service Risk [5]	10.0%
9	Total additional non-market risks	25.0%
10	Discount Rate	38.9%
11	Less: Long-term sustainable growth rate	-3.0%
12	Capitalization rate for earnings	35.9%
13	Capitalization rate for earnings, rounded	36.0%
14	Add: Additional risk for excess earnings	5.0%
15	Capitalization rate for excess earnings, rounded	41.0%

Notes:

[1] Represents the 20-year rate for long-term U.S. Treasury Securities as of December 26, Year 1 according to the Federal Reserve Bank of Saint Louis Research Division US Financial Data updated through January 4, Year 0.

[2] Represents the large company stock total returns minus long-term government bond income returns according to the Ibbotson Associates publication entitled "SBBI: Valuation Edition Year 1 Yearbook".

[3] Represents the size premium for micro-cap stocks in the 10th decile according to the Ibbotson Associates publication entitled "SBBI: Valuation Edition Year 1 Yearbook".

[4] Based on the inherent differences in the risks of an investment in the subject company and a diversified portfolio of the smallest 10% of New York Stock Exchange stocks, including size, industry risk, key person dependence and relatively undiversified operations (customers, suppliers, or products).

[5] Considers the inherent risk associated with the valuation of professional goodwill based on the services of an individual.

POWER DIAGNOSTICS, PA
APPLICATION OF TRANSACTION MULTIPLES
As of December 31, Year 1

1	Price-to-Sales				Weight Applied
2	Average sales	$	7,070,260	Schedule 7	
3	Selected multiple (a)		0.73	Calculated below	
4	Indicated value		5,190,889		
5	Plus adjusted working capital		(484,519)	Schedule 4	
6	Indicated value	$	4,706,370		50.0%
7	Price-to-Pretax Earnings Before Physician Comp.				
8	Adjusted pretax income	$	2,555,965	Schedule 2	
9	Plus owner (physician) salary		2,310,000	Schedule 5	
10	Pretax inc. before physician sal.		4,865,965		
11	Selected multiple		0.97	Schedule 10	
12	Indicated value		4,741,787		
13	Plus adjusted working capital		(484,519)	Schedule 4	
14	Indicated value	$	4,257,268		50.0%
15	Weighted Average Value				$ **4,481,819**

(a) Median revenue multiples are from Schedule 10, adjusted for differences in profitability.

Adjusted pretax profit	$	2,555,965	Schedule 2
Plus: owner's salary		2,310,000	Schedule 5
Pretax profit before physician comp.	$	4,865,965	
Profit to revenue - subject practice		68.8%	
Profit to revenue - transactions		42.2%	Schedule 10
Subject practice to industry		163.0%	
Unadjusted P/R multiple		0.45	
Adjustment		1.63	
Adjusted P/R multiple		0.73	

POWER DIAGNOSTICS, PA
GOODWILL REGISTRY TRANSACTIONS - RADIOLOGY
As of December 31, Year 1

	Date	State	Region	Gross Revenue	Profit Margin	(Note 1) Practice Price	Goodwill Value	Earnings	Price to Gross Revenue	Price to Earnings
1	Jun-Yr 7	CA	West	$ 2,395,424	32.27%	$ 1,015,204	$ 166,864	$ 772,898	0.42	1.31
2	Sep - Yr 6	TN	Southeast	2,060,000	60.26%	981,075	1,040,000	1,241,300	0.48	0.79
3	Nov - Yr 6	OH	Mid - West	4,200,000	34.53%	817,562	790,000	1,450,138	0.19	0.56
4	Nov - Yr 6	OH	Mid - West	957,000	54.04%	490,537	726,000	517,200	0.51	0.95
5	Jan - Yr 4	GA	Southeast	1,152,000	47.79%	518,729	448,000	550,541	0.45	0.94
6	Feb - Yr 4	AZ	Southwest	6,522,000	34.68%	2,142,577	3,460,000	2,261,902	0.33	0.95
7	Apr - Yr 4	LA	Southwest	10,620,000	27.47%	2,311,727	6,100,000	2,916,784	0.22	0.79
8	Dec - Yr 4	CA	West	1,015,412	64.89%	535,954	173,760	658,901	0.53	0.81
9	Dec - Yr 4	CA	West	3,216,000	35.73%	1,567,464	1,608,000	1,149,077	0.49	1.36
10	Jun - Yr 3	IL	Mid - West	3,400,000	35.24%	1,635,124	350,000	1,198,008	0.48	1.36
11	Jul - Yr 3	CA	West	6,700,000	54.00%	3,721,317	2,374,000	3,618,000	0.56	1.03
12	Aug - Yr 3	CA	West	3,900,000	35.17%	1,482,889	85,000	1,371,800	0.38	1.08
13	Jul - Yr 2	KY	Mid - West	7,390,172	42.82%	3,383,016	1,217,720	3,164,619	0.46	1.07
14	Sep - Yr 2	TN	Southeast	4,900,000	31.26%	2,001,618	710,000	1,531,800	0.41	1.31
15	Nov - Yr 2	CA	West	1,380,000	43.28%	563,836	310,000	597,265	0.41	0.94
16	Dec - Yr 2	KY	Mid - West	6,216,572	54.22%	5,243,674	17,785,600	3,370,538	0.84	1.56
17	Dec - Yr 2	MO	Mid - West	8,910,000	42.21%	3,664,934	4,160,000	3,760,911	0.41	0.97
18	Median			$ 3,900,000	42.2%	$ 1,567,464	$ 790,000	$ 1,371,800	0.45	0.97
19	Average			$ 4,407,916	42.9%	$ 1,886,896	$ 2,441,467	$ 1,772,452	0.45	1.05
20	Count			17	17	17	17	17	17	17
21	POWER DIAGNOSTICS, PA			$ 7,070,260	68.8%			$ 4,865,965		
22	HIGH			10,620,000	64.9%	5,243,674				
23	Average			4,407,916	42.9%	1,886,896				
24	Median			3,900,000	42.2%	1,567,464				
25	LOW			957,000	27.5%	490,537				

Note 1 - It is assumed that the transactions exclude any working capital in the price.

POWER DIAGNOSTICS, PA
Source Document List

Primary documents reviewed for the valuation - The following are the primary documents reviewed in preparation of the valuation report:

1. Federal and state tax returns of Power Diagnostics, PA for the period Year 5 to Year 1
2. Financial statements of Power Diagnostics, PA for the period Year 5 to Year 1
3. Salary information from Medical Group Management Association (MGMA)
4. Risk Management Association (RMA)
5. Goodwill Registry
6. Account receivable and collection reports provided by management
7. Written offers from Dr. Jones and Dr. Smith
8. Shareholder agreement, employment agreements and other business records
9. Various discussions with David Allen, MD
10. Complete tour of the medical facility
11. General ledgers for the period Year 5 to Year 1
12. Ibbotson Stocks Bonds Bills and Inflation Valuation Edition Year 1
13. Federal Reserve Statistical Release, The Federal Reserve
14. Year 1 Tax Rate Schedule, Internal Revenue Service (IRS)
15. Various restricted stock and IPO studies
16. Mergerstat Review
17. Hitchner, et al, Financial Valuation Applications and Models

April 18, 2015

Victoria Fetterman, Esq.
Hernandez, Carter & Fetterman, LLP
Nita Bar Building, Suite 222
Nita City, Nita 99990

Re: Allen v. Allen
Value of the Community Interest in Power Diagnostics, PA
as of December 31, YR-1

Dear Ms. Fetterman,

We have reviewed certain financial books, records, and documents for Power Diagnostics, PA ("Power"). The purpose of our engagement was to determine the fair market value of a 100 percent community interest in the Company, including goodwill, as of December 31, 2014.

For the purpose of this appraisal, fair market value is defined by the American Institute of Certified Public Accountants Statement on Standards for Valuation Services as the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

In making a determination of the existence of goodwill, we considered Nita Business and Professions Code Section 14100, which defines goodwill as follows:

> "The goodwill of a business is the expectation of continued public patronage."

After careful consideration, it is our conclusion that the value of the 25 percent community interest in Power at December 31, 2014 is:

<u>ONE MILLION NINE HUNDRED SIXTY THOUSAND DOLLARS</u>

<u>$1,960,000</u>

During this appraisal, we were provided with financial and operational data prepared by management. We have relied on this data as fairly presenting the results of operations and financial position of the Company. We have not reviewed or audited this data as part of this appraisal and express no opinion or other form of assurance regarding its accuracy. We reserve the right to amend, supplement, or revise this appraisal on receipt of additional, supplemental, or revised data.

Description of Subject Company

Dr. David Allen has a 25 percent ownership interest in Power (an S-Corporation). Dr. Allen is a radiologist specializing in neuroradiology.

Determination of Adjusted Net Income after Taxes (Exhibit C)

The historical results of Power require several adjustments as outlined below. These adjustments are necessary to reflect the true earnings of the business.

We adjusted the salary of David Allen to eliminate the actual salary expense and owner's distributions paid and replaced these payments with an estimate of reasonable compensation. Our estimate of reasonable compensation was derived from an analysis based on statistical market data.

We also eliminated expenses that are discretionary and not necessary to the operation of the business. These include charitable and perquisites.

Adjusted Balance Sheet (Exhibit E)

As of December 31, 2014, the net adjusted equity value reported by the Company is $898, 557. This represented the book value of DA, Inc. as of December 31, 2014.

Conclusion—Capitalized Net Income Method (Exhibit F)

The capitalized net income method starts with an analysis of the historical financial results to determine the Company's normalized annual income. Once normalized income is estimated, it is capitalized (divided by a capitalization rate) to determine the value of the Company's equity.

The average adjusted net income for the Company for the five years ended December 31, YR-1, is approximately $2.3 million. Growing the average adjusted net income by a 3.0 percent projected long-term growth rate results in the normalized annual income of approximately $2.4 million. This income is capitalized at an appropriate capitalization rate, which encompasses both the discount rate and the long-term growth rate. The result of the capitalized net income method is an indicated value of approximately $9.1 million.

Conclusion—Excess Earning Method (Exhibit G)

The Excess Earnings method determines whether the business can generate excess earnings after providing for an economic return on the tangible investment necessary for the operation of the business. If there are excess earnings, this amount is capitalized at an appropriate rate, which is slightly higher than the net income capitalization rate due to the increased risk inherent in a company's excess earnings.

The capitalization rate for excess earnings is different from the capitalization rate for net income. Excess earnings are a component of net income and are the riskier portion of net income. In a competitive environment, economic theory suggests that competition would increase as long as excess earnings are available. In other words, competition tends to reduce excess earnings over time. The capitalization rate for excess earnings is calculated as the net income capitalization rate plus additional percentage points for increased risk. We assess the increased risk at 5 percentage points; therefore, the excess earnings capitalization rate is 30.9 percent (25.9 + 5.0 percent)

The excess earnings method starts with a normalized net income for the business. This figure was determined previously (in the capitalization of net income approach) as approximately $2.4 million. From this income, estimated returns on the Company's net tangible assets are deducted based on interest rates around the date of value. What remains is the excess earnings capacity of the business. Capitalizing the normalized excess earnings results in a goodwill value of approximately $7.4 million. Adding the net tangible assets to the goodwill value results in an equity value of approximately $8.3 million.

Conclusion—Discounting (Exhibit A)

We calculated the value of Mr. Allen's 25 percent interest in Power. As Mr. Allen's interest is less than a 100 percent interest, discounts for lack of control and lack of marketability were considered.

A discount for minority interest is a discount for lack of control. Although Mr. Allen owns a 25 percent interest in Power, he is the managing physician and makes all major decisions (clinical and nonclinical). However, he owns only 25 percent of Power stock and, therefore, some minority discount is applicable. Accordingly, we applied a 5 percent discount for lack of control.

A discount for marketability is also appropriate. As there are no readily available markets to exchange ownership interests, we applied a 5 percent lack of marketability discount.

Conclusion (Exhibit A)

As a result of the above-described methodologies, we have concluded that the value of the community's 25 percent ownership interest in Power to be $1,960,000 (rounded):

ONE MILLION NINE HUNDRED SIXTY THOUSAND DOLLARS

$1,960,000

Our engagement and compensation for this report and conclusions are not contingent on the value reported or the outcome of the court proceedings. We hereby swear under penalty of perjury that we have no interest, either present or contemplated, in the Company or the individual on which this report is based. This report and the attached exhibits are solely for use in the Allen dissolution of marriage proceedings presently before the Superior Court of the State of Nita, County of Darrow.

Respectfully submitted,

ROSS AND ERNST, PA

Power Diagnostics, PA
Summary and Conclusion of Value
As of December 31, Year 1

			Equity Value	Weight Applied		Weighted Value
1	Method 1: Capitalization of Net Income (Exhibit F)	$	9,070,448	50%	$	4,535,224
2	Method 2: Capitalization of Excess Earnings (Exhibit G)		8,268,659	50%		4,134,329
3	Weighted Average				$	8,669,553
4	Indicated Fair Market Value of a 100.0% interest in Power Diagnostics, PA as of December 31, Year 1, Rounded			100%	$	8,670,000
5	Dr. David Allen's 25% pro-rata interest			25%	$	2,167,500
6	Less: Discount for Lack of Control (at 5%)			5%		(108,375)
7	Value before consideration of Lack of Marketability Discount					2,059,125
8	Less: Discount for Lack of Marketability (at 5%)			5%		(102,956)
9	**Fair Market Value of 25% interest in Power, Rounded**				$	**1,960,000**

Power Diagnostics, PA
Profit and Loss Comparison
For the Years Ended December 31, Year 5 through December 31, Year 1

		Year 5	Year 4	Year 3	Year 2	Year 1
1	Income:					
2	Revenue	$ 9,358,834	$ 9,182,451	$ 8,269,243	$ 6,050,254	$ 5,864,285
3	Expenses:					
4	Officer salary and benefits	2,407,280	2,306,290	1,961,339	1,705,696	1,789,935
5	Depreciation	57,800	80,200	61,080	82,656	51,280
6	Mortgage interest	125,239	123,980	117,113	112,538	107,583
7	Charitable contributions	188,840	184,000	119,464	21,811	8,000
8	Business contributions	144,952	149,440	139,600	132,800	122,000
9	Other expenses	2,224,899	2,211,071	2,627,035	2,403,990	2,201,040
10	Total expenses	5,149,010	5,054,981	5,025,631	4,459,491	4,279,837
11	Taxable net income/loss	4,209,824	4,127,469	3,243,612	1,590,763	1,584,448
12	State taxes	95,330	95,180	79,960	74,080	56,000
13	Net income after taxes	$ 4,114,494	$ 4,032,289	$ 3,163,652	$ 1,516,683	$ 1,528,448

Source: Financial statements

Power Diagnostics, PA
Balance Sheet Comparison
As of December 31, Year 5 through December 31, Year 1

		Year 5	Year 4	Year 3	Year 2	Year 1
1	Assets:					
2	Cash	$ 93,967	$ 289,052	$ 621,437	$ 113,137	$ 11,476
3	Accounts receivable	-	-	-	-	-
4	Total other assets	93,967	289,052	621,437	113,137	11,476
5	Furniture and equipment	170,141	152,696	152,696	130,811	130,810
6	Less accum. depreciation	(154,250)	(65,850)	(75,650)	(48,009)	(48,008)
7	Net fixed assets	15,891	86,846	77,046	82,802	82,802
8	Office building	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
9	Less accum. Depreciation	(100,500)	(151,780)	(203,060)	(254,340)	(305,620)
10	Net building	1,899,500	1,848,220	1,796,940	1,745,660	1,694,380
11	Other assets	-	13,600	13,600	-	-
12	Total other assets	-	13,600	13,600	-	-
13	Total assets	$ 2,009,358	$ 2,237,718	$ 2,509,023	$ 1,941,599	$ 1,788,658
14	Liabilities:					
15	Accounts payable	$ 166,964	$ 179,682	$ 189,134	$ 145,252	$ 136,516
16	Credit line	566,072	540,636	521,666	559,496	785,802
17	Total current liabilities	733,036	720,318	710,800	704,748	922,318
18	Mortgage	1,166,464	1,127,902	1,086,140	1,040,912	993,796
19	Shareholder loans	107,858	387,498	609,387	193,938	195,924
20	Total long-term liabilities	1,274,322	1,515,400	1,695,527	1,234,850	1,189,720
21	Capital:	-	-	-	-	-
22	Shareholder's capital	2,000	2,000	102,697	2,000	(323,380)
23	Total liabilities & capital	$ 2,009,358	$ 2,237,718	$ 2,509,024	$ 1,941,598	$ 1,788,658

Source: Financial statements

Power Diagnostics, PA
Adjusted Profit and Loss Comparison
For the Years Ended December 31, Year 5 through December 31, Year 1

		Year 5	Year 4	Year 3	Year 2	Year 1	5-Year Simple Average
1	Revenue	$ 9,358,834	$ 9,182,451	$ 8,269,243	$ 6,050,254	$ 5,864,285	7,745,013
2	Pretax income (unadjusted)	4,209,824	4,127,469	3,243,612	1,590,763	1,584,448	2,951,223
3	Adjustments:						
4	Plus: Owners' compensation (a)	2,400,000	2,300,000	1,950,000	1,700,000	1,700,000	2,010,000
5	Less: Reasonable owners' comp. (a)	(1,860,000)	(1,860,000)	(1,860,000)	(1,860,000)	(1,860,000)	(1,860,000)
6	Plus: Excess salary (Norma Starks) (b)	20,000	20,000	20,000	20,000	20,000	20,000
7	Plus: Charitable contributions (c)	188,840	184,000	119,464	21,811	8,000	104,423
8	Plus: Life insurance expense (d)	40,000	40,000	40,000	40,000	40,000	40,000
9	Plus: Other perquisites (e)	543,926	549,563	780,505	678,223	433,064	597,056
10	Less: non-recurring ownership sale	(66,667)	(66,667)	(66,667)	(66,667)	-	(53,334)
11	Less: non-recurring sale of equip	-	(15,000)	-	(25,000)	-	(8,000)
12	Total adjustments	1,266,099	1,151,896	983,302	508,367	341,064	850,146
13	Adjusted pre-tax net income	5,475,923	5,279,365	4,226,915	2,099,131	1,925,512	3,801,369
14	Estimated income taxes (40.0%)	2,190,369	2,111,746	1,690,766	839,652	770,205	1,520,548
15	Adjusted net income	$ 3,285,554	$ 3,167,619	$ 2,536,149	$ 1,259,478	$ 1,155,307	$ 2,280,821
16	Weights applied	1	1	1	1	1	

(a) Actual salaries are eliminated and reasonable salaries are utilized. Reasonable owner's compensation for Dr. Allen's duties as a diagnostic (non-invasive) radiologist are based on Year 1 Medical Group Management Association 75th percentile.

(b) Norma Starks' salary of $70,000 per annum is eliminated and a reasonable replacement salary of $50,000 per annum is added.

(c) Charitable contributions are eliminated as a non-business expense.

(d) It appears that the life insurance is not a keyman policy. As such, the life insurance expense has been added back as it is an unrelated business expense.

(e) Perquisites calculated by Ross and Ernst, PA. See Exhibit J.

Power Diagnostics. PA
Adjusted Balance Sheet
As of December 31. Year 1

		Actual (a) Year 1	Adjustments	Adjusted Year 1	Notes
1	Assets:				
2	Cash	$ 11,476	$ -	$ 11,476	
3	Accounts receivable (net)	-	710,538	710,538	51.2% collectable based on a 2 year analysis
4	Total other assets	11,476	710,538	722,014	
5	Furniture	92,964	-	92,964	
6	Equipment	37,846	294,070	331,916	Based on appraisal as of December 31. Year 1
7	Less accum. depreciation	(48,008)	-	(48,008)	
8	Net fixed assets	82,802	294,070	376,872	
9	Office building	2,000,000	-	2,000,000	
10	Less accum. depreciation	(305,620)	305,620	-	
11	Net building	1,694,380	305,620	2,000,000	
12	Other assets	-	-	-	
13	Total other assets	-	-	-	
14	Total assets	$ 1,788,658	$ 1,310,228	$ 3,098,886	
15	Liabilities:				
16	Accounts payable	$ 136,516	$ -	$ 136,516	
17	Credit line	785,802	-	785,802	
18	Deferred taxes	-	284,215	284,215	40% of net accounts receivable
19	Total current liabilities	922,318	284,215	1,206,533	
20	Mortgage	993,796	-	993,796	
21	Shareholder loans	195,924	(195,924)	-	Shareholder loan is elminated
22	Total long-term liabilities	1,189,720	(195,924)	993,796	
23	Capital:				
24	Shareholder's capital	(323,380)	-	(323,380)	
25	APPRAISAL ADJUSTMENT	-	1,221,937	1,221,937	
26	Total capital	(323,380)	1,221,937	898,557	
27	Total liabilities & capital	$ 1,788,658	$ 1,310,228	$ 3,098,886	

Ross and Ernst. PA

Exhibit E

Power Diagnostics, PA
Method 1: Capitalized Net Income
As of December 31, Year 1

1	**Average adjusted net income after taxes (Exhibit D)**	**$ 2,280,821**
2	Long-term growth rate	3.0%
3	**Normalized net income after taxes (a)**	**$ 2,349,246**
4	Capitalization rate	25.90%
5	**Concluded fair market value**	**$ 9,070,448**

Assumptions (Exhibit H):	
Discount rate	28.90%
Long-term growth rate	3.00%
Capitalization rate	25.90%

(a) Normalized net income after taxes is based on the average adjusted net income as calculated on Exhibit D, grown by a 3% long term growth rate.

Power Diagnostics, PA
Method 2: Capitalization of Excess Earnings
As of December 31, Year 1

1	**Estimated normalized income (Exhibit F)**				**$ 2,349,246**
2	Less: return on tangible assets	$	898,557	8.00%	(71,885)
3	Excess earnings				2,277,361
4	Goodwill capitalization rate				30.9%
5	**Value of intangible assets (intellectual property, goodwill, etc.)**				**7,370,102**
6	Plus: net tangible assets				898,557
7	**Concluded fair market value**				**$ 8,268,659**

Assumptions (Exhibit H):	
Discount rate	28.90%
Long-term growth rate	3.00%
Cash flow capitalization rate	25.90%
Increased risk of excess earnings	5.00%
Goodwill capitalization rate	30.90%

Prime rate as of December 31, Year 1	3.25%

Power Diagnostics, PA
Discount Rate Analysis
As of December 31, Year 1

				Notes (Exhibit I)
1	Cost of Equity Capital - Buildup Method			(a)
2	Rf =	Risk-free rate, based on the 20-year Treasury bond as of December 31, Year 1		(b)
3		(source: Federal Reserve website, www.federalreserve.gov)	2.54%	
4	Ep =	Equity risk premium of large capitalization stocks over the 20-year Treasury bond		
5		(source: SBBI Year 1 Yearbook, Valuation Edition)	6.70%	(c)
6		General Equity Rate of Return = Rf + Ep =	9.24%	
7	EpSS =	Small stock risk premium in excess of the Large Stock benchmark		
8		(source: SBBI Year 1 Yearbook, Valuation Edition)	4.70%	(d)
9	SCR =	Specific company risk premium	15.00%	(e)
10	K_e	Cost of Equity Capital = Rf + Ep + EpSS + SCR =	28.94%	
11		**Cost of Equity Capital (Rounded)**	**28.90%**	
12	g =	Long-term growth rate, based on economic, industry, and specific company factors	3.00%	
13		**Capitalization Rate**	**25.90%**	
14		Prime rate as of December 31, Year 1	3.25%	
15		(source: Federal Reserve website, www.federalreserve.gov)		

Power Diagnostics, PA
Notes to Discount Rate Analysis
As of December 31, Year 1

Note: All references to "Ibbotson" refer to the Ibbotson Stocks Bonds Bills and Inflation Valuation Edition Year 1.

(a) According to Ibbotson, the build-up model is an additive model in which the return on an asset is estimated as the sum of a risk-free rate, and one or more risk premia. Ibbotson devotes an entire chapter to the build-up model alone, and one chapter to all other cost of equity models.

(b) The risk-free rate is based on the 20-year treasury bond yield as of December 31, Year 1 according to the Federal Reserve's H.15 report. The 20-year bond is used because Ibbotson calculates the long-term equity premiums based on the 20-year treasury yields (see Year 1 Valuation Edition). The 20-year bond also matches the long-term investment horizon and data is available on the 20-year bond back to 1926.

(c) The equity risk premium is equal to the long-horizon expected equity risk premium for large company stocks. This factor is calculated by Ibbotson as the average annual large stock total returns less the average annual treasury bond income return (yield). The time period covered is 1926-Year 2. "Large stocks" are currently defined by Ibbotson of the Year 1 Valuation Edition as the S&P 500 composite with dividends reinvested. The use of longer periods (e.g. 1926-Year 2) are encouraged by Ibbotson to avoid manipulation of the data (see Year 1 Valuation Edition). Longer periods also cover numerous economic cycles and match the typical long-term investment horizon.

(d) The small stock premium represents the extra risk required by investors to invest in a small company stock. Ibbotson currently defines "small company stock" by reference to the DFA Micro Cap Fund. According to the Year 1 fact sheet for this fund, the portfolio "purchases the securities of companies whose marketcapitalization falls within the smallest 4% of the total U.S. market universe." DFA reports that the median capitalization for the fund is $182 million. This is similar but slightly larger than the average capitalization for the Ibbotson 10th decile ($124 million which can be calculated with data from the Ibbotson Year 1 Valuation Edition, median unavailable).

(e) The specific company risk premium (SCR) reflects the risk of the subject investment over and above the risk already represented in the build-up model. In this case, the build-up model before the SCR represents the required return for a minority investment in a small company stock fund. The subject investment in the Marriage of Allen is a 25% ownership interest in the medical facility, that is:
<u>Size</u> = much smaller than the smallest size premium group
<u>Industry risk</u> = per Ibbotson, a 4.9% discount (not a premium) applies for doctors offices
<u>Volatility of returns</u> = Power's adjusted pretax earnings varied from $2.2 million to $6.4 million between Year 5 and Year 1.
<u>Profitability</u> = Consistently profitable. Healthy margins. Very low risk of losses.
<u>Leverage</u> = Moderate

Power Diagnostics, PA
Perquisite Expenses
For the Years Ended December 31, Year 4 through December 31, Year 1

		Year 5	Year 4	Year 3	Year 2	Year 1
1	Auto (50%)	$ 112,049	$ 107,558	$ 131,686	$ 113,309	$ 128,945
2	Country club dues ^	50,000	50,000	50,000	50,000	50,000
3	Travel *	306,549	275,828	343,333	355,863	138,892
4	Promotion	75,328	116,177	255,486	159,050	115,226
5	Total perquisites	$ 543,926	$ 549,563	$ 780,505	$ 678,223	$ 433,064

^ Included in dues & subscriptions.
* Included in medical meetings.

Power Diagnostics, PA

Reasonable Salary Indications

	MGMA Year 1 - Radiology	Median	(Note a) 75th Percentile	(Note b) 90th Percentile
1	All physicians	$ 375,000	$ 490,000	$ 590,000
2	State of Nita Only	407,000	445,000	555,000
3	10 or less physicians	370,000	455,000	565,000
4	8-17 years experience	390,000	475,000	615,000
5	**MEDIAN**	**$ 382,500**	**$ 465,000**	**$ 577,500**

Notes:

(a) The 75th percentile is the value where three quarters (75 percent) of the responses are lower and the remainder greater.

(b) The 90th percentile is the value where nine tenths (90 percent) of the responses are lower and the remainder greater.

Power Diagnostics, PA
Profit and Loss Spreads per Financial Statements
For the Years Ended December 31, Year 5 through December 31, Year 1

		Year 5	Year 4	Year 3	Year 2	Year 1
1	Ordinary Income/Expense:					
2	Income:					
3	Revenue	$ 9,358,834	$ 9,182,451	$ 8,269,243	$ 6,050,254	$ 5,864,285
4	Expense:					
5	Advertising	3,360	3,184	2,771	-	-
6	Auto expenses	-	-	-	-	-
7	Rental	7,064	15,660	6,744	3,064	1,996
8	Gasoline	20,312	20,190	20,902	15,789	15,336
9	Insurance	16,551	16,288	16,336	16,245	16,501
10	Lease	144,000	144,000	144,000	144,000	144,000
11	Registration	6,384	6,112	6,168	4,128	3,752
12	Repairs	26,427	9,682	66,452	43,392	76,306
13	Total auto expenses	224,097	215,116	263,373	226,618	257,890
14	Bank charges	200	368	3,184	856	288
15	Books & journals	3,136	4,179	14,181	8,926	3,008
16	Business contributions	144,952	149,440	139,600	132,800	122,000
17	Computer maintenance	11,384	9,510	-	-	8,967
18	Depreciation	57,800	80,200	61,080	82,656	51,280
19	Dues & subscriptions	65,347	72,304	78,592	63,876	83,392
20	Education/Training	46,512	44,752	2,760	2,544	1,432
21	Officer salary and benefits					
22	Officer salary	2,400,000	2,300,000	1,950,000	1,700,000	1,700,000
23	Officer medical	7,280	6,290	11,339	5,696	13,595
24	Officer health insurance	-	-	-	-	76,339
25	Insurance	419,352	422,369	361,402	374,284	308,734
26	Medical supplies	117,873	109,278	107,561	109,508	157,484
27	Legal & accounting	44,200	27,746	41,470	15,026	70,134
28	Meals & entertainment	77,019	72,812	191,366	139,186	33,454
29	Medical meeting	306,549	275,828	343,333	355,863	138,892

Power Diagnostics, PA
Profit and Loss Spreads per Financial Statements
For the Years Ended December 31, Year 5 through December 31, Year 1

		Year 5	Year 4	Year 3	Year 2	Year 1
30	Mortgage interest	125,239	123,980	117,113	112,538	107,583
31	Office supplies	31,687	49,299	48,214	41,845	6,327
32	Employee salary	708,462	706,066	807,991	819,090	847,371
33	Postage	2,787	3,864	5,285	3,471	1,379
34	Promotion	75,328	116,177	255,486	159,050	115,226
35	Records storage	-	11,624	31,696	30,968	32,960
36	Repairs & maintenance	-	2,040	-	1,312	4,493
37	Taxes, licenses & fees	21,559	3,000	8,200	9,602	10,835
38	Telephone/Answering service	44,742	55,074	55,900	42,298	27,439
39	Corporate tax (State)	95,330	95,180	79,960	74,080	56,000
40	Total expense	5,030,834	4,956,495	4,979,085	4,512,093	4,236,504
41	Net Ordinary Income	$ 4,328,000	$ 4,225,955	$ 3,290,158	$ 1,538,161	$ 1,627,781
42	Interest income	$ -	$ -	$ 17,624	$ -	$ -
43	Ownership interest sale	66,667	66,667	66,667	66,667	-
44	Sale of equipment	-	15,000	-	25,000	-
45	Other expenses					
46	Disability insurance	51,333	51,333	51,333	51,333	51,333
47	Life insurance	40,000	40,000	40,000	40,000	40,000
48	Charitable contributions	188,840	184,000	119,464	21,811	8,000
49	Total other expense	280,173	275,333	210,797	113,144	99,333
50	Net other income / (expenses)	(213,506)	(193,666)	(126,506)	(21,477)	(99,333)
51	Net Income	$ 4,114,494	$ 4,032,289	$ 3,163,652	$ 1,516,683	$ 1,528,448
52	Corporate tax (State)	95,330	95,180	79,960	74,080	56,000
53	Net pretax income	$ 4,209,824	$ 4,127,469	$ 3,243,612	$ 1,590,763	$ 1,584,448

Ross and Ernst, PA

Exhibit L

Power Diagnostics, PA
Sources of Information
As of December 31, Year 1

We reviewed the following documents as part of our assignment:

1. Federal and state Sub S (1120S) income tax returns for the years ended December 31, Year 6 through December 31, Year 1
2. Externally-prepared financial statements for the years ended December 31, Year 5 through December 31, Year 1
3. Internally-prepared financial data (general ledgers, trial balances, etc.) for the year ended December 31, Year 6
4. Interviews and depositions of Dr. Allen
5. Interview with the office manager
6. Shareholder agreement as of Year 5
7. Medical Group Management Association
8. Accounts receivable and accounts payable data provided by management
9. Curriculum Vitae of Dr. Allen as of December 31, Year 1
10. Discussions with Mr. Johnson (corporate attorney)
11. Financial data from the Wall Street Journal and Ibbotson Associates YR-1 Yearbook
12. Various restricted stock and IPO studies
13. Mergerstat Review
14. Hitchner, et al, Financial Valuation Applications and Models
15. Ibbotson Stocks Bonds Bills and Inflation Valuation Edition Year 1

Allen v. Allen
Power Diagnostics, P.A.
Summary of Conclusions

	Johnson (H's expert)		Ernst (W's expert)	
Value - 100%	$ 4,403,106		$ 8,670,000	
Value - 25%	$ 660,000		$ 1,960,000	
Adjusted net income (after-tax)	$ 1,533,579		$ 2,280,821	
Discounts:				
Lack of control	20%		5%	
Lack of marketability	20%		5%	
Capitalized net income method - weighted	$ 4,388,000	33%	$ 9,070,448	50%
Capitalized excess earnings method - weighted	$ 4,339,500	33%	$ 8,268,659	50%
Market approach - weighted	$ 4,481,819	33%	$ -	n/a
Income tax on sale @ 20%	$ 40,899		$ -	
Reasonable compensation	$ 2,310,000		$ 1,860,000	
Capitalized net income:				
Adjusted net income	Weighted		Straight line	
Capitalization rate - net income	36%		26%	
Capitalized excess earnings:				
Adjusted net income	Weighted		Straight line	
Capitalization rate - excess earnings	41%		31%	
ROI - net assets	8%		8%	
Balance sheet appraisal adjustment	$ 927,867		$ 1,221,937	
Discount rates:				
Market:				
Risk free rate	2.54%		2.54%	
Equity risk premium	6.70%		6.70%	
Small stock risk premium	4.70%		4.70%	
Total market risk	13.94%		13.94%	
Non-market:				
Company specific risk	15%		15%	
Professional service risk	10%		0%	
Discount rate	38.94%		28.94%	
Less: long-term growth rate	-3%		-3%	
Capitalization rate for earnings	35.94%		25.94%	
Add: additional risk for excess earnings	5%		5%	
Capitalization rate for excess earnings	40.94%		30.94%	
Offers:	Dr. Smith (3x)		Dr. Jones (6x)	
Pre-tax (rounded)	$ 1,190,000		$ 2,380,000	
After-tax (assumed 40% tax rate) (rounded)	$ 714,000		$ 1,428,000	

Allen v. Allen
Power Diagnostics, P.A.
Summary of Impact of Certain Changes to Each Appraisers Conclusions

Johnson report $660,000 - impact of certain changes		Result		Change
1. Eliminate taxes on assumed sale	$	700,000	$	40,000
2. Adjustment above and use cap rates per Ernst*	$	930,000	$	230,000
3. Adjustment above and use reasonable comp per Ernst*	$	1,090,000	$	160,000
4. Adjustment above and use straight line, not weighted*	$	1,330,000	$	240,000
5. Adjustment above and use discounts per Ernst*	$	1,880,000	$	550,000

Ernst report $1,960,000 - impact of certain changes				
1. Assume taxes on sale	$	1,670,000	$	(290,000)
2. Adjustment above and use cap rates per Johnson	$	1,268,000	$	(402,000)
3. Adjustment above and use reasonable comp per Johnson	$	1,140,000	$	(128,000)
4. Adjustment above and use weighted, not straight line	$	940,000	$	(200,000)
5. Adjustment above and use discounts per Johnson	$	700,000	$	(240,000)

* Assumes market approach was not used; therefore, equal weighting was given to the capitalized net income method and the capitalized excess earnings method.

SURE-FIRE TECHNIQUES IN CROSS EXAMINING THE FINANCIAL EXPERT

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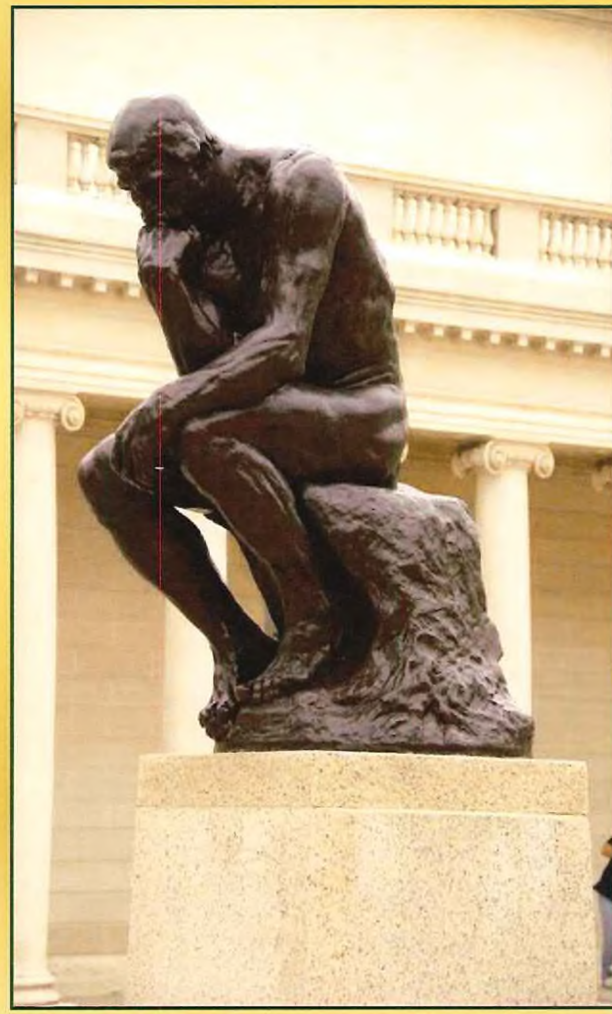
YOU HAVE DONE YOUR DISCOVERY
OK, SO WHAT NOW??



THE PURPOSE …

(KNOW WHAT YOU WANT TO DO BEFORE YOU START)

- Bolster/undermine expert credibility
  - Battle of credentials
- Show what the expert did & Why it’s right or wrong
- Bolster/Undermine weak/less conservative parts of the report
- Have your expert’s conclusion accepted by the court

ANALYSIS: THE METHOD

SUBJECT	PETITIONER'S EXPERT	RESPONDENT'S EXPERT
Party	David Allen	Lynne Allen
Expert	Jaime A. Johnson , CPA,	Chris Ernst, MBA, CPA
Valuation Date	December 31, 2014	December 31, 2014
Interest Valued	100% and 25% Capital Stock, Power Diagnostics	100% and 25% Capital Stock, Power Diagnostics
Conclusion for 100% Value	$4,403,106	$8,670,000
Conclusion for Interest Valued	$660,000	$1,960,000
Standard of Value	Fair Market Value	Fair Market Value

ANALYSIS: THE INFORMATION SOURCES ...

SUBJECT	PETITIONER	RESPONDENT
DOCUMENTS REVIEWED	1. Federal and state tax returns of Power Diagnostics, PA for the period Year 5 to Year 1 2. Financial statements of Power Diagnostics, PA for the period Year 5 to Year 1 3. Salary information from Medical Group Management Association (MGMA) 4. Risk Management Association (RMA) 5. Goodwill Registry 6. Account receivable and collection reports provided by management 7. Written offers from Dr. Jones and Dr. Smith 8. Shareholder agreement, employment agreements and other business records	1. Federal and status Sub S (1120S) income tax returns for the years ended December 31, Year 6 through December 31, Year 1 2. Externally-prepared financial statements for the years ended December 31, Year 5 through December 31, Year 1 3. Internally-prepared financial data (general ledgers, trial balances, etc.) for the year ended December 31, Year 6 4. Interviews and depositions of Dr. Allen 5. Interview with the office manager 6. Shareholder agreement as of Year 5 7. Medical Group Management Association 8. Accounts receivable and accounts payable data provided by management

ANALYSIS: THE INFORMATION SOURCES (cont.)...

SUBJECT	PETITIONER	RESPONDENT
DOCUMENTS REVIEWED	9. Various discussions with David Allen, MD 10. Complete tour of the medical facility 11. General ledgers for the period Year 5 to Year 1 12. Ibbotson Stocks Bonds Bills and Inflation Valuation Edition Year 1 13. Federal Reserve Statistical Release, the Federal Reserve 14. Year 1 Tax Rate Schedule, Internal Revenue Service (IRS) 15. Various restricted stock and IPO studies 16. Mergerstat Review 17. Hitchner, et. al, Financial Valuation Applications and Models	9. Curriculum Vitae of Dr. Allen as of December 31, Year 1 10. Discussions with Mr. Johnson (corporate attorney) 11. Financial data from the Wall Street Journal and Ibbotson Associates YR-1 Year book 12. Various restricted stock and IPO studies 13. Mergerstat Review 14. Hitchner, et al. Financial Valuation Applications and Models 15. Ibbotson Stocks Bonds Bills and Inflation Valuation Edition Year 1

More Information Sources

SUBJECT	PETITIONER	RESPONDENT
Interviews	David Allen, M.D.	David Allen, M.D. interview and deposition. Office Manager Interview Corporate Attorney Discussion
Site Visit	Tour of Medical Facility	None Mentioned

ANALYSIS: THE EXPERTS' FINANCIAL ANALYSIS

SUBJECT	PETITIONER	RESPONDENT
# Years of Data Used	5	5
Adjustments to Income	Automobile Expenses Life Insurance Charitable Contributions Non-recurring Equipment Sales Includes Estimated Taxes on Sale Salaries	Owner's Compensation Charitable Contributions Norma Starks' Salary Life Insurance Perquisites Non-recurring Equipment Sales
Adjustments to Balance Sheet	Accounts Receivable Allowance for Uncollectible Deferred Taxes Shareholder Loans (Eliminate)	Accounts Receivable Uncollectible Allowance Equipment Adj. Value Upward Eliminate Building Depreciation Deferred Taxes Eliminate Shareholder Loan

MARKET APPROACHES

SUBJECT	PETITIONER	RESPONDENT
Application	Yes	No
Conclusion	$4,481,819	Not Used
Method		
Guideline Public Companies		
Companies Used		
Which Multipliers		
Guideline Transactions		
Guideline Transaction Companies		
Guideline Transaction Multipliers		

ASSET BASED APPROACHES NOT USED

SUBJECT	PETITIONER	RESPONDENT
Date		
Method		
Outside Appraisals		
Adjustments		
Conclusion		

INCOME BASED APPROACH: Capitalization of Excess Earnings

SUBJECT	PETITIONER	RESPONDENT
Base Economic Earnings	$1,533,579 Weighted	$2,280,821 Straight Line
Capitalization Rate	8% for Tangible Assets 41% for Excess Earnings	8% for Tangible Assets 31% for Excess Earnings
Value	100% $4,339,500 Total	100% $8,268,659 Total

INCOME BASED APPROACH: Capitalized Net Earnings

SUBJECT	PETITIONER	RESPONDENT
After Tax Income	$1,533,579 (1 Year) Weighted	$2,280,821 (1 Year) Straight Line
Capitalization Rate	36%	26%%
Control Premium	20%	25%
Value 100%	$4,388,000	$9,070,488

INCOME BASED APPROACH: DISCOUNTED FUTURE EARNINGS NOT USED

SUBJECT	PETITIONER	RESPONDENT
Earnings Period		
Growth Rate		
Base Year Earnings		
Discount Rate(s)		
Value Before Discounts/Premiums		
Control Premium		
Value		

WEIGHTING & DISCOUNTS

SUBJECT	PETITIONER	RESPONDENT
Weight of Approaches	33.33% Capitalization of Excess Earnings 33.3% Capitalization of Net Income 33.3% Market Approach	50% Capitalized Net Income 50% Capitalized Excess Earnings
Discount Lack of Control/ Premium for Control	20% Discount	5% Discount
Marketability	20% Discount	5% Discount

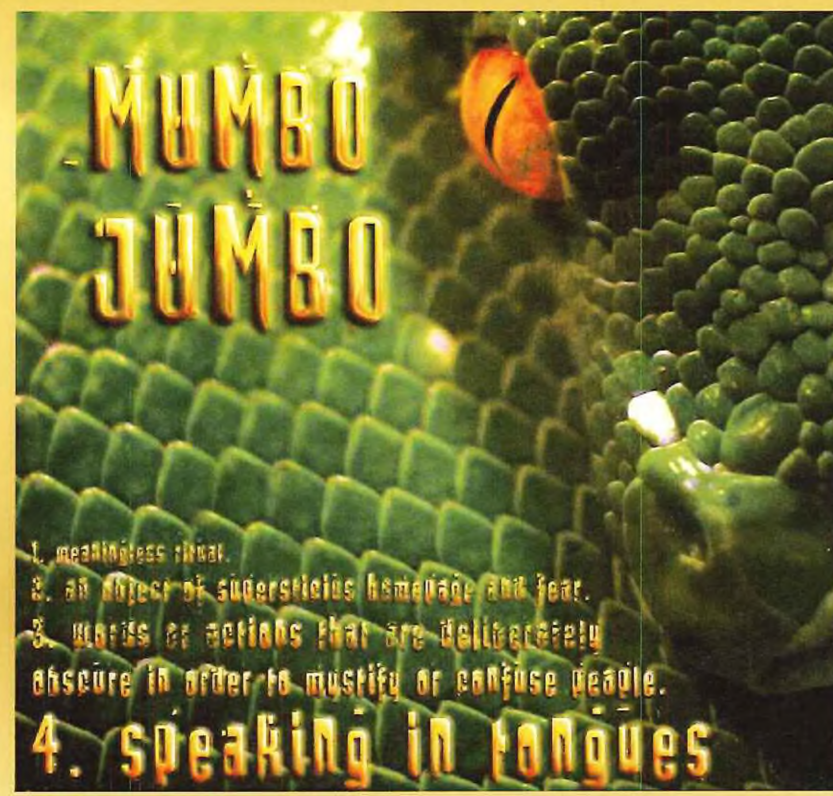
WHY DID WE DO ALL THAT??

- Highlight differences in selected methods
- Highlight the differences in adjustments to financial data
- Highlight the differences in assumptions
- Figure out which differences have most impact on value
- These areas we bolster on direct & undermine on cross

THE EXAMINATION

(Prior Planning Prevents Poor Performance)

- Remember, there are not bad witnesses, only bad questions
- Experts have a language of their own, and they speak it better than the lawyers!



THIS IS NOT ABOUT DIRECT BUT KNOWING THE DIFFERENCES HELPS: DIRECT EXAM FEATURES

- Accredit as Qualified Expert
- Get the opinion/report into evidence
- Showcase the expert with:
  - explaining the basis and conclusions
  - value judgments they made to get there.
- Use open questions to explain terms of art/acronyms

CROSS

- Follow the Rules of Cross Examination
- Use the right terms of art
- Highlight the commonalities this expert and your expert's work
- Challenge bias or impartiality if appropriate
- Substitute information
  - Change assumptions and/or varying facts
  - Move the conclusion closer your expert's

POINTS COMMON TO DIRECT & CROSS

- Use chapters or headnotes for each topic
- Watch the Judge/Jury for Comprehension
- Direct the Judge/Jury to pertinent report pages
- Demeanor: appropriate to direct/cross

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A. TEN COMMANDMENTS FOR TRIAL CROSS EXAMINATION.

1. **Clearly Define the Purpose.** Sequence cross examination to teach the theory of the case in the best way and to literally expand the rules of admissibility.

    a. Cross examination is another chance to tell your client's story by gaining admissions, demonstrating why the witness should not be believed or by discounting the damage of direct examination.

    b. You can repair, discount or mitigate the damage done on direct.

    c. You can score good points, enhance your case and detract from their case.

    d. You can discredit testimony on direct by pointing out inconsistencies or by showing bias or an interest in the outcome of the case.

    e. You can reflect on the credibility of another witness.

    f. You can accentuate your arguments and make it the foundation for your closing statement and final argument.

    g. You need to think about how this witness advances your theory of the case?

        i. Is the witness mistaken?
        ii. Is the witness lying?
        iii. Is he biased?
        iv. Is he unreliable?

v. Will he admit the facts that support your argument?
vi. A combination of all of the above?

2. **Consider whether to cross examine at all.** The ultimate in courage and discipline: "Your Honor, I have no questions of this witness." This may be the best cross examination you have because you are not dignifying the testimony by asking any questions. This should only be done on rare occasions.

3. **Don't confuse cross examination with a deposition.** See 6.a.i. below.

4. **Keep it short.** You don't want the trier of fact to conclude the witness's testimony to be of particular significance. Short cross examination makes it more memorable, minimizes the risks and adds flair. Do not permit the witness to repeat his direct examination. Your cross should be surgical and precise.

   a. Do not keep asking questions until you run out and you just sit down. Make sure your last question is a good one and the witness is forced to say nothing more than yes or no. If the custody expert has testified that primary custody should be with the mother and you represent the father, what thought should remain in the judge's mind when the witness leaves the stand? If the theory is that this expert should not have made a recommendation at all, but under the guidelines should only have gathered the psychological facts to offer to the judge for her discretion, here is a sample cross. **Example**:

   Q: You agree, Doctor, that under the APA guidelines, your job was to assess the best psychological interests of the children?
   A: Yes, that's what the guidelines recommend.
   Q: There are other factors for the court to consider in placing these children?
   A: Of course.
   Q: You have no training in predicting the future?
   A: Of course not.
   Attorney: Thank you, Dr. Expert, you're excused.

b. The last thing in the judge's mind is the acknowledgment that the expert witness cannot predict the future but is attempting to tell the court the best future placement for the children. Closing argument will highlight the fact that these experts can no more determine the appropriate placement for the children than can a fortune teller, as you ask the court to discount the doctor's recommendation.

c. Once you have accomplished your goal with the witness, get the adverse witness off the stand as quickly as possible; their job is not to help you. Their job is to support your opponent's case, not yours. If you have properly prepared for the cross-examination, you know the areas to cover with each witness and the appropriate questions to ask. Ask them and then quit. No one witness makes an entire case. If you can highlight some good points and maybe point out weaknesses, exaggerations, or falsehoods in the testimony of an adverse witness, thank him and excuse him.

d. After the weak points of the direct examination and counsel's strong points have been made, excuse the witness. Nothing is gained by the length of the cross-examination. Too many questions of the adverse witness may prove to be detrimental to your case.

5. **Always know the answer to your question or don't ask it at all.** The only exception is when either answer (yes or no) is helpful to your case.

6. **Avoid open ended questions.**

   a. Never (99.999% of the time) ask questions which start with "who, what, when, where, why, how, describe or please explain."

      i. Open ended questions should be used at ***deposition***. Encourage the narrative in the deposition:

         1. Hear the story so that you understand their version and positions. Let them sing—be a sponge not a hose.

2. This is the <u>foundation</u> for cross examination in the courtroom.

3. This is where you harvest the raw material so that you can lead the witness in the courtroom.

b. Delete the word "remember" from your vocabulary in cross examination questions. Only use the word, "remember," if you want the witness to say, "I don't remember" or you are about to have him recall a prior inconsistent statement. You can then proceed directly to impeachment if a witness says, "I don't remember" when you have his prior inconsistent statement or a document shows that he did recall at a different time. Another example is the question "Do you remember that I took your deposition on June 10^{th} of this year. You recall that you testified that you never spoke to John?"

c. The question must be leading.

   i. The answer is the question.

   ii. You make a statement with a question mark at the end of it.

   iii. You are the focus and not the witness.

   iv. The witness is there to agree with everything you say (ask).

d. Questions should be short and not compounded or convoluted.

   i. Generally, do not waste words. Try to avoid using crutches at the beginning or end of your question. Example: **"Isn't it true** you drank Long Island Iced Tea?" or "You drank a Long Island Iced Tea, **isn't that right?**"

   ii. Avoid framing questions with negative endings, such as "did you not?" or "have you not", or "are you not". They are confusing, they compromise clarity, and are fraught with danger. If the witness answers "No" does it mean the affirmative or the negative. Confusion abounds. If you need to use a tagline at the end of a question, use “correct”, “true” or “right”.

iii. The exception is to underscore a particular point—**The fact is,** you drank a Long Island Iced Tea?”—as you reach for the transcript of witness’s deposition.

e. There should be a single fact per question.

i. Yes or no is the only permitted answer.

ii. The question you pose has an iron clad response and it is a good one for you. Yes or no is the only permitted answer.

iii. Keep it simple. Convoluted questions often leads the trier of fact to conclude you are trying to confuse the witness.

iv. Write the source of each and every (fact) question because you never know when you’ll need to impeach the witness (depos page and lines; exhibit; letter or email; etc.).

v. **Example** of cross exam of an **eye witness** to an act of domestic violence when you are attempting to prove the eye witness’s recollection was affected by her intoxication when she saw the violent act:

“The shooting happened at midnight?”
“You had just walked out of the Poco Loco when the shots were fired?”
“The Poco Loco is a bar?”
“You were at that bar for 2 hours?”
“You drank alcohol during those 2 hours?”
“You drank a drink called a Long Island Iced Tea?”
“A Long Island contains vodka?”
“It also contains rum?”
“Also tequila?

"Also, gin?"
"Also, triple sec liqueur?"
"There are five different types of alcohol in one Long Island?"
"You drank four Long Islands?"
"You drank four Long Islands each of which contained five different types of alcohol?"

vi. **Example** of cross exam of opposing party's **forensic accountant** who valued your client's company (The ABC Company):

Q: "ABC Company is not a public company?"
Q: "Your report compares it to 5 companies?"
Q: "All of the 5 companies that you have compared it to are public companies?"
Q: "Those public companies that you compared the ABC Company to are much larger?"
Q: "Those public companies are more diversified than the ABC Company?"
Etc., etc., etc.

7. **Use the witness's own words to follow your theme and theory.** When possible, take the witness's own words from his/her report or deposition testimony to frame your questions.

8. **Use "loops" (the practice of incorporating and repeating key phrases and terms in successive questions to the witness) to rename witnesses, exhibits and favorable testimony.**

    a. Looping is the repetition of a favorable fact in successive questions.

    b. It reinforces the fact and even ties it to new facts. Looping makes questions longer, but ties the positive fact to a new fact.

    c. Looping is a technique on cross-examination in which the question builds on the answer previously given. It requires the examiner to listen to what is said and to use some of those words to create what is asked next and the direction in which the questions will travel. Looping picks up on the answers of the witness, building on his original answer, using his words to build the next question addressed. By listening to the answers and by moving very carefully with short questions, you are able to lead the witness.

d. **Example** of looping favorable testimony:

Double Loop – establish Fact 1, then Fact 2, then loop together in subsequent question or questions.

Q: “You were present when Susie signed the prenuptial agreement?”
Q: “She was crying at the time?”
Q: “She was hysterical at the time?”
Q: “Susie, while crying and hysterical (double loop), signed the prenuptial agreement?”
Q: “You personally witnessed Susie, while crying and hysterical, sign the prenuptial agreement?”

9. **Have a strong ending.** Make it a real zinger if possible. Don’t permit the ending of your cross to be an “objection sustained.” Write it at the end of your pad **in bold face**. No matter how badly the cross went, you can end on this winner which:

   a. Must be admissible.

   b. Must be central to your case.

   c. Should be a memorable phrase that captures your theme.

   d. Must be undeniable.

10. **Control, control, control.** You lose control if you ask open ended questions or you use the word, “remember.” Ask questions with only yes or no answers. You have the right to insist on a responsive answer. Establish the ground rules from the start. You are in charge—be nice, but firm. If all else fails, enlist the Judge. **Examples**:

a. "Apparently you didn't understand my question, let me repeat it."

b. "Repeat the original question." The witness will get the message.

c. "Please answer my question either yes or no."

d. "Your Honor, I move to strike the answer as non-responsive."

e. "Your Honor, would you please instruct the witness to answer my question, yes or no?"

B. <u>Contrasting Styles</u>.

1. There are different styles of cross examination—**Constructive or Destructive.**

   a. **Constructive** is when you are getting the witness to admit facts favorable to your client's position. (see 6.e.v. above)

   b. **Destructive** is when you are getting the witness to admit facts that didn't occur or to destroy the credibility of the witness and limit the effect of the witness's direct testimony. **Example** of a destructive cross examination of a psychologist:

   Q: "Dr. Graham, your Curriculum Vitae is accurate?"
   Q: "You are not a physician?"
   Q: "You're not an M.D.?"
   Q: "You're not a Psychiatrist?"
   Q: "You state in your CV that you are a member of the American Academy of Child and Adolescent Psychology?"
   Q: "You realize that the American Academy of Child and Adolescent Psychology only allows memberships to Physicians?"

C. Cross Examination: Science or Art?

a. There are tried and true methods of preparing and executing an effective cross examination. Some attorneys call this the science of cross.

b. On the other hand, every lawyer has a different personality and a different style. The result is that the cross examination by different lawyers results in different approaches and is called the art of cross examination.

c. Cross examination therefore is a **scientific art**. Pozner and Dodd write that "trial lawyers free the talent within by applying the scientific approach to cross examination preparation and delivery".

D. General Recommendations.

a. Maintain eye contact.

b. Do not appear overbearing or bullying.

c. Do not be rude or sarcastic.

d. Develop a rhythm or cadence.

e. Use bullet points or notes. Annotate them for purposes of impeachment.

f. Notes are important to make sure you cover all the points you wish to make and so you have the answer previously given if impeachment is required. Your notes are your roadmap.

g. You must balance the use of notes and precision with maintaining eye contact and control and not coming across as too scripted.

h. **Preparation** is the key to a good cross examination. The best cross examinations are created in your office.

E. References and suggested ways to enhance your trial skills and become more effective in your cross-examination of financial expert witnesses:

- Pozner & Dodd's Cross-Examination: Science & Techniques, Second Edition. Book and audio CD.

- ABA Family Trial Law Trial Advocacy Institute in Boulder, CO in July of each year for seven days (limited to 48 participants for beginner and intermediate levels). Faculty consists of top AAML trial lawyers and experts.

- Houston Family Trial Law Trial Advocacy Institute in Houston, TX in May of each year for seven days (limited to __ participants for beginner and intermediate levels). Faculty consists of top AAML trial lawyers and experts.

- ABA Family Law Section. Cross-Examination: A Primer for the Family Lawyer (October 15-18, 2014).

  Moderator:
  Kendra Randall-Jolivet, Esq., Baltimore, MD

  Speakers:
  Donn C. Fullenweider, Esq., Houston, TX (past president of AAML)
  Stephen Gassman, Esq., Garden City, NY

- AAML/AICPA National Conference on Divorce in April or May of each even numbered year in Las Vegas, NV.

THE DON'TS OF CROSS-EXAMINATION

by

Peter Economidis

Waterfall, Economidis, Caldwell, Hanshaw & Villamana, P.C.

In your first year of law school you learn how to study the law with some procedural law courses thrown in. In the second year you begin to study substantive law. In your third year of law school, you continue the study of substantive law subjects and try to prepare for the bar. By the third year, you have either figured out how to study the law or you're not in your third year. But, nowhere in the three years of law school do you learn how to **practice law.** I am convinced that law schools assume that their students learn how to practice law by some divine inspiration and thus, it is unnecessary to instruct on the practice of law.

Not all graduating lawyers become trial lawyers but for a portion of each graduating law class, trials become an integral part of their practice. It is often said that a lawyer's reputation as a good trial lawyer puts him well ahead in negotiating settlements of lawsuits. Trial lawyers who have developed the reputation as good trial lawyers are generally those lawyers who have mastered the art of cross-examination. The question, of course, is how did these trial lawyers develop their skills as cross-examiners? Certainly not in law school.

In law school, other than mock-court competition or other minor trial experiences, nowhere are we taught how to try a case or how to cross-examine witnesses. To begin with, teaching cross-examination is almost an impossible task. You can teach principals and techniques of cross-examination but skill as a cross-examiner is developed in the courtroom. Most trial lawyers learn their craft primarily through experience in actually trying cases. At the outset of the trial lawyer's career, the results may be something less than successful but each trial becomes a learning experience.

As with trial practice, there are hundreds of books on the subject of cross-examination.[1] They provide many great ideas about how to cross-examine a witness and the various techniques used by the experts from these books and essays but that information, as valuable as it is, means very little until you put the techniques you have read about into practice and they become natural to you. Each writer has his or her own ideas and most tell you about those **things that you should do.** My intent is to discuss those **things you should not do.**

There are lots of do's and don't's in the art of cross-examination and most of it is common sense. But it sometimes helps to remind ourselves of what makes a good cross--

[1]One of the best known books on cross-examination is Irving Younger's book, "*The Art of Cross-Examination.*"

examiner, and in that vein, what good cross-examiners **don't do**. The theme herein is generally similar to what most writers discuss in their books on cross-examination but here are some personal thoughts on the **don'ts** of cross-examination.

1. **<u>DON'T CROSS WITHOUT BEING PREPARED</u>.** Not long after being admitted to the Bar, I began attending all of the many seminars offered to teach young lawyers how to practice law. It seems that in each seminar I attended, I heard the words, "PREPARATION, PREPARATION, PREPARATION" over and over and over again to the point I got tired of hearing about being prepared. I learned that to never doubt the fact that preparation truly is the key to success especially in cross-examination. In cross-examining the opposing party and his witnesses, you are given the opportunity of destroying the opposing party's case. That's strong language but it is possible. You can't damage their case without being fully prepared to do so. If you cross-examine a witness without being prepared, you are wasting your time. Furthermore, you may make a bad mistake that hurts your case.

Quite simply, being fully prepared to cross-examine a witness is essential to the success of the exam. You cannot be successful in cross-examining a witness without knowing everything about your case. In order to know what to accomplish in your cross-examination, you must know all of the facts. To repeat, you cannot successfully cross-examine anyone if you don't know everything about your case and have carefully planned your cross. At a minimum, this means:

A. Reading and summarizing all of the depositions, especially the deposition of the witness you intend to cross-examine.
B. Reading and summarizing all of the discovery materials.
C. Carefully analyzing your theory of the case and the law that supports your theory.
D. Carefully analyzing the opposing party's position and the cases and law cited by the opposing party to determine their weaknesses.
E. Prepare your closing argument in the case. Doing so helps refine and develop your theory of your case.
F. Determine your objective in cross-examining the witness.
G. Fashion your cross-examination to accomplish your objectives.
H. Carefully script your cross-examination.

2. **<u>DON'T CROSS IF THE WITNESS HASN'T HURT YOU.</u>** There is a natural and terrible urge to cross-examine every witness that testifies against you, an urge that often is difficult and sometimes impossible to overcome. Resist that urge. If the witness hasn't hurt you, don't cross-examine, it's as *simple* (sic) as that. Interesting enough, if you don't cross-examine, there is often a subtle message to the judge that the witness did not damage your case. A simple, "I have no questions of this witness your honor", makes this message reasonably clear. If the witness's testimony was damaging and you weren't prepared for that testimony, try to ameliorate the damage by asking a few, innocuous

questions.

Q. Mr. Jones, do I understand that you recently changed jobs?
A. Yes.
Q. You were previously working for Jim Click Ford, is that correct?
A. Yes.
Q. And you are now working for Thoroughbred Nissan, is that true?
A. Yes.
Q. Do you prefer selling Nissans rather than Fords?

Thank you, that's all I have of this witness.

In this fashion, you want the judge to think that the witness's testimony was not sufficiently damaging to fully cross-examine the witness. You may get an objection as to relevance of an innocuous question so try some questions closer to the facts in your case.

3. **DON'T CROSS WITHOUT HAVING AN OBJECTIVE.** In cross-examining a witness, make sure you know what you wish to accomplish with the witness. Is your objective in cross-examining the witness to discredit or impeach him, to minimize or modify his testimony, to counter the points made on direct examination that have hurt you or some other objective? The nature of your cross-examination will be quite different if your purpose is to discredit or impeach the witness versus countering the damaging points he has made. Furthermore, if the witness is likeable, the court may like the witness and you will need to be careful not to attack the witness in your cross-examination. However, if you have a strong cross-examination prepared, you may wish to push the witness to accomplish your objective. If a witness becomes angry, he may lose control and blurt out testimony he never intended to provide. It happens. Don't cross-examine without knowing what you wish to accomplish in your cross-examination, i.e., your objective.

4. **DON'T ASK A QUESTION IF YOU DON'T KNOW THE ANSWER.** The purpose of taking depositions is to discover what the opposing party and his witnesses intend to say. Thus, if you have a deposition or other discovery which reveals what the opposing party and his witnesses intend to say, you can prepare a cross-examination that can minimize the testimony, impeach the witness or modify the testimony to suit your case. Depositions give you the fuel; you light the fire. More important, knowing what a witness will testify to allows you to avoid asking questions at trial which gives the witness the opportunity to explain or expand upon his position. Having the deposition testimony permits you structure your cross to accomplish your objective. Don't ask a question if you don't know the answer; you are likely to be surprised and that surprise may hurt you.

5. **DON'T ASK THE ONE-TOO-MANY QUESTION.** As mentioned above, deciding not to cross examine is a difficult decision to make. Deciding when to end your cross-examination is equally difficult. End on whatever high note you are at and sit down. Asking the one-too-many questions can be deadly.

A prime example is what may have been an actual trial likely from the early 1900's.[2] The story goes as follows:

Plaintiff brought an action against the Defendant to recover for personal injuries sustained when the Defendant's car struck the Plaintiff's horse and carriage. The Plaintiff testified at length about his injuries and Defendant's counsel cross-examined as follows:

Q. "Mr. Jones. Isn't it true that at the time of this incident, my client came up to you and asked whether your were alright?
A. Yes sir.
Q. And isn't it also true that at the time my client asked you whether you were alright, you answered that you were perfectly fine?
A. Yes sir.

The one-too-many question.

Q. Well Mr. Jones. How do you explain the fact that at the time of this incident, when my client asked how you were, you responded that you were perfectly fine and today, before this jury, you claim to be seriously injured?
A. Well sir, at the time of the accident, your client got out of his car, came over to the ditch where my horse and I were thrown, he looked at my horse and walked back to his car. He came back with a shotgun and shot my horse. When he asked me how I was, I thought it was best to tell him that I was perfectly fine.

The attorney made three mistakes. One, he never should have asked the last question. He made his point without this question and should have stopped. He could have gone on to other matters so that when Plaintiff's counsel finally addressed the issue, the sting of his Admission that he was alright could not be fully minimized. Two, in cross-examination you should never ask a question that permits the witness the opportunity to explain. Three, if he had properly prepared his cross, he would have known the answer to the question and never asked it.

6. **DON'T ASK A QUESTION THAT GIVES THE WITNESS THE OPPORTUNITY TO EXPLAIN.** Cross-examination should be prepared such that only questions which require a "yes" of "no" answer should be asked of the witness. Do not permit the witness to explain his answers. Doing so allows the witness to repeat his testimony given on direct examination. Keep control of the witness throughout the cross-examination by only asking questions that call for a "yes" or "no" answer. If the witness attempts to answer with anything other than "yes" or "no", immediately stop him and ask the court to instruct the witness to answer the question noting that it only called for a "yes"

[2] I read this story many years ago and have never forgotten it. I tried to find the source without success. However, I take no credit for the story.

or "no" answer.

Two things happen if you allow an explanation; one, you have lost control over the witness and two, you will permit the witness to repeat his testimony given on direct. If his testimony hurt you on direct, his repetition of the testimony results in a double hurt. This is especially true in cross-examining expert witnesses. You should never ask an expert a question that does not call for a "yes" or "no" answer. Expert witnesses believe that they have the privileged and can explain their theories and opinions regardless of whether it is during direct or cross-examination. They will almost always answer a "yes" or "no" answer with a lecture. That will occur only if you allow it to occur by asking a question that cannot be answered with a "yes" or"no".

Expert witnesses are generally more knowledgeable in their field and thus, difficult to control. They will push back to explain. If you don't assert your control at the outset, you will have considerable difficult gaining any control over the witness. At the outset, if the expert begins an explanation, you need to stop the witness and remind him that your question was quite simple and only required that he answer "yes" or "no". If he continues to explain as they are prone to do, immediately ask the court to instruct the witness as noted above. If you ask a question that allows an explanation, be prepared to once again hear the entire opinion of the expert and how that opinion is the only reasonable opinion that can exist on the issue.

7. **<u>DON'T ASK LONG, CONVOLUTED QUESTIONS.</u>** Each question should relate to one fact, not several. The Judge will be better able to follow your cross if each question only deals with one particular fact. Questions such as the following cannot be answered simply and allows a witness the opportunity of explaining his answer.

> Q. Sir, isn't it true that at the time you entered the intersection and struck my client's car, you were going 55 miles per hour, in a 30 miles per hour zone, when the traffic signal was red?

Which question do you want the witness to answer? You asked the question, the witness is now entitled to answer.

> A. Well, first of all I was not going 55 miles per hour, the light was not red and your client struck my car. You can see that by the angle in which your client's car hit my car. If anyone was going 55 miles per hour, it was your client. I tried to turn away from his car and couldn't because he was going so fast. You are totally wrong.

It doesn't get much worse than this. The convoluted question gives the witness an opportunity to give a narrative response which an adverse witness will always use to repeat his direct testimony in order to hurt you. As a cross-examiner, you are the enemy and if the witness is given the opportunity of giving a narrative response, they will use that opportunity to hurt you.

8. **DON'T TRY TO GET A WITNESS TO CHANGE HIS MIND.** As trial lawyers we have egos which sometimes cause us to believe that we can accomplish miracles. If a witness has testified that the traffic signal was red when your client entered the intersection, the miracle you want to accomplish is to get the witness to recant and change his testimony saying it was something other than red. The likelihood of that happening is generally nil. The usual result, if you press the issue, is that the witness's resolve gets stronger and stronger and his position that the light was red more emphatic. Most often, it is an impossible task and trying to accomplish such a feat may damage your case since the witness's testimony gets repeated with stronger emphasis.

Before considering pursuing such a cross-examination, know the witness. Was he a strong witness on direct Was his testimony sufficiently strong that the likelihood of his questioning his opinion is minimal? In such event, don't make the effort. Instead, attack the witness's credibility and the basis for his testimony. Where was he at the time of the incident? Was he at such a distance that it makes his observations questionable? Was there anything that could have obstructed his vision of the event? A witness understands for whom he is providing testimony and they generally want to help that person. Most often, he will not alter his testimony so, in such cases, the objective is to attack the grounds upon which the witness's testimony is based. And perhaps most important, don't try to get more from the witness than is realistic. Again, keep your ego in check.

9. **DON'T BE CONFRONTATIONAL.** This **Don't** depends upon the witness, his testimony and the circumstances. If the witness is likeable, being confrontational is likely to offend the judge and may prejudice him against you and your case. On the other hand, if the witness is arrogant and his attitude disrespectful [which often occurs if the witness is a relative or close friend of the litigant], he deserves to be punished and confrontation may be appropriate. On the other hand, showing the witness respect generally relaxes the witness and often gives the impression that you are befriending him. If his alarm system is turned off, you may well get a lot more from him than if he perceives you as his enemy. My father always reminded me that you get far more with honey than with vinegar.

There are lawyers who may have been born with the natural skills required of a good cross-examiner. The F. Lee Baileys and the Irving Youngers of the world are known as having these skills. Those of us who weren't born with these skills have to work hard to obtain them. Hopefully, some of these points help.

The Cross-Examination of Experts

Foreword

The purpose of this discussion is not to demonstrate any unusual ability to examine valuation experts. It simply supports the principle that you need not have taken a college level accounting course, be a CPA or have taken a business valuation course or courses to cross-exam a business valuation expert. It does, however, support the principle that thorough preparation and a <u>respectful</u> lack of deference to the expert's opinion are essential if you want to be effective. Every comment or extract that follows is based on actual <u>not</u> hypothetical illustrations. These deposition extracts involve approximately ten (10) different experts and include some of the best known experts who routinely testify in Arizona courts.

Unlike the cross-examination of ordinary witnesses, the cross-examination of a well-trained expert usually favors the expert both by specific education and experience. Therefore, if you hope to have even modest success you cannot prepare your questions at breakfast the day of the deposition.

My recommendations are as follows, but by no means are they other than what has worked for me. I have redacted, but only to the extent necessary, case entity and witness names. Otherwise, the exchanges are verbatim. Some of the exchanges are lengthy because laying the predicate was essential.

1. Obtain and study the expert's CV and do not simply assume his or her credentials. One of the most egregious witnesses discussed later has a B.S. in accounting, an M.S. in taxation and lists multiple presentations. (also see paragraph 3)

2. Do not simply accept the value standard proposed by the expert.

    A. The fair value standard is similar to the fair market value standard, with the minority interest and marketability discounts ignored; it is used often in Arizona domestic relations cases. (Suitable questions when the Expert adopts only one formula)

        i. What is the other standard of value?
        ii. Have you ever used the fair market standard when valuing a professional practice?
        iii. Did you do so in this case to at least provide another value?
        iv. Can law practices be sold?
        v. Isn't the lack of marketability one of the components of the fair market value standard?
        vi. If a law practice cannot be sold isn't it reasonable to use fair market value?
        vii. Can you name the case that says that only fair value is the Arizona standard?

viii. What do the Arizona cases hold on this subject of fair value versus fair market value?

3. In a case where the lawyer's goodwill was found by Husband's expert to be over $1,000,000, her well-credentialed expert found the "value" to be $60,000.

   A. Based on my review and analysis, it is my opinion that Brown's employment/shareholder status at the Firm does not confer any realizable economic benefits in excess of her capital account balance, reported at the current date at $60,000.

   B. The attribution of significant value to Brown's "employment" circumstance ignores the possibility that her "employment" with the Firm could cease tomorrow, through voluntary or involuntary separation, death or disability. In such a circumstance, Brown (or her estate) would receive nothing more than the repayment of the $60,000 in her capital account.

   C. Brown dissolution Capitalized Excess Economic Earnings Method:

<u>Capitalized Excess Economic Earnings Analysis:</u>

Actual Compensation	[a]			$1,000,000	
* Normalized Compensation (rounded)	[b]			(800,000)	
Expected Long-Term Earnings				200,000	
Less: Estimated Personal Income Taxes	[c]			(80,000)	
Expected Long-Term Net Earnings				$ 120,000	
Less: Required Return on Net Tangible Assets					
Committed Practice Capital (i.e., Capital Account Balance)	[d]	$60,000			
Less: Current Liabilities		0			
Less: Noncurrent Liabilities		0			
Reported Net Capital Account Balance			$60,000		
Required Rate of Return on Net Capital Account Balance	[e]		3%		
Estimated Required Return on Net Tangible Assets				($ 1,800)	
Indicated Excess Earnings				118,200	
Divided by Capitalization Rate	[f]			50.0%	
Indicated Intangible Asset Value					$236,400
Plus: Net Tangible Assets					60,000

Indicated Value of Capital (rounded)					**$296,400**

D. Brown Dissolution Reasonable Compensation Analysis:

Law Firm Industry – *Total Compensation:

			2010
Partners/Shareholders with Significant Management Responsibilities	Mountain Geographic Area	Median	307,745
Partners/Shareholders with Significant Management Responsibilities	Mountain Geographic Area	Upper Quartile (75^{th} percentile)	369,070
Partners/Shareholders with Significant Management Responsibilities	Mountain Geographic Area	Ninth Decile (90^{th} percentile)	460,866
			2011
Partners/Shareholders with Significant Management Responsibilities	Metropolitan Divison	Median	577,560
Partners/Shareholders with Significant Management Responsibilities	Metropolitan Divison	Upper Quartile (75^{th} percentile)	745,693
Partners/Shareholders with Significant Management Responsibilities	Metropolitan Divison	Ninth Decile (90^{th} percentile)	1,066,193
			2012
Partners/Shareholders with Significant Management Responsibilities	Over 150 Lawyer Firm	Median	788,107
Partners/Shareholders with Significant Management Responsibilities	Over 150 Lawyer Firm	Upper Quartile (75^{th} percentile)	1,393,714
Partners/Shareholders with Significant Management Responsibilities	Over 150 Lawyer Firm	Ninth Decile (90^{th} percentile)	2,235,540
			2012
Partners/Shareholders with Significant Management Responsibilities	All Firms	Median	395,317
Partners/Shareholders with Significant Management Responsibilities	All Firms	Upper Quartile (75^{th} percentile)	614,763
Partners/Shareholders with Significant Management Responsibilities	All Firms	Ninth Decile (90^{th} percentile)	956,712

	Median	Upper Quartile	Ninth Decile
Min	267,614	369,070	460,866
Max	788,107	1,393,714	2,235,540
Mean	423,574	612,937	878,746
Median	397,923	525,080	720,369

E. Altman Weil Publications Survey Data – **Attorney Billable Hours**:

		Pub. Year 20xx	**Pub. Year 20xx**
	Status	*Median Billable Hours*	*Median Billable Hours*
Over 150 Lawyers	Equity Partner	1,735	1,668

Metropolitan Division	Equity Partner	1,726	1,693
Admitted to Bar	83-86	1,687	1,649
Average		1,716	1,670

F. Law Practice of Susan Brown:

<u>Computation of Discount Rate and Capitalization Rate:</u>

<u>Equity Rate:</u>	
Risk-Free Return	
(Return on U.S. Treasury Bonds)	4.6%
Equity Risk Premium	
(Stocks-Bonds)	6.7%
Size Premium	6.3%
Company Specific Risk	
(less management depth, less geographic & product diversification)	<u>7.0%</u>
Equity Discount Rate	<u>24.6%</u>
Less: Expected Long-Term Growth	<u>3.0%</u>
Debt-Free Capitalization Rate	<u>21.6%</u>

4. Know beforehand what is required to obtain each of the witness's listed credentials and which organization issues it. Is the credential peer driven? Is there a test or a series of tests and does the designation have a specific focus? Sometimes experts try to appear qualified in an area but their training or experience does not support an opinion in the subject area. Do not hesitate to involve another expert as part of your deposition preparation but pay them for their time.

Q. Have you ever taken any tests that were designed upon completion successfully to grant you a certified business evaluator classification?
A. I took one when that evaluation first came out.
Q. And did you pass it?
A. I did not.
Q. Okay. Now, there are other agencies or associations that provide some form of certified business valuation designations, true?
A. True.
Q. Have you taken any of those tests?
A. No.
Q. Have you ever disclosed to anyone who has taken your deposition prior to today that you failed the test?
A. It has not been ***asked.***

5. Avoid the temptation to show the expert how smart or well-prepared you are. Even if you are smart and well-prepared (and this will be self-evident) follow up if you are uncertain about a definition or its use, or you do not understand an answer. Simply state that you do not understand the answer, could the expert explain it more simply or provide an illustration. For example: you cannot be expected to know what every acronym or term such as CPT stands for.

   Q. Now, you indicated to me that you were accredited in business valuation by the American Institute of Certified Public Accountants?
   A. Correct.
   Q. And that's abbreviated AICPA?
   A. Yes.

   * * * *

   Q. What does CPT stand for?
   A. Current procedure terminology.

6. Cover their past testifying experience in detail as to the court(s) and the number of appearances at each level.

   Q. Other than the current one [law firm] then, is it fair to say that you have never valued a law firm that had offices outside of Arizona?
   A. That may be true.
   Q. With respect to the firms that you have valued here in Arizona, how many of those had employees over 150?
   A. Other than this one?
   Q. Other than this one.
   A. I would believe none.
   [Actually, only one valuation <u>possibly</u> in the witness's many year career as further questions revealed]

7. What was the issue in the prior case or cases in which the expert participated? For example, testifying as to professional goodwill does not automatically make one an experienced business valuation witness. The methodology and particularly the reference sources are <u>entirely</u> different.

8. Has the witness ever testified for the opposing lawyer (or their law firm) or the particular company? Do any friends or relatives work at the entity?

9. Has the witness, a relative or family member ever been represented by the lawyer or another lawyer in the firm?

10. Does the witness have an opinion that only a specific formula should be used such as fair value as opposed to fair market value? Has he/she ever used the other formula?

And, if not, why not? What facts does he/she claim permit another formula or calculation?

SAME EXPERT

Case 1

A. "At your request, ABC, Inc. was retained to provide a preliminary calculation of the fair market value of the [company] as of December 31, 2013." (Lead sentence in the report)

Case 2

B. "….as it is our understanding that there is no contemplated sale of the interest (equity interest in retail business) and the hypothetical value that the interest would yield in the open market under the fair market value standard of value may not be **relevant."**

REBUTTAL EXPERT (Case 2)

C. Listing the eight **relevant valuation factors** he [opposing expert] considered from IRC Revenue Ruling 59-60, **the ruling established the definition of fair market value used by the expert earlier on the same page.**

11. What, by number of employees and/or gross revenues, is the largest entity he/she has valued? What were the equivalent numbers in the source materials?

12. What are the corresponding numbers for the subject entity?

13. Have the witness identify each publication or source consulted and why. Be sure to get the exact title and year of publication so you can do your own research accurately. Is the information only available to subscribers?

14. Once you know the sources he or she consulted, be sure to read them thoroughly. Sources such as comparable industry sales are factually sketchy at best and are usually composed of larger enterprises than most of us encounter.

15. When comparing doctors, be especially careful that comparisons are similar as to region, city size by population, area of practice (don't compare neurosurgeons with pediatricians), presence or absence of an interest in a related surgery or pain center (this is a huge difference if present). Also, do the experts' chosen peers have pension plans and are they included or not included in the peer group's income? Does the peer group have perks that have been excluded in the subject report?

16. When comparing lawyers, you also must consider size of the firm, population and area of the country, area of practice, pension plan contributions, and years of practice.

17. Most experts mark their report as a draft even though it seldom is. If you discover a fatal flaw, such as a serious mathematical error, and you point it out, it will be corrected and your advantage lost if the case proceeds to trial or arbitration. It can be a sensitive decision at mediation. I might handle it as follows if there is a subsequent correction:

> Q: As of the date of this report, you expected to testify under oath that the value of ABC Company was $1.8 million.
> A: Yes.
> Q: You would have told the court that $1.8 million was the value produced by your education and experience.
> A: Yes.
> Q: And, you would have been wrong by $600,000.
> A: Yes.

18. At the end of the deposition, always ask if as a result of the deposition has he/she reconsidered or changed their opinion in any regard.

19. Always ask the expert if courts always accept their opinion or do courts modify it on occasion or adopt the other expert's opinion.

20. If applicable, has he/she read your expert's opinion and what issues or facts does he/she dispute. Have him/her specifically identify the disputed facts or issues, why he/she disputes them and what impact it would have on the report.

21. Especially if you are inexperienced, but at any level, think about potential follow-up questions to likely or even unlikely answers.

> Q. And do you have any reason to suspect that Mr. White somehow disregarded your reports?
> A. I don't know what thought process he went through, but it was clear to me that they weren't given proper consideration.
> Q. By someone who's qualified, submitted by someone who's not qualified, true?
> A. Yes.
>
> * * * *
>
> Q. What Arizona case do you maintain says that you have to adopt fair value if there is not to be a sale of the business?
> A. There is not an Arizona case per se that I am aware of.

* * * *

Q. Is not the classic definition that it is a hypothetical transaction occurring between a hypothetical buyer and a hypothetical seller, it is not an actual transaction?
A. That's fair value or fair-market value.
Q. Right. And then it's not up to the accountant necessarily or the business valuator to make the decision; it is a legal decision, true?
A. It is a legal issue ultimately, yes.
Q. Okay. And you came down on the side that it should be preferably, in your opinion, it should be fair value, true?
A. Yes.
Q. Because you don't take a discount for marketability or liquidity, true?
A. Yes.

* * * *

Q. How many of your valuation reports were offered in a family law case?
A. All of them.
Q. Okay. And so your standard is that when you are doing a family law case and there is not an actual transaction or sale planned, then you must use fair value?
A. Yes.

* * * *

Q. And we previously established, and I want to turn to the very last sentence on page 1 where you say "the high level of personal expenses claimed as business expenses." You make that point again, do you not?
A. Yes.
Q. And we previously established – I hope we don't have to go over it again, but we can if you want – that Mrs. Jones played a significant subjective role in determining what was business expense and what was non-business expense, true?
A. Yes.

* * * *

Q. Well, wouldn't it be of some interest to you how she gained this information when they didn't live together for six out of the last nine years?
A. I know they had been married for some 30 years.

* * * *

Q. But what constitutes that level of cash? Is that cash sales?
A. No, that's cash in the bank.
Q. Okay. And down below when you use level of cash – for tool stores, is that cash in the bank?
A. Yes.
Q. And then you took the business' level of cash [tool store] from what?
A. From the financial statement [balance sheet] for the period ending September 30, 2013.
Q. Does that number have anything to do with cash sales?
A. Yes.

Q. Well, it's [balance sheet cash] actually, though, a component of all sales, isn't it?
A. Yes.
Q. In other words, that number includes credit cards presumably or the conversion of credit cards to cash, true?
A. Yes.
Q. It includes checks written to the business that is being evaluated, true?
A. Yes.

OPPOSING COUNSEL: Well, in this case the cash that's on the evaluator's report is what the entity has in the bank, so there's no ability to tell you what source it comes from.

DEPOSING COUNSEL: Precisely my point.

Q. Cash, as reflected on a balance sheet, is a component of a great many things, isn't it?
A. Yes.
Q. It is a component that reflects, does it not, that business expenses have presumably been met and this is what may remain among current assets?
A. Yes.
Q. So how does this relate, if I may ask, to cash sales?
A. It relates to cash sales because it's another indicia that cash sales are not being reported because, especially after I apply the tests, there's an indication that this company is short of cash. There's another test I did previously that indicates it was around $160, $180,000 in terms of pure cash sales, and these industry tests, again, confirm that the prior test that I did indicates that, associated with cash sales, there could be $160 $180,000 of cash not coming in from cash sales –
Q. But my point, sir, is that you don't deny that the level of cash in any of these comparables that you utilized is composed of at least three segments, true?
A. True.

* * * *

Q. To support your conclusion that somehow this represents that cash is not being deposited.
A. This indicates the level of cash that is on the balance sheets of comparable companies.
Q. Yes. But you don't know what their Internet sales are, do you, these comparable companies?
A. No.
Q. You don't know what their cash transactions over the counter are, do you?
A. No.

* * * *

Q. In other words, you can’t really accurately do a merged percentage unless you know how much is represented by tool sales and how much is represented by equipment rental sales, true?
A. That would refine the calculation, yes.
Q. Thank you. And did you attempt to do that?
A. I didn’t do a precise calculation.
Q. I asked you did you attempt to do that? Simple, yes, I did, no, I didn’t.
A. Yes, I did.
Q. Okay. And what did you use as your starting component for tool sales?
A. The percentage we just discussed.
Q. No, no, no. What amount of [tool] sales did you apply that percentage of profit to?
A. I did a big picture calculation in my mind.
Q. Okay.
A. I didn’t do an extremely detailed calculation right to the bottom line.
Q. Okay. So you took some global approach and were satisfied with it?

22. If you have concerns about your own expert witness, be sure that you, well in advance of the deposition, carefully read his report and have a meeting(s**) in person**. Candidly address your concerns and elicit his responses. This interview should be done as early as possible.

<u>Valuations</u>

1. The only true value of anything is what someone who is a well-informed third party will pay. But even well-informed third parties may pay very different amounts depending on the purchaser’s own goals. These goals can include literally dozens of often multiple reasons:
    a. Increased market share,
    b. Expansion into a new area already being serviced by the acquired company,
    c. Synergy of product lines such as tires/hubcaps, soap/deodorant, donuts/coffee, etc.,
    d. Desire to gain a valuable patent or control a developing market;
    e. Sale to a relative, often a child, on favorable terms.

    However, these reasons are not articulated in the sources that business valuations are based on.

2. Likewise, if the valuation is of an individual professional, the valuator should reduce the subject’s income for excess hours worked against the assumed hours worked by the peer group. However, we all know individual lawyers who have great staff or are more efficient and produce within eight hours what others take ten hours to produce.

3. Perhaps the greatest fallacy most of us will have to address in all industrial and retail valuations is the huge difference between the comparison enterprises and the subject enterprise. This materially affects the build-up rate which in turn directly affects the multiplier which I regard as the black box of all industrial/retail valuations.
4. There are three commonly accepted formulas for valuing a company but only one is widely used: anticipated future earnings reduced to present value. The other two are adjusted book value (sometimes incorrectly referred to as liquidation value) and market value based on similar enterprises.

The classic method of determining value under the future earnings model is to identify adjusted revenues for five years and weight the most recent years more heavily. For example, the revenues five years ago (2010) would be multiplied by one (1), the most current year (2014) would be multiplied by five (5), the revenues would then be added and divided by fifteen (15).

Revenues	Resultant
2010 – 200,000 x 1	200,000
2011 – 350,000 x 2	700,000
2012 – 375,000 x 3	1,125,000
2013 – 450,000 x 4	1,800,000
2014 – 600,000 x 5	3,000,000
15	$6,625,000

[$6,625,000 / 15 = average weighted revenues or $440,000 (rounded)]

So far, the approach is mechanical, but it requires judgment. Especially if the company is established, the process can be both straight forward and account for the revenue cycle. However, the next step – the risk build-up calculation -- is much more debatable and subject to subjective choices. The risk build up calculation employs and requires many choices. The format is usually stated as follows:

Cost of Equity Estimation	Low	High	Source:
Risk Free Rate of Interest	3.05%	3.05%	Federal Reserve Board – 20 Year Bond Yield as of 12/31/2009
+ Equity Risk Premium	6.43%	6.43%	Implied equity risk premium as of 12/31/2009
= Market Return on Equity	**9.48%**	**9.48%**	**Sum of above**
+/- Industry Risk Premium	0.00%	0.00%	Morningstar SBBI – SIC #736 – Personal Supply Services
+/- Size Risk Premium	5.82%	5.82%	Morningstar SBBI – Size Decile 10
+/- Company Specific Risk Premium	4.00%	6.00%	Estimated by ABC Appraisers, Inc.
= Required Return on Equity (K)	**19.30%**	**21.30%**	**Sum of above, rounded**

[Hot Tip: If possible, meet with another expert prior to the deposition for at least two reasons. Often I thought I noted clear mistakes in the opposing expert's report which were actually my mistakes or misunderstandings. Also, very few experts can resist the temptation to point out another expert's failings.]

[Hot Tip: Do not hesitate to subpoena other reports authored by the expert. Recently I utilized the following language in a subpoena to an expert:

> **(a) All notes expert took by any means (handwritten, typed, etc.) at the vocational interview;**
> **(b) All the source data to which expert refers; and**
> **(c) All reports expert has written for a spouse in the past rhee years, if any, concerning a woman who is in or intends to go into a medical career other than as an M.D. or D.O. If he wishes, expert can redact the names.]**

Practice Tips from the Appellate Court

Practice Tip:

If you want the Family Court to make findings of fact and conclusions of law when the court is not otherwise statutorily required to make findings, file your request before trial under Arizona Rule Family Law Procedure 82.

And do not forget to ask the Family Court for time to file your proposed Findings of Fact and Conclusions of Law.

And if you did not ask for the court to make its findings, think about whether you want to object to the proposed findings and the basis for the objection, as well as submitting your own proposed findings and conclusion.

Finally, do not forget to highlight the support for your proposed findings, whether in the joint pretrial statement, your expert's report, or elsewhere in the record.

The benefit:

You will know the factual and legal basis for the Family Court's ruling.

Once you know the basis for the ruling, you will be able to think about whether you want to file an appeal challenging the ruling. Generally, the Court of Appeals reviews the division of property interests for an abuse of discretion. The Court generally defers to the Family Court's factual findings if supported in the record. An abuse of discretion only occurs if the findings are legally incorrect or contrary to the evidence, when viewed in the light most favorable to upholding the trial court's decision. *See Jenkins v. Jenkins,* 215 Ariz. 35, 37, ¶ 8, 156 P.3d 1140, 1142 (App. 2007); *Fuentes v. Fuentes*, 209 Ariz. 51, 56, ¶ 23, 97 P.3d 876, 881 (App. 2004).

Practice Tip:

Be prepared to quickly file a motion for reconsideration if the Family Court made a factual error, or legal error. Although judges do not like to reconsider rulings, judges want to ensure the facts and law are supported by the record.

But remember that if you are going to ask for a new trial under Family Rule of Procedure 83, you do so within fifteen (15) days of the signed decree.

Practice Tip:

Timely file your notice of appeal after any judgment, and after amend it after the denial (or grant) of the motion for new trial. Family Law Rule of Procedure 78(B); ARCAP 9.

Arizona Rules of Family Court Procedure.

Rule 82. Findings by the Court; Judgment on Partial Findings

A. Effect. In all family law proceedings tried upon the facts, the court, if requested before trial, shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 81. Requests for findings are not necessary for purposes of review. Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. It will be sufficient if the findings of fact and conclusions of law are stated orally and recorded in open court following the close of the evidence or appear in an opinion or minute entry or memorandum of decision filed by the court. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 32 and 79 or any other motion, except as provided in paragraph C.

B. Sufficiency of Evidence. When findings of fact are made, the question of the sufficiency of the evidence to support the findings may thereafter be raised in a Rule 83 motion for new trial or amended judgment, whether or not the party raising the question has objected to those findings in the superior court or made a motion to amend them or a motion for judgment.

C. Judgment on Partial Findings. If during a family law proceeding a party has been fully heard on an issue and the court, after determining the facts, finds against the party on that issue, the court may enter judgment as a matter of law against that party with respect to a claim or defense that cannot under the controlling law be maintained or defeated without a favorable finding on that issue, or the court may decline to render any judgment until the close of all the evidence. Such a judgment shall be supported by findings of fact and conclusions of law, if requested as required by paragraph A.

D. Submission on Agreed Statement of Facts. The parties to an action may submit the matter in controversy to the court upon an agreed statement of facts, stated orally in open court on the record, or signed by them and filed with the clerk, and the court shall render judgment thereon as in other cases. The agreed statement, certified by the court to be correct, and the judgment shall constitute the record of the action.

Rule 83. Motion for New Trial or Amended Judgment

A. Grounds. A ruling, decision or judgment may be altered or amended, or vacated and a new trial granted, on motion of the aggrieved party for any of the following causes materially affecting that party's rights:

1. irregularity in the proceedings of the court or a party, or abuse of discretion, whereby the moving party was deprived of a fair trial;

2. misconduct of a party;

3. accident or surprise which could not have been prevented by ordinary prudence;

4. material evidence, newly discovered, which with reasonable diligence could not have been discovered and produced at the trial;

5. error in the admission or rejection of evidence or other errors of law occurring at the trial or during the progress of the action;

6. that the ruling, decision, findings of fact, or judgment is not justified by the evidence or is contrary to law.

B. Scope. A ruling, decision or judgment may be altered or amended, or a new trial may be granted to all or any of the parties and on all or part of the issues for any reasons for which new trials are authorized by law or rule of court. On a motion for new trial, the court may open the judgment, if one has been entered, take additional testimony, amend or alter findings of fact and conclusions of law or make new findings and conclusions, and direct the entry of a new ruling, decision or judgment.

C. Contents of Motion; Amendment; Rulings Reviewable.

1. The motion for new trial shall be in writing, shall specify generally the grounds upon which the motion is based, and may be amended at any time before it is ruled upon by the court.

2. Upon the general ground that the court erred in admitting or rejecting evidence, the court shall review all rulings during the trial upon objections to evidence.

3. Upon the general ground that the decision, findings of fact, or judgment is not justified by the evidence, the court shall review the sufficiency of the evidence.

D. Procedure for Filing Motion for New Trial; New Trials Granted.

1. Time for Motion. A motion for new trial shall be filed not later than fifteen (15) days after entry of the judgment.

2. Time for serving affidavits. When a motion for new trial is based upon affidavits they shall be served with the motion. The opposing party has ten (10) days after such service within which to serve opposing affidavits, which period may be extended for an additional period not exceeding twenty (20) days either by the court for good cause shown or by the parties by written stipulation. The court may permit reply affidavits.

3. Number of new trials. Not more than two (2) new trials shall be granted to either party in the same action.

4. Specification of grounds for new trial in order. No order granting a new trial shall be made and entered unless the order specifies with particularity the grounds on which the new trial is granted.

E. New Trial Ordered On Initiative of Court. Not later than fifteen (15) days after entry of judgment the court of its own initiative may order a new trial for any reason for which it might have granted a new trial on motion of a party. After giving the parties notice and an opportunity to be heard on the matter, the court may grant a motion for a new trial, timely served, for a reason not stated in the motion. In either case, the court shall specify in the order the grounds therefore.

F. Questions to Be Considered in New Trial. A new trial, if granted, shall be only a new trial of the question or questions with respect to which the decision is found erroneous, if separable.

G. After Service by Publication.

1. When judgment has been rendered on service by publication, and the respondent has not appeared, a new trial may be granted upon application of the respondent for good cause shown by affidavit, made within one (1) year after rendition of the judgment.

2. Execution of the judgment shall not be stayed, except on motion of the party or the court's own motion and order of the court. The court may require the respondent to give a bond in an amount set by the court to assure that the party will prosecute the application for a new trial and will satisfy such judgment as may be rendered by the court should its decision be against the respondent.

TAB 6

Divorce and Income Taxes

Divorce and Income Taxes:

Using Individual Tax Returns as Discovery Tools Checklist

- **Income From Wages, Salaries and Tips (Form 1040 Line 7)**
  - Obtain and review Forms W-2 for existences of deferred compensation and other fringe benefits.
  - Determine if there is compensation from the exercise of non-qualified stock options, which may be a marital asset.

- **Interest and Dividend Income (Lines 8 and 9 and Schedule B)**
  - Review names of payers and/or account information to determine if there are assets not previously disclosed.
  - Note any foreign bank accounts or foreign income.
  - Review Forms 1099's for interest from Tax Free Bonds.

- **Taxable Refunds of State and Local Taxes (Line 10)**
  - Determine who received the income and how it was used.
  - Investigate for overpayment of state and federal taxes that are credited for future tax years and then refunded.

- **Schedule C Profit or Loss From Business (Line 12)**
  Review for the following:
  - Potential understatement of revenues;
  - Deductions of personal or owner discretionary expenses, such as personal vehicle expenses and a home office deduction;
  - Section 179 and Bonus Depreciation and existence of fixed assets with value.

- **Retirement Plan Distributions (Lines 15a and 16a)**
  - Determine if the party received a distribution from a deferred compensation plan or IRA and if so, determine how the funds were used.

- **Schedule E, Supplemental Income or Loss, Line 17 (From rental real estate, royalties, partnerships, S Corporations, estates, trusts, etc)**
  - Review all S-corporations and partnerships reporting pass-through income or loss to determine that all ownership interests have been disclosed.
  - Review all rental properties listed.
  - Review any reported royalties and determine if the asset(s) generating royalties has been disclosed.
  - Note any estate and trust income, as the spouse may be an income beneficiary to estate or trust.
  - Also review Other Income (Line 21) for other types of income such as gambling winnings or non-employee compensation

- **Schedule A Deductions**
  - Review real estate taxes, personal property taxes, mortgage interest and points for indication of undisclosed property, other assets or refinancing transactions.
  - If the party owns real estate but no mortgage interest is deducted, inquire as to how the property was acquired and method of payment.

- **Alternative Minimum Tax**
  - An entry on the alternative minimum tax line might indicate that the taxpayer has a tax preference which can lead to the discovery of hidden assets.

Form 1040 U.S. Individual Income Tax Return (99) 2014

OMB No. 1545-0074 | IRS Use Only - Do not write or staple in this space.

For the year Jan. 1-Dec. 31, 2014, or other tax year beginning , 2014, ending , 20 | See separate instructions.

Your first name and initial	JOHN N.
Last name	DOE
Your social security number	724 11 0905
If a joint return, spouse's first name and initial	JANE M.
Last name	DOE
Spouse's social security number	042 10 6187
Home address (number and street). If you have a P.O. box, see instructions.	123 ELM STREET
Apt. no.	
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below.	ANYWHERE, AZ 23456
Foreign country name	
Foreign province/state/county	
Foreign postal code	

▲ Make sure the SSN(s) above and on line 6c are correct.

Presidential Election Campaign
Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 [X] Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a [X] **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b [X] **Spouse**

Boxes checked on 6a and 6b: 2
No. of children on 6c who: ● lived with you: 2
● did not live with you due to divorce or separation (see instructions):
Dependents on 6c not entered above:

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit
JACK DOE	042-00-2011	SON	X
JEANIE DOE	061-82-2014	DAUGHTER	X

If more than four dependents, see instructions and check here ▶ ☐

d Total number of exemptions claimed — Add numbers on lines above ▶ 4

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2			7	157,500.
8a	**Taxable** interest. Attach Schedule B if required			8a	2,659.
b	**Tax-exempt** interest. **Do not** include on line 8a	8b			
9a	Ordinary dividends. Attach Schedule B if required			9a	1,090.
b	Qualified dividends	9b	940.		
10	Taxable refunds, credits, or offsets of state and local income taxes	STMT 1	STMT 2	10	1,534.
11	Alimony received			11	
12	Business income or (loss). Attach Schedule C or C-EZ			12	40,258.
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13	-3,000.
14	Other gains or (losses). Attach Form 4797			14	
15a	IRA distributions	15a	b Taxable amount	15b	
16a	Pensions and annuities	16a	b Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	7,665.
18	Farm income or (loss). Attach Schedule F			18	
19	Unemployment compensation			19	
20a	Social security benefits	20a	b Taxable amount	20b	
21	Other income. List type and amount			21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶			22	207,706.

Adjusted Gross Income

23	Educator expenses	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	Deductible part of self-employment tax. Attach Schedule SE	27	2,844.		
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction	29	10,682.		
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction	32			
33	Student loan interest deduction	33			
34	Tuition and fees. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 35			36	13,526.
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	194,180.

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12-31-14

Tax and Credits

Standard Deduction for -
- People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.
- All others: Single or Married filing separately, $6,200; Married filing jointly or Qualifying widow(er), $12,400; Head of household, $9,100

38	Amount from line 37 (adjusted gross income)	38	194,180.
39a	Check if: ☐ **You** were born before January 2, 1950, ☐ Blind. ☐ **Spouse** was born before January 2, 1950, ☐ Blind. **Total boxes checked** ▶ 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40	28,836.
41	Subtract line 40 from line 38	41	165,344.
42	**Exemptions.** If line 38 is $152,525 or less, multiply $3,950 by the number on line 6d. Otherwise, see inst.	42	15,800.
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	149,544.
44	**Tax.** Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐	44	29,005.
45	**Alternative minimum tax.** Attach Form 6251	45	0.
46	Excess advance premium tax credit repayment. Attach Form 8962	46	
47	Add lines 44, 45, and 46 ▶	47	29,005.
48	Foreign tax credit. Attach Form 1116 if required	48	
49	Credit for child and dependent care expenses. Attach Form 2441	49	
50	Education credits from Form 8863, line 19	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit. Attach Schedule 8812, if required	52	
53	Residential energy credits. Attach Form 5695	53	
54	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54	
55	Add lines 48 through 54. These are your **total credits**	55	
56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0- ▶	56	29,005.

Other Taxes

57	Self-employment tax. Attach Schedule SE	57	5,688.
58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
60a	Household employment taxes from Schedule H	60a	
b	First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
61	Health care: Individual responsibility (see instructions) Full-year coverage [X]	61	
62	Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Inst.; enter code(s)	62	
63	Add lines 56 through 62. This is your **total tax** ▶	63	34,693.

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	64	35,500.		
65	2014 estimated tax payments and amount applied from 2013 return	65			
66a	**Earned income credit (EIC)**	66a			
b	Nontaxable combat pay election 66b				
67	Additional child tax credit. Attach Schedule 8812	67			
68	American opportunity credit from Form 8863, line 8	68			
69	Net premium tax credit. Attach Form 8962	69			
70	Amount paid with request for extension to file	70			
71	Excess social security and tier 1 RRTA tax withheld	71			
72	Credit for federal tax on fuels. Attach Form 4136	72			
73	Credits from Form: a ☐ 2439 b ☐ Reserved c ☐ Reserved d ☐	73			
74	Add lines 64, 65, 66a, and 67 through 73. These are your **total payments** ▶			74	35,500.

Refund

75	If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you **overpaid**			75	807.
76a	Amount of line 75 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐			76a	
b	Routing number ▶ c Type: ☐ Checking ☐ Savings ▶ d Account number				
77	Amount of line 75 you want **applied to your 2015 estimated tax** ▶	77	807.		

Direct deposit? See instructions.

Amount You Owe

78	**Amount you owe.** Subtract line 74 from line 63. For details on how to pay, see instructions ▶			78	
79	Estimated tax penalty (see instructions)	79			

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? [X] **Yes.** Complete below. ☐ **No**

Designee's name ▶ JANE SMITH Phone no. ▶ 520-321-4600 Personal identification number (PIN) ▶ 25900

Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
		COMPUTER TECHNICIAN	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here
		SOFTWARE PROGRAMMER	

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
JANE SMITH				

Firm's name ▶ BEACHFLEISCHMAN PC — Firm's EIN ▶ 86 0683059

Firm's address ▶ 1985 E. RIVER ROAD, SUITE 201, TUCSON, AZ 85718-7176 — Phone no. 520-321-4600

SCHEDULE A (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Itemized Deductions

▶ Information about Schedule A and its separate instructions is at *www.irs.gov/schedulea*.
▶ Attach to Form 1040.

OMB No. 1545-0074

2014

Attachment Sequence No. **07**

Name(s) shown on Form 1040	Your social security number
JOHN N. & JANE M. DOE	724 11 0905

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see instructions) SEE STATEMENT 8	1	6,462.		
	2	Enter amount from Form 1040, line 38 — 2 — 194,180.				
	3	Multiply line 2 by 10% (.10). But if either you or your spouse was born before January 2, 1950, multiply line 2 by 7.5% (.075) instead	3	19,418.		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	0.
Taxes You Paid	5	State and local **(check only one box):**				
		a [X] Income taxes, **or** / b [ ] General sales taxes	5	5,800.		
	6	Real estate taxes (see instructions)	6	3,818.		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	9,618.
Interest You Paid	10	Home mortgage interest and points reported to you on Form 1098 STMT 6	10	13,726.		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	11			
Note. Your mortgage interest deduction may be limited (see instructions).	12	Points not reported to you on Form 1098. See instructions for special rules	12			
	13	Mortgage insurance premiums (see instructions)	13			
	14	Investment interest. Attach Form 4952 if required. (See instructions.) STMT 7	14	492.		
	15	Add lines 10 through 14			15	14,218.
Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see instructions	16	5,000.		
If you made a gift and got a benefit for it, see instructions.	17	Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	17			
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	5,000.
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See instructions.)			20	
Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses - job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ▶	21			
	22	Tax preparation fees	22	750.		
	23	Other expenses - investment, safe deposit box, etc. List type and amount ▶ SAFE DEPOSIT BOX 84. MERRILL LYNCH ADVISOR FEES 768.	23	852.		
	24	Add lines 21 through 23	24	1,602.		
	25	Enter amount from Form 1040, line 38 — 25 — 194,180.				
	26	Multiply line 25 by 2% (.02)	26	3,884.		
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	0.
Other Miscellaneous Deductions	28	Other - from list in instructions. List type and amount ▶			28	
Total Itemized Deductions	29	Is Form 1040, line 38, over $152,525? [X] **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. [ ] **Yes.** Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.			29	28,836.
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ [ ]				

LHA 419501 01-20-15 **For Paperwork Reduction Act Notice, see Form 1040 instructions.** **Schedule A (Form 1040) 2014**

SCHEDULE B
(Form 1040A or 1040)
Department of the Treasury
Internal Revenue Service (99)

Interest and Ordinary Dividends

▶ Attach to Form 1040A or 1040.
▶ Information about Schedule B and its instructions is at www.irs.gov/scheduleb.

OMB No. 1545-0074
2014
Attachment Sequence No. **08**

Name(s) shown on return: JOHN N. & JANE M. DOE
Your social security number: 724 11 0905

Part I Interest

1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions and list this interest first. Also, show that buyer's social security number and address ▶

		Amount
WELLS FARGO BANK, N.A.	1	650.
WELLS FARGO BANK, N.A.	1	2,000.
FROM K-1 - JANES BAKERY	1	5.
FROM K-1 - ENTERPRISE PRODUCTS PARTNERS	1	4.
2 Add the amounts on line 1	2	2,659.
3 Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
4 Subtract line 3 from line 2. Enter the result here and on Form 1040A, or Form 1040, line 8a ▶	4	2,659.

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note. If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

5 List name of payer ▶

		Amount
MERRILL LYNCH	5	800.
KRAFT	5	128.
MONDOLEZ	5	162.
6 Add the amounts on line 5. Enter the total here and on Form 1040A, or Form 1040, line 9a ▶	6	1,090.

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

Note. If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

	Yes	No
7a At any time during 2014, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		X
If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements		
b If you are required to file FinCen Form 114, enter the name of the foreign country where the financial account is located ▶		
8 During 2014, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions		X

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11-07-14

SCHEDULE C (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business

(Sole Proprietorship)

▶ Information about Schedule C and its separate instructions is at *www.irs.gov/schedulec.*
▶ Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074
2014
Attachment Sequence No. **09**

Name of proprietor: JOHN N. DOE
Social security number (SSN): 724-11-0905

A Principal business or profession, including product or service (see instructions): COMPUTER TECHNICIAN
B Enter code from instructions ▶

C Business name. If no separate business name, leave blank.: QUAD J
D Employer ID number (EIN), (see instr.): 86-7654321

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: (1) [X] Cash (2) [ ] Accrual (3) [ ] Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2014? If "No," see instructions for limit on losses [X] Yes [ ] No

H If you started or acquired this business during 2014, check here ▶ [ ]

I Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) [X] Yes [ ] No

J If "Yes," did you or will you file required Forms 1099? [X] Yes [ ] No

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ▶ [ ]	1	264,385.
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	264,385.
4	Cost of goods sold (from line 42)	4	68,877.
5	**Gross profit.** Subtract line 4 from line 3	5	195,508.
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	195,508.

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8	1,200.	18	Office expense	18	6,000.
9	Car and truck expenses (see instructions) STMT 9	9	13,840.	19	Pension and profit-sharing plans	19	
				20	Rent or lease (see instructions):		
10	Commissions and fees	10		a	Vehicles, machinery, and equipment	20a	
11	Contract labor (see instructions)	11	42,310.	b	Other business property	20b	
12	Depletion	12		21	Repairs and maintenance	21	1,364.
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	43,662.	22	Supplies (not included in Part III)	22	
				23	Taxes and licenses	23	50.
				24	Travel, meals, and entertainment:		
14	Employee benefit programs (other than on line 19)	14		a	Travel	24a	8,000.
				b	Deductible meals and entertainment (see instructions)	24b	5,000.
15	Insurance (other than health)	15	5,100.				
16	Interest:			25	Utilities	25	4,862.
a	Mortgage (paid to banks, etc.)	16a		26	Wages (less employment credits)	26	14,962.
b	Other	16b	3,100.	27 a	Other expenses (from line 48)	27a	4,800.
17	Legal and professional services	17	1,000.	b	**Reserved for future use**	27b	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27a ▶	28	155,250.
29	Tentative profit or (loss). Subtract line 28 from line 7	29	40,258.
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). **Simplified method filers only:** enter the total square footage of: (a) your home: ____ and (b) the part of your home used for business: ____ . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	40,258.

32 If you have a loss, check the box that describes your investment in this activity (see instructions).
• If you checked 32a, enter the loss on both **Form 1040, line 12,** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3.**
• If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.

32a [ ] All investment is at risk.
32b [ ] Some investment is not at risk.

LHA **For Paperwork Reduction Act Notice, see the separate instructions.** **Schedule C (Form 1040) 2014**

420001 10-17-14

Part III Cost of Goods Sold (see instructions)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36	Purchases less cost of items withdrawn for personal use	36	
37	Cost of labor. Do not include any amounts paid to yourself	37	
38	Materials and supplies	38	
39	Other costs SEE STATEMENT 10	39	68,877.
40	Add lines 35 through 39	40	68,877.
41	Inventory at end of year	41	
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on line 4	42	68,877.

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ / /

44 Of the total number of miles you drove your vehicle during 2014, enter the number of miles you used your vehicle for:

a Business b Commuting c Other

45 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

46 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

47 a Do you have evidence to support your deduction? ☐ Yes ☐ No

b If "Yes," is the evidence written? ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8-26 or line 30.

CELL PHONE	4,800.
48 **Total other expenses.** Enter here and on line 27a — 48	4,800.

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR.
▶ Information about Schedule D and its separate instructions is at *www.irs.gov/scheduled* .
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074
2014
Attachment Sequence No. **12**

Name(s) shown on return: JOHN N. & JANE M. DOE

Your social security number: 724 11 0905

Part I Short-Term Capital Gains and Losses - Assets Held One Year or Less

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked	6,000.	6,500.		<500.>
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on page 2	7	<500.>

Part II Long-Term Capital Gains and Losses - Assets Held More Than One Year

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked	89,563.	99,872.		<10,309.>
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked				

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then go to Part III on page 2	15	<10,309.>

LHA **For Paperwork Reduction Act Notice, see your tax return instructions.** **Schedule D (Form 1040) 2014**

420511
11-24-14

Part III **Summary**

16	Combine lines 7 and 15 and enter the result	16	<10,809.>

- If line 16 is a **gain,** enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.
- If line 16 is a **loss,** skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.
- If line 16 is **zero,** skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.

17 Are lines 15 and 16 **both** gains?

☐ **Yes.** Go to line 18.

☐ **No.** Skip lines 18 through 21, and go to line 22.

18 Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** in the instructions ▶ **18**

19 Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** in the instructions ▶ **19**

20 Are lines 18 and 19 **both** zero or blank?

☒ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). **Do not** complete lines 21 and 22 below.

☐ **No.** Complete the **Schedule D Tax Worksheet** in the instructions. **Do not** complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of:

- The loss on line 16 or
- ($3,000), or if married filing separately, ($1,500)

SEE STATEMENT 11 **21** (3,000.)

Note. When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?

☒ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42).

☐ **No.** Complete the rest of Form 1040 or Form 1040NR.

Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ **Information about Form 8949 and its separate instructions is at** ***www.irs.gov/form8949.***
▶ **File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.**

OMB No. 1545-0074
2014
Attachment Sequence No. **12A**

Name(s) shown on return: JOHN N. & JANE M. DOE

Social security number or taxpayer identification no. 724-11-0905

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either may show your basis (usually your cost) even if your broker did not report it to the IRS. Brokers must report basis to the IRS for most stock you bought in 2011 or later (and for certain debt instruments you bought in 2014 or later).

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are short-term. For long-term transactions, see page 2.
Note. You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the total directly on Schedule D, line 1a; you are not required to report these transactions on Form 8949 (see instructions).

You must check Box A, B, or C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- [ ] **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- [X] **(B)** Short-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS
- [ ] **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See instructions. (f) Code(s)	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) & combine the result with column (g)
MERRILL LYNCH (SEE ATTACHED)	01/10/14	11/20/14	6,000.	6,500.			<500.>
2 Totals. Add the amounts in columns (d), (e), (g) and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 1b** (if **Box A** above is checked), **line 2** (if **Box B** above is checked), or **line 3** (if **Box C** above is checked) ▶			6,000.	6,500.			<500.>

Note. If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side: JOHN N. & JANE M. DOE

Social security number or taxpayer identification no. 724-11-0905

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either may show your basis (usually your cost) even if your broker did not report it to the IRS. Brokers must report basis to the IRS for most stock you bought in 2011 or later (and for certain debt instruments you bought in 2014 or later).

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are long term. For short-term transactions, see page 1.

Note. You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the total directly on Schedule D, line 8a; you are not required to report these transactions on Form 8949 (see instructions).

You must check Box D, E, or F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- [ ] **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- [X] **(E)** Long-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS
- [ ] **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See instructions. (f) Code(s)	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) & combine the result with column (g)
MERRILL LYNCH (SEE ATTACHED)	VARIOUS	12/16/14	89,563.	99,872.			<10,309.>
2 Totals. Add the amounts in columns (d), (e), (g) and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ▶			89,563.	99,872.			<10,309.>

Note. If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

SCHEDULE E (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
▶ Attach to Form 1040, 1040NR, or Form 1041.
▶ Information about Schedule E and its separate instructions is at www.irs.gov/schedulee.

OMB No. 1545-0074
2014
Attachment Sequence No. **13**

Name(s) shown on return: JOHN N. & JANE M. DOE
Your social security number: 724-11-0905

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see instructions). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☒ No
B If "Yes," did you or will you file required Forms 1099? ☐ Yes ☐ No

1a	Physical address of each property (street, city, state, ZIP code)
A	TUCSON, AZ 85745
B	
C	

1b	Type of Property (from list below)
A	1
B	
C	

2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the **QJV** box only if you meet the requirements to file as a qualified joint venture. See instructions.

	Fair Rental Days	Personal Use Days	QJV
A	365		☐
B			☐
C			☐

Type of Property:
1 Single Family Residence
2 Multi-Family Residence
3 Vacation/Short-Term Rental
4 Commercial
5 Land
6 Royalties
7 Self-Rental
8 Other (describe)

	Properties:		A	B	C
Income:					
3	Rents received	3	28,000.		
4	Royalties received	4			
Expenses:					
5	Advertising	5			
6	Auto and travel (see instructions)	6			
7	Cleaning and maintenance	7	1,200.		
8	Commissions	8			
9	Insurance	9	900.		
10	Legal and other professional fees	10	100.		
11	Management fees	11			
12	Mortgage interest paid to banks, etc. (see instructions)	12			
13	Other interest	13	8,548.		
14	Repairs	14	2,200.		
15	Supplies	15			
16	Taxes	16	3,024.		
17	Utilities	17	750.		
18	Depreciation expense or depletion	18			
19	Other (list) ▶ STMT 12	19	612.		
20	Total expenses. Add lines 5 through 19	20	17,334.		
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file **Form 6198**	21	10,666.		
22	Deductible rental real estate loss after limitation, if any, on **Form 8582** (see instructions)	22	(401.)	( )	( )

23a	Total of all amounts reported on line 3 for all rental properties	23a	28,000.
b	Total of all amounts reported on line 4 for all royalty properties	23b	
c	Total of all amounts reported on line 12 for all properties	23c	
d	Total of all amounts reported on line 18 for all properties	23d	
e	Total of all amounts reported on line 20 for all properties	23e	17,334.
24	**Income.** Add positive amounts shown on line 21. **Do not** include any losses	24	10,666.
25	**Losses.** Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	(401.)
26	**Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26	10,265.

LHA **For Paperwork Reduction Act Notice, see the separate instructions.** **Schedule E (Form 1040) 2014**

421491
10-22-14

Name(s) shown on return. Do not enter name and social security number if shown on page 1. | Your social security number

JOHN N. & JANE M. DOE | 724-11-0905

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check column **(e)** on line 28 and attach **Form 6198.** See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? ☐ Yes ☒ No

If you answered "Yes," see instructions before completing this section.

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
A	JANES BAKERY	S		86-1234567	
B	ENTERPRISE PRODUCTS PARTNERS	P		76-0568219	
C					
D					

	Passive Income and Loss		Nonpassive Income and Loss		
	(f) Passive loss allowed (attach Form 8582 if required)	(g) Passive income from Schedule K-1	(h) Nonpassive loss from Schedule K-1	(i) Section 179 expense deduction from Form 4562	(j) Nonpassive income from Schedule K-1
A			2,600.		
PTP B	0.				
C					
D					
29a Totals					
b Totals			2,600.		

30	Add columns (g) and (j) of line 29a	30
31	Add columns (f), (h), and (i) of line 29b	31 (2,600.)
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	32 -2,600.

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a	35
36	Add columns (c) and (e) of line 34b	36 ( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36. Enter the result here and include in the total on line 41 below	37

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs) - Residual Holder

38 (a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see instructions)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

39 Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below | 39

Part V Summary

40	Net farm rental income or (loss) from **Form 4835.** Also, complete line 42 below	40
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17, or Form 1040NR, line 18 ▶	41 7,665.
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code V; and Schedule K-1 (Form 1041), box 14, code F (see instructions)	42
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040 or Form 1040NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43

Schedule E

Publicly Traded Partnerships

Name of Activity: ENTERPRISE PRODUCTS PARTNERS - ACTIVITY NO. 2

Activity net income	
Activity net loss	-6,595.
Prior year unallowed losses	
Net income (loss)	-6,595.
Total loss allowed from the PTP for 2014	
Disallowed losses from this PTP	6,595.

Form or Schedule	Gain/Loss	Prior Year Carryover	Net Gain/Loss	Unallowed Loss	Allowed Loss
SCH E	-6,330.	0.	-6,330.	6,330.	
FORM 4797	-265.	0.	-265.	265.	
	-6,595.		-6,595.	6,595.	

Alternative Minimum Tax

Activity net income	
Activity net loss	-6,357.
Prior year unallowed losses	
Net income (loss)	-6,357.
Total loss allowed from the PTP for 2014	
Disallowed losses from this PTP	6,357.
Alternative minimum tax adjustment	

Form or Schedule	Gain/Loss	Prior Year Carryover	Net Gain/Loss	Unallowed Loss	Allowed Loss
SCH E	-6,092.	0.	-6,092.	6,092.	
FORM 4797	-265.	0.	-265.	265.	
	-6,357.		-6,357.	6,357.	

SCHEDULE SE
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ Information about Schedule SE and its separate instructions is at *www.irs.gov/schedulese.*
▶ **Attach to Form 1040 or Form 1040NR.**

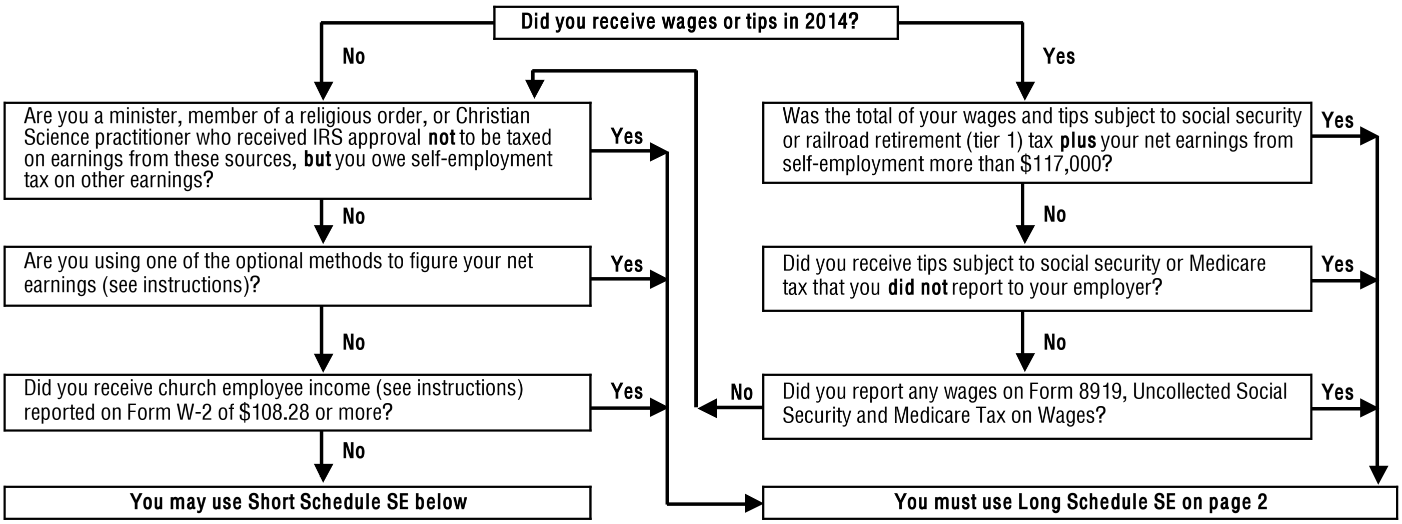
OMB No. 1545-0074
2014
Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040 or Form 1040NR)	Social security number of person with **self-employment** income ▶
JOHN N. DOE	724 11 0905

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A-Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	**1a**	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Z	**1b**	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report STMT 13	**2**	40,258.
3	Combine lines 1a, 1b, and 2	**3**	40,258.
4	Multiply line 3 by 92.35% (.9235). If less than $400, you do not owe self-employment tax; **do not** file this schedule unless you have an amount on line 1b ▶ **Note.** If line 4 is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.	**4**	37,178.
5	**Self-employment tax.** If the amount on line 4 is: • $117,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 57,** or **Form 1040NR, line 55** • More than $117,000, multiply line 4 by 2.9% (.029). Then, add $14,508 to the result. Enter the total here and on **Form 1040, line 57,** or **Form 1040NR, line 55**	**5**	5,688.
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.50). Enter the result here and on **Form 1040, line 27,** or **Form 1040NR, line 27** — **6** 2,844.		

DOES NOT APPLY

Form **6251** Department of the Treasury Internal Revenue Service (99)

Alternative Minimum Tax - Individuals

▶ Information about Form 6251 and its separate instructions is at www.irs.gov/form6251.
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074 **2014** Attachment Sequence No. **32**

Name(s) shown on Form 1040 or Form 1040NR: JOHN N. & JANE M. DOE

Your social security number: 724 11 0905

Part I Alternative Minimum Taxable Income

1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41, and go to line 2. Otherwise, enter the amount from Form 1040, line 38, and go to line 7. (If less than zero, enter as a negative amount.)	1	165,344.
2	Medical and dental. If you or your spouse was 65 or older, enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2.5% (.025) of Form 1040, line 38. If zero or less, enter -0-	2	
3	Taxes from Schedule A (Form 1040), line 9	3	9,618.
4	Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet in the instructions for this line	4	
5	Miscellaneous deductions from Schedule A (Form 1040), line 27	5	
6	If Form 1040, line 38, is $152,525 or less, enter -0-. Otherwise, see instructions	6	0.
7	Tax refund from Form 1040, line 10 or line 21	7	-1,534.
8	Investment interest expense (difference between regular tax and AMT)	8	492.
9	Depletion (difference between regular tax and AMT)	9	
10	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10	
11	Alternative tax net operating loss deduction	11	
12	Interest from specified private activity bonds exempt from the regular tax	12	
13	Qualified small business stock (7% of gain excluded under section 1202)	13	
14	Exercise of incentive stock options (excess of AMT income over regular tax income)	14	
15	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	15	
16	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	16	
17	Disposition of property (difference between AMT and regular tax gain or loss)	17	
18	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT) STMT 15	18	537.
19	Passive activities (difference between AMT and regular tax income or loss)	19	0.
20	Loss limitations (difference between AMT and regular tax income or loss)	20	
21	Circulation costs (difference between regular tax and AMT)	21	
22	Long-term contracts (difference between AMT and regular tax income)	22	
23	Mining costs (difference between regular tax and AMT)	23	
24	Research and experimental costs (difference between regular tax and AMT)	24	
25	Income from certain installment sales before January 1, 1987	25	
26	Intangible drilling costs preference	26	
27	Other adjustments, including income-based related adjustments	27	
28	**Alternative minimum taxable income.** Combine lines 1 through 27. (If married filing separately and line 28 is more than $242,450, see instructions.)	28	174,457.

Part II Alternative Minimum Tax (AMT)

29 Exemption. (If you were under age 24 at the end of 2014, see instructions.)

IF your filing status is...	AND line 28 is not over...	THEN enter on line 29...
Single or head of household	$117,300	$52,800
Married filing jointly or qualifying widow(er)	156,500	82,100
Married filing separately	78,250	41,050

STMT 14 — **29** — 77,611.

If line 28 is **over** the amount shown above for your filing status, see instructions.

30	Subtract line 29 from line 28. If more than zero, go to line 31. If zero or less, enter -0- here and on lines 31, 33, and 35, and go to line 34	30	96,846.
31	• If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter. • If you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b; **or** you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on page 2 and enter the amount from line 64 here. • **All others:** If line 30 is $182,500 or less ($91,250 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract $3,650 ($1,825 if married filing separately) from the result.	31	25,077.
32	Alternative minimum tax foreign tax credit (see instructions)	32	
33	Tentative minimum tax. Subtract line 32 from line 31	33	25,077.
34	Add Form 1040, line 44 (minus any tax from Form 4972), and Form 1040, line 46. Subtract from the result any foreign tax credit from Form 1040, line 48. If you used Sch J to figure your tax on Form 1040, line 44, refigure that tax without using Schedule J before completing this line (see instructions)	34	29,005.
35	**AMT.** Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45	35	0.

Part III **Tax Computation Using Maximum Capital Gains Rates**

Complete Part III only if you are required to do so by line 31 or by the Foreign Earned Income Tax Worksheet in the instructions.

36	Enter the amount from Form 6251, line 30. If you are filing Form 2555 or 2555-EZ, enter the amount from line 3 of the worksheet in the instructions for line 31	36	96,846.
37	Enter the amount from line 6 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44, or the amount from line 13 of the Schedule D Tax Worksheet in the instructions for Schedule D (Form 1040), whichever applies (as refigured for the AMT, if necessary) (see instructions). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	37	940.
38	Enter the amount from Schedule D (Form 1040), line 19 (as refigured for the AMT, if necessary) (see instructions). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	38	
39	If you did not complete a Schedule D Tax Worksheet for the regular tax or the AMT, enter the amount from line 37. Otherwise, add lines 37 and 38, and enter the **smaller** of that result or the amount from line 10 of the Schedule D Tax Worksheet (as refigured for the AMT, if necessary). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	39	940.
40	Enter the **smaller** of line 36 or line 39	40	940.
41	Subtract line 40 from line 36	41	95,906.
42	If line 41 is $182,500 or less ($91,250 or less if married filing separately), multiply line 41 by 26% (.26). Otherwise, multiply line 41 by 28% (.28) and subtract $3,650 ($1,825 if married filing separately) from the result ▶	42	24,936.
43	Enter: • $73,800 if married filing jointly or qualifying widow(er), • $36,900 if single or married filing separately, or • $49,400 if head of household.	43	73,800.
44	Enter the amount from line 7 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44, or the amount from line 14 of the Schedule D Tax Worksheet in the instructions for Schedule D (Form 1040), whichever applies (as figured for the regular tax). If you did not complete either worksheet for the regular tax, enter the amount from Form 1040, line 43; if zero or less, enter -0-. If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	44	148,604.
45	Subtract line 44 from line 43. If zero or less, enter -0-	45	0.
46	Enter the **smaller** of line 36 or line 37	46	940.
47	Enter the **smaller** of line 45 or line 46. This amount is taxed at 0%	47	0.
48	Subtract line 47 from line 46	48	940.
49	Enter: • $406,750 if single • $228,800 if married filing separately • $457,600 if married filing jointly or qualifying widow(er) • $432,200 if head of household	49	457,600.
50	Enter the amount from line 45	50	0.
51	Enter the amount from line 7 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44, or the amount from line 19 of the Schedule D Tax Worksheet, whichever applies (as figured for the regular tax). If you did not complete either worksheet for the regular tax, enter the amount from Form 1040, line 43; if zero or less, enter -0-. If you are filing Form 2555 or Form 2555-EZ, see instructions for the amount to enter	51	148,604.
52	Add line 50 and line 51	52	148,604.
53	Subtract line 52 from line 49. If zero or less, enter -0-	53	308,996.
54	Enter the smaller of line 48 or line 53	54	940.
55	Multiply line 54 by 15% (.15) ▶	55	141.
56	Add lines 47 and 54	56	940.
	If lines 56 and 36 are the same, skip lines 57 through 61 and go to line 62. Otherwise, go to line 57.		
57	Subtract line 56 from line 46	57	0.
58	Multiply line 57 by 20% (.20) ▶	58	
	If line 38 is zero or blank, skip lines 59 through 61 and go to line 62. Otherwise, go to line 59.		
59	Add lines 41, 56, and 57	59	
60	Subtract line 59 from line 36	60	
61	Multiply line 60 by 25% (.25) ▶	61	
62	Add lines 42, 55, 58, and 61	62	25,077.
63	If line 36 is $182,500 or less ($91,250 or less if married filing separately), multiply line 36 by 26% (.26). Otherwise, multiply line 36 by 28% (.28) and subtract $3,650 ($1,825 if married filing separately) from the result	63	25,180.
64	Enter the **smaller** of line 62 or line 63 here and on line 31. If you are filing Form 2555 or 2555-EZ, do not enter this amount on line 31. Instead, enter it on line 4 of the worksheet in the instructions for line 31	64	25,077.

Form **4952**

Department of the Treasury
Internal Revenue Service (99)

Investment Interest Expense Deduction

▶ Information about Form 4952 and its instructions is at *www.irs.gov/form4952.*
▶ Attach to your tax return.

OMB No. 1545-0191
2014
Attachment Sequence No. **51**

Name(s) shown on return	Identifying number
JOHN N. & JANE M. DOE	724-11-0905

Part I Total Investment Interest Expense

1	Investment interest expense paid or accrued in 2014 (see instructions)		1	
2	Disallowed investment interest expense from 2013 Form 4952, line 7 SEE STATEMENT 16		2	492.
3	**Total investment interest expense.** Add lines 1 and 2		3	492.

Part II Net Investment Income

4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment) STMT 17	4a	3,749.		
b	Qualified dividends included on line 4a	4b	940.		
c	Subtract line 4b from line 4a			4c	2,809.
d	Net gain from the disposition of property held for investment	4d			
e	Enter the **smaller** of line 4d or your net capital gain from the disposition of property held for investment (see instructions)	4e			
f	Subtract line 4e from line 4d			4f	
g	Enter the amount from lines 4b and 4e that you elect to include in investment income (see instructions)			4g	
h	Investment income. Add lines 4c, 4f, and 4g			4h	2,809.
5	Investment expenses (see instructions)			5	
6	**Net investment income.** Subtract line 5 from line 4h. If zero or less, enter -0-			6	2,809.

Part III Investment Interest Expense Deduction

7	Disallowed investment interest expense to be carried forward to 2015. Subtract line 6 from line 3. If zero or less, enter -0-	7	0.
8	**Investment interest expense deduction.** Enter the **smaller** of line 3 or 6. See instructions STMT 18	8	492.

Form **8582**

Department of the Treasury
Internal Revenue Service (99)

Passive Activity Loss Limitations

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1041.
▶ Information about Form 8582 and its instructions is available at www.irs.gov/form8582.

OMB No. 1545-1008
2014
Attachment Sequence No. 88

Name(s) shown on return	Identifying number
JOHN N. & JANE M. DOE	724-11-0905

Part I 2014 Passive Activity Loss

Caution: *Complete Worksheets 1, 2, and 3 before completing Part I.*

Rental Real Estate Activities With Active Participation (For the definition of active participation, see **Special Allowance for Rental Real Estate Activities** in the instructions.)

1a	Activities with net income (enter the amount from Worksheet 1, column (a))	1a	401.	
b	Activities with net loss (enter the amount from Worksheet 1, column (b))	1b	( )	
c	Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	1c	(401.)	
d	Combine lines 1a, 1b, and 1c			1d

Commercial Revitalization Deductions From Rental Real Estate Activities

2a	Commercial revitalization deductions from Worksheet 2, column (a)	2a	( )	
b	Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	2b	( )	
c	Add lines 2a and 2b			2c ( )

All Other Passive Activities

3a	Activities with net income (enter the amount from Worksheet 3, column (a))	3a		
b	Activities with net loss (enter the amount from Worksheet 3, column (b))	3b	( )	
c	Prior years unallowed losses (enter the amount from Worksheet 3, column (c))	3c	( )	
d	Combine lines 3a, 3b, and 3c			3d
4	Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used			4

If line 4 is a loss and:
- Line 1d is a loss, go to Part II.
- Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.
- Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.

Caution: *If your filing status is married filing separately and you lived with your spouse at any time during the year,* ***do not*** *complete Part II or Part III. Instead, go to line 15.*

Part II Special Allowance for Rental Real Estate Activities With Active Participation

Note: *Enter all numbers in Part II as positive amounts. See instructions for an example.*

5	Enter the **smaller** of the loss on line 1d or the loss on line 4			5
6	Enter $150,000. If married filing separately, see instructions	6		
7	Enter modified adjusted gross income, but not less than zero (see instructions)	7		
	Note: *If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.*			
8	Subtract line 7 from line 6	8		
9	Multiply line 8 by 50% (.5). **Do not** enter more than $25,000. If married filing separately, see instructions			9
10	Enter the **smaller** of line 5 or line 9			10

If line 2c is a loss, go to Part III. Otherwise, go to line 15.

Part III Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities

Note: *Enter all numbers in Part III as positive amounts. See the example for Part II in the instructions.*

11	Enter $25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions	11
12	Enter the loss from line 4	12
13	Reduce line 12 by the amount on line 10	13
14	Enter the **smallest** of line 2c (treated as a positive amount), line 11, or line 13	14

Part IV Total Losses Allowed

15	Add the income, if any, on lines 1a and 3a and enter the total	15
16	**Total losses allowed from all passive activities for 2014.** Add lines 10, 14, and 15. See instructions to find out how to report the losses on your tax return	16

Caution: *The worksheets must be filed with your tax return. Keep a copy for your records.*

Worksheet 1 - For Form 8582, Lines 1a, 1b, and 1c (See instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
Total. Enter on Form 8582, lines 1a, 1b, and 1c ▶	401.		-401.		

Worksheet 2 - For Form 8582, Lines 2a and 2b (See instructions.)

Name of activity	(a) Current year deductions (line 2a)	(b) Prior year unallowed deductions (line 2b)	(c) Overall loss
Total. Enter on Form 8582, lines 2a and 2b ▶			

Worksheet 3 - For Form 8582, Lines 3a, 3b, and 3c (See instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 3a)	(b) Net loss (line 3b)	(c) Unallowed loss (line 3c)	(d) Gain	(e) Loss
Total. Enter on Form 8582, lines 3a, 3b, and 3c ▶					

Worksheet 4 - Use this worksheet if an amount is shown on Form 8582, line 10 or 14 (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a)
Total ▶					

Worksheet 5 - Allocation of Unallowed Losses (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Unallowed loss
Total ▶				

Form **8903** (Rev. December 2010) Department of the Treasury Internal Revenue Service

Domestic Production Activities Deduction

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-1984

Attachment Sequence No. **143**

Name(s) as shown on return	Identifying number
JOHN N. & JANE M. DOE	724-11-0905

	Note. Do not complete column (a), unless you have oil-related production activities. Enter amounts for all activities in column (b), including oil-related production activities.		(a) Oil-related production activities	(b) All activities
1	Domestic production gross receipts (DPGR)	1		20.
2	Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3	2		5.
3	Enter deductions and losses allocable to DPGR (see instructions)	3		13.
4	If you are using the small business simplified overall method, enter the amount of cost of goods sold and other deductions or losses you ratably apportion to DPGR. All others, skip line 4	4		
5	Add lines 2 through 4	5		18.
6	Subtract line 5 from line 1	6		2.
7	Qualified production activities income from estates, trusts, and certain partnerships and S corporations (see instructions)	7		
8	Add lines 6 and 7. Estates and trusts, go to line 9, all others, skip line 9 and go to line 10	8		2.
9	Amount allocated to beneficiaries of the estate or trust (see instructions)	9		
10a	**Oil-related qualified production activities income.** Estates and trusts, subtract line 9, column (a), from line 8, column (a), all others, enter amount from line 8, column (a). If zero or less, enter -0- here	10a		
b	**Qualified production activities income.** Estates and trusts, subtract line 9, column (b), from line 8, column (b), all others, enter amount from line 8, column (b). If zero or less, enter -0- here, skip lines 11 through 21, and enter -0- on line 22	10b		2.

11	Income limitation (see instructions): ● Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction ● All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)	11	194,180.
12	Enter the smaller of line 10b or line 11. If zero or less, enter -0- here, skip lines 13 through 21, and enter -0- on line 22	12	2.
13	Enter 9% of line 12	13	
14a	Enter the smaller of line 10a or line 12 (14a)		
b	Reduction for oil-related qualified production activities income. Multiply line 14a by 3%	14b	
15	Subtract line 14b from line 13	15	
16	Form W-2 wages (see instructions)	16	
17	Form W-2 wages from estates, trusts, and certain partnerships and S corporations (see instructions)	17	
18	Add lines 16 and 17. Estates and trusts, go to line 19, all others, skip line 19 and go to line 20	18	
19	Amount allocated to beneficiaries of the estate or trust (see instructions)	19	
20	Estates and trusts, subtract line 19 from line 18, all others, enter amount from line 18	20	
21	Form W-2 wage limitation. Enter 50% of line 20	21	
22	Enter the smaller of line 15 or line 21	22	
23	Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6	23	
24	Expanded affiliated group allocation (see instructions)	24	
25	**Domestic production activities deduction.** Combine lines 22 through 24 and enter the result here and on Form 1040, line 35; Form 1120, line 25; or the applicable line of your return	25	0.

Qualified Production Activity Income Schedule

Name
JOHN N. & JANE M. DOE

Identifying Number:
724-11-0905

Description	Domestic Production Gross Receipts (DPGR)	DPGR Ratio	Directly Allocable Expenses: Costs of Goods Sold	Directly Allocable Expenses: Other Costs	Apportioned Expenses	Interest Expense Allocation/ Apportionment: Allocable Assets	Interest Expense Allocation/ Apportionment: Assets Ratio	Interest Expense Allocation/ Apportionment: Interest Expense	Total Qualified Expenses	Qualified Production Activity Income
ENTERPRISE PRODUCTS PARTNERS	20.	1	5.	13.	0.				18.	2.
TOTAL	20.	1	5.	13.	0.				18.	
TOTAL FROM QUALIFIED ACTIVITIES	20.	1	5.	13.	0.				18.	2.

408501
05-01-14

Form **4562**

Department of the Treasury
Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)

▶ Attach to your tax return. SCHEDULE C- 1

▶ Information about Form 4562 and its separate instructions is at www.irs.gov/form4562.

OMB No. 1545-0172

2014

Attachment Sequence No. **179**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
JOHN N. & JANE M. DOE	QUAD J	724-11-0905

Part I Election To Expense Certain Property Under Section 179 **Note:** *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount (see instructions)	1	500,000.
2	Total cost of section 179 property placed in service (see instructions)	2	39,062.
3	Threshold cost of section 179 property before reduction in limitation	3	2,000,000.
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0.
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	500,000.

6 (a) Description of property	(b) Cost (business use only)	(c) Elected cost
COMPUTERS	6,500.	5,500.
TOYOTA TUNDRA	32,562.	32,562.

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	38,062.
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	38,062.
10	Carryover of disallowed deduction from line 13 of your 2013 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5	11	233,220.
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	38,062.
13	Carryover of disallowed deduction to 2015. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II **Special Depreciation Allowance and Other Depreciation (Do not** include listed property.**)**

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year	14	500.
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III **MACRS Depreciation (Do not** include listed property.) (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2014	17	5,000.
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B - Assets Placed in Service During 2014 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only - see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property		500.	5 YRS.	HY	200DB	100.
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property	/		27.5 yrs.	MM	S/L	
	/		27.5 yrs.	MM	S/L	
i Nonresidential real property	/		39 yrs.	MM	S/L	
	/			MM	S/L	

Section C - Assets Placed in Service During 2014 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year	/		40 yrs.	MM	S/L	

Part IV **Summary** (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations - see instr.	22	43,662.
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

Part V **Listed Property** (Include automobiles, certain other vehicles, certain aircraft, certain computers, and property used for entertainment, recreation, or amusement.)

Note: *For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete* only *24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A - Depreciation and Other Information (Caution: *See the instructions for limits for passenger automobiles.***)**

24a Do you have evidence to support the business/investment use claimed? ☐ Yes ☐ No **24b** If "Yes," is the evidence written? ☐ Yes ☐ No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/ investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use						25		
26 Property used more than 50% in a qualified business use:								
	010106	57.56 %						
		%						
		%						
27 Property used 50% or less in a qualified business use:								
		%				S/L -		
		%				S/L -		
		%				S/L -		
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1						28		
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1							29	

Section B - Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle		(c) Vehicle		(d) Vehicle		(e) Vehicle		(f) Vehicle	
30 Total business/investment miles driven during the year (**do not** include commuting miles)	14,000											
31 Total commuting miles driven during the year												
32 Total other personal (noncommuting) miles driven	10,322											
33 Total miles driven during the year. Add lines 30 through 32	24,322											
	Yes	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
34 Was the vehicle available for personal use during off-duty hours?												
35 Was the vehicle used primarily by a more than 5% owner or related person?												
36 Is another vehicle available for personal use?	X											

Section C - Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who **are not** more than 5% owners or related persons.

	Yes	No
37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
39 Do you treat all use of vehicles by employees as personal use?		
40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
41 Do you meet the requirements concerning qualified automobile demonstration use?		

Note: *If your answer to 37, 38, 39, 40, or 41 is "Yes," do not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
42 Amortization of costs that begins during your 2014 tax year:					
43 Amortization of costs that began before your 2014 tax year				43	
44 Total. Add amounts in column (f). See the instructions for where to report				44	

FORM 1040 STATE AND LOCAL INCOME TAX REFUNDS STATEMENT 1

	2013	2012	2011
	ARIZONA		
GROSS STATE/LOCAL INC TAX REFUNDS	1,534.		
LESS: TAX PAID IN FOLLOWING YEAR			
NET TAX REFUNDS ARIZONA	1,534.		
TOTAL NET TAX REFUNDS	1,534.		

FORM 1040 TAXABLE STATE AND LOCAL INCOME TAX REFUNDS STATEMENT 2

	2013	2012	2011
NET TAX REFUNDS FROM STATE AND LOCAL INCOME TAX REFUNDS STMT.	1,534.		
LESS:REFUNDS-NO BENEFIT DUE TO AMT -SALES TAX BENEFIT REDUCTION			
1 NET REFUNDS FOR RECALCULATION	1,534.		
2 TOTAL ITEMIZED DEDUCTIONS BEFORE PHASEOUT	21,479.		
3 DEDUCTION NOT SUBJ TO PHASEOUT			
4 NET REFUNDS FROM LINE 1	1,534.		
5 LINE 2 MINUS LINES 3 AND 4	19,945.		
6 MULT LN 5 BY APPL SEC. 68 PCT	15,956.		
7 PRIOR YEAR AGI	83,623.		
8 ITEM. DED. PHASEOUT THRESHOLD	250,000.		
9 SUBTRACT LINE 8 FROM LINE 7 (IF ZERO OR LESS, SKIP LINES 10 THROUGH 15, AND ENTER AMOUNT FROM LINE 1 ON LINE 16)	-166,377.		
10 MULT LN 9 BY APPL SEC. 68 PCT			
11 ALLOWABLE ITEMIZED DEDUCTIONS (LINE 5 LESS THE LESSER OF LINE 6 OR LINE 10)			
12 ITEM DED. NOT SUBJ TO PHASEOUT			
13A TOTAL ADJ. ITEMIZED DEDUCTIONS			
13B PRIOR YR. STD. DED. AVAILABLE			
14 PRIOR YR. ALLOWABLE ITEM. DED.			
15 SUBTRACT THE GREATER OF LINE 13A OR LINE 13B FROM LINE 14			
16 TAXABLE REFUNDS (LESSER OF LINE 15 OR LINE 1)	1,534.		
17 ALLOWABLE PRIOR YR. ITEM. DED.	21,479.		
18 PRIOR YEAR STD. DED. AVAILABLE	6,100.		
19 SUBTRACT LINE 18 FROM LINE 17	15,379.		
20 LESSER OF LINE 16 OR LINE 19	1,534.		
21 PRIOR YEAR TAXABLE INCOME	58,244.		

22 AMOUNT TO INCLUDE ON FORM 1040, LINE 10 * IF LINE 21 IS -0- OR MORE, USE AMOUNT FROM LINE 20 * IF LINE 21 IS A NEGATIVE AMOUNT, NET LINES 20 AND 21	1,534.
STATE AND LOCAL INCOME TAX REFUNDS PRIOR TO 2011	
TOTAL TO FORM 1040, LINE 10	1,534.

FORM 1040 WAGES RECEIVED AND TAXES WITHHELD STATEMENT 3

T S -	EMPLOYER'S NAME	AMOUNT PAID	FEDERAL TAX WITHHELD	STATE TAX WITHHELD	CITY SDI TAX W/H	FICA TAX	MEDICARE TAX
S	ABC COMPANY	157,500.	35,500.	5,800.		7,254.	2,538.
	TOTALS	157,500.	35,500.	5,800.		7,254.	2,538.

FORM 1040 QUALIFIED DIVIDENDS STATEMENT 4

NAME OF PAYER	ORDINARY DIVIDENDS	QUALIFIED DIVIDENDS
MERRILL LYNCH	800.	650.
KRAFT	128.	128.
MONDOLEZ	162.	162.
TOTAL INCLUDED IN FORM 1040, LINE 9B		940.

FORM 1040 SELF-EMPLOYED HEALTH INSURANCE DEDUCTION WORKSHEET STATEMENT 5

JOHN N. DOE

QUAD J

1	NONSPECIFIED HEALTH INSURANCE PAYMENTS		10,682.
2	NET PROFIT FROM TRADE OR BUSINESS UNDER WHICH INSURANCE PLAN IS ESTABLISHED		40,258.
3	TOTAL OF ALL NET PROFITS AND EARNED INCOME	40,258.	
4	DIVIDE LINE 2 BY LINE 3	1.0000	
5	DEDUCTIBLE PORTION OF SELF-EMPLOYMENT TAX	2,844.	
6	LINE 4 TIMES LINE 5		2,844.
7	LINE 2 MINUS LINE 6		37,414.
8	SELF-EMPLOYED SEP, SIMPLE, AND QUALIFIED PLANS ATTRIBUTABLE TO TRADE OR BUSINESS NAMED ABOVE		0.
9	LINE 7 MINUS LINE 8		37,414.
10	FORM 2555, LINE 45 ATTRIBUTABLE TO THE TRADE OR BUSINESS NAMED ABOVE		
11	LINE 9 MINUS LINE 10		37,414.
12	SELF-EMPLOYED HEALTH INSURANCE DEDUCTION. LESSER OF LINE 1 OR LINE 11		10,682.

SCHEDULE A MORTGAGE INTEREST AND POINTS REPORTED ON FORM 1098 STATEMENT 6

DESCRIPTION	AMOUNT
PNC, P.O. BOX 1820, DAYTON, OH 45401-1820	1,747.
GREEN TREE SERVICING LLC, PO BOX 6172, RAPID CITY, SD 57709-6172	11,979.
TOTAL TO SCHEDULE A, LINE 10	13,726.

SCHEDULE A	INVESTMENT INTEREST	STATEMENT 7

DESCRIPTION	AMOUNT
DISALLOWED INVESTMENT INTEREST PRIOR YEARS	492.
TOTAL TO SCHEDULE A, LINE 14	492.

SCHEDULE A	MEDICAL AND DENTAL EXPENSES	STATEMENT 8

DESCRIPTION	AMOUNT
PRESCRIPTION MEDICINES AND DRUGS	2,500.
TRANSPORTATION	282.
DOCTORS, DENTISTS, ETC.	2,080.
EYEGLASSES AND CONTACTS	1,600.
TOTAL TO SCHEDULE A, LINE 1	6,462.

SCHEDULE C	CAR AND TRUCK EXPENSES	STATEMENT 9

DESCRIPTION	AMOUNT
VEHICLE NUMBER 1 - 14000 BUSINESS MILES @ $0.560	7,840.
CAR AND TRUCK EXPENSES	6,000.
TOTAL TO SCHEDULE C, LINE 9	13,840.

SCHEDULE C	OTHER COSTS OF GOODS SOLD	STATEMENT 10

DESCRIPTION	AMOUNT
	68,877.
TOTAL TO SCHEDULE C, LINE 39	68,877.

SCHEDULE D	CAPITAL LOSS CARRYOVER		STATEMENT 11
1.	ENTER THE AMOUNT FROM FORM 1040, LINE 41		165,344.
2.	ENTER THE LOSS FROM SCHEDULE D, LINE 21, AS A POSITIVE AMOUNT		3,000.
3.	COMBINE LINES 1 AND 2. IF ZERO OR LESS, ENTER -0-		168,344.
4.	ENTER THE SMALLER OF LINE 2 OR LINE 3		3,000.
5.	ENTER THE LOSS FROM SCHEDULE D, LINE 7, AS A POSITIVE AMOUNT		500.
6.	ENTER THE GAIN, IF ANY, FROM SCHEDULE D, LINE 15		
7.	ADD LINES 4 AND 6		3,000.
8.	SHORT-TERM CAPITAL LOSS CARRYOVER TO NEXT YEAR. SUBTRACT LINE 7 FROM LINE 5. IF ZERO OR LESS, ENTER -0-		0.
9.	ENTER THE LOSS FROM SCHEDULE D, LINE 15, AS A POSITIVE AMOUNT		10,309.
10.	ENTER THE GAIN, IF ANY, FROM SCHEDULE D, LINE 7		
11.	SUBTRACT LINE 5 FROM LINE 4. IF ZERO OR LESS, ENTER -0-	2,500.	
12.	ADD LINES 10 AND 11		2,500.
13.	LONG-TERM CAPITAL LOSS CARRYOVER TO NEXT YEAR. SUBTRACT LINE 12 FROM LINE 9. IF ZERO OR LESS, ENTER -0-		7,809.

SCHEDULE E	OTHER EXPENSES	STATEMENT 12

RENTAL - TUCSON, AZ 85745

DESCRIPTION	AMOUNT
ASSOCIATION FEES	600.
LICENSES AND FEES	12.
TOTAL TO SCHEDULE E, PAGE 1, LINE 19	612.

SCHEDULE SE	NON-FARM INCOME	STATEMENT 13

DESCRIPTION	AMOUNT
COMPUTER TECHNICIAN	40,258.
TOTAL TO SCHEDULE SE, LINE 2	40,258.

FORM 6251	EXEMPTION WORKSHEET	STATEMENT 14

1 ENTER: $52,800 IF SINGLE OR HEAD OF HOUSEHOLD; $82,100 IF MARRIED FILING JOINTLY OR QUALIFYING WIDOW(ER); $41,050 IF MARRIED FILING SEPARATELY		82,100.
2 ENTER YOUR ALTERNATIVE MINIMUM TAXABLE INCOME (AMTI) FORM 6251, LINE 28	174,457.	
3 ENTER: $117,300 IF SINGLE OR HEAD OF HOUSEHOLD; $156,500 IF MARRIED FILING JOINTLY OR QUALIFYING WIDOW(ER); $78,250 IF MARRIED FILING SEPARATELY	156,500.	
4 SUBTRACT LINE 3 FROM LINE 2. IF ZERO OR LESS ENTER -0-	17,957.	
5 MULTIPLY LINE 4 BY 25% (.25)		4,489.
6 SUBTRACT LINE 5 FROM LINE 1. IF ZERO OR LESS, ENTER -0-. IF ANY OF THE THREE CONDITIONS UNDER CERTAIN CHILDREN UNDER AGE 24 APPLY TO YOU, COMPLETE LINES 7 THROUGH 10. OTHERWISE, STOP HERE AND ENTER THIS AMOUNT ON FORM 6251, LINE 29, AND GO TO FORM 6251, LINE 30		77,611.
7 MINIMUM EXEMPTION AMOUNT FOR CERTAIN CHILDREN UNDER AGE 24		
8 ENTER YOUR EARNED INCOME, IF ANY		
9 ADD LINES 7 AND 8		
10 ENTER THE SMALLER OF LINE 6 OR LINE 9 HERE AND ON FORM 6251, LINE 29, AND GO TO FORM 6251, LINE 30		

FORM 6251	DEPRECIATION ON ASSETS PLACED IN SERVICE AFTER 1986	STATEMENT 15

DESCRIPTION	AMOUNT
COMPUTER	107.
EQUIPMENT	430.
TOTAL TO FORM 6251, LINE 18	537.

FORM 4952	INVESTMENT INTEREST EXPENSE	STATEMENT 16

DESCRIPTION	CURRENT	CARRYOVER
	0.	
DISALLOWED INVESTMENT INTEREST PRIOR YEARS		492.
TOTALS TO FORM 4952, LINES 1 AND 2		492.

FORM 4952 INCOME FROM PROPERTY HELD FOR INVESTMENT STATEMENT 17

DESCRIPTION	AMOUNT
INTEREST INCOME	2,659.
DIVIDEND INCOME	1,090.
TOTAL TO FORM 4952, LINE 4A	3,749.

FORM 4952 INVESTMENT INTEREST EXPENSE DEDUCTION SUMMARY STATEMENT 18

NAME	FORM OR SCHEDULE	INVESTMENT INTEREST EXPENSE	INVESTMENT INTEREST EXPENSE C/O	DISALLOWED INVESTMENT INTEREST EXPENSE	ALLOWED INVESTMENT INTEREST EXPENSE
	SCH A	0.	0.	0.	0.
DISALLOWED INVESTMENT	SCH A	0.	492.	0.	492.
TOTALS		0.	492.	0.	492.

FORM 8582 ACTIVE RENTAL OF REAL ESTATE - WORKSHEET 1 STATEMENT 19

	CURRENT YEAR		PRIOR YEAR	OVERALL GAIN OR LOSS	
NAME OF ACTIVITY	NET INCOME	NET LOSS	UNALLOWED LOSS	GAIN	LOSS
RENTAL - TUCSON, AZ 85745	401.	0.	-401.		
TOTALS	401.	0.	-401.		

FORM 8582 SUMMARY OF PASSIVE ACTIVITIES STATEMENT 20

R R E A	NAME	FORM OR SCHEDULE	GAIN/LOSS	PRIOR YEAR C/O	NET GAIN/LOSS	UNALLOWED LOSS	ALLOWED LOSS
X	RENTAL - TUCSON, AZ 85745	SCH E	401.	-401.	0.		
	TOTALS		401.	-401.	0.		
	PRIOR YEAR CARRYOVERS ALLOWED DUE TO CURRENT YEAR NET ACTIVITY INCOME						401.
	TOTAL						401.

FORM 4562 PART I - BUSINESS INCOME STATEMENT 21

INCOME TYPE	AMOUNT
WAGES	157,500.
SCHEDULE C	40,258.
S CORPORATIONS	-2,600.
SECTION 179 EXPENSE	38,062.
TOTAL BUSINESS INCOME USED IN FORM 4562, LINE 11	233,220.

TAB 7

Forensic Evidence

Forensics and Electronic Evidence: What's Possible, What's not

What is ESI—Electronically Stored Information

- This includes all data contained on any device.
- Devices include all computers, notepads, tablets, cell phones, thumb drives, removable hard drives, etc.
- Data includes matter that is intentionally stored or contained on a device. Data also includes unintentionally stored information, such as metadata.
- Data is originated in native formatting. Native formatting includes the software in which it is originally created. Non-native formatting normally includes data that has been transferred to a different software program that eliminates some or all of the metadata. Non-native formatting may not present the data in a format that matches native formatting. Non-native formatting may not disclose all of the information that is being sought.
- Examples include:
    - Word and Excel documents that have metadata associated with the document. If the document is stripped of its metadata, then it does not reflect a complete history of the data.
    - Photos have metadata associated with each photo
    - Documents have metadata
    - Accounting data: QuickBooks vs. Excel.

Duty of lawyer and accountant if ESI exists.

- A litigation hold should be placed on all ESI the moment that litigation is anticipated or filed that could relate to such ESI.
- A litigation hold is this: A directive to all employees or others who have access to or control of ESI that may relate to the litigation. In such a situation, all employees and others who have the ability to modify or eliminate such ESI should be notified of such a hold. Such notification should be in writing (a writing may include electronic communication).
    - It is important to be able to prove that a litigation hold was instituted and when.
    - It is important to be able to verify that all relevant people have been notified of the litigation hold.
- If in doubt, one should review the opinions of U.S. District Judge Shira Scheindlin in *Zubalake v. UBS Warburg* (381 F.Supp. 2d 536; 231 F.R.D. 159 (2005)) and subsequent cases in which the responding party was required to place a litigation hold as to evidence and to require the responding party to properly search the electronic databases for compliance with discovery requests and disclosure duties. Sanctions were imposed because of the failure to preserve and produce, which included adverse inferences at trial. Judge Scheindlin's opinions in the *Zubalake* case have established the standard of practice for litigation holds and the duty to fully search the data for discovery compliance.

ESI is to be handled as according to Rule 62(B), Arizona Rules of Family Law Procedure.

- The requesting party may specify the form in which ESI is to be produced.
- If the responding party does not agree with the form of production that has been requested, or if the request does not specify the form for the production, the responding party must then state the form it intends to use.
- If a conflict exists between the requesting party and the responding party (that is, the producer or custodian of the data), then the Court will resolve the conflict.

A subset of ESI is health care information that is covered by HIPAA (Health Insurance Portability and Accountability Act). This federal law requires that the health information of all individuals is to be protected. To the extent that law firms and others collect health care information on individuals, the law firms are covered by HIPAA. This commonly arises regarding custody and as to claims of disability based on health issues. Questions:

- What protections do you establish to safeguard such data in your office?
- What protections do you establish to prevent hacking into your law firm data base? Do you have standards that are sufficient to prevent invasion by another?
- When was the last time that you misplaced your cell phone or tablet?
- Are your devices password protected? If so, is the password sufficient?

- When you dispose of information, do you have a method of preventing disclosure to another?
    - Shred documents
        - We have a shredding service that provides a medium size container for shredding. The service picks up on request and then provides a replacement container. The cost is $
    - Clean hard drives and memory cards
        - Don't forget copiers have memory cards in them.
        - These should be cleaned professionally.

- Need for *ex parte* court orders to seize data
    - If there is a threat that the data may be removed or deleted, then one should consider an *ex parte* court order to have the devices seized.
    - One needs to have a forensic expert take possession who can
        - Preserve the existing device
        - Copy the device without damaging the original
        - Perform analytics on the copy to find the relevant data
        - Find hidden or deleted data

- Role of special master in investigations

    - Under Rule 72, Arizona Rules of Family Law Procedure, the court may appoint an individual to serve as a special master for such issues as discovery.
    - I have served many times as a Discovery Master.

- In the event of difficulties of discovery, especially when there is substantial data and documents subject to disclosure, it may be helpful to ask the court to appoint a Discovery Master.
- The appointment and compensation must be specified by the court in its order.
- Thereafter, the Discovery Master will consider the presentation of issues and make a recommendation to the court for its ruling.

- Legal issues when privacy is violated
  - Offending party is subject to criminal proceedings and is subject to claims for damages and for injunctive relief. See 18 USC § 2511 *et seq*.
  - When ill-gotten data is obtained in violation of the federal law, it is not allowed to be used in any court proceeding in the U.S.
  - 18 USC § 2515 – Prohibition of use as evidence of intercepted wire or oral communications
  - "Whenever any wire or oral communication has been intercepted, no part of the contents of such communication and no evidence derived therefrom may be received in evidence in any trial, hearing, or other proceeding in or before any court, grand jury, department, officer, agency, regulatory body, legislative committee, or other authority of the United States, a State, or a political subdivision thereof if the disclosure of that information would be in violation of this chapter."

- Discovery issues

  - Authentication of ESI options:
    - Arizona Rule of Evidence 901: To satisfy the requirement of authenticating or identifying an item of evidence, the proponent must produce evidence sufficient to support a finding that the item is what the proponent claims it is.
    - The following are possible authenticators:
      - Owner of ESI to testify
      - User of ESI to testify
      - Forensic expert to testify

- Is a computer private to one party only

  - Password protected or not
  - Who has access to the password
  - Is it a shared password
  - Is the password private to the party
  - Can you use documents obtained surreptitiously from the other side
  - What if you are not sure that it is shared
  - What if you uncover waste
    - David Simon is a hedge fund operator in NY; his Wife employed a computer forensic team to prove that he was paying money for sugardaddy.com and to pay off a woman who is the mother of one of his children. Hedge

fund and Husband both sued Wife, computer forensic expert and Wife's attorney.

- Spy software
    - Capturing communications and data as they are being transmitted or stored.
    - Clearly a violation of wiretap laws. 18 USC § 2510
    - Be careful:
        - People who commit such bugging may be dangerous to the spouse; you want the spouse to act carefully on this issue
            - Cid Torrez monitored his wife's emails with spyware that he installed. The wife disappeared in 2012. Husband is now charged with murder and wiretapping.
    - Billionaire Kirk Kerkorian and his son were accused of wiretapping Kirk's ex-wife. The lesson learned from this is that the son (then an attorney) was sent to prison for wiretapping.

- Warnings to client at first meeting regarding law of privacy

    - Protect your own information
    - Do not invade the other person's information
    - Is there a need to have a computer forensic expert review all of the devices in order to prevent future disclosures to the other side?
    - Does client have a password that the other party will not be able to discover?

        - Advise client not to use:
            - Child’s name
            - Pet’s name
            - Significant dates
            - Anything that the other party may be able to figure out

- Arizona wiretap law statute:

    A.R.S. § 13-3005. <u>Interception of wire, electronic and oral communications; installation of pen register or trap and trace device; classification; exceptions</u>

    A. Except as provided in this section and section 13-3012, a person is guilty of a class 5 felony who either:

    1. Intentionally intercepts a wire or electronic communication to which he is not a party, or aids, authorizes, employs, procures or permits another to so do, without the consent of either a sender or receiver thereof.

    2. Intentionally intercepts a conversation or discussion at which he is not present, or aids, authorizes, employs, procures or permits another to so do, without the consent of a party to such conversation or discussion.

    3. Intentionally intercepts the deliberations of a jury or aids, authorizes, employs, procures or permits another to so do.

    B. Except as provided in sections 13-3012 and 13-3017, a person who intentionally and without lawful authority installs or uses a pen register or trap and trace device on the telephone lines or communications facilities of another person which are utilized for wire or electronic communication is guilty of a class 6 felony.

- Arizona ethics rules for lawyers
- Can a lawyer secretly record or have his/her client secretly record
  - 00-04: Recorded Conversations; Advice to Client; Divorce 11/2000

    An attorney may ethically advise a client that the client may tape record a telephone conversation in which one party to the conversation has not given consent to its recording, if the attorney concludes that such taping is not prohibited by federal or state law. [ERs 1.2(d), 1.4(b), 2.1]

  - 01-04: Confidentiality; Disclosure; Withdrawal from Representation 3/2001

  - This Opinion discusses a lawyer's ethical obligations not to use information obtained by a client in a civil case from documents copied from the records of a potentially adverse party *that contain privileged or otherwise confidential information* without the consent of opposing counsel or court order. The lawyer also must advise the client to refrain from obtaining other privileged documents and notify opposing counsel of the receipt of the information. [ERs 1.2, 1.6, 1.16, 3.4, 4.1, 4.4, 8.4]

- One recent case before the U.S. Supreme Court dealt with electronic communications (texting) and the ability of the employer (in this case, the city) to claim ownership of such: *City of Ontario v. Quon*, 560 U.S. 746, 130 S.Ct. 2619, 177 L.Ed.2d 216 (2010). Quon, an employee of the city, used an alphanumeric pager to communicate with others on personal matters in addition to communications related to his job. The city owned the pager and supplied the pager to employees. When the city investigated Quon's non-job usage, the employee claimed the city violated his privacy. The U.S. Supreme Court held that the pager belonged to the city and the city had the right to investigate such as long as it was reasonable in scope and related to the job. In this situation, the City only searched text messages from the pager for a limited time period and also limited its review to the period when Quon was actually on the job. After determining that Quon abused the text messaging system, he was disciplined. Quon appealed and ultimately lost because U.S. Supreme Court found that the search by the City was reasonable.

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Evidence Solutions, Inc.
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Present:

Electronic Evidence

October 2015

Presented by:

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American Academy of Matrimonial Lawyers Arizona Divorce Conference

Marital Issues & Divorces are Fueling Spy Technology Sales

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- Almost Everything: from the character of the user to their interests, activities, financial health, acquaintances and more.
- Collected from their life online: applications, email systems, web browsers and free space.
- The details from their life, outlook, intelligence and interactions are as individual as any fingerprint.
- All Public & Private business transactions, communications with accomplices, fraud indicators and much more are frequently available.

What can data Forensics Tell Us?

- Hiding / Finding Assets
- Overseas Accounts
- Investment Accounts
- Disposal of Assets
- Immoral Activities
  - Sex
  - Drugs
  - Drinking

General Uses

- Illicit affairs
- Gambling
- Schedules – missing kids events
- Surveillance of spouse activities
- Pre-divorce Planning
- Manipulation of Finances

General Uses

- Keyloggers
- GPS devices
- Spyware
- Planting of contraband
- Remote access to
  - Computers
  - Email
  - etc

Hazards

- Cyberstalking
- Cyberharrassment
- Social Media

Hazards

Getting Started

- All known devices
  - Computers
  - Cell phones
  - Tablets
  - Backup drives

Portable Sources of Evidence

- Cell Phones & Tablets
  - Text messages
  - Photos?
    - GeoTagging
  - Calendars
  - Phone Books
  - Call Logs
  - Complete information about where the phone has been….

Cell Phone Spying Software

- Mspy
- Mobi Stealth
- Spy Bubble
- Spy Phone Tap

- Android
- iPhone
- BlackBerry
- Windows Mobile

- Monitor / Record Calls
- Record Surroundings
- SMS & MMS
- GPS Location
- Internet Use
- Remote Access to:
  - Calendar
  - Contacts
- Instant Messages
- Photos & Videos
- Turn on Camera & Microphone
- Remote Control

Cell Phone Spying Software

- GPS
  - Built into the car
  - Stand alone
  - Yes they can be attached to a car and report back everywhere the car has been
    - Active
    - Passive

Beware: GPS

GPS Tracking Devices

GPS Tracking Devices

Beware

- Keyloggers
- Spying software
  - Computers
  - Cell Phones
- Hidden Cameras

Keyloggers

- KeyLogger Pro
- Spyrix Free Keylogger

- Can be installed and then hidden
- Send keystrokes elsewhere
  - Including Web Addresses & Passwords

- Financial Institutions, Dating Sites, Social Media, Etc

Spying Equipment

Spying Equipment

Spying Equipment

Spying Equipment

Spying Equipment

Spying Equipment

Spying Equipment

- Can send video to remote locations
- Can record video for later download
- Can store video on the Internet

Spying Equipment

Spying Equipment

- Voice Records have similar functionality to Video Devices

Spying Equipment

- **Anti-Spy Technology**
  - Some of these companies also offer “Counter Surveillance” technology including:
    - Bug Detectors
    - Phone Tap Detectors
    - Audio Jammers
    - Voice Changers

Anti-Spying Equipment

- **Data Wiping, File Wiping, Data Scrubbing or Hard Disk Drive Wiping Utilities (Data Shredding):**
  - These software applications are used to permanently and completely destroy electronic data from Data Storage Devices making it unrecoverable.

Beware Wiping Software

Beware Wiping Software

- Eraser 6
- DBAN (Darik's Boot and Nuke)
- CBL Data Shredder
- ErAce
- HDShredder Free Edition
- HDDErase
- MHDD
- KillDisk
- Format Command With Write Zero Option
- Macrorit Disk Partition Wiper
- Eraser
- Freeraser
- Disk Wipe
- Hardwipe
- Secure Eraser
- PrivaZer
- PC Shredder
- AOMEI Partition Assistant Standard Edition
- Remo Drive Wipe
- CCleaner

Other things...

- Ownership
- Invasion of privacy
- Time is of the essence

Resources

- SpygearGadgets.com
- SpyTecInc.com
- SpyEmporium.com

- One site that sells some Spy Equipment:
  - "… all you have to do is obtain permission from the phone's owner/user, install a small application on the phone ..."
  - Then you can monitor their whereabouts, track them by GPS, read their email, and read their text messages.
  - Warning: The description stops short of warning the purchaser to check local laws or consult an attorney prior to purchase or use.

Warning!!!

- Meta Data is Everywhere
  - – it can tell a much different story than the data
- How does a lawyer know when to call for help?
  - - upfront a consultant can steer an attorney in the right direction
  - - data that looks suspicious

What to do/How to do it

Contact Information

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Drop me an email and ask to be put on my mailing list.

TAB 8

Spousal Rights and Benefits Relating to Social Security

Social Security Claiming Education for Family Law Attorneys

Valuable Strategies and Costly Mistakes

James P. Dew, CFP®, MBA, ChFC®, CDFA™

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Stuff Lawyers Create that only Lawyers read

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Why does this matter to you?
Because it will help you help your clients!

- Longevity Insurance
- Lifetime Income after Divorce
- Portfolio Protection
- Income Tax Planning
- Divorce Planning
- Spousal Benefits Pre/Post Divorce
- Beneficiary Protection
- Fee Justification
- Prevents Liability (Malpractice)

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How is the benefit calculated?

- PIA (Primary Insurance Amount)
- AWI (Average Wage Indices)
- AIME (Average Indexed Monthly Earnings)
- Bend Points
- 1979 it started (1977)
- $9,779.44
- Bend Points $180, $1,085

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Primary Insurance Amount (PIA)

- If you qualify in 2015 (age 62), they use number from 2013 (age 60) for your AWI
- 2015 uses $44,888.16
- $44,888.16/$9,779.44 = 4.5901
- Bend Points for 2015 are
  $180 * 4.5901 and $1,085 * 4.5901
- $826 and $4,980

Sample PIA calculation

- If your AMIE is $7,000 for 2015:
- 90 % of $826 plus
- 32% of ($4,980 – $826) plus
- 15% of the amount over $4,980
- Equals $2,375 (this is the PIA)

When is FRA?

- FRA depends on date of birth
- You are born one day before your B-day according to SS (New Year’s babies)
- Born in 1942 FRA is 65 and 10 months
- Born 1943 to 1954 FRA is 66
- Born in 1955 FRA is 66 and 2 months
- Born 1960 or later FRA is 67

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When is FRA for survivors?

- Subtract 2 years from prior chart to get FRA for Survivor’s benefits
- Example: If you were born in 1957, your FRA is 66 and 6 months.
- Your FRA for Survivor’s Benefits is the same as someone’s FRA born in 1955. That is 66 and 2 months

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What does it mean to delay?

- Age 62 – 75% of PIA
- Age 63 – 80% of PIA
- Age 64 – 86.7% of PIA
- Age 65 – 93.3% of PIA
- Age 66 – 100% of PIA
- Age 67 – 108% of PIA
- Age 68 – 116% of PIA
- Age 69 – 124% of PIA
- Age 70 – 132% of PIA

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Why don't people delay benefits?

- No one has shown them how to collect one benefit while receiving another
- No one has done an analysis to give them options
- Many people don't understand that they will not get more by claiming early

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Taxation of Benefits

- Single Taxpayer
  - Above $25,000 of Provisional Income 50% of Benefit Becomes Taxable
  - Above $34,000 of Provisional Income 85% of Benefit Becomes Taxable
- Married Filing Jointly
  - Above $32,000 of Provisional Income 50% of Benefit Becomes Taxable
  - Above $44,000 of Provisional Income 85% of Benefit Becomes Taxable

Survivor's Benefits

- Survivor is entitled to larger of own or Survivor's Benefit
- Survivor's Benefit can be claimed as early as 60
- If a survivor takes at age 60 he/she will get 71.5% of deceased spouse's benefit
- If survivor is FRA then he/she will get at least 82.5% of deceased spouse's PIA

Survivor's Benefits

- General Formula
- Survivor's Benefit = Survivor Benefit Fraction X Full Widow's Benefit
- Where Full Widow's Benefit =

  MAX (Deceased Spouse's mo Benefit Amt, 82.5% of Deceased Spouse's PIA)

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Spousal Benefits

- An individual is entitled to the larger of benefits based on his/her work record or Spousal Benefits (up to 50% of spouse's PIA)
- Both spouses cannot receive Spousal Benefits at the same time (but Divorced People can)
- An individual can only receive Spousal Benefits after his/her spouse has filed (Divorced = 62+)
- If an individual files prior to his/her FRA, he/she is "deemed" to be filing for the combo
- After FRA, he/she can apply for Spousal Benefits only and switch to his/her benefits later
- Spousal benefits are reduced when taken before FRA
- Spousal benefits don't grow after FRA

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Key Points On Divorce

- A marriage must last a minimum of 10 years (2 years post divorce) to qualify for Spousal Benefits on Ex's work record
- To collect Spousal Benefits on an Ex the Ex has to be 62 years old or older
- A Divorced Person can keep Survivor Benefits on an Ex Spouse if he/she doesn't remarry before age 60

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Key Points On Divorce

- If a Divorced Person was married to more than one person for 10 years each, she can choose which Spousal Benefit to take (and may be able to have a Survivor Benefit as well if one of them predeceases her).
- If someone is receiving Spousal Benefits, he/she will retain them after Divorce unless he/she remarries

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What Benefits Could a Divorced Person ("Betty") Receive?

- Betty's Own Benefit
- Betty's Spousal Benefit on Ex-Spouse's Work Record
  - Marriage Lasted 10 years
  - Ex must be 62 years old or older
  - Betty can't be married
  - Betty must be 62 years old or older

Betty's Benefits (Cont'd)

- Betty's Survivor Benefit on Ex-Spouse
  - Marriage of 10 years +
  - She Retains this Benefit Even if She Remarries after age 60
  - Betty must be over 60 (or 50 if disabled)
  - Ex-Spouse must die (not at Betty's hands)
  - (If Betty's Spouse died while they were married, there is only a 9 month requirement)

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How Is Being Divorced Better?

- Married Couples cannot each receive a Spousal Benefit at the same time – Divorced People can!
- For a Married Person to receive a Spousal Benefit, the other spouse has to have filed. For a Divorced Person, the other spouse merely needs to be 62 +

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How Is Being Divorced Better?

- Social Security will not notify a Divorced Person if the Ex claims on his/her benefit (it can be a secret, Shhhhhh!)
- Claiming a benefit on an Ex Spouse doesn't reduce his/her benefits in any way (If someone is fond of an Ex, it won't hurt him/her)

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Case Study Divorced Survivor

- You are Jane's trusted attorney
- Her marriage to Tom lasted 14 years
- Jane informs you her Ex Tom has passed away
- She has questions about how this might impact the Divorce Decree
- She has questions about her income

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Case Study Divorced Survivor

- Tom dies at 64, Jane is 60
- Assume Tom's PIA is $2,400
- Jane's PIA is $1,690
- FRA for both is 66 (66 for Survivor's Benefits)
- Tom never started benefits. If she starts survivor benefits at age 60, she receives 71.5% of $2,400 or $1,716/mo.

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Case Study Divorced Survivor

- You recommend Jane contact Social Security
- SS office tells her that her Survivor's benefit is $1,716/mo at age 60 and her own benefit is $1,690 at age 66
- She elects to take her Survivor's benefit

Case Study Divorced Survivor

- Unlike Spousal Benefits, you can switch from Survivor's Benefits to your own and vice versa (with some exceptions).
- Jane could take her Survivor's Benefit at age 60 of $1,716/mo and delay her own benefit until age 70. At that time, she would switch to get $2,330/mo for life.
- She just added $132,624 to her benefits

Survivor Mistake 2

- You represented Lisa in her divorce
- The marriage lasted 15 years
- She calls because her Ex passed

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Survivor Mistake 2

- Lisa has a PIA of $2,000
- John has a PIA of $1,600
- At 65 and 6 months Lisa retired and claimed her reduced benefit of $1,933/mo
- At age 68 John dies (Lisa's age 66)

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Survivor Mistake 2

- You recommend that she call Social Security.
- Social Security tells her that her Survivor's Benefit of $1,600 is less than her current benefit of $1,933
- She keeps receiving her current benefit

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Survivor Mistake 2

- Oops! Mistake!
- Lisa can use her "Do Over" and repay the benefits she has received $11,598
- Then she can take her Survivor's Benefit of $1,600/mo
- At age 70, she can switch to her benefit that has earned 32% of delayed retirement credits
- Her new benefit at 70 will be $2,640/mo

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Survivor Mistake 2

- This preferred strategy adds $136,728 to her cumulative lifetime benefits
- In addition, it reduces her longevity risk and gives her significantly more income at older ages
- Breakeven point on this strategy is age 73.5

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Deemed Filing Example

- John & Mary divorced after 31yrs in 2012
- John is 65 with a PIA of $2,000
- Mary is 62 with a PIA of $800
- Both have FRA of 66
- Since John is over 62 when she applies, she is “deemed” to be filing for both her own and spousal benefits.
- Thus she gets 75% of $800 (her PIA) plus 70% of (1,000-800). Which is $740/mo.

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Divorce Planning Mistake

- Mark and Linda were married for 20 years and divorced in 2011. Mark is 66 (FRA) and Linda is 63 (she has not claimed)
- You helped Mark through his divorce
- Linda's PIA is $2,000
- Mark's PIA is $950
- Mark is your client. He has not remarried. He tells you he is filing for his SS benefit.
- He does some research online
- He finds out that he will get a spousal benefit of $1,000/mo (50% of her PIA) because it's larger than his PIA of $950
- Mark just LOST $45,720 of FREE MONEY!!!

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Divorce Planning Mistake

- When Mark Claimed, Social Security calculated his benefit this way:
- His Benefit + (Half of Linda's - His)
- $950 + ($1,000 - $950) = $1,000/month
- Instead Mark could have asked them to calculate it this way:
- Half of Linda's (Restricted Spousal Benefit)
- $1,000

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Survivor/Spousal Example

- You represented Christine in her divorce
- She was married for 17 years
- She remarried at age 60
- At her age 63 her current husband dies
- What benefits can she claim?

Survivor/Spousal Benefits

- She can claim a Survivor Benefit on second husband
- She can claim a Spousal Benefit on first husband
- Her PIA is $1,900
- First Husband's PIA is $1,200 (he is over 62)
- Second Husband's PIA is $2,600

Survivor/Spousal Benefits

- Her life expectancy is 88
- Her best claiming strategy is to take her Survivor's Benefit from her 2nd husband at 63 of $1,029/mo
- Switch to Spousal Benefit from 1st husband at her FRA (66) of $1,300/mo,
- Switch to her own benefit at age 70 of $2,508/mo

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Claiming Before Divorce

- Ben is 68 and has already claimed
- Ben files for divorce (6 year marriage)
- His PIA is $2,600
- Shirley is 61 and her PIA is $500
- The Divorce drags on and Shirley turns 62
- Divorce will be final soon

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Claiming Before Divorce

- If Shirley does nothing and the divorce becomes final here are her Benefit Options at age 62, 66, and 70
- $375/mo at 62
- $500/mo at 66
- $660/mo at 70

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Claiming Before Divorce

- If she claims now (before the divorce is final), she will get 75% of $500 Plus 70% of ($1,300 - $500) or $935/mo for life
- If she lives to 90 the difference is $314,160 versus $158,400 (if she waits until 70) or versus $126,000 (if she claims immediately after the divorce at age 62)
- A difference $155,760 (or $188,160)

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Divorced Person (less than 10)

- You helped Pete (age 66) married for 8 years get divorced
- Will never remarry (never, never, never)
- Pete's Life Expectancy is 85
- PIA = $2,500 "Cross Over Analysis" of age 79
- He chooses to delay until 70 due to cross over and longevity risk

Divorced Client (less than 10)

- At age 69, he is diagnosed with terminal cancer (6 months to live)
- He calls Social Security and they tell him he can back date his application by 6 months
- He gets a lump sum of $19,200 (age 69 benefit of $3,200/mo X 6 months)

Divorced Client (less than 10)

- The correct recommendation would be to have him File and Suspend his benefit at FRA
- If he is healthy at 70, he gets his PIA plus Delayed Retirement Credits
- If he is diagnosed at 69, he can get a lump sum back to date of suspension
- $105,000 versus $19,200

To FICA or not to FICA

- Tax Preparers Often Help Business Owners To Reduce FICA
- In Some Cases, This Will Reduce Future Social Security Benefits That Might Outweigh The FICA Savings From Current Tax Year
- Make Sure Social Security Benefits Are Taken Into Account When Reducing FICA

What if someone has already claimed?

- Do Over (timeframe & taxation)
- Suspend
- Lump Sum

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Little Things That Matter

- Demand a copy of the other Spouse's Social Security statement BEFORE the divorce is complete
- Encourage your client to contact the Social Security Administration if her name changes after the divorce
- Discover if Your Client has been married 10 + Years and divorced previously
- Discover if your client is a Survivor

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Little Things That Matter

- Consider delaying divorce if marriage is close to 10 years
- Consider delaying remarriage to age 60 if there is a Survivor Benefit (you may see this opportunity if you do Prenuptial Agreements)

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Things to remember

- Social Security claiming strategies cannot be decided in a vacuum
  - Financial information specific to each client must be considered
  - Portfolio must be managed with claiming strategy in mind
- Social Security claiming can only be decided after careful analysis

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Expert Analysis

An Expert Analysis does three things:

- Shows a client all the benefits they are eligible for
- Gives a client options and flexibility to change between them
- Tells a client “How to file” so they don’t make mistakes
- Customizes claiming strategy with all unique financial circumstances for that client

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- **Jim Dew, CFP®, MBA, ChFC®, CFDA™**
- **480-614-9119**
- **jim@dewwealth.com**

Recommended Reading

Center for Retirement Research at Boston College

- http://crr.bc.edu/
- Ebook *The Social Security Claiming Guide,* by Steven Sass, Alicia H. Munnell, and Andrew Eschtruth
- Many briefs and working papers have great information on this site. Just do a search for "Social Security"

Social Security Strategies, by Reichenstein & Meyer

Recommended Reading

Social Security Administration

- http://ssa.gov/
- Retirement Planner: Benefits for Your Divorced Spouse
- Survivors Benefits
- Social Security for Women

TAB 9

Divorce and Income Taxes Continued

Tax Filing Summary

Filing Status Table:

Marital Status at 12/31	Legally Separated	Living together in same household 07/01-12/31	Dependent child or other dependent living in the home	Tax filing status available at year end
Married	no	yes	n/a	MFJ, MFS
Married	yes	no	no	S
Married	yes	no	yes	S, HOH
Divorced	n/a	yes	no	S
Divorced	n/a	no	no	S
Divorced	n/a	no	yes	S, HOH

MFJ=Married filing joint
MFS= Married filing separate
HOH=Head of household
S=Single

Although the MFS status can assist in the right circumstance, below are some disadvantages to keep in mind:

1. The gain exclusion for the sale of a primary residence is limited to $250,000 whereas MFJ can claim exclusion up to $500,000.
2. Only $1,500 net capital losses can be deducted whereas MFJ can deduct up to $3,000.
3. Cannot claim a standard deduction if the other spouse itemizes. If the standard deduction is claimed it is 50% of the amount if a joint return was filed.
4. Cannot make a Roth IRA contribution if taxpayer or spouse's Modified Adjusted Gross Income exceeds $10,000.
5. Cannot claim the American Opportunity or Lifetime Learning tax credits.
6. Cannot claim a deduction for college tuition and related fees.
7. Cannot claim the college loan interest write-off.
8. Generally cannot claim the child and dependent care credit.

It is best for the client to have his or her CPA "run the numbers" to evaluate the pros and cons of using the MFS status.

Spousal Support:

1. Payments must be required by written instrument
2. Payments must cease on death of recipient
3. Payments may not be treated as child support

4. Written instrument cannot state payment is "not alimony"
    a) However spouse and recipient can designate in the written instrument that certain payments that qualify as "alimony" are not alimony but both parties must acknowledge the payer is not deducting the payments as alimony and the recipient is excluding the receipt as income. The receiving party must then attach the document designating the payment as "not alimony" on his or her return.
5. Forms of payment:
    a) Cash, checks, money orders, bank transfers, etc.
    b) Qualified payments to a third-party on behalf of former spouse under the terms of the divorce or separation instrument can be "alimony" if they qualify. Payments include medical expenses; life, medical, home, and auto insurance premiums; housing costs; taxes; tuition; etc.
    c) Example of qualified payment to third-party:
        i. If a spouse is awarded the title to a principal residence and the former spouse is paying the mortgage payments, real estate taxes, repairs, utilities, etc., the former spouse can deduct the payments as alimony paid and the receiving spouse must report the payments as alimony received. The receiving spouse can then deduct the real estate taxes and any mortgage interest, if itemizing deductions. If however the spouse making the payments was awarded title to the residence but does not occupy the home, the only payments that can be deducted as alimony are the utility payments.
6. Recapture:
    a) If alimony payments decrease (or end) during the first three calendar years of payment, the recapture rule may apply. If the recapture rule applies, the payer must add to income a portion of previously deducted alimony payments and the recipient may deduct amounts previously reported as income. Note: recaptured amounts are reported on the third-year tax return only. Refer to Worksheet 1 in Publication 504: Divorced or Separated Individuals (for use in preparing 2013 Returns).

    b) The recapture rule applies if alimony paid in the third year of the three-year period is $15,000 (or more) less than in the second year, or if the average alimony paid in the second and third years decreases significantly from the amount paid in the first year. The three-year period begins with the first calendar year in which an alimony payment is made. <u>Not included in alimony subject to recapture are:</u>

        i. Payments made under a temporary support order

ii. Payments over at least three calendar years that represent a percentage of business income (such as self employment or employee compensation)

iii. Payments that decrease because of the death of either spouse or remarriage of the recipient spouse.

Children and Dependency Exemptions:

1. The custodial parent is entitled to the dependency exemption. Parents, together or separately, must provide at least one-half of the child's support.
2. Two exceptions to the general rule that custodial parent is entitled to the dependency exemption:
   a) A multiple support agreement is in place.
   b) The custodial parent relinquishes the rights to the exemption (either annually or permanently).
3. Table of credits available to custodial and non-custodial parent:

Release of Exemption to Noncustodial Parent		
Parent entitled to claim child as qualifying child for…	Custodial Parent	Noncustodial Parent
Dependency exemption		X
Child and dependent care credit	X	
Child tax credit		X
Education tax credits (Hope or Lifetime learning)		X
Earned income tax credit	X	
Student loan interest deduction		X
Head of household filing status	X	
Income exclusion of employer-provided dependent care assistance benefits	X	

Form **8857**
(Rev. January 2014)
Department of the Treasury
Internal Revenue Service (99)

Request for Innocent Spouse Relief

▶ **Information about Form 8857 and its separate instructions is at *www.irs.gov/form8857.***

OMB No. 1545-1596

Important things you should know

- **Do not file this form with your tax return.** See *Where To File* in the instructions.
- Review and follow the instructions to complete this form. Instructions can be obtained at *www.irs.gov/form8857* or by calling 1-800-TAX-FORM (1-800-829-3676).
- While your request is being considered, the IRS generally cannot collect any tax from you for the year(s) you request relief. However, filing this form extends the amount of time the IRS has to collect the tax you owe, if any, for those years.
- The IRS is required by law to notify the person on line 5 that you requested this relief. That person will have the opportunity to participate in the process by completing a questionnaire about the tax years you enter on line 3. This will be done before the IRS issues preliminary and final determination letters.
- The IRS will not disclose the following information: your current name, address, phone numbers, or employer.

Part I Should you file this form?

Generally, both you and your spouse are responsible, jointly and individually, for paying any tax, interest, or penalties from your joint return. If you believe your current or former spouse should be solely responsible for an erroneous item or an underpayment of tax from your joint tax return, you may be eligible for innocent spouse relief.

Innocent spouse relief may also be available if you were a resident of a community property state (see list of community property states in the instructions) and did not file a joint federal income tax return and you believe you should not be held responsible for the tax attributable to an item of community income.

1 **Do either of the paragraphs above describe your situation?**

☐ Yes. You should file this Form 8857. Go to question 2.

☐ No. Do not file this Form 8857, but go to question 2 to see if you need to file a different form.

2 **Did the IRS take your share of a joint refund from any tax year to pay any of the following past-due debt(s) owed ONLY by your spouse?** • Child support • Spousal support • Student loan (or other federal nontax debt) • Federal or state taxes

☐ Yes. You may be able to get back your share of the refund. See Form 8379, Injured Spouse Allocation, and the instructions to that form. Go to question 3 if you answered "Yes" to question 1.

☐ No. Go to question 3 if you answered "Yes" to question 1. If you answered "No" to question 1, do not file this form.

3 **If you determine you should file this form, enter each tax year you want innocent spouse relief.** It is important to enter the correct year. For example, if the IRS used your 2011 income tax refund to pay a 2009 joint tax liability, enter tax year 2009, not tax year 2011.

Tax Year ________ Tax Year ________ Tax Year ________
Tax Year ________ Tax Year ________ Tax Year ________

Part II Tell us about yourself and your spouse for the tax years you want relief

4 Your current name (see instructions) | **Your social security number**

Address where you wish to be contacted. If this is a change of address, see instructions.

Number and street or P.O. box | Apt. no. | **County**

City, town or post office, state, and ZIP code. If a foreign address, see instructions. | Best or safest daytime phone number (between 6 a.m. and 5 p.m. Eastern Time)

5 **Who was your spouse for the tax years you want relief?** File a separate Form 8857 for tax years involving different spouses or former spouses.

That person's current name | **Social security number** (if known)

Current home address (number and street) (if known). If a P.O. box, see instructions. | Apt. no.

City, town or post office, state, and ZIP code. If a foreign address, see instructions. | Daytime phone number (between 6 a.m. and 5 p.m. Eastern Time)

Note. If you need more room to write your answer for any question, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Part II Tell us about yourself and your spouse for the tax years you want relief *(Continued)*

6 **What is the current marital status between you and the person on line 5?**

☐ Married and still living together

☐ Married and living apart since ________ MM DD YYYY

☐ Widowed since ________ MM DD YYYY Attach a photocopy of the death certificate and will (if one exists).

☐ Legally separated since ________ MM DD YYYY Attach a photocopy of your entire separation agreement.

☐ Divorced since ________ MM DD YYYY Attach a photocopy of your entire divorce decree.

Note. A divorce decree stating that your former spouse must pay all taxes does not necessarily mean you qualify for relief.

7 **What was the highest level of education you had completed when the return(s) were filed?** If the answers are **not** the same for all tax years, explain.

☐ Did not complete high school

☐ High school diploma or equivalent

☐ Some college

☐ College degree or higher. List any degrees you have ▶ ________

List any college-level business or tax-related courses you completed ▶ ________

Explain ▶ ________

8 **Were you or other members of your family a victim of spousal abuse or domestic violence, or suffering the effects of such abuse during any of the tax years you want relief or when any of the returns were filed for those years?**

☐ Yes. If you want the IRS to consider this information in making its determination, complete Part V of this form in addition to other parts of the form. First read the instructions for Part V, to understand how the IRS will proceed with evaluating your claim for relief in these circumstances.

If you checked "Yes" above, we will put a note on your separate account. This will enable us to respond appropriately and be sensitive to your situation. We will remove the note from your account if you request it (as explained in the instructions).
If you do not want us to put a note on your account, check here . . . . ▶ ☐

☐ No. Complete the other parts of this form except for Part V.

9 **When any of the returns listed on line 3 were filed, did you have a mental or physical health problem or do you have a mental or physical health problem now?** If the answers are **not** the same for all tax years, explain below.

☐ Yes. **Attach a statement** to explain the problem and **when** it started. Provide photocopies of any documentation, such as medical bills or a doctor's report or letter.

☐ No.

Explain ▶ ________

10 **Is there any information you are afraid to provide on this form, but are willing to discuss?**

☐ Yes ☐ No

Part III Tell us if and how you were involved with finances and preparing returns for those tax years

11 **Did you agree to file a joint return?** ☐ Yes ☐ No

Explain why or why not ▶ ________

12 **Did you sign the joint return?** See instructions. ☐ Yes ☐ No

Explain why or why not ▶ ________

Note. If you need more room to write your answer for any question, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Part III Tell us if and how you were involved with finances and preparing returns for those tax years *(Continued)*

13 **What was your involvement with preparing the returns?** Check all that apply and explain, if necessary. If the answers are **not** the same for all tax years, explain.

- ☐ You were not involved in preparing the returns.
- ☐ You filled out or helped fill out the returns.
- ☐ You gathered receipts and cancelled checks.
- ☐ You gave tax documents (such as Forms W-2, 1099, etc.) for the preparation of the returns.
- ☐ You reviewed the returns before they were filed.
- ☐ You did not review the returns before they were filed. Explain below why you did not review the returns.
- ☐ You did not know a joint return was filed.
- ☐ Other ▶

Explain how you were involved ▶

14 **When the returns were filed, what did you know about any incorrect or missing information?** Check all that apply and explain, if necessary. If the answers are **not** the same for all tax years, explain below.

- ☐ You knew something was incorrect or missing, but you said nothing. Explain below.
- ☐ You knew something was incorrect or missing and asked about it. Explain below.
- ☐ You did not know anything was incorrect or missing.
- ☐ Not applicable. There was no incorrect or missing information.

Explain ▶

15 **When any of the returns were filed, what did you know about the income of the person on line 5?** Check all that apply and explain, if necessary. If the answers are **not** the same for all tax years, explain.

- ☐ You knew that the person on line 5 had income.

  List each type of income on the lines provided below. (Examples are wages, social security, gambling winnings, or self-employment business income.) Enter each tax year and the amount of income for each type you listed. If you do not know any details, enter "I don't know."

- ☐ You knew that the person on line 5 was self-employed and you helped with the books and records.
- ☐ You knew that the person on line 5 was self-employed and you did not help with the books and records.
- ☐ You knew that the person on line 5 had no income.
- ☐ You did not know whether the person on line 5 had income.

Explain why you did not know whether the person on line 5 had income ▶

16 **When the returns were filed, did you know if the returns showed a balance due to the IRS for those tax years?** If the answers are **not** the same for all tax years, explain.

- ☐ Yes. Explain when and how you thought the amount of tax reported on the return would be paid ▶
- ☐ No. Explain why you did not know the return showed a balance due. ▶
- ☐ Not applicable. There was no balance due on the return.

17 **When any of the returns were filed, were you having financial problems** (for example, bankruptcy or bills you could not pay)? If the answers are **not** the same for all tax years, explain.

- ☐ Yes. Explain ▶
- ☐ No.
- ☐ Did not know. Explain ▶

Note. If you need more room to write your answer for any question, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Part III Tell us if and how you were involved with finances and preparing returns for those tax years *(Continued)*

18 **For the years you want relief, how were you involved in the household finances?** Check all that apply. If the answers are **not** the same for all tax years, explain.

- ☐ You were not involved in handling money for the household. Explain below.
- ☐ You knew the person on line 5 had separate accounts.
- ☐ You had joint accounts with the person on line 5, but you had limited use of them or did not use them. Explain below.
- ☐ You used joint accounts with the person on line 5. You made deposits, paid bills, balanced the checkbook, or reviewed the monthly bank statements.
- ☐ You made decisions about how money was spent. For example, you paid bills or made decisions about household purchases.
- ☐ Other ▶

Explain anything else you want to tell us about your household finances ▶

19 **Did you (or the person on line 5) incur any large expenses, such as trips, home improvements, or private schooling, or make any large purchases, such as automobiles, appliances, or jewelry, during any of the years you want relief or any later years?**

☐ Yes. Describe (a) the types and amounts of the expenses and purchases and (b) the years they were incurred or made.

☐ No.

20 **Has the person on line 5 ever transferred assets (money or property) to you?** (Property includes real estate, stocks, bonds, or other property that you own or possess now or possessed in the past.) See instructions.

☐ Yes. List the assets, the dates they were transferred, and their fair market values on the dates transferred. If the property was secured by any debt (such as a mortgage on real estate), explain who was responsible for making payments on the debt, how much was owed on the debt at the time of transfer and whether the debt has been satisfied. Explain why the assets were transferred to you. If you no longer possess or own the assets, explain what happened with the assets.

☐ No.

Part IV Tell us about your current financial situation

21 **Tell us about your assets.** Your assets are your money and property. Property includes real estate, motor vehicles, stocks, bonds, and other property that you own. In the table below, list the amount of cash you have on hand and in your bank accounts. Also list each item of property, the fair market value (as defined in the instructions) of each item, and the balance of any outstanding loans you used to acquire each item. Do not list any money or property you listed on line 20.

Description of Assets	Fair Market Value	Balance of Any Outstanding Loans You Used To Acquire the Asset

Note. If you need more room to write your answer for any question, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Part IV Tell us about your current financial situation *(Continued)*

22 **How many people are currently in your household, including yourself?** Adults ________ Children ________

23 **Tell us your current average monthly income and expenses for your entire household.**

Monthly Income — If family or friends are helping to support you, include the amount of support as gifts below.	**Amount**
Gifts	
Wages (Gross pay)	
Pensions	
Unemployment	
Social security	
Government assistance, such as housing, food stamps, grants	
Alimony	
Child support	
Self-employment business income	
Rental income	
Interest and dividends	
Other income, such as disability payments, gambling winnings, etc. List each type below:	
Type	
Type	
Type	
Total Monthly Income	

Monthly Expenses — Enter all expenses, including expenses paid with income from gifts.	**Amount**
Food and Personal Care:	
Food	
Housekeeping supplies	
Clothing and clothing services	
Personal care products and services	
Transportation:	
Auto loan/lease payment, gas, insurance, licenses, parking, maintenance, etc.	
Public transportation	
Housing and Utilities:	
Rent or mortgage	
Real estate taxes and insurance	
Electric, oil, gas, water, trash, etc.	
Telephone and cell phone	
Cable and Internet	
Medical:	
Health insurance premiums	
Out-of-pocket expenses	
Other:	
Child and dependent care	
Caregiver expenses	
Income tax withholding (federal, state, and local)	
Estimated tax payments	
Term life insurance premiums	
Retirement contributions (employer required)	
Retirement contributions (voluntary)	
Union dues	
Unpaid state and local taxes (minimum payment)	
Student loans (minimum payment)	
Court-ordered debt payments (for example, court- or agency-ordered child support, alimony and garnishments). List each type below:	
Type	
Type	
Type	
Miscellaneous	
Total Monthly Expenses	

Note. If you need more room to write your answer for any question, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Part V Complete this part if you were (or are now) a victim of domestic violence or spousal abuse

As stated in line 8, providing this additional information is not mandatory but may strengthen your request. **Additionally, if you prefer to provide this information orally, check the "Yes" box on line 10.**

If you were (or are now) a victim of domestic violence or spousal abuse by the person on line 5, the IRS will consider the information you provide in this part to determine whether to grant innocent spouse relief. However, the IRS is required by law to notify the person on line 5 that you requested this relief. There are no exceptions to this rule. That person will have the opportunity to participate in the process by completing a questionnaire about the tax years you entered on line 3. This will be done before the IRS issues preliminary and final determination letters. However, the IRS is also required by law to keep all the personal identifying information (such as current names, addresses, and employment-related information) of both you and the person on line 5 confidential. This means that the IRS cannot disclose one person's information to the other person. If the IRS does not grant you relief and you choose to petition the Tax Court, your personal identifying information is available, unless you ask the Tax Court to withhold it.

The person on line 5 will receive a questionnaire about the tax years you entered on line 3. Except for your current name, address, phone numbers, and employer, this form and any attachments could be disclosed to the person on line 5. If you have any privacy concerns, see instructions.

The IRS understands and is sensitive to the effects of domestic violence and spousal abuse, and encourages victims of domestic violence to call 911 if they are in immediate danger. **If you have concerns about your safety,** please consider contacting the 24-Hour (Confidential) National Domestic Violence Hotline at 1-800-799-SAFE (7233), or 1-800-787-3224 (TTY), or 1-855-812-1001 (Video Phone Only for Deaf Callers) before you file this form.

A representative from the IRS may call you to gather more information and discuss your request. Be sure you enter your correct contact information on line 4.

24a During any of the tax years for which you are seeking relief or when any of the returns were filed for those years, did the person on line 5 do any of the following? Check all that apply. (Note. If this does not apply to you, skip lines 24a, b, and c, and complete lines 25 through 29.)

- ☐ Physically harm or threaten you, your children, or other members of your family.
- ☐ Sexually abuse you, your children, or other members of your family.
- ☐ Make you afraid to disagree with him/her.
- ☐ Criticize or insult you or frequently put you down.
- ☐ Withhold money for food, clothing, or other basic needs.
- ☐ Make most or all the decisions for you, including financial decisions.
- ☐ Restrict or control who you could see or talk to or where you could go.
- ☐ Isolate you or keep you from contacting your family members and/or friends.
- ☐ Cause you to fear for your safety in any other way.
- ☐ Stalk you, your children, or other members of your family.
- ☐ Abuse alcohol or drugs.

b Describe the abuse you experienced, including approximately when it began and how it may have affected you, your children, or other members of your family. Explain how this abuse affected your ability to question the reporting of items on your tax return or the payment of the tax due on your return.

c Attach photocopies of any documentation you have, such as:

- Protection and/or restraining order.
- Police reports.
- Medical records.
- Doctor's report or letter.
- Injury photographs.
- A statement from someone who was aware of or witnessed the abuse or the results of the abuse (notarized if possible).
- Any other documentation you may have.

25 Are you afraid of the person listed on line 5?

☐ Yes ☐ No

26 Does the person listed on line 5 pose a danger to you, your children, or other members of your family?

☐ Yes ☐ No

27 Were the police, sheriff, or other law enforcement ever called?

☐ Yes ☐ No

28 Was the person listed on line 5 charged or arrested for abusing you, your children, or other members of your family?

☐ Yes. Provide details below.

☐ No

29 Have you sought help from a local domestic violence program?

☐ Yes. Provide details below.

☐ No

Note. If you need more room to write your answer for any question, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Part VI Additional Information

30 Please provide any other information you want us to consider in determining whether it would be unfair to hold you liable for the tax.

Part VII Tell us if you would like a refund

31 By checking this box and signing this form, you are indicating that you would like a refund if you qualify for relief and if you already paid the tax. See instructions . . . . ☐

Caution

By signing this form, you understand that, by law, we must contact the person on line 5. See instructions for details.

Sign Here

Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this form and any accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

ARIZONA FORM
200

Request for Innocent Spouse Relief and Separation of Liability and Equitable Relief

Do not file with your tax return.

Do not use Form 200 to make an injured spouse claim. You are an injured spouse if your share of an overpayment shown on your joint return was, or is expected to be, applied against your spouse's past-due state taxes, child support or spousal maintenance, or debts owed to another Arizona state agency, the IRS, or a court. **If you are an injured spouse, see the note on page 1 of the instructions.**

Your First Name and Initial	Last Name		Your Social Security Number
Current Home Address - number and street, rural route		Apt. No	Daytime Phone No. (optional) Include area code
City, Town or Post Office	State	Zip Code	

Part I Type of Relief. You **must** complete this part for each tax year.

IMPORTANT: You must have filed an Arizona income tax return for each year for which you are requesting relief.

		Tax Year 1	Tax Year 2	Tax Year 3*
1 *Enter each tax year you want relief.* It is important to enter the correct year. For example, if the department used your 2009 income tax refund to pay a 2007 tax amount you jointly owned, enter tax year 2007, not tax year 2009	**1**	YYYY	YYYY	YYYY
2 *Check the box* for each year you would like a refund if you qualify for relief. You may be required to provide proof of payment. *See instructions*	**2**	☐	☐	☐
3 For each year, *check the box* for the type of relief claimed. *See the instructions before you check any boxes on lines 3a through 3c.* Also be sure to attach all required statements for the type of relief you are requesting. *Check all that apply:*				
3a Separation of Liability	**3a**	☐	☐	☐
3b Innocent Spouse Relief	**3b**	☐	☐	☐
3c Equitable Relief	**3c**	☐	☐	☐
4 Did you file a joint return for the tax year listed on line 1?	**4**	Yes ☐ No ☒	Yes ☒ No ☐	Yes ☐ No ☒

* If you want relief for more than 3 years, fill out an additional form.

If you completed federal Form 8857, you do not need to complete the rest of Form 200. *Check this box and* ☐

- *Attach all required statements for the type of relief you are requesting.*
- If you were granted relief by the IRS, please *attach a copy of the IRS letter.*
- *Attach a copy of your completed federal Form 8857.*
- ***Sign Form 200*** on page 5.
- *Mail* to the address shown below.

Mail Form 200 to:

Arizona Department of Revenue • Individual Income Tax Audit
Room 520, Attention Form 200
1600 West Monroe • Phoenix, AZ, 85007-2650

Continued on page 2 →

Print Page

Your Name (as shown on page 1)	Your Social Security No.

If you need more room to write your answer to any question, attach more pages. Write your name and social security number on the top of each page you attach.

Part II Information about you and your spouse (or former spouse)

5 Spouse's (or former spouse's) Current Name			Social Security Number (if known)
Current Home Address - number and street, rural route		Apt. No	Daytime Phone No. Include area code
City, Town or Post Office	State	Zip Code	

6 What is the current marital status between you and the person on line 5? *Check one box:*

- ☐ Married and still living together
- ☐ Married and living apart since: M M D D Y Y Y Y .
- ☐ Widowed since: M M D D Y Y Y Y . *Attach a photocopy of the death certificate and will if one exists.*
- ☐ Legally separated since: M M D D Y Y Y Y . *Attach a photocopy of your entire separation agreement.*
- ☐ Divorced since: M M D D Y Y Y Y . *Attach a photocopy of your entire divorce decree.*

Note: A divorce decree stating that your former spouse must pay all taxes does not necessarily mean you qualify for relief.

7 What was the highest level of education you had completed when the return(s) were filed? If the answers are *not* the same for all tax years, *explain*.

- ☐ High school diploma, equivalent, or less
- ☐ Some college
- ☐ College degree or higher. *List any degrees you have:*

List any college-level business or tax-related courses you completed:

Explain:

8 Were you a victim of spousal abuse or domestic violence during any of the tax years you want relief? If the answers are *not* the same for all tax years, *explain.*

- ☐ Yes. *Attach a statement* to explain the situation and *when* it started. Provide photocopies of any documentation, such as police reports, a restraining order, a doctor's report or letter, or a notarized statement from someone who was aware of the situation.
- ☐ No

9 Did you sign the return(s)? If the answers are *not* the same for all tax years, *explain.*

- ☐ Yes. If you were forced to sign under duress (threat of harm or other form of coercion), *check this box:* ☐. *See instructions.*
- ☐ No. Your signature was forged. *See instructions*.

10 When any of the returns were signed, did you have a mental or physical health problem, or do you have a mental or physical health problem now? If the answers are *not* the same for all tax years, *explain.*

- ☐ Yes. *Attach a statement* to explain the problem and *when* it started. Provide photocopies of any documentation, such as medical bills or a doctor's report or letter.
- ☐ No

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Continued on page 3 →

Your Name (as shown on page 1)	Your Social Security No.

If you need more room to write your answer to any question, attach more pages. Write your name and social security number on the top of each page you attach.

Part III Your Financial and Return Preparation Involvement

11 How were you involved with preparing the returns? *Check all that apply and explain,* if necessary. If the answers are *not* the same for all tax years, *explain*:

- ☐ You filled out or helped fill out the returns.
- ☐ You gathered receipts and cancelled checks.
- ☐ You gave the tax documents (such as Forms W-2, 1099, etc.) to the person who prepared the returns.
- ☐ You reviewed the returns before they were signed.
- ☐ You did not review the returns before they were signed. *Explain below.*
- ☐ You were not involved in preparing the returns.
- ☐ Other:

Explain how you were involved:

12 When the returns were signed, were you concerned that any of the returns were incorrect or missing information? *Check all that apply and explain,* if necessary. If the answers are *not* the same for all tax years, *explain*:

- ☐ You knew something was incorrect or missing, but you said nothing.
- ☐ You knew something was incorrect or missing and asked about it.
- ☐ You did not know anything was incorrect or missing.

Explain:

13 When any of the returns were signed, what did you know about the income of the person on line 5? If the answers are *not* the same for all tax years, *explain:*

- ☐ You knew that person had income.

List each type of income on a separate line. (Examples are wages, social security, gambling winnings, or self-employment business income.) Enter each tax year and the amount of income for each type you listed. If you don't knowy any details, *enter, "I don't know."*

Type of Income	Who paid it to that person?	Tax Year 1	Tax Year 2	Tax Year 3
		$	$	$
		$	$	$
		$	$	$

- ☐ You knew that person was self-employed and you helped with the books and records.
- ☐ You knew that person was self-employed and *you did not help* with the books and records.
- ☐ You knew that person had no income.
- ☐ You *did not know* if that person had income.

Explain:

14 When the returns were signed, did you know any amount was owed to the department for those tax years? If the answers are *not* the same for all tax years, *explain*.

- ☐ Yes. *Explain* when and how you thought the amount of tax reported on the return would be paid:

- ☐ No. *Explain:*

Print Page

Continued on page 4 →

Your Name (as shown on page 1)	Your Social Security No.

If you need more room to write your answer to any question, attach more pages. Write your name and social security number on the top of each page you attach.

Part III *(Continued)*

15 When any of the returns were signed, were you having financial problems (*for example,* bankruptcy or bills you could not pay)? If the answers are *not* the same for all tax years, *explain*.

☐ Yes. *Explain:*

☐ No

☐ Did not know

Explain:

16 For the years you want relief, how were you involved in the household finances? *Check all that apply.* If the answers are *not* the same for all tax years, *explain.*

☐ You knew the person on line 5 had separate accounts.

☐ You had joint accounts but you had limited use of them or did not use them. *Explain below.*

☐ You used joint accounts. You made deposits, paid bills, balanced the checkbook, or reviewed the monthly bank statements.

☐ You made decisions about how money was spent. *For example,* you paid bills or made decisions about household purchases.

☐ You were not involved in handling money for the household.

☐ Other:

Explain anything else you want to tell us about your household finances:

17 Has the person on line 5 ever transferred assets (money or property) to you? Property includes real estate, stocks, bonds, or other property to which you have title. *See instructions.*

☐ Yes. *List* the assets and the dates they were transferred. *Explain why* the assets were transferred.

☐ No

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Continued on page 5 →

Your Name (as shown on page 1)	Your Social Security No.

If you need more room to write your answer to any question, attach more pages. Write your name and social security number on the top of each page you attach.

Part IV Your Current Financial Situation

18 Tell us the number of people currently in your household: Adults ☐ Children ☐

19 Tell us your current average monthly income and expenses for your entire household. If family or friends are helping to support you, include the amount of support as gifts under **Monthly Income**. Under **Monthly Expenses**, enter all expenses, including expenses paid with income from gifts.

Yellow-colored fields calculate and are read-only. You cannot enter data in these fields.

Monthly Income	Amount	Monthly Expenses	Amount
Gifts	$	Federal, state, and local taxes deducted from your paycheck	$
Wages (gross pay)	$	Rent or mortgage	$
Pensions	$	Utilities	$
Unemployment	$	Telephone	$
Social security	$	Food	$
Government assistance, such as housing, food stamps, grants	$	Car expenses, payments, insurance etc.	$
Alimony	$	Medical expenses, including medical insurance	$
Child support	$	Life insurance	$
Self-employment business income	$	Clothing	$
Rental income	$	Child care	$
Interest and dividends	$	Public transportation	$
Other income, such as disability payments, gambling winnings, etc. *List the type below:*		Other expenses, such as real estate taxes, child support, etc. *List the type below:*	
Type:	$	Type:	$
Type:	$	Type:	$
Type:	$	Type:	$
Total Monthly Income	**$**	**Total Monthly Expenses**	**$**

20 Please provide any other information you want us to consider in determining whether it would be unfair to hold you liable for the tax:

CAUTION: By signing this form, you understand that, by law, we must contact the person on line 5. *See instructions.*

PLEASE SIGN HERE

Under penalties of perjury, I declare that I have examined this form and any accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

➔ YOUR SIGNATURE DATE

PAID PREPARER'S SIGNATURE DATE FIRM'S NAME (PREPARER'S IF SELF-EMPLOYED)

PAID PREPARER'S TIN PAID PREPARER'S ADDRESS PAID PREPARER'S PHONE NO.

Form **8958**
(Rev. November 2014)
Department of the Treasury
Internal Revenue Service (99)

Allocation of Tax Amounts Between Certain Individuals in Community Property States

▶ Attach to Form 1040.
▶ Information about Form 8958 and its instructions is at *www.irs.gov/form8958*.

OMB No. 1545-0074
Attachment Sequence No. **63**

Your first name and initial	Your last name	Your social security number
Spouse's or partner's first name and initial	Spouse's or partner's last name	Spouse's or partner's social security number

	A Total Amount	B Allocated to Spouse or RDP SSN ______-____-______	C Allocated to Spouse or RDP SSN ______-____-______
1 Wages (each employer)			
2 Interest Income (each payer)			
3 Dividends (each payer)			
4 State Income Tax Refund			
5 Self-Employment Income (See instructions)			
6 Capital Gains and Losses			
7 Pension Income			
8 Rents, Royalties, Partnerships, Estates, Trusts			

	A Total Amount	B Allocated to Spouse or RDP SSN ______-____-______	C Allocated to Spouse or RDP SSN ______-____-______
9 Deductible part of Self-Employment Tax (See instructions)			
10 Self-Employment Tax (See instructions)			
11 Taxes Withheld			
12 Other items such as: Social Security Benefits, Unemployment Compensation, Deductions, Credits, etc.			

General Instructions

Future developments. For the latest information about developments related to Form 8958 and its instructions, such as legislation enacted after they were published, go to *www.irs.gov/form8958*.

Purpose of Form

Use Form 8958 to determine the allocation of tax amounts between married filing separate spouses or registered domestic partners (RDPs) with community property rights. If you need more room, attach a statement listing the source of the item and the total plus the allocated amounts. Be sure to put your name and social security number (SSN) on the statements and attach them at the end of your return.

Community property laws affect how you figure your income on your federal income tax return if you are married, live in a community property state or country, and file separate returns.

This form is used for married spouses in community property states who choose to file married filing separately. This form is also for RDPs who are domiciled in Nevada, Washington, or California. For 2010 and following years, a RDP in Nevada, Washington, or California generally must follow state community property laws and report half the combined community income of the individual and his or her RDP.

CAUTION

RDPs are not married for federal tax purposes. They can only use the single filing status, or if they qualify, the head of household filing status.

Community or Separate Income

In a community property state, if you file a federal tax return separately from your spouse, you must report half of all community income and all of your separate income. Likewise, a RDP must report half of all community income and all of his or her separate income on his or her federal tax return. Generally, the laws of the state in which you are domiciled govern whether you have community income or separate income for federal tax purposes.

Generally, community income is income from:

- Community property.
- Salaries, wages, or pay for services of you, your spouse or RDP, or both during your marriage or registered domestic partnership.
- Real estate that is treated as community property under the laws of the state where the property is located.

Generally, income from separate property is the separate income of the spouse or RDP who owns the property.

For more information, see Pub. 555, Community Property.

Identifying Income and Deductions

You and your spouse or RDP must be able to identify your community and separate income, deductions, credits, and other return amounts according to the laws of your state.

Income

The following is a discussion of the general effect of community property laws on the federal income tax treatment of certain items of income.

Wages and self-employment income from sole proprietorship. A spouse's or RDP's wages and self-employment income from a sole proprietorship are community income and must be evenly split.

TIP

For RDPs, the self-employment income from a sole proprietorship is also split for self-employment tax purposes. See Self-employment tax*, later.*

Interest, dividends, and rents. Interest, dividends, and rents from community property are community income and must be evenly split.

Gains and losses. Gains and losses are classified as community or separate depending on how the property is held.

Withdrawals from individual retirement arrangements (IRAs). There are several kinds of individual retirement arrangements (IRAs). Distributions of IRAs by law are deemed to be separate property, even if the funds in the account would otherwise be community property. These distributions are wholly taxable to the spouse or RDP whose name is on the account. That spouse or RDP is also liable for any penalties and additional taxes on the distributions.

Pensions. Generally, distributions from pensions will be characterized as community or separate income depending on the respective periods of participation in the pension while married (or during the registered domestic partnership) and domiciled in a community property state or in a noncommunity property state during the total period of participation in the pension. These rules may vary between states.

Partnership income. If an interest is held in a partnership, and income from the partnership is attributable to the efforts of either spouse or RDP, the partnership income is community property.

TIP

For RDPs, the self-employment income from a partnership is also split for self-employment tax purposes. See Self-employment tax*, later.*

Tax-exempt income. For spouses, community income exempt from federal tax generally keeps its exempt status for both spouses. For example, under certain circumstances, income earned outside the United States is tax exempt. If you earned income and met the conditions that made it exempt, the income is also exempt for your spouse even though he or she may not have met the conditions. RDPs should consult the particular exclusion provision to see if the exempt status applies to both.

Income from separate property. In some states, income from separate property is separate income. Other states characterize income from separate property as community income.

For more information, see Pub. 555. For specific information that pertains to your situation, check with the laws of your state.

Deductions

If you file separate returns, your deductions generally depend on whether the expenses involve community or separate income.

Business and investment expenses. If you file separate returns, expenses incurred to earn or produce community business or investment income are generally divided equally between you and your spouse or RDP. Each of you is entitled to deduct one-half of the expenses on your separate returns. Separate business or investment income are deductible by the spouse or RDP who earns the income.

Other limits may also apply to business and investment expenses. For more information, see Pub. 535, Business Expenses, Pub. 550, Investment Income and Expenses, and Pub. 555.

IRA deduction. Deductions for IRA contributions cannot be split between spouses or RDPs. The deduction for each spouse or RDP is figured separately and without regard to community property laws.

Personal expenses. Expenses that are paid out of separate funds, such as medical expenses, are deductible by the spouse or RDP who pays for them. If these expenses are paid from community funds, divide the deduction equally between you and your spouse or RDP.

Deductible portion of self-employment tax. The deductible portion of the self-employment tax is split only when the self-employment tax is split by the spouses or RDPs. See *Self-employment tax*, later.

Credits, Taxes, and Payments

Self-employment tax. Although the self-employment tax rules contain a provision that overrides community income treatment in the case of spouses (IRC 1402(a)(5)), this provision does not apply to RDPs. RDPs split self-employment income from sole proprietorships and partnerships for self-employment tax purposes.

The following rules apply only to persons married for federal tax purposes.

Sole proprietorship. With regard to net income from a trade or business (other than a partnership) that is community income, self-employment tax is imposed on the spouse carrying on the trade or business.

Partnerships. All of the distributive share of a married partner's income or loss from a partnership trade or business is attributable to the partner for computing any self-employment tax, even if a portion of the partner's distributive share of income or loss is community income or loss that is attributable to the partner's spouse for income tax purposes. If both spouses are partners, any self-employment tax is allocated based on their distributive shares.

Federal income tax withheld. If you and your spouse file separate returns on which each of you reports half the community wages, each of you is entitled to credit for half the income tax withheld on those wages. Likewise, each RDP is entitled to credit for half the income tax withheld on those wages.

To determine estimated tax payments, earned income credit, and overpayments, see Pub. 555 for more information. For specific information that pertains to your situation, check with the laws of your state.

Specific Instructions

How To Complete Form 8958

To complete Form 8958, identify your community or separate income, deductions, credits and other return amounts on the separate lines under the item name on lines 1 through 12.

Enter the total amount of your community or separate income, deductions, credits, and other return amounts on their respective lines in Column A. Enter each spouse's or RDP's allocation of these amounts in Column B and C. Together, Columns B and C should equal Column A.

CAUTION *In a community property state, if you file a federal tax return separately from your spouse, you must report half of all community income and all of your separate income. Likewise, a RDP must report half of all community income and all of his or her separate income on his or her federal return. The laws of the state in which you are domiciled govern whether you have community income or separate income for federal tax purposes.*

Line 1

Identify the wages from each payer on separate lines. Enter the total from each payer in Column A. Allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 2

Identify the interest from each payer on separate lines. Enter the total from each payer in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 3

Identify the dividends from each payer on separate lines. Enter the total from each payer in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 4

Identify the state income tax refund from each payer on separate lines. Enter the total from each payer in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 5

Identify the self-employment income from each entity on separate lines. Enter the total from each entity in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 6

Enter the gain or loss from each entity. Enter the total from each entity in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 7

Enter the pension income from each payer on separate lines. Enter the total from each payer in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 8

Identify the rent, royalty, partnership, estate, or trust item(s) on separate lines. Enter the total(s) from each item(s) in Column A and allocate the total(s) from Column A between each spouse or RDP in Columns B and C.

Line 9

Identify the deductible part of self-employment tax from each entity on separate lines. Enter the total from each entity in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 10

Identify the self-employment tax from each entity on separate lines. Enter the total from each entity in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 11

Identify the taxes withheld from each payer or entity on separate lines. Enter the total from each payer or entity in Column A and allocate the total from Column A between each spouse or RDP in Columns B and C.

Line 12

Identify any item not previously reported, such as social security benefits, unemployment compensation, deductions, credits, etc., on separate lines. Enter the total from each item in Column A; then allocate the total from each item from Column A between each spouse or RDP in Columns B and C.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The average time and expenses required to complete and file this form will vary depending on individual circumstances. For the estimated averages, see the instructions for your income tax return.

If you have suggestions for making this form simpler, we would be happy to hear from you. See the instructions for your income tax return.

STATE OF ARIZONA

Department of Revenue

Janice K. Brewer
Governor

David Raber
Director

ARIZONA INDIVIDUAL INCOME TAX RULING
ITR 14-2

(Supersedes Arizona Individual Income Tax Ruling ITR 93-23)

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

ISSUE:

For Arizona income tax purposes, how do divorced individuals treat their income, deductions, exemptions, and withholding for the year of divorce?

RULING:

Income received after the termination of the community is the separate income of the individual who earned it or owns the property producing it. The termination of the community occurs when the petition for dissolution of marriage is filed, if that petition results in a divorce.

For the year of divorce, each individual reports one-half of community income and any separate income on his or her Arizona return. When community income is reported, each individual may claim one-half of the deductions and credits related to items of community property, including one-half of the Arizona income tax withheld from community income. A taxpayer may claim a dependent exemption for a person only if the taxpayer is eligible to claim a dependent exemption for that person on his or her federal income tax return. The personal exemption is claimed by each taxpayer on his or her respective return.

Income Example: H and W divorced during the taxable year. They lived with each other during the taxable year, but separated and filed for divorce on April 1 of the taxable year. The divorce became final on September 15 of that same year. Therefore, the community was terminated on April 1 of the taxable year. H's and W's total income for the year consists of $65,000 wages. Of the total wages ($65,000), $16,250 is community wages (the wages earned prior to the filing of the divorce). The breakdown of the wages for each is as follows:

Division of total wages earned by H and W during the taxable year						
	H			W		
	Earned 1/1 - 3/31	Earned 4/1 – 12/31	Total	Earned 1/1 - 3/31	Earned 4/1 – 12/31	Total
Wages	$10,000	$30,000	$40,000	$6,250	$18,750	$25,000

Wages Reportable by H for the Return Filed for the Year of Divorce			
½ community wages earned by H for period prior to filing of the divorce (.50 X 10,000)	$5,000		
½ community wages earned by W for period prior to filing of the divorce (.50 X 6,250)	$3,125		
Total community wages reportable by H for the taxable year (5,000 + 3,125)		$ 8,125	
Separate wages earned by H after filing of the divorce		$30,000	
Total wages reportable by H for the taxable year			$38,125

Wages Reportable by W for the Return Filed for the Year of Divorce			
½ community wages earned by H for period prior to filing of the divorce (.50 X 10,000)	$5,000		
½ community wages earned by W for period prior to filing of the divorce (.50 X 6,250)	$3,125		
Total community wages reportable by H for the taxable year (5,000 + 3,125)		$ 8,125	
Separate wages earned by W after filing of the divorce		$18,750	
Total wages reportable by W for the taxable year			$26,875

Withholding Example**:** H and W divorced during the taxable year. They lived with each other during the taxable year, but separated and filed for divorce on April 1 of the taxable year. The divorce became final on September 15 of that same year. Therefore, the community was terminated on April 1 of the taxable year. H's and W's total Arizona withholding for the taxable year was $1,530. Of the total Arizona withholding ($1,530), $382 is from community wages (the amount withheld prior to the filing of the divorce). The breakdown of the Arizona withholding for each is as follows:

Division of total Arizona Withholding Between H and W for the Taxable Year						
	H			W		
	AZ Tax Withheld From Wages Earned 1/1 - 3/31	AZ Tax Withheld From Wages Earned 4/1 – 12/31	Total	AZ Tax Withheld From Wages Earned 1/1 - 3/31	AZ Tax Withheld From Wages Earned 4/1 – 12/31	Total
Arizona Withholding	$270	$810	$1,080	$112	$338	$450

AZ Withholding Reportable by H for the Return Filed for the Year of Divorce			
½ AZ Withholding from community wages earned by H for period prior to filing of the divorce (.50 X 270)	$135		
½ AZ Withholding from community wages earned by W for period prior to filing of the divorce (.50 X 112)	$ 56		
Total AZ Withholding from community wages reportable by H for the taxable year (135 + 56)		$191	
AZ Withholding from Separate wages earned by H after filing of the divorce		$810	
Total AZ Withholding reportable by H for the taxable year			$1,001

AZ Withholding Reportable by W for the Return Filed for the Year of Divorce			
½ AZ Withholding from community wages earned by H for period prior to filing of the divorce (.50 X 130)	$135		
½ AZ Withholding from community wages earned by W for period prior to filing of the divorce (.50 X 112)	$ 56		
Total AZ Withholding from community wages reportable by H for the taxable year (135 + 56)		$191	
AZ Withholding from Separate wages earned by W after filing of the divorce		$338	
Total AZ Withholding reportable by W for the taxable year			$529

<u>DISCUSSION:</u>

Income received after the termination of the community is the separate income of the individual who earned it or owns the property producing it. Under Arizona law, the termination of the community occurs when the petition for dissolution of marriage is filed, rather than the date the divorce is granted, if that petition resulted in a divorce.

Since the marital status of taxpayers is determined on the last day of the tax year, a person who has been granted a decree of dissolution of marriage during the year is not eligible to file a joint return with the former spouse. In determining items reportable on their respective returns, the parties, in effect, split their tax year into the period before the termination of the community and the period after the termination of the community.

With respect to the period before the divorce, the former spouses may have community income, deductions, and withholding. Each individual should report one-half of community income and any separate income on his or her respective return. When community income is reported, each individual may claim one-half of the deductions and credits related to items of community property, including one-half of the total income tax withheld from community income. A taxpayer may claim a dependent exemption for a person only if the taxpayer is eligible to claim a dependent exemption for that person on his or her federal income tax return. The personal exemption is claimed by each taxpayer on his or her respective return.

Deductible **<u>expenses paid out of separate funds</u>** are deductible only by the spouse who pays them. **For example**, if otherwise deductible medical expenses are paid from an account that is the separate property of one of the spouses, only that spouse may claim a deduction for the expenditure. (Otherwise deductible medical expenses would be those medical expenses paid out of the taxpayer's separate funds for medical services his or her spouse received while married or for expense paid for his or her spouse while married.)

If **<u>expenses are paid from funds from an account that is considered community property</u>**, the deduction should generally be split between both spouses. **For example**, if otherwise deductible mortgage interest on a residence owned by both spouses is paid from a joint checking account, each spouse would deduct half of the mortgage interest on their separate returns.

If, only one of the spouses is entitled to a deduction for the expense (for example, a payment of property taxes for property owned by just one of the spouses), only that spouse is allowed a deduction for the expenditure even if the expense is paid from joint funds.

Each spouse must maintain records documenting who is considered to have paid the expense.

<u>APPLICABLE LAW:</u>

Arizona Revised Statutes (A.R.S.) § 25-211 provides that all property acquired by either husband or wife during marriage is community property, except that which is acquired by gift or by inheritance or that which is acquired after service of a petition for dissolution of marriage, legal separation or annulment if the petition results in a decree of dissolution of marriage, legal separation or annulment.

A.R.S. § 25-213(A) provides that all property owned by each spouse before marriage, and that property acquired after marriage by gift or by inheritance, is the separate property of such spouse.

A.R.S. § 25-213(B) provides that property that is acquired by a spouse after service of a petition for dissolution of marriage, legal separation or annulment is also the separate property of that spouse if the petition results in a decree of dissolution of marriage, legal separation or annulment.

A.R.S. § 43-1001 defines a "married person," for Arizona income tax purposes, to mean a married person on the last day of the taxable year.

David Raber, Director

Signed: May 14, 2014

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.

APPENDIX TO ARIZONA INDIVIDUAL INCOME TAX RULING ITR 14-2

For more information concerning the application of Arizona's community property provisions to Arizona income taxation, see the following income tax rulings:

ITR 93-18	Income Reporting Requirements for Married Arizona Residents Who File Separate Arizona Individual Income Tax Returns
ITR 93-19	Deductions, Exemptions, and Credits for Married Taxpayers Who File Separate Arizona Individual Income Tax Returns
ITR 93-20	Income Reporting Requirements of Resident and Nonresident Spouses Who File Separate Arizona Individual Income Tax Returns
ITR 93-22	When Community Income May Be Treated as Separate Income
ITR 93-25	Tax Collection from a Divorced Individual for Tax Due on a Separate Return Filed by the Former Spouse
ITR 93-26	Tax Collection from Married Individuals for Premarital Income Tax Liabilities
ITR 11-5	Joint and Several Income Tax Liability
ITR 14-1	Filing a Joint Tax Return When a Resident Spouse is Married to a Part- Year Resident or Nonresident

STATE OF ARIZONA
Department of Revenue

Janice K. Brewer
Governor

John A. Greene
Director

ARIZONA INDIVIDUAL INCOME TAX RULING
ITR 11-5

(Supersedes Arizona Individual Income Tax Ruling ITR 97-2)

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

ISSUE:

When is the Arizona income tax liability of a husband and wife joint and several?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 25-211 provides that all property acquired by either husband or wife during marriage is community property, except that which is acquired by gift or by inheritance.

A.R.S. § 43-301 sets forth the individual filing requirements and provides for joint and several liability in the case of a husband and wife.

A.R.S. § 43-309 allows married individuals to file joint income tax returns.

A.R.S. § 43-562 also provides for joint and several liability in the case of a husband and wife.

Internal Revenue Code (I.R.C.) § 66 contains provisions under which, for federal income tax purposes, community property laws may be disregarded and community income treated as the income of the spouse earning the income.

DISCUSSION:

A.R.S. § 43-562 provides that, in the case of a husband and wife, the spouse who controls the disposition of or who receives or spends community income, as well as the spouse who is taxable on such income, is liable for the payment of Arizona income taxes on that income. In addition, if a husband and wife file a joint income tax return, the liability for the tax on the aggregate income is joint and several. When the income tax liability is joint and several, the department may proceed separately against either spouse or both spouses for the entire liability. There are no restrictions with respect to when the department may proceed separately against only one spouse. It is not necessary to establish that the other spouse cannot be located or that the other spouse is unable to pay the tax.

Under Arizona's individual income tax filing provisions, married persons are given the option of filing either a joint return or separate returns. If a joint Arizona income tax return is filed, the tax liability on the aggregate income (community and separate income) is joint and several. It does not matter if only one of the spouses earns income. Generally, one spouse cannot avoid joint and several liability by disavowing a joint return after he or she learns of the other spouse's omissions from income or erroneous deductions.

If separate returns are filed, each spouse is separately liable for the income tax imposed on his or her separate income and for the tax imposed on his or her share of community income, and to the extent he or she controls, receives, or spends the other spouse's share of community income, for the tax imposed on the other spouse's share of community income.

The following examples will illustrate joint and several liability incurred when separate returns are filed.

Example 1:

Husband and wife are a married couple who live and work in Arizona. Both are wage earners, and wages are their only source of income. Both spouses receive, control, and spend the wage income.

Husband and wife file separate Arizona income tax returns for the tax year. Each spouse's Arizona income tax return properly reports one-half of husband's wages and one-half of wife's wages since all of the wages in this case are community income.

Husband is liable for the tax liability from his separate Arizona income tax return since husband is taxable on the income reported on that return. Husband is also jointly and severally liable for the tax liability from wife's separate return since he also receives, controls, and spends the income reported on wife's separate income tax return.

Wife is liable for the tax liability from her separate Arizona income tax return since wife is taxable on the income reported on that return. Wife is also jointly and severally liable for the tax liability from husband's separate return since she also receives, controls, and spends the income reported on husband's separate income tax return.

In this example, both spouses are jointly and severally liable on the total tax liability from both separate returns.

Example 2:

Husband and wife are a married couple who live and work in Arizona. Husband and wife are wage earners, and wages are their only source of income. Wife sends all of her wages to her mother who lives in another country. Husband does not receive, control, or spend any of wife's wages. Both spouses receive, control, and spend husband's wages.

Husband and wife file separate Arizona income tax returns for the tax year. Each spouse's Arizona income tax return properly reports one-half of husband's wages and one-half of wife's wages since all of the wages in this case are community income.

Husband is liable for the tax liability from his separate Arizona income tax return since husband is taxable on the income reported on that return. Husband is also jointly and severably liable for the portion of his wife's tax liability that relates to his wife's share of community income earned by the husband, since husband shared in receiving, controlling, and spending those wages. However, husband is not liable for the portion of his wife's tax liability that relates to the wife's share of community income earned by wife since husband did not receive, control, or spend that income.

Wife is liable for the tax liability from her separate Arizona income tax return since wife is taxable on the income reported on that return. Wife is also jointly and severably liable for the tax liability from husband's separate return since she receives, controls, and spends the income reported on husband's separate income tax return.

In this example, wife is subject to joint and several liability on the total tax liability from both separate returns, and husband is jointly and severally liable for the total liability from his separate return and for the portion of his wife's tax liability that relates to his wife's share of community income earned by him.

RULING:

If a joint Arizona income tax return is filed, the entire income tax liability from the joint return is joint and several.

If separate Arizona income tax returns are filed, each spouse is liable for the tax imposed on his or her separate income, his or her share of community income, and his or her spouse's share of community income to the extent he or she receives, controls, or spends the other spouse's share of that community income.

When the income tax liability is joint and several, the department may proceed separately against either spouse or both spouses for the entire liability, but the department will not collect it more than once.

Cross References:

A spouse may qualify for relief from joint and several liability under A.R.S. §§ 42-2074, 42-2201 or 42-2202 if the conditions in those statutes are met. For an explanation of these conditions and the procedure to apply for relief, see Arizona Individual Income Tax Procedure ITP 00-1 "Procedure for Requesting Relief from Joint and Several Liability."

For an explanation of the exceptions when community income is treated as separate income pursuant to Internal Revenue Code § 66, see Arizona Individual Income Tax Ruling ITR 93-22 "When Community Income May Be Treated as Seperate Income."

John A. Greene, Director

Signed: August 17, 2011

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.

ARIZONA DEPARTMENT OF REVENUE

1600 WEST MONROE - PHOENIX, ARIZONA 85007-2650

JANE DEE HULL
GOVERNOR

MARK W. KILLIAN
DIRECTOR

ARIZONA INDIVIDUAL INCOME TAX RULING
ITR 02-3

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

ISSUE:

How should joint estimated tax payments be allocated when the spouses subsequently file separate returns?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 25-211 provides that all property acquired by either husband or wife during marriage is community property, except that which is acquired by gift or inheritance.

A.R.S. § 43-581 requires certain individuals to make estimated income tax payments and allows voluntary payments by individuals not required to make mandatory payments.

Internal Revenue Service (IRS) Treasury Regulation (Treas. Reg.) § 1.6015(b)-1(b) provides for allocation of joint estimated tax payments between spouses that subsequently file separate returns.

IRS Letter Ruling 200011047 provides that the IRS shall allocate joint estimated tax payments between spouses in accordance with the formula set out in Treas. Reg. § 1.6015(b)-1(b) when the spouses who have made joint estimated tax payments subsequently file separate returns and cannot agree on how to divide the payments.

DISCUSSION:

For federal estimated tax payment purposes, former Internal Revenue Code § 6015(c) permitted the division of estimated tax payments by spouses who had filed a joint estimated tax declaration but then chose not to file joint returns. Treas. Reg. § 1.6015(b)-1(b) sets forth rules for dividing the joint estimated tax payments. Under Treas. Reg. § 1.6015(b)-1(b), joint estimated tax payments may be treated as payments on account of the tax liability of either the husband or wife for the taxable year, or may be divided between them in such manner as they agree. Therefore, if the spouses agree to an allocation of the payments, as evidenced by their claiming the payments on their respective separate tax returns, the IRS will accept that allocation. However, if the spouses do not agree to an allocation of the payments, IRS Letter Ruling 200011047 provides that the IRS will allocate the payments in proportion to their separate tax in accordance with the formula provided in Treas. Reg. § 1.6015(b)-1(b), even though this may ignore local law. Under this regulation, the amount allocated to each spouse is determined using the following formula:

$$\frac{\text{tax imposed on husband's OR wife's return}}{\text{total tax imposed on both returns}} \times \text{the estimated payment}$$

For example: H and W made joint estimated payments of $19,500 for the taxable year. The amount of tax shown on H's return is $12,000. The amount of tax shown on W's return is $8,000. Based on the foregoing formula, H would be allowed estimated payments of $11,700 ($12,000/$20,000 X $19,500) and W would be allowed estimated payments of $7,800 ($8,000/$20,000 X $19,500).

For Arizona income tax purposes, A.R.S. § 43-581(C) requires the department to prescribe rules for payments of estimated tax that provide for estimated payments in a manner similar to the manner prescribed in the Internal Revenue Code. Therefore, when spouses are unable to agree on separate allocation for estimated tax payments that were made jointly, Arizona will apply the formula prescribed in Treas. Reg. § 1.6015(b)-1(b).

RULING:

When spouses make estimated tax payments jointly and later file separate income tax returns, the spouses may allocate the estimated tax payments between their returns in whatever manner they agree by claiming the payments on their respective returns.

When spouses who made joint estimated tax payments and later file separate income tax returns do not agree on the allocation, the following formula will be used to determine the amount of estimated tax allocated to each spouse without regard to community property:

$$\frac{\text{tax imposed on husband's OR wife's return}}{\text{total tax imposed on both returns}} \text{ X the estimated payment}$$

Mark W. Killian, Director

Signed: July 15, 2002

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.

ARIZONA DEPARTMENT OF REVENUE

1600 WEST MONROE - PHOENIX, ARIZONA 85007-2650

JANE DEE HULL
GOVERNOR

MARK W. KILLIAN
DIRECTOR

ARIZONA INDIVIDUAL INCOME TAX PROCEDURE
ITP 00-1

Procedure for Requesting Relief from Joint and Several Liability

(This procedure supersedes ITP 97-3)

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 25-211 provides that all property acquired by either husband or wife during marriage is community property, except that which is acquired by gift or by inheritance.

A.R.S. § 42-1251 provides for appeal to the department for a hearing, correction or redetermination of a proposed assessment.

A.R.S. § 42-1253 provides for appeal to the state board of tax appeals of a final decision of the department.

A.R.S. § 42-2074 provides for equitable relief from joint and several liability under certain circumstances.

A.R.S. § 42-2201 provides for relief from joint and several liability on a joint income tax return when certain conditions are met.

A.R.S. § 42-2202 provides that a taxpayer who filed a joint income tax return may elect to limit his or her liability with respect to a deficiency assessed for that return when certain conditions are met.

A.R.S. § 43-301 sets forth the individual filing requirements and provides for joint and several liability in the case of a husband and wife who file a joint return.

A.R.S. § 43-309 allows married individuals to file joint income tax returns.

A.R.S. § 43-562 also provides for joint and several liability in the case of a husband and wife who file a joint return.

<u>DISCUSSION</u>:

Under Arizona's individual income tax filing provisions, married persons are given the option of filing a joint return. If a joint Arizona income tax return is filed, the tax liability on the aggregate income (community and separate income) is joint and several. When the income tax liability is joint and several, the department may proceed separately against either spouse or both spouses for the entire liability. However, in some cases, a spouse may be relieved of joint and several liability. Three types of relief are available.

l. Innocent spouse relief (A.R.S. § 42-2201).

2. Relief by separation of liability (A.R.S. § 42-2202).

3. Equitable relief (A.R.S. § 42-2074).

These relief provisions apply to any joint and several tax liability arising on or after August 6, 1999, and for any joint and several tax liability that remains unpaid as of August 6, 1999.

<u>Innocent Spouse Relief</u>

A spouse may qualify for innocent spouse relief from joint and several liability under A.R.S. § 42-2201 when the following conditions are met:

1. A joint Arizona income tax return was filed for the tax year for which relief is requested.

2. There is an understatement of tax attributable to erroneous items of the other spouse.

3. The innocent spouse did not know, and had no reason to know, that there was an understatement of tax when he or she signed the joint return.

4. Under the circumstances it would be inequitable to hold the innocent spouse liable for the deficiency resulting from the understatement of tax.

An erroneous item with respect to a spouse is any item of gross income attributable to that spouse which is omitted from gross income. The determination of the spouse to which income is attributable is made without regard to community property laws. For example, commissions earned by a wife from self-employment and omitted from the joint return are attributable only to the wife even though the commissions may constitute community income.

An erroneous item with respect to a spouse also includes any claim for deduction, subtraction, credit, or basis claimed by that spouse in an amount for which there is no basis in fact or law. For example, a deduction has no basis in fact when the expense for which a deduction is claimed was never incurred.

An understatement of tax is generally the difference between the total amount of tax that should have been shown on the return and the amount of tax that was actually shown on the return.

An innocent spouse may qualify for partial relief if, at the time the return was signed, the innocent spouse knew or had reason to know that there was an understatement of tax due to the other spouse's erroneous items, but the innocent spouse did not know the full extent of the items. The innocent spouse may be relieved of part of the understatement of tax.

Relief by Separation of Liability

A taxpayer may qualify for relief from joint and several liability on a jointly filed return by making a separate liability election under A.R.S. § 42-2202 when **either** of the following conditions are met.

1. The taxpayer is no longer married to, or is legally separated from, the spouse with whom the taxpayer filed the joint return.

2. The taxpayer was not a member of the same household as the spouse with whom the joint return was filed at any time during the 12 month period ending on the date the separate liability election was filed with the department.

Under this relief, liability for an understatement of tax on a joint return may be allocated between the electing taxpayer and his or her spouse or former spouse. Items giving rise to the understatement of tax will be allocated to the taxpayers as if separate returns had been filed for the taxable year without regard to community property laws.

Even if a taxpayer meets the requirements mentioned above, a request for separation of liability will **not** be granted in the following situations:

1. The electing taxpayer and his or her spouse transferred assets as part of a fraudulent scheme.

2. The electing taxpayer had actual knowledge that any items giving rise to the deficiency and allocable to the taxpayer's spouse were incorrect. In this situation, the request will be denied only for the part of the deficiency which relates to the incorrect items of which the electing taxpayer had actual knowledge.

3. The electing taxpayer transferred property to his or her spouse (or former spouse) just to avoid tax or the payment of tax.

Equitable Relief

A taxpayer who does not qualify for innocent spouse relief or separation of liability may be relieved of joint and several liability through equitable relief. A taxpayer may qualify for equitable relief under A.R.S. § 42-2074 if the following conditions are met.

1. The taxpayer is not eligible for innocent spouse relief under A.R.S. § 42-2201.

2. The taxpayer is not eligible for separation of liability under A.R.S. § 42-2202.

3. Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for an understatement or underpayment of tax.

Unlike innocent spouse relief or separation of liability, a taxpayer may obtain relief from joint and several liability on a joint return for an understatement of tax and also **an underpayment** of tax (tax shown on a return that was not paid) through equitable relief.

PROCEDURE:

I. Application for Relief

A taxpayer's request for innocent spouse relief, relief by separation of liability, or equitable relief must be in writing and must provide sufficient information to establish that the conditions prescribed for the relief requested have been met. Arizona Form 200 "Request for Innocent Spouse Relief And Separation of Liability and Equitable Relief" is provided for this purpose. To apply for relief, the taxpayer should submit a completed Arizona Form 200, together with the necessary information as follows:

- If the taxpayer is meeting with a department employee for an examination, appeal, or collection, the form may be submitted to that employee.

- If the taxpayer receives a department notice of deficiency, the form may be submitted to the department employee named in the notice. (Attach a copy of the notice.)

- In all other situations the form should be submitted to:

Arizona Department of Revenue
P.O. Box 29081
Phoenix, AZ 85038-9081

Assistance in completing Form 200 may be obtained by contacting Taxpayer Information and Assistance at (602) 255-3381 or nationwide toll free at (800) 352-4090. A copy of the form is attached to this procedure. The form may also be obtained by calling (602) 542-4260.

When a taxpayer requests relief from joint and several liability, the department is required to notify the taxpayer's spouse or former spouse of the request. The department must also allow the other party to participate in the determination of the amount of relief from liability. Notification will be mailed to the other party's last known address as determined from department records or as shown on the taxpayer’s Form 200.

II. Determination by the Department

The Individual Income Tax Audit Section (audit section) will review the taxpayer’s Form 200 and determine whether the taxpayer qualifies for innocent spouse relief (A.R.S. § 42-2201) or relief by separation of liability (A.R.S.§ 42-2202). The audit section may require the taxpayer to furnish additional information. The audit section may determine that the taxpayer qualifies for full relief from the understatement, that the taxpayer qualifies for partial relief, or that the taxpayer does not qualify for relief.

If the audit section determines that the taxpayer does not qualify for innocent spouse relief or relief by separation of liability, the audit section will review the taxpayer’s Form 200 to determine whether the taxpayer qualifies for equitable relief under A.R.S. § 42-2074. The audit section may require the taxpayer to furnish additional information. Any recommendation by the audit section with respect to equitable relief will be reviewed by an Equitable Relief Review Committee of the department.

The department will notify the taxpayer requesting relief, and the other party, in writing with respect to the department’s determination.

III. Review of Unfavorable Determination

A party who disagrees with the determination of the audit section with respect to innocent spouse relief, relief by separation of liability, or equitable relief may petition the department’s Hearing Office for a review under A.R.S. § 42-1251. The petition must be in writing and must be submitted within 90 days of the mailing of the audit section’s determination.

The Hearing Office may affirm or reverse the audit section's determination, or may remand the request for relief back to the audit section with additional instructions. The Hearing Office will notify the taxpayer requesting relief, and the other party, in writing with respect to the determination on review.

A party who disagrees with a determination of the Hearing Office may appeal the determination to the Director of the Department of Revenue. The Director may also independently determine that a Hearing Office decision requires review. If no appeal is made to the Director within 30 days after the Hearing Office decision is received, and the Director does not independently review the decision, the Hearing Office decision is the final order of the department. If the decision is reviewed by the Director, the Director's decision is the final order of the department.

Either party may appeal a final order of the department (whether a Hearing Office decision or a Director's decision) to the State Board of Tax Appeals under A.R.S. § 42-1253.

____
Mark W. Killian, Director

____
Date

Explanatory Notice

The purpose of a tax procedure is to provide procedural guidance to the general public and to department personnel. A tax procedure is a written statement issued by the department to assist in the implementation of tax laws, administrative rules, and tax rulings by delineating procedures to be followed in order to achieve compliance with the law. Relevant statute, case law, or administrative rules, as well as a subsequent procedure, may modify or negate any or all of the provisions of any tax procedure. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.

ADDENDUM
TO
ARIZONA INDIVIDUAL INCOME TAX PROCEDURE
ITP 00-1

WORKSHEETS FOR FIGURING UNDERSTATEMENT OF TAX

INNOCENT SPOUSE (A.R.S. § 42-2201)

The department will figure the tax, interest, and penalties that qualify for relief after you file a completed Form 200 with all the required attachments. **You are not required to figure these amounts.** But if you wish, you can figure the understatement of tax yourself by using Worksheet 1. If your want to use Worksheet 1, you will need the following items.

- A copy of your tax return for the year(s) you are requesting relief.
- The tax return instructions for the year(s) you are requesting relief. The instructions have the tax table or tax rate schedule you will need.

Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**
(**Note**. This worksheet is optional. Keep it for your records.)

1. Enter your total tax including all changed items. .... 1. ______

   Note. This should be shown on the department's notice or audit report.

2. Refigure your total tax by excluding adjustments relating to your spouse's erroneous items. Include items you knew about or had reason to know about .... 2. ______

3. **Tax eligible for innocent spouse relief.**
   Subtract line 2 from line 1.. 3. ______

Example: John and Joan Smith filed a joint 1996 tax return (Form 140) in 1997. The total tax on the return was $1,650 (taxable income of $50,000). In 1999 the department audited their return and determined that John did not report $10,500 in wages. On August 31, 1999 the department mailed the Smiths a Notice of Deficiency showing additional tax of $441.

At the time Joan signed the return, she knew about $5,500 of John's wages. She did not know about, and had no reason to know about, the other $5,000. She believes it would be unfair for the department to make her responsible for the understatement of tax due to the $5,000 of wages. Joan uses Worksheet 1 to figure the tax that qualifies for innocent spouse relief.

ADDENDUM

(Continued)

Line 1: Joan enters $2,091. This is the total tax as refigured by the department.

Line 2: $1,881 is what the total tax would be by including only the unreported income that Joan knew about. She figures this amount as follows:

1. Taxable income shown on Joint Return $50,000
2. Plus: John's unreported income that Joan knew about .... $ 5,500
3. Refigured taxable income... $55,500
4. Refigured tax on $55,500 from Table Y in 1996 Form 140 instructions .... $ 1,881

Line 3: Joan subtracts line 2 from line 1 to get the understatement of tax ($210) due to the unreported wages she did not know about, and had no reason to know about. **This is the tax that is eligible for innocent spouse relief.**

Filled in Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**
(Note. This worksheet is optional. Keep it for your records.)

1. Enter your total tax including all changed items. 1. $2,091

   Note. This should be shown on the department's notice or audit report.

2. Refigure your total tax by excluding adjustments relating to your spouse's erroneous items. Include items you knew about or had reason to know about 2. $1,881

3. **Tax eligible for innocent spouse relief.** Subtract line 2 from line 1.. 3. $ 210

Example: Jerry and Pat Green filed a joint 1996 tax return (Form 140) in 1997. The total tax on the return was $1,650 (taxable income of $50,000). Jerry and Pat claimed an enterprise zone credit for 1996 in the amount of $1,500 for new employees hired for Jerry's business. In 1999, the department audited their return and determined that Jerry's business did not hire any new employees during 1996 and therefore, did not qualify for the enterprise zone credit. On September 30, 1999, the department mailed the Greens a Notice of Deficiency showing additional tax of $1,500.

At the time Pat signed the return, she knew about the credit, but she was not involved in Jerry's business and did not know that Jerry's business did not hire any new employees during 1996. She believes it would be unfair for the department to make her responsible for the understatement of tax due to the disallowed credit. Pat uses worksheet 1 to figure the tax that qualifies for innocent spouse relief.

ADDENDUM

(Continued)

Line 1: Pat enters $1,650. This is the total tax as refigured by the department.

Line 2: $150 is what the total tax would be by excluding the adjustment relating to Jerry's erroneous item (the enterprise zone credit).

Line 3: Pat subtracts line 2 from line 1 to get the understatement of tax ($1,500) due to the disallowed credit. **This is the tax that is eligible for innocent spouse relief.**

Filled in Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**
(Note. This worksheet is optional. Keep it for your records.)

1. Enter your total tax including all changed items. 1. $1,650

   Note. This should be shown on the department's notice or audit report.

2. Refigure your total tax by excluding adjustments relating to your spouse's erroneous items. Include items you knew about or had reason to know about .... 2. $ 150

3. **Tax eligible for innocent spouse relief.**
   Subtract line 2 from line 1.. 3. $1,500

SEPARATION OF LIABILITY (A.R.S. § 42-2202)

The department will figure your separation of liability and figure any related interest and penalties after you file a completed Form 200 with the required attachment. **You are not required to figure these amounts.** But if you wish, you can figure your separation of liability yourself by using Worksheet 2.

If you reported your child's tax liability on your joint return, do not include that liability when figuring your separation of liability. Allocate it as appropriate between you and your spouse.

When allocating income and deductions taken into account in computing the understatement of tax, allocate them in the same manner you would have allocated them if you and your spouse had filed separate returns without regard to community property laws.

Allocate wages and salaries to the spouse who performed the job and received the Form W-2. You generally allocate business and investment income (including capital gains) according to which spouse owned the business or investment that produced the income. Income from a jointly owned business or investment should be allocated equally between you and your spouse unless there is clear and convincing evidence that supports a different allocation.

ADDENDUM

(Continued)

Allocate business deductions according to the ownership of the business. Allocate personal deductions (such as itemized deductions for mortgage interest and taxes) equally between you and your spouse unless there is evidence that shows a different allocation is appropriate.

An item that is otherwise allocable to one spouse must be allocated to the other spouse to the extent the item created a tax benefit for the other spouse.

Worksheet 2. **Worksheet for Figuring Your Separation of Liability**
(**Note**: This worksheet is optional. Keep it for your records.)

1. Enter the net amount of income and deductions taken into account in computing the understatement of tax and allocated to you .... 1. ____

2. Enter the net amount of **all** income and deductions taken into account in computing the understatement of tax* .... 2. ____

3. Divide line 1 by line 2. Enter the result as a decimal (rounded to at least 3 places)... 3. ____

4. Enter the understatement of tax*.................................. 4. ____

5. Enter any credits taken into account in computing the understatement of tax and allocated to your spouse* .... 5.____

6. Enter any credits taken into account in computing the understatement of tax and allocated to you*.................................... 6. ____

7. Add lines 5 and 6 .... 7. ____

8. Subtract line 7 from line 4.. 8. ____

9. Multiply line 8 by line 3 .... 9. ____

10 Add lines 9 and 6. This is the understatement of tax you are responsible for... 10. ____

*This should be shown on the department's notice or audit report.

Example: Bob and Betty Brown filed a joint 1996 tax return (Form 140) in 1997. The total tax on the return was $3,750 (taxable income of $100,000). Bob and Betty were divorced in 1998. On August 31, 1999 the department audited their return and issued a Notice of Deficiency to the Browns relating to their 1996 return. There were four items listed on the notice.

ADDENDUM

(Continued)

- $20,000 of business expense deductions relating to Betty's real estate business were disallowed.

- $7,000 of commissions were unreported by Betty.

- $2,000 of business expense deductions relating to Bob and Betty's bookstore were disallowed.

- $500 of interest income from an account that belonged to Bob was unreported.

Bob had no actual knowledge with respect to the deductions and commissions from Betty's real estate business. He decides to file Form 200 to request relief from the $29,500 deficiency under separation of liability. He allocates the items between himself and Betty as follows (he attaches this allocation to his Form 200).

	Betty	Bob
Real estate business expense deduction	$20,000	
Real estate commissions	$ 7,000	
Bookstore expense deduction	$ 1,000	$ 1,000
Interest income		$ 500

To determine the understatement of tax that is allocable to him, Bob fills out Worksheet 2 as follows:

Line 1: Bob enters one-half of the disallowed bookstore business expense deduction ($1,000) and the unreported interest income ($500).

Line 2: Bob enters the net amount of **all** income and deductions taken into account in computing the understatement of tax ($29,500).

Line 3: Bob divides line 1 by line 2 to get .051.

Line 4: Bob enters the $1,534 understatement of tax. This is shown on the department's Notice of Deficiency.

Lines 5, 6, and 7: Bob enters zero on these lines since there are no credits to be allocated.

Lines 8 – 10: Bob completes lines 8 through 10. Line 10 shows that he is responsible for $78 of the understatement of tax. Betty is responsible for the remaining amount ($1,456).

ADDENDUM

(Continued)

Filled in Worksheet 2. **Worksheet for Figuring Your Separation of Liability**
(**Note**: This worksheet is optional. Keep it for your records.)

1. Enter the net amount of income and deductions taken into account in computing the understatement of tax and allocated to you .... 1. $ 1,500

2. Enter the net amount of **all** income and deductions taken into account in computing the understatement of tax* 2. $29,500

3. Divide line 1 by line 2. Enter the result as a decimal (rounded to at least 3 places).. 3. .051

4. Enter the understatement of tax*.................................. 4. $1,534

5. Enter any credits taken into account in computing the understatement of tax and allocated to your spouse*...................... 5. –0-

6. Enter any credits taken into account in computing the understatement of tax and allocated to you*................................... 6. –0-

7. Add lines 5 and 6 .... 7. –0-

8. Subtract line 7 from line 4.. 8. $1,534

9. Multiply line 8 by line 3 .... 9. $ 78

10. Add lines 9 and 6. This is the understatement of tax you are responsible for.. 10. $ 78

*This should be shown on the department's notice or audit report.

ELECTRONIC CODE OF FEDERAL REGULATIONS

e-CFR data is current as of September 25, 2015

Title 26 → Chapter I → Subchapter A → Part 1 → §1.1041-2

Title 26: Internal Revenue
PART 1—INCOME TAXES (CONTINUED)

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§1.1041-2 Redemptions of stock.

(a) *In general*—(1) *Redemptions of stock not resulting in constructive distributions.* Notwithstanding Q&A-9 of §1.1041-1T(c), if a corporation redeems stock owned by a spouse or former spouse (transferor spouse), and the transferor spouse's receipt of property in respect of such redeemed stock is not treated, under applicable tax law, as resulting in a constructive distribution to the other spouse or former spouse (nontransferor spouse), then the form of the stock redemption shall be respected for Federal income tax purposes. Therefore, the transferor spouse will be treated as having received a distribution from the corporation in redemption of stock.

(2) *Redemptions of stock resulting in constructive distributions.* Notwithstanding Q&A-9 of §1.1041-1T(c), if a corporation redeems stock owned by a transferor spouse, and the transferor spouse's receipt of property in respect of such redeemed stock is treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the redeemed stock shall be deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock shall be deemed first to be transferred by the corporation to the nontransferor spouse in redemption of such spouse's stock and then to be transferred by the nontransferor spouse to the transferor spouse.

(b) *Tax consequences*—(1) *Transfers described in paragraph (a)(1) of this section.* Section 1041 will not apply to any of the transfers described in paragraph (a)(1) of this section. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(2) *Transfers described in paragraph (a)(2) of this section.* The tax consequences of each deemed transfer described in paragraph (a)(2) of this section are determined under applicable provisions of the Internal Revenue Code as if the spouses had actually made such transfers. Accordingly, section 1041 applies to any deemed transfer of the stock and redemption proceeds between the transferor spouse and the nontransferor spouse, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041, however, will not apply to any deemed transfer of stock by the nontransferor spouse to the redeeming corporation in exchange for the redemption proceeds. *See* section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(c) *Special rules in case of agreements between spouses or former spouses*—(1) *Transferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, and shall not be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as a redemption distribution to the transferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(2) *Nontransferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, and shall not be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(3) *Execution of agreements.* For purposes of this paragraph (c), a divorce or separation instrument must be effective, or a valid written agreement must be executed by both spouses or former spouses, prior to the date on which the transferor spouse (in the case of paragraph (c)(1) of this section) or the nontransferor spouse (in the case of paragraph (c)(2) of this section) files such spouse's first timely filed Federal income tax return for the year that includes the date of the stock redemption, but no later than the date such return is due (including extensions).

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. Corporation X has 100 shares outstanding. A and B each own 50 shares. A and B divorce. The divorce instrument requires B to purchase A's shares, and A to sell A's shares to B, in exchange for $100x. Corporation X redeems A's shares for $100x. Assume that, under applicable tax law, B has a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption results in a constructive distribution to B. Also assume that the special rule of paragraph (c)(1) of this section does not apply. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for $100x in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the $100x to A in a transfer to which section 1041 applies.

Example 2. Assume the same facts as *Example 1,* except that the divorce instrument provides as follows: "A and B agree that the redemption will be treated for Federal income tax purposes as a redemption distribution to A." The divorce instrument further provides that it "supersedes all other instruments or agreements concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption." By virtue of the special rule of paragraph (c)(1) of this section and under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X and shall not be treated as resulting in a constructive distribution to B. See section 302.

Example 3. Assume the same facts as *Example 1,* except that the divorce instrument requires A to sell A's shares to Corporation X in exchange for a note. B guarantees Corporation X's payment of the note. Assume that, under applicable tax law, B does not have a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption does not result in a constructive distribution to B. Also assume that the special rule of paragraph (c)(2) of this section does not apply. Accordingly, under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X. See section 302.

Example 4. Assume the same facts as *Example 3,* except that the divorce instrument provides as follows: "A and B agree the redemption shall be treated, for Federal income tax purposes, as resulting in a constructive distribution to B." The divorce instrument further provides that it "supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption." By virtue of the special rule of paragraph (c)(2) of this section, the redemption is treated as resulting in a constructive distribution to B for purposes of paragraph (a)(2) of this section. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for a note in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the note to A in a transfer to which section 1041 applies.

(e) *Effective date.* Except as otherwise provided in this paragraph, this section is applicable to redemptions of stock on or after January 13, 2003, except for redemptions of stock that are pursuant to instruments in effect before January 13, 2003. For redemptions of stock before January 13, 2003 and redemptions of stock that are pursuant to instruments in effect before January 13, 2003, see §1.1041-1T(c), A-9. However, these regulations will be applicable to redemptions described in the preceding sentence of this paragraph (e) if the spouses or former spouses execute a written agreement on or after August 3, 2001 that satisfies the requirements of one of the special rules in paragraph (c) of this section with respect to such redemption. A divorce or separation instrument or valid written agreement executed on or after August 3, 2001, and before May 13, 2003 that meets the requirements of the special rule in Regulations Project REG-107151-00 published in 2001-2 C.B. 370 (*see* §601.601(d)(2) of this chapter) will be treated as also meeting the requirements of the special rule in paragraph (c)(2) of this section.

[T.D. 9035, 68 FR 1536, Jan. 13, 2003]

981 F.2d 456 (1992)

Joann C. **ARNES**, Plaintiff-Appellee, v. UNITED STATES of America, Defendant-Appellant.

No. 91-35752.

United States Court of Appeals, Ninth Circuit.

Argued and Submitted October 9, 1992.
Decided December 11, 1992.

Charles Bricken, **U.S.** Dept. of Justice, Tax Div., Washington, DC, for defendant-appellant.

Margo T. Keller and Paul A. Tonella, Lasher, Holzapfel, Sperry & Ebberson, Seattle, WA, for plaintiff-appellee.

457 *457 Before: HUG, FLETCHER, and BRUNETTI, Circuit Judges.

HUG, Circuit Judge:

The issue in this case is whether a taxpayer must recognize for income tax purposes the gain that she realized when, pursuant to a divorce settlement, a corporation redeemed her half of the stock in the corporation, the remaining stock of which was owned by her former husband. The district court, ruling on cross-motions for summary judgment, held that Section 1041 of the Internal Revenue Code of 1986 (I.R.C.) relieved the taxpayer of having to recognize the gain, and awarded the taxpayer a refund of $53,053 for 1988.

The district court had jurisdiction over the taxpayer's claim pursuant to 28 U.S.C. § 1346(a)(1) (1988). We have jurisdiction over the Government's timely appeal pursuant to 28 U.S.C. § 1291 (1988). We affirm.

I.

Joann **Arnes**, the Taxpayer-Appellee, married John **Arnes** in 1970. In 1980, they formed a corporation, "Moriah," to operate a McDonald's franchise in Ellensburg, Washington. That corporation issued 5,000 shares of stock in the joint names of John **Arnes** and Joann **Arnes**. In 1987, the couple agreed to divorce. McDonald's Corporation required 100% ownership of the equity and profits by the owner/operator, and informed John **Arnes** that there should be no joint ownership of the restaurant after the divorce.

Joann and John **Arnes** entered into an agreement to have their corporation redeem Joann **Arnes**' 50 percent interest in the outstanding stock for $450,000. The corporation would pay that money to Joann **Arnes** by forgiving a debt of approximately $110,000 that she owed the corporation, by making two payments of $25,000 to her during 1988, and by paying the remainder of approximately $290,000 to her in monthly installments over ten years beginning in February 1988. The agreement was incorporated into the decree of dissolution of the marriage, dated January 7, 1988. Joann **Arnes** surrendered her 2,500 shares to the corporation on December 31, 1987, and the corporation cancelled her stock certificate on May 4, 1988, then issuing another 2,500 shares to John **Arnes**.

On her federal income tax return for 1988, Joann **Arnes** reported that she sold her stock in Moriah on January 2, 1988, for a price of $450,000, and that her basis was $2,500, resulting in a profit of $447,500. She received $178,042 in 1988 as part of the sales price. Using an installment method, she treated $177,045 as long-term capital gain and the remainder as recovery of a portion of her basis.

On December 27, 1989, she filed a timely claim for refund of $53,053 for 1988 on the ground that she was not required to recognize any gain on the transfer of her stock because the transfer was made pursuant to a divorce instrument. The IRS did not allow the claim for refund, and Joann **Arnes** initiated this suit.

The district court found that the redemption of Joann **Arnes**' stock in Moriah was required by a divorce instrument, and that John **Arnes** had benefitted from the transaction because it was part of the marital property settlement, which limited future community property claims that Joann **Arnes** might have brought against him. The court, in applying the IRS regulations, found that, although Joann transferred her stock directly to Moriah, the transfer was made on behalf of John and should have been treated as having been made to John. Therefore, the transfer qualified for nonrecognition of gain pursuant to the I.R.C. exemption for transfers made to spouses or former spouses incident to a divorce settlement. *See* 26 U.S.C. § 1041 (1988). Summary judgment was granted in favor of Joann **Arnes**.

The Government appeals. Meanwhile, in order to insure that the capital gain will be taxed, the Government has asserted a protective income tax deficiency against John **Arnes**, who has contested the deficiency by filing a petition with the Tax Court. His case is pending but not before this court. The Government maintains that, although Joann
458 **Arnes** is the appropriate party to be *458 taxed for the gain, John **Arnes** should be taxed if the district court's ruling is upheld. If neither John nor Joann is taxed, the $450,000 used to redeem Joann's appreciated stock apparently will be taken out of the corporation tax-free.

II.

A grant of summary judgment is reviewed *de novo*. *T.W. Elec. Serv., Inc. v. Pacific Elec. Contractors Ass'n,* 809 F.2d 626, 629 (9th Cir.1987).

III.

The Government contends that the gain resulting from Moriah's redemption of Joann **Arnes**' stock does not qualify for exemption under section 1041, which is limited to transfers made directly to one's spouse or former spouse, or transfers made into trust for that person. Joann **Arnes**' transfer to Moriah, the Government contends, is outside the scope of the exemption.

Joann **Arnes** contends that her transfer of stock to Moriah should be considered a transfer to John, resulting in a benefit to John, and absolving her of the obligation to bear the burden of any resulting tax.

Section 1041 provides in part:

> (a) General rule. No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) —
>
> (1) a spouse, or
>
> (2) a former spouse, but only if the transfer is incident to the divorce.
>
> (b) Transfer treated as gift; transferee has transferor's basis. In the case of any transfer of property described in subsection (a) —
>
> (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
>
> (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

26 U.S.C. § 1041 (1988) ("Transfers of property between spouses or incident to divorce").

The purpose of the provision is to defer the tax consequences of transfers between spouses or former spouses. *See* H.R.Rep. No. 432, Pt. II, 98th Cong., 2d Sess. 1491 (1984), *reprinted in* 1984 ***U.S.****Code Cong. & Admin.News* 697, 1134 ("a husband and wife are a single economic unit"). Property received in such a transfer is excluded from the recipient's gross income. The recipient's basis is then equal to the transferor's basis. 26 U.S.C. § 1041(b)(2) (1988). Later, when the recipient transfers the property to a third party, the gain or loss must be recognized.

After section 1041 was enacted, the Treasury Department published a temporary regulation to implement the statute. Temp.Treas.Reg. § 1.1041-1T (1992). The regulation explains that in certain cases a transfer of property to a third party "on behalf of" a spouse or former spouse should be treated as a transfer to the spouse or former spouse. *Id.* at Q-9, A-9. One example supplied in the regulation is the case where the transfer to the third party is required by a divorce or separation instrument. Such a transfer of property

> will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

Temp.Treas.Reg. § 1.1041-1T, A-9 (1992).

The example suggests that the tax consequences of any gain or loss arising from the transaction would fall upon the nontransferring spouse for whose benefit the transfer was made, rather than upon the transferring spouse. Consistent with the policy of the statute, which is to defer recognition until the property is conveyed to a party outside the marital unit, the regulation seems to provide for shifting the tax burden from one spouse to the other, where appropriate.

459 Thus, a transfer by a spouse to a third party can be treated as a transfer to the *459 other spouse when it is "on behalf of" the other spouse. Whether the redemption of Joann's stock can be construed as a transfer to John, pursuant to the regulation example in A-9, depends upon the meaning of "on behalf of." The district court interpreted the regulation as meaning that a transfer was made "on behalf of" John **Arnes** if he received a benefit from the transfer. The court then concluded that John did receive a benefit, because the transfer was part of the marital property agreement which settled any future community property claims that Joann **Arnes** could have asserted against John.

Although no case is directly on point, many tax cases concern transfers made on behalf of other persons. Generally, a transfer is considered to have been made "on behalf of" someone if it satisfied an obligation or a liability of that person. If an employer pays an employee's income tax, that payment is income to the employee. *See* *Old Colony Trust Co. v. Commissioner,* 279 **U.S.** 716, 729-31, 49 S.Ct. 499, 504, 73 L.Ed. 918 (1929). If a corporation assumes a shareholder's bank note in exchange for stock, the shareholder receives a taxable constructive dividend. *Schroeder v. Commissioner,* 831 F.2d 856, 859 (9th Cir.1987).

In *Schroeder,* the taxpayer borrowed money from a bank to buy stock in the corporation. The corporation later redeemed part of that stock, assumed the taxpayer's bank note, and forgave a debt owed by the taxpayer to the corporation. At the time that the taxpayer borrowed the money from the bank, he owned no part of the corporation and had no authority to act on behalf of the corporation. *See id.* at 859-60 & n. 7. The taxpayer had the primary obligation to repay the loan, and the corporation's assumption of the loan relieved the taxpayer of that obligation. We held that the redemption of Schroeder's stock was a taxable constructive dividend. *Id.* at 859.

The Government argues that the **Arnes** stock transfer is more properly analogized to *Holsey v. Commissioner,* 258 F.2d 865 (3rd Cir.1958), where the Third Circuit held that a shareholder who owned fifty percent of the stock in a corporation did not receive a taxable benefit when the corporation redeemed the other fifty percent of the stock. The court found that the redemption "did not discharge any obligation of [the taxpayer] and did not benefit him in any direct sense," although the result was that the shareholder gained control of the company. *Id.* at 868.

John **Arnes** had an obligation to Joann **Arnes** that was relieved by Moriah's payment to Joann. That obligation was based in their divorce property settlement, which called for the redemption of Joann's stock. Although John and Joann were the sole stockholders in Moriah, the obligation to purchase Joann's stock was John's, not Moriah's. Furthermore, John personally guaranteed Moriah's note to Joann. Under Washington law, Joann could sue John for payment without suing Moriah. *See* Wash. Rev.Code Ann. § 62A.3-416(1) (West 1979). Thus, John was liable, with Moriah, for the payments due Joann.

We hold that Joann's transfer to Moriah did relieve John of an obligation, and therefore constituted a benefit to John. Joann's transfer of stock should be treated as a constructive transfer to John, who then transferred the stock to Moriah. The $450,000 was paid to Joann by Moriah on behalf of John. The transfer of $450,000 from the corporate treasury need not escape taxation, if we hold, as we do, that Joann is not required to recognize any gain on the transfer of her stock, because it is subject to section 1041. The tax result for Joann is the same as if she had conveyed the property directly to John.

The Government argues that because Joann transferred her stock to the corporation, rather than to John, the exception in section 1041 should not apply. The corporation cancelled Joann's stock and agreed to pay Joann $450,000. As a result, no asset with a carryover basis exists. John received an additional 2,500 shares from the corporation after Joann's shares were cancelled, but he did not carry over Joann's basis, because the transfer was not
460 made directly to him. Under this literal application *460 of the statute, Joann's gain, from the appreciation of the stock, would not be recognized by John if he were to dispose of his stock. Although John became the sole owner of the corporation as a result of the transfer, the net worth of the corporation was depleted, because the corporation incurred the debt of $450,000 to Joann. As the Government puts it, before the stock redemption, John owned half of a corporation worth $900,000; after the redemption, he owned all of a corporation worth $450,000. John has realized no gain; the value of his stock is still in the corporation, and the redemption did not increase the value of John's stock. In contrast, Joann received cash (and debt forgiveness) for her transfer of stock.

We reject the Government's application of the statute. The regulations, particularly as explained by Question and Answer 9, in Temp.Treas.Reg. § 1.1041-1T, demonstrate that the statute is meant to apply to situations such as this one, where a transfer is made on behalf of one's former spouse.

Finally, the Government points to one other example in the Temporary Treasury Regulations interpreting section 1041. Question 2 describes a situation in which a corporation wholly owned by one spouse sells property to the other spouse. That sale is not subject to the exemption rule of section 1041. *See* Temp.Treas.Reg. § 1.1041-1T(a), Q-2, A-2, ex. 3 (1992). The example does not apply to the **Arnes** transaction because Moriah was owned one-half each by John and Joann.

The judgment of the district court is AFFIRMED.

102 T.C. 522 (1994)

JOHN A. ARNES, PETITIONER
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 23291-91.

United States Tax Court.

Filed April 5, 1994.

Darrell D. Hallett, for petitioner.

Lisa M. Oshiro, for respondent.

FAY, *Judge*:

This case is before the Court on the parties' cross-motions for summary judgment pursuant to Rule 121.[1]

523 *523 By notice of deficiency dated October 8, 1991, respondent determined deficiencies in petitioner's Federal income taxes as follows:

Year	Deficiency
1987	$42,725
1988	27,337

FINDINGS OF FACT

John A. **Arnes** (petitioner) resided in Ellensburg, Washington, when he filed the petition.

Petitioner and his former wife, Joann **Arnes** (Joann), were married in 1970. After having worked for a number of years in McDonald's restaurants and for McDonald's Corp. (McDonald's), petitioner developed an interest in operating his own McDonald's franchise.

On October 8, 1979, petitioner and Joann entered into a license agreement with McDonald's granting them a McDonald's franchise in Ellensburg, Washington. After about a year, they formed Moriah Valley Enterprises, Inc. (Moriah), to own and operate the franchise, and 5,000 shares of Moriah stock were issued to petitioner and Joann jointly.

The articles of incorporation of Moriah include a right of first refusal, which states in relevant part as follows:

In the event any one or more of the shareholders of this corporation should desire to sell or transfer all or any part of his stock in the corporation and retire from the said business, * * * *then the corporation shall have the option to purchase and acquire the whole of the stock interest of such party * * * so desiring to sell or transfer his interest.* In the event the corporation does not exercise this option, the shareholders shall have a secondary option to purchase said shares at the same price contained in the corporation's options; said secondary option of the shareholders to be computed on a basis of number of shares held on a pro rata basis. Nothing in this paragraph shall prevent the corporation and the shareholders from agreeing to terms and conditions relating to the exercise of the foregoing option as to time within which to exercise the option, terms of payment, security for payment, methods of effecting transfer, and related matters. [Emphasis added.]

On August 5, 1981, McDonald's executed a memorandum entitled "Change of Unit Ownership" recognizing and
524 approving the assignment of the McDonald's franchise to Moriah *524 and also noting that petitioner and Joann were both 50-percent owners of Moriah.

Petitioner and Joann permanently separated in January 1987. McDonald's wrote a letter dated January 14, 1987, to petitioner, which states in pertinent part:

In conjunction with your pending divorce, we would like to explain McDonald's position concerning dissolution of the marriages of McDonald's operators.

As you know, we are primarily concerned with the operation of the McDonald's restaurant, and an essential element of good operations is 100% ownership of the equity and profits by the owner/operator on premises. Since all divorces include some sort of property settlement, we want to be assured that there is no *joint* ownership of the McDonald's restaurant business by you and your wife after you divorce and the spouse who ends up with the business is operationally and financially qualified.

We have the right to consent to such a property settlement because it results in a change in the equity ownership of the business and changes the status of the former husband and wife to that of a partnership of unrelated parties. As you know, it has been a long-standing franchising policy of this company to refuse to franchise partnerships.

On December 16, 1987, petitioner and Joann surrendered their jointly held shares of Moriah stock and were each issued separate stock certificates representing 2,500 shares of Moriah stock. On December 17, 1987, petitioner and Joann entered into an agreement regarding property custody and support (the property settlement agreement), providing in part as follows:

The parties hereto shall cause the corporation owned by the parties known as Moriah Valley Corporation to redeem from wife 2,500 shares of stock (Certificate #4) that she owns, said shares being one-half of the issued stock. That the obligations of the corporation to pay wife in accordance with the provisions hereinafter set forth, shall be and are personally guaranteed by husband and the corporation shall execute any security documents and/or other instruments necessary to secure and perfect the security granted to wife for said obligation. The corporation shall pay to wife the sum of FOUR HUNDRED FIFTY THOUSAND DOLLARS ($450,000.00) for wife's stock in the corporation. Of said sum, ONE HUNDRED TEN THOUSAND NINE HUNDRED EIGHTY-THREE AND 56/ 100ths DOLLARS ($110,983.56) shall be paid by the corporation by forgiving that certain Promissory Note dated April 17, 1987 in the principal sum of ONE HUNDRED FIVE THOUSAND DOLLARS ($105,000.00) that has accured [sic] interest of FIVE THOUSAND NINE HUNDRED EIGHTY-THREE AND 56/100ths DOLLARS ($5,983.56). That on the 2nd day of January, 1988, the corporation shall pay to wife the sum of TWENTY-FIVE THOUSAND DOLLARS ($25,000.00) and
525 a like sum on the 1st day *525 of May, 1988. That the balance of TWO HUNDRED EIGHTY-NINE THOUSAND SIXTEEN AND 44/100ths DOLLARS ($289,016.44) shall be paid by the corporation to wife and shall bear interest from January 1, 1988 at the rate of nine percent (9%) per annum and shall be paid through monthly installments of THREE THOUSAND SIX HUNDRED SIXTY-ONE AND 84/100ths DOLLARS ($3,661.84) per month commencing February 1, 1988. That said obligation shall be paid in full no later than January 1, 1998.

On December 28, 1987, Moriah and Joann entered into an agreement as to corporate stock providing for a redemption by Moriah of Joann's stock, with Moriah's obligation guaranteed by petitioner.

The property settlement agreement was filed with the Superior Court of Washington for Kittitas County and incorporated in the decree of dissolution of marriage by the court, entered on January 7, 1988.

On January 18, 1988, Joann, petitioner, and McDonald's executed an assignment and consent to redemption of stock (the McDonald's consent agreement). The McDonald's consent agreement provided that Moriah would redeem Joann's stock in accordance with the payment schedule set forth in the property settlement agreement and that petitioner would be the guarantor of Moriah's payment obligations thereunder.

At all times during the divorce proceeding and during the negotiations relating to the redemption of Joann's stock in Moriah, petitioner and Joann were each represented by an attorney.

On her Federal income tax return for 1988, Joann reported and paid the tax on capital gain arising out of the redemption. Joann subsequently claimed a refund of income tax on the ground that under section 1041 she was not required to recognize gain on the redemption because it should be deemed a nontaxable transfer of property from Joann to Moriah on behalf of petitioner, and then she initiated a refund suit in the U.S. District Court for the Western District of Washington. The District Court granted summary judgment in Joann's favor in ***Arnes** v. United States,* 91-1 USTC par. 50,207 (W.D. Wash. 1991), concluding that section 1041 governed the income tax consequences of the transaction to Joann.

526 *526 On February 10, 1992, petitioner filed his motion for partial summary judgment in this case. On March 9, 1992, respondent filed a motion to stay proceedings and also a response to petitioner's motion for partial summary judgment, in part contending that the stay would conserve this Court's time because the Court of Appeals for the Ninth Circuit's decision in Joann's case would be dispositive of this case. On March 19, 1992, petitioner filed his objection to respondent's motion. By order dated July 8, 1992, we granted respondent's motion. On August 12, 1992, petitioner filed a motion for reconsideration of order staying proceedings and also a memorandum in support of such motion, in part stating that it would be beneficial for the Court of Appeals for the Ninth Circuit to consider both Joann's and petitioner's cases simultaneously if respondent were to lose this case. On September 21, 1992, respondent filed a response to petitioner's motion for reconsideration of order staying proceedings, objecting to petitioner's motion. By order dated October 2, 1992, this Court denied petitioner's motion.

Thereafter, the District Court's decision in Joann's case was argued before and affirmed by the Court of Appeals for the Ninth Circuit in ***Arnes** v. United States,* 981 F.2d 456 (9th Cir. 1992).

OPINION

Respondent argues that the decision in ***Arnes*** controls our decision here. Petitioner contends, to the contrary, that Moriah redeemed Joann's stock and that no constructive dividend resulted to petitioner. We agree with petitioner and consider his motion first.

Summary judgment is appropriate where the record shows that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. Rule 121(b); *Sundstrand Corp. v. **Commissioner**,* 98 T.C. 518, 520 (1992), affd. 17 F.3d 965 (7th Cir. 1994); *Marshall v. **Commissioner**,* 85 T.C. 267, 271 (1985). The burden of proof is on the moving party to show that no issue of material fact exists. We view the evidence in the light most favorable to the party opposing the motion. *Blanton v. **Commissioner**,* 94 T.C. 491, 494 (1990); *Jacklin v.*
527 ***Commissioner**,* 79 T.C. 340, 344 (1982). A motion for summary judgment will be denied *527 if there is any reasonable doubt as to the facts in issue. *Hoeme v. **Commissioner**,* 63 T.C. 18, 20 (1974).

The issue before us is whether Moriah's redemption of Joann's stock resulted in a constructive dividend to petitioner. If a corporation redeems stock that its remaining shareholder was obligated to buy, a constructive dividend results to the remaining shareholder. *Wall v. United States,* 164 F.2d 462 (4th Cir. 1947); *Hayes v. **Commissioner**,* 101 T.C. 593 (1993); *Edler v. **Commissioner**,* T.C. Memo. 1982-67, affd. 727 F.2d 857 (9th Cir. 1984). However, this rule is limited to those circumstances where the obligation of the remaining shareholder is both primary and unconditional. *Enoch v. **Commissioner**,* 57 T.C. 781 (1972); *Priester v. **Commissioner**,* 38 T.C. 316 (1962); *Edenfield v. **Commissioner**,* 19 T.C. 13 (1952); *Edler v. **Commissioner**, supra.*

In *Edler v. **Commissioner**,* 727 F.2d 857 (9th Cir. 1984), the Court of Appeals for the Ninth Circuit affirmed our decision that the taxpayer did not receive a constructive dividend when the corporation in which he was the majority shareholder redeemed the stock owned by his former spouse. In that case, an interlocutory divorce judgment had awarded the taxpayer all of the stock in the company and had ordered him to deliver a promissory note payable to the wife. A nunc pro tunc order was later entered, deleting reference to the husband's obligation or to the enforcement and execution of this promissory note, and incorporating an agreement between the husband and wife, which read, in pertinent part, as follows:

whereunder * * * [the wife] would give up [her] money judgment position, recall the writ of execution, * * * and substitute, in the place and stead thereof, the delivery * * * of a minority shareholder position in Edler Industries, Inc., ON THE CONDITION that the corporation concurrently, redeem for cash, said minority shares * * * for the same amount of said money, to which * * * [the wife] is now entitled. [*Id.* at 858-859.]

After the modification, the husband had a secondary obligation to the wife to be fulfilled only if the corporation failed to redeem her stock.

The Court of Appeals expressed no doubt that the original agreement between the parties had created an obligation of the husband which would have resulted in a constructive dividend to him if the stock had been redeemed by the
528 corporation. *528 However, the court affirmed our holding that, under the nunc pro tunc modification, the husband did not have a primary and unconditional obligation, and that, therefore, there was no constructive dividend. In so doing, the Court of Appeals for the Ninth Circuit noted that, in the Tax Court, respondent had not questioned the ability of the divorce court to modify its own judgment and that it, therefore, would not consider, on appeal, whether, under ***Commissioner** v. Estate of Bosch,* 387 U.S. 456, 465 (1967), the Tax Court should not have given effect to the nunc pro tunc order. *Edler v. **Commissioner**, supra* at 859.

Despite respondent's attempts to distinguish *Edler,* the undisputed facts in the case before us are even more compelling for concluding that petitioner did not have a primary and unconditional obligation to acquire Joann's stock. From the inception, Moriah was obligated to redeem Joann's stock; there was no nunc pro tunc order changing a prior obligation of petitioner. The rationale of *Edler* was not affected by the enactment of section 1041, and the case is still the law of the Court of Appeals for the Ninth Circuit, to which this case is appealable.

This conclusion is further supported by respondent's own published position in Rev. Rul. 69-608, 1969-2 C.B. 42, 44. Situation 5 states:

A and B owned all of the outstanding stock of X corporation. An agreement between A and B provided that upon the death of either, X will redeem all of the X stock owned by the decedent at the time of his death. In the event that X does not redeem the shares from the estate, the agreement provided that the surviving shareholder would purchase the unredeemed shares from the decedent's estate. B died and, in accordance with the agreement, X redeemed all of the shares owned by his estate.

In this case A was only secondarily liable under the agreement between A and B. Since A was not primarily obligated to purchase the X stock from the estate of B, he received no constructive distribution when X redeemed the stock.

This scenario is directly analogous to the case before us. Indeed, petitioner argues on brief that, in structuring the redemption of Joann's Moriah stock, he had the right to rely on *Edler v. **Commissioner**, supra,* and Rev. Rul. 69-608, 1969-2 C.B. at 43, situation 5. See *Estate of Henry v. **Commissioner***, 69 T.C. 665, 674-675 (1978). Petitioner and
529 Joann owned all of the stock of Moriah. Their property settlement *529 agreement provided that Moriah would redeem Joann's shares, with Moriah's obligation guaranteed by petitioner. Under applicable Washington State law, the property settlement agreement created at most a secondary obligation, which could only mature on Moriah's default on its primary obligation. See *National Bank of Washington v. Equity Investors*, 81 Wash. 2d 886, 917, 506 P.2d 20, 39 (1973); *Amick v. Baugh*, 66 Wash. 2d 298, 303-308, 402 P.2d 342, 345-348 (1965). The McDonald's letter did not create a primary and unconditional obligation on petitioner to acquire Joann's shares.[2] Because petitioner was not primarily obligated to purchase Joann's shares, he received no constructive distribution when Moriah redeemed the stock.

Respondent contends, under the principle of *Golsen v. **Commissioner***, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), that the following statement by the Court of Appeals for the Ninth Circuit in ***Arnes** v. United States,* 981 F.2d at 459, controls our decision in the instant case:

John **Arnes** had an obligation to Joann **Arnes** that was relieved by Moriah's payment to Joann. That obligation was based in their divorce property settlement, which called for the redemption of Joann's stock. Although John and Joann were the sole stockholders in Moriah, the obligation to purchase Joann's stock was John's, not Moriah's. Furthermore, John personally guaranteed Moriah's note to Joann. Under Washington law, Joann could sue John for payment without suing Moriah. *See* Wash. Rev. Code Ann. § 62A.3-416(1) (West 1979). Thus, John was liable, with Moriah, for the payments due Joann.

Golsen v. ***Commissioner****, supra,* does not apply because ***Arnes*** *v. United States, supra,* does not address the legal issue here: whether there is a constructive dividend to petitioner. That case concerned the tax consequences to Joann under section 1041. *Bonaire Dev. Co. v.* ***Commissioner****,* 76 T.C. 789, 799-801 (1981), affd. on other grounds 679 F.2d 159 (9th Cir. 1982); *Estate of Henry v.* ***Commissioner****,* 69 T.C. 665, 674 (1978). We note that petitioner was not a party in ***Arnes****,* and Joann had a possibly[3] adverse position to petitioner in that case.

530 *530 Moreover, petitioner's guarantee did not create a primary and unconditional obligation. Under Wash. Rev. Code Ann. sec. 62A.3-416(1) (West 1979), cited by the Court of Appeals for the Ninth Circuit, any obligation[4] of petitioner would arise only after Moriah failed to make payments to Joann.[5] Any obligation of petitioner implied in the property settlement agreement would be the same as would exist in any situation involving a divorce and a division of property and as existed in *Edler v.* ***Commissioner****,* 727 F.2d 857 (9th Cir. 1984), affg. T.C. Memo. 1982-67, after the nunc pro tunc modification. To the extent this is suggested by the Court of Appeals for the Ninth Circuit in ***Arnes*** *v. United States, supra,* we conclude that the obligation is not primary and unconditional, and the statement constitutes dictum.

Applying these standards to the record as a whole, and the undisputed facts therein, we conclude that petitioner demonstrated that there is no genuine issue of material fact that could establish that payments made by Moriah to Joann in redemption of her stock were constructive distributions by Moriah to petitioner that could properly be treated as dividends to him.

In hindsight, tactically, it might have been preferable if respondent had taken action to facilitate simultaneous consideration of petitioner's and Joann's cases by the Court of Appeals for the Ninth Circuit, instead of the course that was taken.

Petitioner's motion for partial summary judgment will be granted. In view of our above conclusions, respondent's motion for summary judgment will be denied in full. To reflect the foregoing,

An appropriate order will be issued.

531 *531 Reviewed by the Court.

HAMBLEN, CHABOT, COHEN, WRIGHT, WELLS, BEGHE, CHIECHI, and LARO, *JJ.,* agree with this majority opinion.

PARR, *J.,* concurs in the result only.

HAMBLEN, *C.J.,* concurring:

I agree not only with the majority opinion, but also with Judge Chiechi's concurring opinion and with that part of Judge Beghe's concurring opinion that relates to the historical and policy reasons for leaving preexisting redemption tax law intact.

WRIGHT and WELLS, *JJ.,* agree with this concurring opinion.

BEGHE, *J.,* concurring:

Having joined the majority opinion, I write separately to extend my comments in *Blatt v.* ***Commissioner****,* 102 T.C. 77, 86 (1994) (Beghe, J., concurring), on the benefits of consolidation, and to address the dissents.

1. *Respondent's Role as Stakeholder*

Of course, it's proper to select a test case and let it go forward because it will be instructive or dispositive as to the identical or similar case or cases that are postponed pending its outcome. But when, as in this case, the parties to a transaction have opposing tax interests, respondent has the institutional obligation, subject to the Court's needs for efficient case management and sound judicial administration, to facilitate consolidation of their cases. Postponing one case while the other goes forward creates an unacceptable risk of depriving the postponed party of his day in court (or in this case, of a meaningful appeal) if he will be foreclosed by the final decision in the case that goes forward.[1] In addition, if the cases are consolidated, respondent can properly communicate to the Court respondent's views on how the generic situation should be handled.

Joann's and John's cases provide an instructive example of lost opportunities. This Court missed the last clear chance
532 in 1992 to put John's summary judgment motion on a fast *532 track, so that his case could catch up with Joann's case coming up from the District Court, and both appeals considered on a consolidated basis by the Court of Appeals for the Ninth Circuit. However, our mistake in agreeing with respondent's arguments for postponement of John's case doesn't mean it's too late for us to try to rectify the situation, insofar as John is concerned. In view of respondent's successful efforts to prevent the appeals in the two cases from being consolidated, the resulting whipsaw is of respondent's own making.

2. *The Case at Hand*

As summarized in Judge Ruwe's peroration (*infra* p. 549):

The result we reach today directly contradicts the holding of the Court of Appeals to which the instant case is appealable [thereby failing to follow our rule in *Golsen v.* ***Commissioner***, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971)], fails to explain why we disagree with the Court of Appeals [thereby perpetuating our failure in *Blatt v.* ***Commissioner***, 102 T.C. 77 (1994), to explain our disagreement with the Ninth Circuit], and produces an untenable result in that neither of the two stockholders of Moriah will incur any tax consequences as a result of the $450,000 stock redemption [thus allowing respondent to be whipsawed]. [Bracketed comments added.]

To each of these arguments I now turn, responding, in passing, to Judge Halpern's conclusion that "it is illogical to think that the Court of Appeals will not reverse us" (*infra* p. 549).

a. *The Golsen question.* This Court recently revisited the *Golsen* doctrine and explained, in our reviewed opinion in *Lardas v.* ***Commissioner***, 99 T.C. 490, 493-498 (1992), the limitations on its application. Although "better judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone", *Golsen v.* ***Commissioner***, 54 T.C. 742, 757 (1970) (fn. refs. omitted), affd. 445 F.2d 985 (10th Cir. 1971), we need not do so where "it is not clear that the Ninth Circuit would disagree with our conclusion" and "Accordingly * * * we are obliged to decide this case as we think right", *Lardas v.* ***Commissioner***, *supra* at 498.

I do not think it is as clear as Judges Ruwe and Halpern do that the Court of Appeals for the Ninth Circuit will reverse
533 us. The briefs filed with the Court of Appeals in *533 Joann's case, ***Arnes*** *v. United States*, 981 F.2d 456 (9th Cir. 1992), affg. 91-1 USTC par. 50,207 (W.D. Wash. 1991), did not bring *Edler v.* ***Commissioner***, 727 F.2d 857 (9th Cir. 1984), affg. T.C. Memo. 1982-67, to the attention of the Court of Appeals. The Court of Appeals should take the opportunity to revisit the redemption situation in the light of *Edler*. In addition, the procedural anomaly created by the delay in getting John's case to the Court of Appeals should lead it not only to review our decision in John's case de novo, but also to reconsider the views expressed by its panel in Joann's case. In these unusual circumstances, I agree with Judge Chiechi that judicial efficiency considerations do not dictate our application of the *Golsen* doctrine in John's case. Cf. *Of Course, Inc. v.* ***Commissioner***, 499 F.2d 754 (4th Cir. 1974), revg. 59 T.C. 146 (1972).

In arguing that it's not clear how the Court of Appeals for the Ninth Circuit will decide the appeal of our decision in John's case, I won't try to make life easy for myself by arguing that a proper application of the tax laws in Joann's and John's cases, or in the generic situation, would be for both spouses (or ex-spouses) to escape tax. But, because the Court of Appeals opinion might be read as leaving open the possibility of this result, I'll try, as a preliminary matter, to lay it to rest. The focus of section 1041 is on the nonrecognition and deferral of gain on the transfers of appreciated property between spouses. Although section 1041 says nothing about transactions with third parties, it did not repeal the rule of *Moline Properties, Inc. v.* ***Commissioner***, 319 U.S. 436 (1943), that, in the absence of applicable sham or agency principles, the corporate entity must be regarded as separate from that of the shareholders.[2]

Section 1041 is a rule of nonrecognition and deferral of gain or loss on transfers of property between spouses (and ex-spouses pursuant to divorce decree or separation agreement). It does not immunize dividends—described by sections
534 *534 301 and 316 as distributions by a corporation out of earnings and profits with respect to stock—from taxation by providing that they are to be excluded from gross income. To allow both spouses to escape tax in the generic redemption situation would allow cash representing earnings and profits to be removed from corporate solution at no tax cost whatsoever, either currently or in the future.[3] This would violate the deferral principle of section 1041.

To allow both spouses to escape tax in the generic redemption situation (of which this case is an example) would overextend the acknowledged purpose of section 1041 to repeal the rule of *United States v. Davis,* 370 U.S. 65 (1962), that a divorce-related transfer of appreciated property in exchange for the release of marital claims resulted in recognition of gain to the transferor. H. Rept. 98-432, at 1491-1492 (1984); Staff of Joint Comm. on Taxation, General Explanation of the Deficit Reduction Act of 1984, at 710 (J. Comm. Print 1985). The *Davis* rule caused unjust results and impeded divorce-actuated transfers of appreciated property because the transferor spouse was taxed on the transfer— without receiving any cash with which to pay the tax—and the transferee spouse received the property with an unpaid-for step-up in basis. The redemption situation does not present this problem; the spouse whose stock is redeemed receives cash, which provides the wherewithal to pay the tax, and this points the way to the proper treatment of the case at hand.

b. *Our disagreements with the Ninth Circuit.* The reasons for our decision in this case can be explicated by at least
535 *535 three lines of argument, none of which appears to have been previously expressed in its application to this case: First, a reminder about the self-acknowledged limitations on the applicability of Q&A-9 of the temporary regulation to this case and the generic redemption situation; second, a revisit to the location of the primary obligation to purchase Joann's stock, as between John and Moriah; and third, a historical and policy analysis of the common law of taxation applicable to stock redemptions of closely held corporations.

(i) *Limitations of the temporary regulation.* The format and preamble of the temporary regulation, sec. 1.1041-1T, Temporary Income Tax Regs., 49 Fed. Reg. 34452 (Aug. 31, 1984), make clear that it does not assert that section 1041 repealed the preexisting and continuing tax common law on the treatment of redemptions of family corporations. The question and answer format and the "Temporary" label alert us that the temporary regulation was not and is not intended to be the Treasury's comprehensive last word on the subject. The preamble to the temporary regulation, also set forth at T.D. 7973, 1984-2 C.B. 170, states that the "document provides temporary regulations relating to the treatment of transfers of property between spouses or former spouses" and is

presented in the form of questions and answers * * * [that] are not intended to address comprehensively the issues raised by sections 1041, 71, 215 and 152(e). Taxpayers may rely for guidance on these questions and answers, which the Internal Revenue Service will follow in resolving issues arising under sections 1041, 71, 215 and 152(e). No inference, however, should be drawn regarding questions not expressly raised and answered.

Even though a temporary regulation has the same dignity as any other interpretative regulation on the subject that is fairly within its ambit, see *Nissho Iwai American Corp. v.* ***Commissioner***, 89 T.C. 765, 776 (1987), its temporary character also tells us that it should not be extended by implication beyond the area with which it purports to deal.

(ii) *Locating the obligation.* It would appear that the Court of Appeals for the Ninth Circuit concluded in Joann's case—because a separation agreement is clearly an agreement between the spouses and because a divorce decree is
536 primarily directed to them—that such an agreement or decree *536 necessarily imposes the primary obligation on the remaining shareholder spouse to see to it that the corporation pays the terminating shareholder spouse in exchange for its redemption purchase of her stock. That is obviously the basis for the characterization of the first situation in Q&A-9, 49 Fed. Reg. 34453, "where the transfer to the third party is required by a divorce or separation instrument," as being "on behalf of" the nontransferring spouse, so that the nontransferring spouse will necessarily be treated as first receiving the property from the transferor spouse and then transferring it to the third party.[4]

That would be a plausible approach if section 1041 had Jbeen enacted in a vacuum or written on a clean slate. But our task is to harmonize or reconcile section 1041 with a preexisting and continuing body of law on the tax treatment of redemptions by closely held corporations. We therefore must decide where the line of demarcation should be drawn between them. For the reasons set forth (*infra* pp. 538-541), the line should be drawn differently from the way in which application of Q&A-9 to the family corporation redemption situation might at first blush seem to require.

The Court of Appeals for the Ninth Circuit concluded in Joann's case, ***Arnes** v. United States, supra* at 459, that John had an obligation to Joann "that was relieved by Moriah's payment to Joann" that "was based in their divorce property settlement, which called for the redemption of Joann's stock" and that "Although John and Joann were the sole stockholders in Moriah, the obligation to purchase Joann's stock was John's, not Moriah's." The ground for these
537 conclusions is not *537 stated in the opinion of the Court of Appeals, but it may have been an interpretation and application of Q&A-9 to the effect that a transfer of property by a spouse to a third party pursuant to a separation agreement or divorce decree must in all circumstances be deemed to be "on behalf of" the nontransferring spouse.

Although, as Judge Ruwe states (*infra* p. 547), the Court of Appeals was "cognizant of Washington State law", I do not believe that it necessarily relied on the State law in deciding Joann's case. The Court of Appeals' citation of Wash. Rev. Code Ann. sec. 62A.3-416(1) (West 1979) concerns only the State law question of the effect of the guarantee, which is an afterthought and a makeweight.[5]

The ground of the Court of Appeals' decision in Joann's case appears to have been a conclusion about Federal tax law, based on Q&A-9, that a transfer to a third party, pursuant to a separation agreement or divorce decree, must be "on behalf of" the nontransferring spouse or ex-spouse.[6] As a result, Q&A-9 of the temporary regulation appears to have been extended beyond its proper purview in the redemption context.

I believe that this is where the Tax Court has parted company with the Ninth Circuit Court of Appeals panel that decided Joann's case. See *Blatt v. **Commissioner**,* 102 T.C. 77, 82-83 (1994). The Court of Appeals should have the
538 opportunity to revisit the question in the context of the *538 nontransferring spouse's tax treatment with the benefit, such as it may be, of our analysis, and the opportunity to reconcile its decision in Joann's case with its prior decision in *Edler v. **Commissioner**,* 727 F.2d 857 (9th Cir. 1984), affg. T.C. Memo. 1982-67.

(iii) *Historical and policy reasons for leaving preexisting redemption tax law intact.* In the absence of any showing that Congress, in enacting section 1041, or the Treasury, in promulgating the temporary regulation, intended to displace the tax common law on redemptions of closely held corporations, that law should remain in place. The way to accomplish this result is to interpret section 1041 and the temporary regulation so that no redemption of one spouse will be considered to be "on behalf of" the remaining spouse unless it discharges that spouse's primary and unconditional obligation to purchase the subject stock, as summarized and set forth in the examples in Rev. Rul. 69-608, 1969-2 C.B. 42, and the case law on which it relies. *Blatt v. **Commissioner**, supra* at 85 (Beghe, J., concurring).

Although the tax treatment of continuing shareholders is not specifically set forth in the Code, the bright line is well established by court decisions, such as *Wall v. United States,* 164 F.2d 462 (4th Cir. 1947), and *Holsey v. **Commissioner**,* 258 F.2d 865 (3d Cir. 1958), and by administrative rulings, such as Rev. Rul. 69-608, *supra.* A nonredeeming shareholder realizes no gain or loss or dividend income solely because all or a portion of the stock of another shareholder was redeemed, even though the effect of the redemption is to increase his percentage ownership in the corporation. The line has been drawn in terms of whether the remaining shareholder blundered into incurring a direct and primary obligation to purchase the stock, which he belatedly attempts to shift to the corporation, as in *Wall v. United States, supra,* and *Schroeder v.* ***Commissioner***, 831 F.2d 856 (9th Cir. 1987).[7]

These longstanding rules amount to a "social compact" that contemplates a pattern in which, when one shareholder or
539 *539 group of shareholders withdraws from the corporation, wholly or partly, with a resulting increase in the percentage ownership of the remaining shareholder, the remaining shareholder will not be taxed. The withdrawing shareholder is treated as having sold or exchanged a capital asset, while the remaining shareholder is considered to have realized nothing that can be viewed as a taxable gain or dividend. Although the withdrawal and shift in interest is financed out of the corporate treasury rather than individual bank accounts, and may be viewed as conferring an indirect benefit on the remaining shareholder, the transaction is considered no more than a sale to the corporation by the holder whose stock interest is terminated or substantially reduced.

All this was persuasively set forth 25 years ago in an article by Professor Chirelstein. He argued, although the **Commissioner** has never officially espoused his view, that publicly held corporations that engage in share repurchase plans should be considered as distributing dividends to their shareholders because such plans in effect give the shareholders the option to take stock or cash. Cf. *Technalysis Corp. v.* ***Commissioner***, 101 T.C. 397 (1993). In making this argument, however, Professor Chirelstein was careful to make clear that there was no historical or policy basis for changing the tax treatment of redemptions of closely held corporations, which treatment was inherent in the structure of section 302:

These results must be considered among the basic structural elements of Subchapter C and are no longer open to any fundamental challenge. * * *

*** * * * * * ***

Section 302 was designed with a specific policy goal in mind and not simply to carry out general principles relating to the tax treatment of stock sales. Most would agree that the aim of the section is to facilitate occasional, and often major, shifts in ownership interests among the shareholders of closely-held or family-owned corporations for whose shares no active market exists apart from the company itself. That, of course, is the image of Section 302 which tax lawyers generally have in mind; virtually every technical detail in the section confirms that Congress did as well. Thus, family attribution rules and other provisions for constructive ownership of stock, restrictions relating to the redemption of stock from controlling shareholders, the disproportionality standard itself together with the prohibition against planned series of redemptions which are pro rata in the aggregate—these rules obviously contemplate a tightly knit
540 shareholder group whose individual interests are virtually identical to those of the corporation. *540 * * * The basic legislative aim * * * is to bear lightly on withdrawals from incorporated partnerships.

Transactions of the latter sort, though perhaps formally initiated by the corporation, are necessarily the product of negotiation and agreement among the shareholders. That is their distinguishing mark. Redemption price, terms of payment, total number of shares to be redeemed, *even the tax consequences,* must be bargained out and agreed to before the redemption is authorized. The reason, of course, is that the redemption is intended to alter the stock interests of particular individuals in specified ways—for example, through the surrender of control by one partner to another, through the retirement of older family members, or on the occasion of the death or resignation of an executive holding shares in the firm. The chief technical features of Section 302 confirm that the section contemplates an advance understanding or agreement by the shareholders. * * * These provisions were developed to permit and encourage taxpayers to act in relatively certain reliance on their applicability in a given case, and it is clear that they contemplate effective planning based on more or less formal agreement among the shareholders as to who will and who will not present his [or her] shares for redemption. * * *

[Chirelstein, "Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares", 78 Yale L. J. 739, 749, 750 (1969); emphasis added.]

It is obvious that John and his counsel and Joann and her counsel negotiated the separation agreement to have Joann's stock redeemed against the background of and in reliance on these rules. Joann originally reported the redemption transaction as resulting in capital gains to her, in accordance with the advice of the attorney who represented her in the negotiation of the separation agreement. She then changed her mind and claimed a refund in repudiation of the original agreement. John's counsel demonstrated on brief, and respondent did not disagree, that the separation agreement was based on the assumption that the community property and liabilities would be equally divided between John and Joann. In agreeing on that equal division, the parties assumed that Joann would bear capital gains taxes on the Moriah distributions that she would receive as payment in exchange for her stock, and that there would be no tax on John. The net effect of taxing John and exonerating Joann is that she would receive and retain more than twice as much of the community property as John.

One of the benefits of having these bright line rules apply to redemptions by family corporations is that they reduce the
541 opportunities for tax game playing between private parties. *541 It is game playing, and engaging in second thoughts, that Joann, with the assistance of counsel, indulged in when she sandbagged John by reneging on their original deal.

The tax commentators have been alert to spot the opportunities for game playing that the decision in Joann's case has created. The most recent comment in this area states:[8]

Recent cases involving the redemption of stock in husband-wife corporations make it clear that even though section 1041 has brought greater ability to specify the tax consequences of divorce, it has not put to rest all uncertainty. Tax practitioners still face a grey area when they are trying to predict when a stock redemption from one spouse will be held to be made "on behalf of" the other spouse. In that context, there are opportunities to take aggressive filing positions—and, in a planning context, to document the divorce transactions to either dictate a specific tax result *or create ambiguity.* [Raby, "Raby Revisits Stock Redemptions Incident to Divorce," Tax Notes 1031-1032 (Feb. 21, 1994); emphasis added.]

Hewing to the bright line rules of Rev. Rul. 69-608, *supra,* in the marital dissolution context will reduce the tax costs of divorce for the owners of small businesses held and operated in corporate form. If the shareholder spouses can negotiate their separation agreement with the assurance that the redemption will be tax free to the remaining shareholder and a capital gain transaction to the terminating shareholder, the overall tax costs will ordinarily be less than if the terminating spouse qualifies for nonrecognition under section 1041, but the remaining spouse suffers a dividend tax.[9] This will leave a bigger pie to be divided in setting the consideration for the shares to be redeemed.

c. *The whipsaw.* Judge Ruwe concludes that our decision produces "an untenable result in that neither of the two stockholders of Moriah will incur any tax consequences as a result of the $450,000 stock redemption" (*infra* p. 549). I
542 join Judge Ruwe and his cohort in deploring the whipsaw result, *542 but it's of respondent's own making.[10] The right lessons to be learned from these cases will best be imparted to all concerned by upholding the result arrived at by our majority opinion in John's case. I hope and expect that the Court of Appeals for the Ninth Circuit will agree.

FAY, *J.,* agrees with this concurring opinion.

CHIECHI, *J.,* concurring:

Although I join the majority opinion, I write separately to explain why I believe the extension of the principle of *Golsen v.* ***Commissioner****,* 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), called for in the dissents does not serve the purpose for which this Court adopted that principle and therefore is not warranted in the present case. In *Lardas v.* ***Commissioner****,* 99 T.C. 490, 495 (1992), we recently had occasion to review that purpose. There, we stated:

It should be emphasized that the logic behind the *Golsen* doctrine is not that we lack the authority to render a decision inconsistent with any Court of Appeals (including the one to which an appeal would lie), but that it would be futile and wasteful to do so where we would surely be reversed. Accordingly, bearing in mind our obligation as a national court * * * we should be careful to apply the *Golsen* doctrine only under circumstances where the holding of the Court of Appeals is squarely on point. * * *

In my view, the majority opinion is not a futile and wasteful insistence of this Court's view as to whether petitioner (John) received a constructive dividend as a result of the redemption by a corporation of the stock of his former spouse (Joann). While it is a virtual certainty that respondent will appeal our holding that John did not receive a constructive dividend to the U.S. Court of Appeals for the Ninth Circuit, it is just as certain that petitioner would have appealed if the dissents had been adopted. What is by no means certain, in my opinion, is the outcome on appeal, since the legal
543 issue in ***Arnes** v. United States,* 981 F.2d 456 (9th Cir. 1992), was *543 the application of section 1041 to Joann, and not whether John received a constructive dividend, the legal issue presented here. In these circumstances, I do not believe we should extend the principle of *Golsen v.* ***Commissioner****, supra,* to the instant proceeding.

HAMBLEN, FAY, CHABOT, COHEN, WRIGHT, and COLVIN, *JJ.,* agree with this concurring opinion.

RUWE, *J.,* dissenting:

I disagree with the majority because I believe that the Court of Appeals for the Ninth Circuit, to which this case is appealable, has already passed on the determinative legal issue. In ***Arnes** v. United States,* 981 F.2d 456 (9th Cir. 1992), the Court of Appeals considered the same transaction that is presently before us.

The ultimate issue in ***Arnes*** was whether section 1041 shielded Mrs. **Arnes** (Joann) from recognizing gain when a corporation (Moriah), in which she and her husband (John) owned stock, redeemed her shares as part of a divorce settlement. Section 1041 generally provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse or former spouse incident to a divorce. Section 1041 does not apply to transfers to third parties. However, section 1.1041-1T, Q&A-9, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984), asks the following question: "May transfers of property to third parties *on behalf of* a spouse (or former spouse) qualify under section 1041?" (Emphasis added.) The question assumes the fact that the transfer to the third party was "on behalf of" the nontransferring spouse. The answer in the temporary regulation also assumes this, stating: "Yes. There are three situations in which a transfer to a third party on behalf of a spouse (or former spouse) will qualify under section 1041". One of those situations is where the transfer was required by a divorce or separation agreement.

It is clear from the regulation and the opinion of the Court of Appeals in ***Arnes** v. United States, supra,* that not every transfer from one spouse to a third party, pursuant to a divorce, will qualify for nonrecognition under section 1041. Rather, only those made "on behalf of" the nontransferring spouse can qualify. As explained by the Court of Appeals:

544 *544 The regulation explains that in certain cases a transfer of property to a third party "on behalf of" a spouse or former spouse should be treated as a transfer to the spouse or former spouse. *Id.* at Q-9, A-9. One example supplied in the regulation is the case where the transfer to the third party is required by a divorce or separation instrument. Such a transfer of property

will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041. Temp. Treas. Reg. § 1.1041-1T, A-9 (1992).

The example suggests that the tax consequences of any gain or loss arising from the transaction would fall upon the nontransferring spouse for whose benefit the transfer was made, rather than upon the transferring spouse. Consistent with the policy of the statute, which is to defer recognition until the property is conveyed to a party outside the marital unit, the regulation seems to provide for shifting the tax burden from one spouse to the other, where appropriate.

Thus, a transfer by a spouse to a third party can be treated as a transfer to the other spouse when it is "on behalf of" the other spouse. Whether the redemption of Joann's stock can be construed as a transfer to John, pursuant to the regulation example in A-9, depends upon the meaning of "on behalf of." * * *

[***Arnes** v. United States, supra* at 458-459.]

The temporary regulation gives no guidance as to the criteria for determining when such a transfer will be deemed to be "on behalf of" the nontransferring spouse. Acknowledging that there were no cases directly on point, the Court of Appeals analyzed whether Moriah's redemption of Joann's stock was on behalf of John by looking to the established legal precedents concerning constructive dividends. The Court of Appeals observed that

Generally, a transfer is considered to have been made "on behalf of" someone if it satisfied an obligation or a liability of that person. If an employer pays an employee's income tax, that payment is income to the employee. *See Old Colony Trust Co. v.* ***Commissioner***, 279 U.S. 716, 729-31, 49 S.Ct. 499, 504, 73 L.Ed. 918 (1929). If a corporation assumes a shareholder's bank note in exchange for stock, the shareholder receives a taxable constructive dividend.[1] *Schroeder v.* ***Commissioner***, 831 F.2d 856, 859 (9th Cir. 1987). [*Id.* at 459.]

545 *545 The Court of Appeals went on to explain that its holding in *Schroeder* that the taxpayer had received a constructive dividend, was based on its conclusion that "The taxpayer had the *primary obligation* to repay the loan, and the corporation's assumption of the loan relieved the taxpayer of that obligation." ***Arnes*** *v. United States, supra* at 459 (emphasis added).

The majority has expressed no disagreement with the Court of Appeals' use of constructive dividend principles for determining that Joann's transfer to Moriah was "on behalf of" John,[2] and the Court of Appeals' articulation of those principles is consistent with those stated by the majority. I recognize that the majority opinion in *Blatt v.* ***Commissioner***, 102 T.C. 77, 82 (1994), stated that "we do not agree with ***Arnes*** and respectfully refuse to follow it." Unfortunately, the majority opinion in *Blatt* failed to give any reasons for its disagreement with the Court of Appeals. *Id.* at 84-85 (Halpern, *J.,* concurring), 85-86 (Beghe, *J.,* concurring). Indeed, as pointed out in Judge Chiechi's concurrence in *Blatt v.* ***Commissioner***, *supra* at 86, it seems to have been totally unnecessary to announce a disagreement with ***Arnes*** *v. United States, supra*.[3]

It appears to me that the *Blatt* majority's real disagreement was with the District Court's opinion in ***Arnes*** where the District Court indicated that Moriah's redemption of Joann's stock would be considered to be "on behalf of" John if he received "any benefit". See *Blatt v.* ***Commissioner***, *supra* at 84 (Halpern, J., concurring), 85 (Beghe, J., concurring). However, the opinion of the Court of Appeals in ***Arnes*** *v. United States, supra* at 458. The Court of Appeals' opinion
546 *546 did not adopt the District Court's view that the redemption would be "on behalf of" John if he derived *any* benefit. Therefore, any error perceived in the District Court's rationale in ***Arnes*** is irrelevant.

Despite the majority's suggestion to the contrary, there is no disagreement between the tax law principles enunciated in ***Arnes*** and those stated in *Edler v.* ***Commissioner***, 727 F.2d 857 (9th Cir. 1984), affg. T.C. Memo. 1982-67. In *Edler,* the Court of Appeals for the Ninth Circuit agreed in principle that if a corporation's redemption of Mrs. Edler's stock was in discharge of Mr. Edler's obligation to purchase her stock, then the amount paid to Mrs. Edler would be a constructive dividend to Mr. Edler. Prior to their divorce, Mr. and Mrs. Edler owned all the stock of the corporation. The original divorce judgment obligated Mr. Edler to purchase Mrs. Edler's stock interest. However, a subsequent nunc pro tunc order placed that responsibility on the corporation. The **Commissioner's** argument that the nunc pro tunc order should not be given any effect for tax purposes was rejected by the Court of Appeals, *but* only because the **Commissioner** had not raised this argument in the lower court. Had the argument been made in the lower court, the result might well have been different. See *Hayes v.* ***Commissioner***, 101 T.C. 593 (1993). In fact, the Court of Appeals noted that "If it were not for the entry of the *nunc pro tunc* order, **Commissioner's** position would be correct". *Edler v.* ***Commissioner***, *supra* at 859.[4]

Having analyzed the meaning of the term "on behalf of" by looking to the appropriate principles of tax law for determining whether the redemption was a constructive dividend to John, the Court of Appeals in ***Arnes*** proceeded to determine whether the redemption relieved John of his obligation to purchase Joann's stock. Whether such an obligation existed must be resolved by reference to State law. *Hayes v.* ***Commissioner***, *supra* at 600.

The Court of Appeals in ***Arnes*** looked at the very same transaction and divorce property settlement that is presently before us and held that

547 *547 John **Arnes** had an obligation to Joann **Arnes** that was relieved by Moriah's payment to Joann. That obligation was based in their divorce property settlement, which called for the redemption of Joann's stock. Although John and Joann were the sole stockholders in Moriah, the obligation to purchase Joann's stock was John's, not Moriah's. Furthermore, John personally guaranteed Moriah's note to Joann. Under Washington law, Joann could sue John for payment without suing Moriah. *See* Wash. Rev. Code Ann. §62A.3-416(1) (West 1979). * * * [***Arnes** v. United States,* 981 F.2d at 459.]

Because the Court of Appeals held that John, not the corporation, was obligated to purchase Joann's stock, the court concluded that the redemption was used to satisfy John's obligation and therefore was "on behalf of" John. Using the formulation in section 1.1041-1T, Q&A-9, Temporary Income Tax Regs., *supra,* the Court of Appeals held that

Joann's transfer of stock should be treated as a constructive transfer to John, who then transferred the stock to Moriah. * * * [***Arnes** v. United States, supra* at 459.[5]]

In direct opposition to the determination by the Court of Appeals, the majority concludes that "petitioner did not have a primary and unconditional obligation to acquire Joann's stock" (majority op. p. 528) and that "Under applicable Washington State law, the property settlement agreement created at most a secondary obligation, which could only mature on Moriah's default on its primary obligation."[6] Majority op. p. 529. The obligation to purchase Joann's stock was either John's obligation or the corporation's. There were no other possibilities. The Court of Appeals, cognizant of Washington State law and looking at the same property settlement agreement and surrounding facts, held that "the

548 obligation to purchase Joann's stock was John's, *not* Moriah's."[7] ***Arnes** v. United States, supra* at 459 (emphasis *548 added). We should accept the Court of Appeals' determination as controlling rather than attempt to reexamine it. The Court of Appeals' holding is squarely in point with the determinative issue in the instant case. "[B]etter judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone." *Golsen v. **Commissioner**,* 54 T.C. 742, 757 (1970) (fn. refs. omitted), affd. 445 F.2d 985 (10th Cir. 1971).

If, however, the majority disagrees with the Court of Appeals over the application of Washington State law to the undisputed facts, it is incumbent on the majority to explain why it disagrees. Nevertheless, there is no explanation or rationale in the majority opinion on this point.[8] The only cases cited by the majority deal with guarantees, not with the issue of who had the original primary obligation to purchase Joann's stock.[9] In lieu of an explanation, we simply are left with an ex cathedra proclamation that the Court of Appeals was wrong and no guidance for the disposition of future cases.[10]

The Court of Appeals was aware that respondent had asserted a protective income tax deficiency against John and that John was contesting the deficiency in the instant case. ***Arnes** v. United States, supra* at 457. The Court of Appeals clearly contemplated that John would be treated as the person who redeemed stock from the corporation and that he, rather than his wife, would incur the tax consequences. Thus, the court stated:

549 *549 Joann's transfer of stock should be treated as a constructive transfer to John, who then transferred the stock to Moriah. The $450,000 was paid to Joann by Moriah on behalf of John. The transfer of $450,000 from the corporate treasury need not escape taxation, if we hold, as we do, that Joann is not required to recognize any gain on the transfer of her stock, because it is subject to section 1041. The tax result for Joann is the same as if she had conveyed the property directly to John. [***Arnes** v. United States, supra* at 459.]

The result we reach today directly contradicts the holding of the Court of Appeals to which the instant case is appealable, fails to explain why we disagree with the Court of Appeals, and produces an untenable result in that neither of the two stockholders of Moriah will incur any tax consequences as a result of the $450,000 stock redemption.

PARKER, SWIFT, GERBER and HALPERN, *JJ.,* agree with this dissent.

HALPERN, *J.,* dissenting:

Arnes** v. United States,* 981 F.2d 456 (9th Cir. 1992), tells us two things: First, the Court of Appeals for the Ninth Circuit will review our decision de novo. *Id.* at 458. Second, because the Court of Appeals held that section 1041 applied to Joann, it is illogical to think that the Court of Appeals will not reverse us. The Court of Appeals held that Joann recognized no gain on account of section 1041. Because of the way section 1041 works, however, a corollary of that holding is that Joann transferred her shares to John, who received them by gift. See sec. 1041(b). It is inconsistent to hold that view (i.e., that John received the shares by gift) and, at the same time, to question whether he received a constructive dividend because he was obligated to buy those shares. That is the question that the majority answers in the negative. The majority has in front of it the exact same transaction addressed by the Court of Appeals in ***Arnes*.* It seems to me that the decision of the Court of Appeals in ***Arnes*** (unless the Court of Appeals overrules itself) precludes the Court of Appeals from even considering the majority's theory. To the extent that *Edler v.* ***Commissioner****,* 727 F.2d 857 (9th Cir. 1984), affg. T.C. Memo. 1982-67, is inconsistent with ***Arnes****,* I assume that it was overruled by ***Arnes****,* sub silentio. *Edler,* of course, predated the enactment of section 1041. Efficiency thus
550 dictates that *550 we decide for respondent. See *Golsen v.* ***Commissioner****,* 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971). We are free, of course, to set forth (as Judge Beghe has done) the reasons why we believe the Court of Appeals to be wrong. *Id.* On the premises stated, I cannot concur in the decision of the majority.

SWIFT, JACOBS, GERBER, and WHALEN, *JJ.,* agree with this dissent.

[1] All Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code in effect for the years in issue, unless otherwise indicated.

[2] The McDonald's letter did not mandate the manner in which ownership of the franchise had to be redistributed or even to whom it had to be redistributed.

[3] This majority opinion does not express an opinion as to whether the standard of "on behalf of" the spouse in sec. 1.1041-1T(c), Q&A-9, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984), is the same as the primary and unconditional obligation rule applicable to a constructive dividend. Suffice it to say that our conclusion in this case is consistent with our conclusion in *Blatt v.* ***Commissioner****,* 102 T.C. 77 (1994), also a Court-reviewed opinion.

[4] Under Washington State law, assuming facts most favorable to respondent, petitioner's guarantee would be classified as an absolute guarantee. An absolute guarantee constitutes a promise to pay on default by the principal obligor. *National Bank of Washington v. Equity Investors,* 81 Wash. 2d 886, 917, 506 P.2d 20, 39 (1973); *Amick v. Baugh,* 66 Wash. 2d 298, 303-308, 402 P.2d 342, 345-348 (1965).

[5] Indeed, Joann was paid to the extent of $110,983.56 on the cancellation of her note to Moriah; any obligation of petitioner under his guarantee would never arise to that extent.

[1] This is particularly true in the case at hand. It is understood that John's motion, in the appeal of Joann's case, to intervene or for leave to file an amicus brief, was denied.

[2] Sec. 1.1041-1T(a), Q&A-2, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984), is in agreement:

Assume the same facts as in example (2) [A's sole proprietorship X Company sells property to B in ordinary course of business; transfer entitled to nonrecognition under sec. 1041], except that X Company is a corporation wholly owned by A. This sale is not a sale between spouses subject to the rules of section 1041. However, in appropriate circumstances, general tax principles, including the step-transaction doctrine, may be applicable in recharacterizing the transaction.

[3] That allowing both spouses to escape tax on the redemption would result in permanent tax avoidance rather than deferral can be demonstrated by a simple example. Suppose, as in our case, that Moriah has the same value of $900,000 and that Joann receives a lump-sum payment of $450,000 in exchange for her stock. But also assume that the stock basis of each shareholder is $250,000, rather than $2,500. If John takes a carryover basis for the stock received from Joann that is canceled by the corporation, he is left with a corporation worth $450,000, and a $500,000 basis for his stock (this would not be a redemption and sec. 301 distribution in which the "mystery of the disappearing basis" would present a problem; see Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 9.22[2], at 9-88 (6th ed. 1994)). If John should promptly thereafter liquidate Moriah, he would have a capital loss of $50,000, and it would be clear that the cash previously paid by Moriah out of its earnings and profits to Joann would have completely escaped individual income taxation. Even if the shareholders had had the low $2,500 basis for their shares

($5,000 in the aggregate), the $445,000 gain that John would realize and recognize on his liquidation of the corporation would be a gain with respect to his remaining interest in the corporation (albeit reduced by the addition of Joann's stock basis to his stock basis), and the cash used to pay for Joann's stock would have completely escaped individual income taxation.

[4] As a technical matter, a separation agreement or divorce decree that requires the corporation to redeem the stock of one shareholder need not thereby be deemed to impose on the remaining shareholder the primary obligation to buy the stock. On more than one occasion, a shareholder obligated to pay for shares has been able to establish that he was acting as agent for the corporation, so that the redemption was treated as a payment by the corporation of its own obligation, rather than that of the shareholder. See *Fox v. Harrison,* 145 F.2d 521 (7th Cir. 1944); *Decker v.* ***Commissioner***, 32 T.C. 326 (1959), affd. 286 F.2d 427 (6th Cir. 1960); *Ciaio v.* ***Commissioner***, 47 T.C. 447 (1967); *Peterson v.* ***Commissioner***, T.C. Memo. 1964-15; *State Pipe & Nipple Corp. v.* ***Commissioner***, T.C. Memo. 1983-339; see also Rev. Rul. 80-240, 1980-2 C.B. 116. But see *Glacier State Elec. Supply Co. v.* ***Commissioner***, 80 T.C. 1047 (1983).

Schroeder v. ***Commissioner***, 831 F.2d 856 (9th Cir. 1987), affg. *Skyline Memorial Gardens, Inc. v.* ***Commissioner***, T.C. Memo. 1985-334, relied on by the Ninth Circuit Court of Appeals in ***Arnes*** *v. United States,* 981 F.2d 456, 459 (9th Cir. 1992), was clearly distinguishable therefrom. In *Schroeder,* the Court of Appeals stated:

At the time that the taxpayer [Schroeder] borrowed the money from the bank, he owned no part of the corporation and had no authority to act on behalf of the corporation. See *id.* at 859-60 & n.7. [*Schroeder v.* ***Commissioner***, *supra* at 859.]

[5] I agree with our majority opinion that the provision of Washington law cited by the Ninth Circuit, and the cases construing it cited by the majority (majority op. p. 530 note 4), support the view that the guarantor's obligation is not primary and unconditional, notwithstanding that the breach by the corporation would entitle the wife to sue the ex-husband directly without vouching in the defaulting corporation. Until the breach by the corporation, it would be the corporation that had the primary obligation to redeem the wife's stock and to make payments to her in accordance with the redemption agreement. However, I wouldn't get too tangled in the vagaries of State law. The legislative history of sec. 1041 instructs us that "uniform Federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws." H. Rept. 98-432 (Part II), at 1492 (1984); Staff of Joint Comm. on Taxation, General Explanation of the Deficit Reduction Act of 1984, at 710 (J. Comm. Print 1985).

[6] This is indicated by the Ninth Circuit's reliance in ***Arnes*** *v. United States, supra* at 459, on *Schroeder v.* ***Commissioner***, 831 F.2d 856, 859 (9th Cir. 1987), and its rejection of the Government's argument that Joann's situation was governed by *Holsey v.* ***Commissioner***, 258 F.2d 865 (3d Cir. 1958), which would have let John off the hook. As Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 9.06[6], at 9-44 n.206 (6th ed. 1994), note, *Schroeder* was similar in facts and result to *Wall v. United States,* 164 F.2d 462 (4th Cir. 1947), the primordial case establishing that a remaining or incoming shareholder whose obligation to purchase and pay for the stock of another shareholder is discharged by the subject corporation will be considered to have received a dividend.

[7] Even in *Edler v.* ***Commissioner***, 727 F.2d 857 (9th Cir. 1984), the remaining shareholder husband appears to have been saved from dividend treatment by the fact that respondent had been dilatory in objecting that the nunc pro tunc extinction of that obligation by a second divorce decree was ineffective for Federal income tax purposes. Cf. *Hayes v.* ***Commissioner***, 101 T.C. 593 (1993).

[8] See also Raby, "If He Gets the Big Mac, Does She Pay the Tax?", Tax Notes 347 (Jan. 17, 1994); Preston & Hart, "Spouse's Stock in a Divorce Can Be Redeemed Tax Free", 78 J. Taxn. 360 (1993); Raby, "A Tale of Two Redemptions: It Was the Best and Worst (of Tax Consequences)", Tax Notes 459 (Jan. 25, 1993).

[9] This seems even more likely to be so with the restoration, by the Revenue Reconciliation Act of 1993, of a substantial differential in the rates of individual income tax on ordinary income and long-term capital gain.

[10] There are other ways by which respondent could reduce the opportunities for game playing that resulted in the whipsaw in this case. One would be to persuade Congress to enact a statutory provision, similar to sec. 1060 on special allocation rules for certain asset acquisitions, that would assure consistent tax treatment by the private parties of this type of transaction. Another would be to get around to replacing the "temporary regulation", published Aug. 31, 1984, in the Federal Register (see *supra* p. 535), or at least issuing a revenue ruling supplementing Rev. Rul. 69-608, 1969-2 C.B. 42, that would set forth clearly respondent's view on how stock redemptions by family corporations should be treated in the marital dissolution context.

[1] This is identical to what we recently stated in *Hayes v.* ***Commissioner***, 101 T.C. 593, 599 (1993):

A shareholder also receives a constructive dividend to the extent of available earnings and profits when a corporation agrees to perform that shareholder's obligation and that shareholder's obligation is thereby extinguished. See *Maher v.* ***Commissioner***, 469

F.2d 225, 229 (8th Cir. 1972), affg. in part, revg. and remanding on another issue 55 T.C. 441 (1970); *Sullivan v. United States, supra* at 728 n.5. * * *

[2] Curiously, the majority states that it "does not express an opinion as to whether the standard of `on behalf of' the spouse in sec. 1.1041-1T(c), Q&A-9, * * * is the same as the primary and unconditional obligation rule applicable to a constructive dividend." Majority op. pp. 529-530 note 3.

[3] In *Blatt v. **Commissioner***, 102 T.C. 77, 83 (1994), the majority acknowledged that

the facts in ***Arnes*** are easily distinguishable from the facts at hand. First, in ***Arnes,*** the Court of Appeals stated that McDonald's Corp. required complete ownership of a franchise by an owner/operator after the divorce; no such requirement is present here with respect to ownership of corporation. Second, in ***Arnes,*** the Court of Appeals stated, in dicta, that the taxpayer's former husband was obligated to become the sole owner of the franchise; such is not the case here. Third, in ***Arnes,*** the taxpayer's former husband guaranteed the corporation's obligation to the taxpayer; by contrast, Blatt did not guarantee corporation's payment to petitioner. Fourth, unlike Washington, Michigan is not a community property State.

[4] I agree with the majority that *Edler v. **Commissioner***, 727 F.2d 857 (9th Cir. 1984), affg. T.C. Memo. 1982-67, is still legal precedent in the Ninth Circuit, and I assume that the Court of Appeals was well aware of its own opinion in *Edler* when it decided ***Arnes***.

[5] It is true that the Court of Appeals did not have the question of John's tax liability before it. However, its conclusion was based on the application of law to undisputed facts identical to those in the instant case. It held that John, not Moriah, was legally obligated to purchase his wife's stock.

[6] The majority's conclusion does not purport to rely on any material facts that were not before the Court of Appeals for the Ninth Circuit, and I am unable to discern any material differences between the statement of facts in the majority opinion and those in the opinion of the Court of Appeals. Both were decided by summary judgment because there were no genuine issues as to any material fact and therefore decision could be rendered as a matter of law.

[7] The majority states, majority op. p. 530, "To the extent this is suggested by the Court of Appeals for the Ninth Circuit in ***Arnes** v. United States, supra,* we conclude that the obligation is not primary and unconditional, and the statement constitutes dictum." The context in which the foregoing sentence appears makes it somewhat unclear what the majority is characterizing as "dictum". However, if the majority is saying that the Ninth Circuit's holding that John, not Moriah, was obligated to purchase Joann's stock was "dictum", I must disagree. ***Arnes*** makes it clear beyond doubt that its holding that John, and not Moriah, was obligated to purchase Joann's stock was absolutely determinative of the outcome of that case and not "dictum". If anything should be characterized as "dictum", it is our disagreement with ***Arnes*** in *Blatt* where the majority failed to specify why it disagreed with the Court of appeals and observed that the facts in *Blatt* were easily distinguishable.

[8] At a minimum, one would expect an analysis of the impact of the combination of unique facts that made the instant case "easily distinguishable" from *Blatt.* See *supra* note 3.

[9] According to the Court of Appeals' holding, the guarantees only came into being when the corporation relieved John of his initial personal obligation to purchase his wife's stock.

[10] Whatever the *Blatt* majority's disagreement with ***Arnes*** may have been, it seems improbable that it involved the application of State law in determining that John, not Moriah, was obligated to purchase Joann's stock. Indeed, the legal analysis in *Blatt* does not even mention State law. Nor did the taxpayer in *Blatt* claim that the redemption satisfied any obligation of her husband. *Blatt v. **Commissioner**, supra* at 81-82.

101 T.C. 593 (1993)

MARY RUTH HAYES, PETITIONER
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
JIMMY L. HAYES, PETITIONER
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 26913-91, 30646-91.

United States Tax Court.

Filed December 29, 1993.

594 *594 Mary Ruth **Hayes**, pro se in docket No. 26913-91.

Kevin C. Johnson, for petitioner in docket No. 30646-91.

Katherine Lee Wambsgans, for respondent.

CHIECHI, *Judge:*

Respondent determined the following deficiencies in Federal income tax with respect to petitioner Jimmy L. **Hayes** (Mr. **Hayes**) and petitioner Mary Ruth **Hayes** (Ms. **Hayes**):

Petitioner	Year	Deficiency
Jimmy L. **Hayes**	1986	$56,527
	1987	5,390
Mary Ruth **Hayes**	1987	3,925

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. At the time their respective petitions were filed, Mr. **Hayes** and Ms. **Hayes** resided at separate addresses in Shaker Heights, Ohio.

595 *595 Mr. **Hayes** and Ms. **Hayes** married in 1953. Divorce proceedings to end their marriage were pending during 1986. At the time of their divorce in 1986, Mr. **Hayes** and Ms. **Hayes** were sole shareholders in JRE, Inc. (JRE), a corporation which operated a franchise from McDonald's Corp. (McDonald's). Mr. **Hayes** held a majority of the stock of JRE, while Ms. **Hayes** held the remainder. Because of the pending divorce of Mr. **Hayes** and Ms. **Hayes**, McDonald's required Ms. **Hayes** to dispose of her stock interest in JRE in order for Mr. **Hayes** to retain the franchise.

On April 2, 1986, Mr. **Hayes** and Ms. **Hayes** executed a separation agreement (the separation agreement) in the presence of their respective counsel, which obligated Mr. **Hayes** to purchase Ms. **Hayes**' stock in JRE for $128,000. Mr. **Hayes** was to pay $100,000 of the total purchase price within 30 days of the date of the separation agreement and two additional installments of $14,000 each on September 30, 1986, and March 31, 1987.

The separation agreement further provided that it could be modified only in writing and that it would be incorporated into any final divorce decree entered by a court with respect to the couple. The separation agreement also stated that, notwithstanding any such incorporation, it shall not be deemed to have merged into any final decree or order entered into by any court, but rather shall remain an enforceable agreement by and/or against the parties, and the terms hereof shall survive independent of any such decree or order.

On April 4, 1986, Mr. **Hayes'** attorney, Joseph H. Blackwell, wrote a letter (the Blackwell letter) to Ms. **Hayes'** counsel, Harvey Snider. The Blackwell letter indicated that Mr. **Hayes** did not have the money to consummate his purchase of Ms. **Hayes'** stock in JRE that was required by the terms of the separation agreement. Mr. **Hayes** did not have the money to pay for that stock because of his poor cash management practices. The Blackwell letter also stated that Mr. **Hayes** would incur a large Federal income tax liability if he were to withdraw money from JRE in order to effectuate that acquisition. The Blackwell letter then proposed that JRE redeem[1] Ms. **Hayes'** stock, since Ms. **Hayes'** tax on
596 such a *596 redemption would be lower than the tax Mr. **Hayes** would have to pay were JRE to distribute a dividend which he would use to purchase her stock.

On May 27, 1986, Donald M. Boehm, Mr. **Hayes'** and JRE's accountant, wrote a letter to Mr. **Hayes'** former counsel in which he recommended that JRE, rather than Mr. **Hayes**, purchase Ms. **Hayes'** stock in JRE.

At or subsequent to the time the separation agreement was executed, the referee hearing the divorce case became impatient with its progress and threatened to dismiss it if Mr. **Hayes** and Ms. **Hayes** could not reach agreement on all outstanding issues relating to their divorce.

On June 4, 1986, the Court of Common Pleas for Cuyahoga County (court of common pleas) entered a judgment in the **Hayes'** divorce proceeding (the original judgment), which granted Ms. **Hayes** a divorce, incorporated the separation agreement into its judgment, and ordered that agreement into full force and effect. Also on June 4, 1986, Ms. **Hayes** and JRE executed an agreement (the redemption agreement) under which JRE agreed to redeem her stock for $128,000. The redemption agreement stated that Ms. **Hayes** had decided to retire for reasons of health and that JRE's board had voted unanimously (with Ms. **Hayes'** abstaining) to purchase her stock. The redemption agreement also stated that JRE had sufficient surplus to effect the redemption. Pursuant to that agreement, JRE was obligated to deliver a check for $128,000 to Ms. **Hayes** upon surrender of her stock. Ms. **Hayes** received from JRE a check in the amount of $114,000 on December 31, 1986, and a check for $14,000 on March 31, 1987.

The redemption agreement made no reference to the separation agreement or to the pending divorce action. Nor was the separation agreement modified in connection with the execution of the redemption agreement.

On March 3, 1987, an order was entered by the court of common pleas in the **Hayes'** divorce case, which stated that it was correcting the original judgment nunc pro tunc (the nunc pro tunc order). The nunc pro tunc order provided that
597 the terms of the original judgment, which required Mr. *597 **Hayes** to buy Ms. **Hayes'** stock of JRE, were changed to provide that Ms. **Hayes** agreed to transfer to JRE, and JRE agreed to redeem from Ms. **Hayes**, her JRE stock. Although the terms of payment under the nunc pro tunc order were the same as originally provided for in the separation agreement, the first payment by JRE was not made in the amount or at the time specified by the nunc pro tunc order, while the second payment was.

Neither Mr. **Hayes** nor Ms. **Hayes** reported any income from the redemption of Ms. **Hayes'** JRE stock on their separate 1986 and 1987 Federal income tax returns. Respondent issued a separate notice of deficiency to each of them in connection with that redemption. In the notice of deficiency issued to Mr. **Hayes**, respondent determined that the redemption of Ms. **Hayes'** stock in JRE resulted in a constructive dividend to him. In the notice of deficiency issued to Ms. **Hayes**, respondent determined that Ms. **Hayes** realized a long-term capital gain from the redemption of her stock in JRE.

OPINION

Each petitioner bears the burden of demonstrating error in the respective determinations made by respondent. Rule 142(a). Respondent has informed the Court that the determinations made against Mr. **Hayes** and Ms. **Hayes** are alternative determinations. Thus, respondent concedes that if one of the petitioners is held liable for tax in connection with the redemption of Ms. **Hayes**' stock in JRE, the other petitioner will not be liable for any such tax.

Although respondent's role in these two cases is that of a stakeholder, she nonetheless argues that the tax incurred as a result of the redemption of Ms. **Hayes**' stock in JRE should be borne by Mr. **Hayes** because JRE's redemption was made on his behalf and therefore constituted a constructive dividend to him. If we were to accept respondent's argument, Ms. **Hayes** would be shielded by section 1041[2] from recognizing gain on the redemption. That section provides nonrecognition treatment for a transfer of property between spouses or former spouses where the transfer is
598 incident to a divorce. *598 Q&A 9 of section 1.1041-1T(c), Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984), confirms this result as to Ms. **Hayes** if we were to adopt respondent's position. There, it is provided that, where one spouse transfers property to a third party on behalf of the other spouse, the transfer is treated as if the transferring spouse transfers the property to the nontransferring spouse, who then transfers it to the third party. Consequently, under respondent's position, Ms. **Hayes** would be treated as if she had transferred her stock in JRE to Mr. **Hayes**, who then transferred it to JRE.[3]

Respondent claims that JRE's redemption of Ms. **Hayes**' stock constituted a constructive dividend to Mr. **Hayes** because the separation agreement created an obligation in Mr. **Hayes**, and not JRE, to purchase Ms. **Hayes**' stock and that that obligation was validly incorporated into the original judgment of divorce. Respondent argues that the nunc pro tunc order should not be given effect for tax purposes because it did not represent the intention of the parties at the time the original judgment was entered, but rather effected a change in the obligations imposed by that judgment.

Ms. **Hayes** contends that, in substance, the redemption of her JRE stock was a transfer of such stock by her to Mr. **Hayes**, who in turn transferred it to JRE. Ms. **Hayes** argues that therefore section 1041 shields her from recognition of gain on that redemption.

Mr. **Hayes** contends that the provision in the original judgment obligating him to purchase Ms. **Hayes**' stock in JRE was erroneous and that the nunc pro tunc order retroactively corrected it. He argues that the judgment as corrected by the nunc pro tunc order obligated JRE, and not him, to purchase Ms. **Hayes**' stock and that therefore JRE's redemption of the stock did not result in a constructive dividend to him.

Whether a corporation has satisfied a shareholder's obligation, thus giving rise to a constructive dividend, is a question
599 *599 of fact. *Jacobs v. **Commissioner**,* 698 F.2d 850, 852 (6th Cir. 1983), affg. per curiam T.C. Memo. 1981-81; *Priester v. **Commissioner**,* 38 T.C. 316, 324-325 (1962).

It is well settled that a shareholder receives a constructive dividend to the extent of available earnings and profits when a corporation redeems stock which that shareholder has a primary and unconditional obligation to purchase.[4] *Sullivan v. United States,* 363 F.2d 724, 728-729 (8th Cir. 1966); *Smith v. **Commissioner**,* 70 T.C. 651, 668 (1978); *Stephens v. **Commissioner**,* 60 T.C. 1004, 1011-1012 (1973), affd. without published opinion 506 F.2d 1400 (6th Cir. 1974). The fact that the corporation may have agreed to perform the shareholder's obligation prior to redeeming the stock does not change this result, provided that the shareholder's obligation continues until the time of the redemption. *Wall v. United States,* 164 F.2d 462, 464-465 (4th Cir. 1947); *Vinnell v. **Commissioner**,* 52 T.C. 934, 944-945 (1969); *Wolf v. **Commissioner**,* 43 T.C. 652, 660-661 (1965), affd. 357 F.2d 483 (9th Cir. 1966); *Schalk Chemical Co. v. **Commissioner**,* 32 T.C. 879, 892 (1959), affd. 304 F.2d 48 (9th Cir. 1962).

A shareholder also receives a constructive dividend to the extent of available earnings and profits when a corporation agrees to perform that shareholder's obligation and that shareholder's obligation is thereby extinguished. See *Maher v. **Commissioner**,* 469 F.2d 225, 229 (8th Cir. 1972), affg. in part, revg. and remanding on another issue 55 T.C. 441 (1970); *Sullivan v. United States, supra* at 728 n.5. In *Maher v. **Commissioner**, supra,* the court stated that a corporation's cancellation of a shareholder's liability can produce a taxable economic benefit to the extent the shareholder's assets are freed as a result of the corporation's act.

Thus, regardless whether a shareholder's obligation is satisfied at the time a corporation actually performs it or is canceled at the time a corporation agrees to perform it, that shareholder receives a constructive dividend, with the only difference being the time at which the dividend is taxable.

600 To apply the foregoing principles to the facts presented in the instant cases, we must identify the nature and extent of the obligations imposed and rights conferred by the separation *600 agreement, the redemption agreement, the original judgment, and the nunc pro tunc order. We must resolve these questions by reference to Ohio law. ***Commissioner** v. Estate of Bosch,* 387 U.S. 456, 464-465 (1967); *Morgan v. **Commissioner**,* 309 U.S. 78, 80 (1940); *Krakoff v. United States,* 439 F.2d 1023, 1025 (6th Cir. 1971); *Emmons v. **Commissioner**,* 36 T.C. 728, 735 (1961), affd. by order 311 F.2d 223 (6th Cir. 1962). Under ***Commissioner** v. Estate of Bosch, supra* at 465, we must apply the law as announced by the Supreme Court of Ohio, and, if there is no decision by that highest court, we must apply what we find to be the law of Ohio, giving proper regard to the decisions of other courts of the State.

We will first consider the effect of the separation agreement. That agreement obligated Mr. **Hayes** to purchase Ms. **Hayes**' stock in JRE for $128,000, which was to be paid pursuant to a specified schedule. On brief, Mr. **Hayes**, who was not present at trial, attempts to minimize the importance of that provision in the separation agreement by arguing alternatively that it did not obligate him personally to purchase Ms. **Hayes**' stock in JRE and that the provision setting forth Mr. **Hayes**' obligation did not reflect the agreement of the parties. Ms. **Hayes**, who appeared as the only witness at the trial of these cases and whom we found to be totally credible, maintains that that provision in the separation agreement specifies "the way the divorce settlement should have gone."

601 We are not inclined to accept Mr. **Hayes**' characterization of the pertinent provision in the separation agreement. The separation agreement is unambiguous. It was signed by Mr. **Hayes** and Ms. **Hayes** in the presence of their attorneys, and the page in that agreement setting forth Mr. **Hayes**' obligation to purchase Ms. **Hayes**' stock was initialed by both Mr. **Hayes** and Ms. **Hayes**. The terms of the separation agreement show that Mr. **Hayes** and Ms. **Hayes** intended it to have present effect as to the division of their property and the release of claims against one another that are reflected therein. There is no indication in the separation agreement, or elsewhere in the record, that Mr. **Hayes** was acting as an agent for JRE with respect to the purchase of Ms. **Hayes**' stock.[5] Consequently, we conclude that the separation agreement, *601 as executed by Mr. **Hayes** and Ms. **Hayes**, constituted a valid, binding contract under Ohio law, which imposed on Mr. **Hayes** a primary and unconditional obligation to purchase Ms. **Hayes**' stock in JRE.

We further find that the separation agreement clearly continued to have binding effect at least until the original judgment in the divorce proceeding was entered on June 4, 1986. The separation agreement provided that it could not be modified except in writing, and no writing evidencing a clearly expressed intent to modify the separation agreement has been placed in the record.[6] None of the legal documents in the record connected with the redemption transaction makes any reference to the separation agreement. Indeed, the redemption agreement itself makes no reference to either the separation agreement or the divorce of Mr. **Hayes** and Ms. **Hayes**.

It appears that, notwithstanding the antimerger clause in the separation agreement, each of the provisions of the separation agreement that was in fact incorporated in the judgment of divorce of the court of common pleas would nonetheless be considered under Ohio law to have merged into such judgment when the original judgment was entered.[7] *Cherry v. Figart,* 620 N.E.2d 174 (Ohio Ct. App. 1993). However, this circumstance would not affect the validity of the separation agreement prior to that time. Merger is prospective from the time of judgment, and entry of judgment does not affect the validity of the contractual undertaking prior to that time. *Bourque v. Bourque,* 518 N.E.2d 49, 51 (Ohio Ct. App. 1986).

602 We next will consider whether the nunc pro tunc order is to be given effect for Federal tax purposes, an issue to which Mr. **Hayes** and respondent have devoted a considerable portion of their briefs. If we decide that the nunc pro tunc order *602 is contrary to the law of Ohio, we must disregard it for Federal tax purposes even though it may be binding on the parties to it.[8] *Graham v. **Commissioner**,* 79 T.C. 415, 420 (1982).

Mr. **Hayes** contends that the nunc pro tunc order of the Court of Common Pleas was valid and that it shows that he did not have an obligation to purchase Ms. **Hayes**' stock in JRE when the redemption occurred, precluding him from receiving a constructive dividend.

Respondent argues that the nunc pro tunc order is not valid because it is contrary to Ohio law. If entry of the nunc pro tunc order were not valid, as respondent contends, Mr. **Hayes** would have received a constructive dividend upon JRE's redemption of Ms. **Hayes**' stock because that redemption would have satisfied the primary and unconditional obligation of Mr. **Hayes** to purchase Ms. **Hayes**' stock in JRE, which was imposed on him by the original judgment that incorporated the separation agreement.[9] *Sullivan v. United States,* 363 F.2d at 728-729; *Smith v. **Commissioner**,* 70 T.C. at 668; *Stephens v. **Commissioner**,* 60 T.C. at 1011-1012; *Gordon v. **Commissioner**,* T.C. Memo. 1975-86; *Berger v. **Commissioner**,* T.C. Memo. 1974-172, affd. without published opinion 538 F.2d 334 (9th Cir. 1976).

Under Ohio law, a court may enter an order correcting the journal entry of its judgment nunc pro tunc only to remedy an error in the recording of the actual judgment, so that the record reflects what the court actually decided. *State ex rel. Phillips v. Industrial Comm.,* 155 N.E. 798 (Ohio 1927); *Reinbolt v. Reinbolt,* 147 N.E. 808 (Ohio 1925). Such an order may not be used to change the judgment of the court. *Webb v. Western Reserve Bond & Share Co.,* 153 N.E. 289 (Ohio 1926); *Roth v. Roth,* 585 N.E.2d 482 (Ohio Ct. App. 1989); *McKay v. McKay,* 493 N.E.2d 317 (Ohio Ct. App. 1985).

603 *603 Because a judgment, once entered, is presumed valid, *Cupicha v. Sefchick,* 173 N.E.2d 901, 903 (Ohio Ct. App. 1961), sufficient grounds for entry of an order changing a judgment nunc pro tunc must be present before a court may do so. *Jacks v. Adamson,* 47 N.E. 48 (Ohio 1897); *Gill v. Pelkey,* 43 N.E. 991 (Ohio 1896); *State v. Coleman,* 169 N.E.2d 703, 706 (Ohio Ct. App. 1959); *Cleveland Trust Co. v. Forkapa,* 117 N.E.2d 442 (Ohio Ct. App. 1954); *Herman v. Ohio Finance Co.,* 32 N.E.2d 28, 31 (Ohio Ct. App. 1940); *Ruby v. Wolf,* 177 N.E. 240 (Ohio App. 1931). For such an order to be proper, the court entering the order must have clear and convincing evidence of the actual judgment of the court with respect to which a correction of the journal entry is sought. *Jacks v. Adamson, supra; Gill v. Pelkey, supra; State v. Coleman, supra; Cleveland Trust Co. v. Forkapa, supra; Ruby v. Wolf, supra*. Moreover, the judgment correcting the earlier journal entry nunc pro tunc must affirmatively show not only what it is intended to correct, but also the ground upon which the court acted in making the correction. *State v. Coleman, supra; Herman v. Ohio Finance Co.,* supra; *Ruby v. Wolf, supra*. In deciding whether to correct a judgment nunc pro tunc, a court may rely on, among other things, its own recollection, minutes made by it, the papers in the case, and/or oral testimony. *Jacks v. Adamson, supra; Elliott v. Plattor,* 1 N.E. 222, 225 (Ohio 1885); *Ruby v. Wolf, supra.*

Based on the record in the present cases, we agree with respondent that entry of the nunc pro tunc order was contrary to the law of Ohio because it did not comply with the foregoing requirements of that law.[10] The instant record contains nothing, except the original judgment, the separation agreement, and the redemption agreement, which shows what the court of common pleas might have had in mind when it entered that judgment. No memorandum, minutes of proceedings, transcript, or other evidence was offered at the trial of this case to show what the actual judgment of the
604 *604 court of common pleas was at the time the original judgment was entered.

Although the redemption agreement was executed on the same day on which the original judgment was entered, there is no evidence that it had been presented to the court of common pleas or to the referee hearing the divorce case at the time the judgment entry was made. It seems to us that the redemption agreement could easily have been referred to in the original judgment had it been before the court of common pleas or the referee at the time that judgment was entered.

Nor is there any indication in the instant record that the court of common pleas was aware of Mr. **Hayes**' financial difficulties or of the tax considerations that motivated his advisers to seek a change in the manner in which Ms. **Hayes**' stock in JRE would be acquired.

Thus, except for the original judgment itself, the record in this case is devoid of the evidence with respect to the court of common pleas' decision at the time the original judgment was entered that is needed for this Court to conclude that the nunc pro tunc order is valid under Ohio law. *Jacks v. Adamson, supra; Gill v. Pelkey, supra; State v. Coleman, supra; Cleveland Trust Co. v. Forkapa, supra; Ruby v. Wolf, supra.*

It is also significant that the nunc pro tunc order itself does not indicate why the original judgment was erroneous, as required under Ohio law. *State v. Coleman, supra; Herman v. Ohio Finance Co., supra; Ruby v. Wolf, supra.* It simply states the change being made in the original judgment, without explaining why the court of common pleas decided that the original judgment was incorrectly recorded. The fact that attorneys for Mr. **Hayes** and Ms. **Hayes** joined in making the motion to correct the original judgment does not establish that the original judgment was erroneously recorded. The attorneys could have agreed to make the motion for collateral reasons, and the court of common pleas' apparent pro forma acceptance of their agreed motion does not supply the necessary justification for entry of the nunc pro tunc order.

Based on the record here and the foregoing considerations, we conclude that the nunc pro tunc order is not valid because it is contrary to Ohio law. On the instant record, we find that that order operated to change retroactively the
605 rights of the *605 parties to the divorce action, rather than to correct an error in the original judgment. Under such circumstances, it should not be given effect for Federal tax purposes. *Graham v. **Commissioner***, 79 T.C. at 420. Accordingly, we sustain respondent's determination that Mr. **Hayes** received a constructive dividend as a result of JRE's redemption of Ms. **Hayes**' stock because that redemption satisfied a primary and unconditional obligation to purchase that stock, which was imposed on him by the original judgment.

We note that, even if entry of the nunc pro tunc order were proper, as Mr. **Hayes** contends, the order would not have prevented him from receiving a constructive dividend under the circumstances surrounding JRE's redemption of Ms. **Hayes**' stock. In order for the judgment of the court of common pleas to have been entered on the basis stated in the nunc pro tunc order, JRE would necessarily have had to obligate itself to redeem Ms. **Hayes**' stock prior to the entry of the original judgment, while Mr. **Hayes** was still subject to a primary and unconditional obligation under the separation agreement to purchase that stock. *Webb v. Western Reserve Bond & Share Co.*, 153 N.E. 289 (Ohio 1926); *Roth v. Roth*, 585 N.E.2d at 484. If, as Mr. **Hayes** also contends, entry of judgment on the terms stated in the nunc pro tunc order extinguished his obligation to purchase Ms. **Hayes**' stock in JRE under the separation agreement,[11] Mr. **Hayes** still would have received a constructive dividend by virtue of JRE's assumption of his obligation, albeit at the time judgment was entered, rather than at the time Ms. **Hayes**' stock was redeemed by JRE. See *Maher v. **Commissioner***,
606 469 F.2d at 229; *Sullivan v. United States*, 363 F.2d at 728 n.5. However, inasmuch as respondent's *606 determination that Mr. **Hayes** received a constructive dividend from JRE when it made the payments in redemption of Ms. **Hayes**' stock is not in dispute insofar as the timing of Mr. **Hayes**' recognition of the income is concerned, and that determination has not been shown to be erroneous, we will not disturb it.

Respondent has indicated to the Court that, if we find that Mr. **Hayes** received a constructive dividend in connection with JRE's undertaking to redeem Ms. **Hayes**' stock, as we have done, she will concede that section 1041 shields Ms. **Hayes** from recognition of gain on the amount realized from the exchange of her stock. Accordingly, under respondent's concession, our resolution of the constructive dividend issue in Mr. **Hayes**' case renders the section 1041 issue in Ms. **Hayes**' case moot.

To reflect the foregoing,

Decision will be entered for petitioner in docket No. 26913-91.

Decision will be entered for respondent in docket No. 30646-91.

[1] When applied to the transaction at issue herein, the use of the terms "redeem" or "redemption" are for descriptive purposes only and do not reflect our conclusion as to the nature of that transaction under the Federal income tax laws.

[2] All section references are to the Internal Revenue Code in effect for the years at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

[3] Even if we were not to agree with respondent that Mr. **Hayes** should bear the tax associated with the transaction at issue here, a question may still arise as to whether sec. 1041 would in any event protect Ms. **Hayes** from recognizing a long-term capital gain on the disposition of her stock. In this regard, we note that the U.S. Court of Appeals for the Ninth Circuit has held in *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992), that sec. 1041 may afford nonrecognition treatment to a spouse whose stock is redeemed pursuant to a divorce decree where the redemption confers a benefit on the other spouse because the other spouse has guaranteed the corporation's performance. However, inasmuch as the instant cases do not present the same situation as in *Arnes,* we need not address the Ninth Circuit's decision.

[4] There is no suggestion by any of the parties that Mr. **Hayes** did not have a constructive dividend because JRE's earnings and profits were inadequate. The redemption agreement states that JRE had sufficient surplus to pay the agreed price for Ms. **Hayes**' stock.

[5] Thus, the instant case is distinguishable from *Nichols v. **Commissioner,*** T.C. Memo. 1973-114, relied on by Mr. **Hayes**.

[6] Although Ms. **Hayes** testified about a handwritten document initialed by her during the divorce proceedings that she believed provided that JRE would acquire her stock, we find her testimony ambiguous. It does not appear that Ms. **Hayes** read any such handwritten documents when she initialed it, and no such document is in evidence. The only handwritten documents in the record consist of certain pages in the separation agreement, none of which provides for a redemption of Ms. **Hayes**' stock. Indeed, it is one of the handwritten pages that is part of the separation agreement and that was initialed by both Mr. **Hayes** and Ms. **Hayes**, which obligates Mr. **Hayes** to purchase Ms. **Hayes**' stock in JRE.

[7] As a general matter, under Ohio law, terms of a separation agreement incorporated into a divorce judgment merge with that judgment, lose their contractual character, and become enforceable only as part of that judgment. *Rosenfeld v. Rosenfeld,* 351 N.E.2d 181 (Ohio 1976); *Greiner v. Greiner,* 399 N.E.2d 571, 578 (Ohio Ct. App. 1979); *Bugay v. Bugay,* 373 N.E.2d 1263, 1265 (Ohio Ct. App. 1977).

[8] However, as discussed below, even if we were to decide that the nunc pro tunc order were valid, it is our view that Mr. **Hayes** nevertheless received a constructive dividend under the facts and circumstances presented here.

[9] The execution of the redemption agreement would not insulate Mr. **Hayes** from receipt of a constructive dividend in this situation because, in agreeing to redeem Ms. **Hayes**' stock, JRE was simply undertaking to perform a primary and unconditional obligation imposed on Mr. **Hayes** by the original judgment. *Sullivan v. United States,* 363 F.2d 724, 728-729 (8th Cir. 1966); *Wall v. United States,* 164 F.2d 462, 466 (4th Cir. 1947); *Schalk Chemical Co. v. **Commissioner***, 32 T.C. 879, 892 (1959), affd. 304 F.2d 48 (9th Cir. 1962). If the nunc pro tunc order were not valid, when JRE redeemed Ms. **Hayes**' stock pursuant to the redemption agreement, JRE would have been satisfying Mr. **Hayes**' obligation under the original judgment, which he was unable to perform due to his lack of funds, resulting in a constructive dividend to him. *Smith v. **Commissioner***, 70 T.C. 651, 670 (1978).

[10] The instant cases are distinguishable from *Edler v. **Commissioner***, T.C. Memo. 1982-67, affd. 727 F.2d 857 (9th Cir. 1984), relied on by Mr. **Hayes**. In the *Edler* case, we held that a husband did not receive a constructive dividend from a redemption carried out pursuant to a nunc pro tunc order where the validity of the nunc pro tunc order was not challenged by the **Commissioner** and it specifically voided the husband's obligation under a prior judgment. Here, in contrast to the *Edler* case, respondent has challenged the validity of the nunc pro tunc order, and we have found it to be contrary to Ohio law and of no effect for Federal tax purposes.

[11] It is not clear that Mr. **Hayes**' obligation under the separation agreement to purchase Ms. **Hayes**' stock would have been extinguished by a valid entry of judgment in accordance with the terms stated in the nunc pro tunc order. That obligation could have survived such an entry of judgment on at least two grounds. First, the court of common pleas, in entering such a judgment, could have intended that JRE act on behalf of Mr. **Hayes**, whose obligation to purchase her stock was unambiguously set forth in the separation agreement which that court reviewed and considered. Second, it is possible that the provision of the separation agreement obligating Mr. **Hayes** to purchase Ms. **Hayes**' stock in JRE might not have been incorporated into and thereby merged with a valid judgment of divorce entered on the terms stated in the nunc pro tunc order. Thus, that provision of the separation agreement may have continued to impose an obligation on Mr. **Hayes** after entry of a valid nunc pro tunc order, which would not have been satisfied until JRE redeemed Ms. **Hayes**' stock. If his obligation under the separation agreement had survived a valid entry of judgment in accordance with the nunc pro tunc order, Mr. **Hayes** would have received a constructive dividend when Ms. **Hayes**' stock was redeemed. *Sullivan v. United States,* 363 F.2d at 728-729; *Wall v. United States,* 164 F.2d at 464-466; *Vinnell v. **Commissioner***, 52 T.C. 934, 944-945 (1969); *Schalk Chemical Co. v. **Commissioner***, 32 T.C. at 892.

102 T.C. 77 (1994)

GLORIA T. BLATT, PETITIONER
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 12456-92.

United States Tax Court.

Filed January 31, 1994.

Lawrence P. Schweitzer, for petitioner.

Tanya M. Marcum, for respondent.

78 *78 LARO, *Judge:*

This case is before the Court pursuant to a petition filed by Gloria T. **Blatt** (petitioner) for a redetermination of respondent's determination of a deficiency of $96,787 in petitioner's 1987 Federal income tax.[1] The sole issue for decision is whether a payment made to petitioner in redemption of all her stock is taxable to her in 1987, the year of redemption, or is nontaxable to her under section 1041.[2] The redemption was made by a corporation owned equally by petitioner and her former husband, Frank J. **Blatt** (**Blatt**), and was made pursuant to a court decree entered incident to their divorce. We hold that the stock redemption payment is taxable to petitioner in 1987.

FINDINGS OF FACT

Pursuant to Rule 122(a), the parties submitted this case to the Court without trial; the record in this case consists of the pleadings and the facts recited in a joint stipulation with accompanying exhibits. These facts and exhibits are incorporated herein by this reference. At the time she filed her petition, petitioner resided in East Lansing, Michigan.

Petitioner married **Blatt** on September 1, 1946. In 1977, petitioner and **Blatt** organized Phyllograph Corp. (corporation) in the State of Washington; petitioner and **Blatt** each owned 50 percent of corporation.[3] Petitioner filed a divorce complaint on October 4, 1985, and the divorce was finalized on July 21, 1987.

On July 16, 1987, corporation redeemed all petitioner's stock in exchange for $45,384. The redemption was incident to the divorce decree.[4] Petitioner did not report any of these proceeds on her 1987 Federal income tax return. Respondent determined that petitioner realized a long-term capital gain of $39,184 on the redemption, and that
79 petitioner should have recognized this gain in 1987; respondent further determined *79 that the redemption did not involve a transfer between spouses or former spouses under section 1041.

OPINION

Gross income includes gains derived from dealings in property, sec. 61(a)(3); gains derived from the redemption of stock are generally includable in the gross income of the redeemed taxpayer, see generally sec. 302 (rules governing redemptions of stock). Petitioner asserts that the proceeds she received from corporation's redemption of her stock are excludable from her gross income under section 1041.

Section 1041 provides a broad rule of nonrecognition for sales, gifts, and other transfers of property between spouses or former spouses incident to divorce.[5] In part, Congress enacted section 1041 to replace the holding in *United States*

v. Davis, 370 U.S. 65 (1962), that a divorce-related transfer of property in exchange for the release of marital claims resulted in recognition of gain to the transferor. H. Rept. 98-432, at 1491-1492 (1984). Before the enactment of section 1041, as a result of *Davis,* the transferring former spouse was taxable on a divorce-related transfer of appreciated property to his or her former spouse, and the recipient received a basis in the transferred property equal to its fair market value on the date of transfer. *United States v. Davis, supra.* Thus, the Government was whipsawed if such a transferor did not report any gain on a transfer of appreciated property. Accordingly, in 1984, Congress enacted section 1041 to remedy this whipsaw.[6] H. Rept. 98-432, at 1491-1492 (1984).

Consistent with the legislative history, section 1041 only addresses transfers between spouses or former spouses; it
80 *80 generally does not include transfers to third parties,[7] such as corporations.[8] The basic policy of section 1041 is to treat a husband and wife as one economic unit, and to defer, but not eliminate, the recognition of any gain or loss on interspousal property transfers until the property is conveyed to a third party outside the economic unit. To that end, no gain or loss is recognized upon the transfer of property from one spouse to another, and the property takes a transferred ("carryover") basis in the hands of the recipient spouse; the carryover basis preserves the gain (or loss) until the recipient spouse transfers the property to a third party in a taxable transaction.

The regulations prescribed under section 1041 apply the tax-free treatment under section 1041 to certain transfers to third parties on behalf of a spouse or former spouse incident to divorce. More specifically, section 1.1041-1T, Q&A 9, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984) provides that

Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. * * * In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

Petitioner contends that Q&A 9 encompasses corporation's redemption of her stock, and, accordingly, the redemption
81 qualifies under section 1041 as a transfer that is nontaxable *81 to her. We disagree; petitioner's transfer of her stock to corporation was outside the provisions of Q&A 9 because the transfer was not on behalf of **Blatt**. To illustrate the operation of Q&A 9, assume that H owes a debt to a bank, and W, as part of a divorce settlement, transfers her unencumbered appreciated stock to the bank in discharge of H's debt. This transfer falls within the first "situation" described in Q&A 9; that is, the transfer is required by a divorce instrument and is made by W on behalf of H. Thus, under Q&A 9, the stock is deemed transferred from W to H, in a nonrecognition transaction under section 1041, and, contemporaneously therewith, the stock is deemed retransferred from H to the bank. Under Q&A 9, H receives a carryover basis in the stock on the deemed transfer from W, and realizes (and must recognize) gain on the retransfer equal to the difference between the amount of the discharged debt and H's carryover basis. The effect of Q&A 9 is that the appreciation in the stock at the time of W's transfer is preserved, and the tax consequences relating to the appreciation are shifted from W to H, on behalf of whose benefit W made the transfer to the bank.

As contrasted with the example above, the record in the instant case is devoid of evidence disproving respondent's determination that petitioner's transfer of her stock to corporation was not on behalf of **Blatt** within the meaning of Q&A 9. The redemption, in form, was a transaction between petitioner and corporation; she transferred her stock to corporation in exchange for its appreciated value in cash.[9] The term "on behalf of" means "in the interest of" or "as a representative of", Webster's Ninth New Collegiate Dictionary (1990); the record does not indicate that petitioner was acting in the interest of **Blatt** or as a representative of **Blatt** at the time of the redemption. A transfer that satisfies an obligation or a liability of someone is a transfer on behalf of that person;[10] petitioner does not claim, and the record

82 does not *82 indicate, that the redemption satisfied any obligation of **Blatt**. In this respect, we note that **Blatt** did not personally guarantee the obligation of corporation to redeem petitioner's stock.[11]

Petitioner relied mainly on *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992), for her proposition that the redemption was a transfer on behalf of **Blatt**. For the reasons stated herein, we do not agree with *Arnes* and respectfully refuse to follow it.[12] In *Arnes,* the taxpayer and her former husband owned jointly a corporation that operated a McDonald's franchise. Pursuant to the divorce decree, the corporation redeemed all the stock owned by the taxpayer for $450,000 of consideration, consisting of cash, relief of debt, and installment payments. The Court of Appeals stated that McDonald's Corp. required complete ownership of the franchise by the owner/operator, and had informed the taxpayer's former husband that there should be no joint ownership of the franchise after the divorce. *Id.* at 457. The Internal Revenue Service asserted that the $450,000 was taxable to the taxpayer.

In holding for the taxpayer, the Court of Appeals for the Ninth Circuit reasoned that, although the taxpayer transferred her stock directly to the franchisee corporation, the transfer was on behalf of her former husband within the meaning of Q&A 9. *Id.* at 458. In this regard, the court stated that the taxpayer's former husband (and not the corporation) was obligated to purchase the taxpayer's stock. In addition, the court stated that the taxpayer's former husband benefited
83 *83 from the redemption because he guaranteed the corporation's payments to her and was liable for those payments under State law. *Id.* at 458-459. Furthermore, the court noted that the trial court found that the transfer benefited the taxpayer's former husband because the transfer limited the taxpayer's future community property claims against her former husband. *Id.* at 457, 459.

As mentioned above, we disagree with *Arnes*; any putative benefit to **Blatt**, such as relief from a possible claim under marital property distribution laws, does not mean that the transfer by petitioner of her shares to corporation was on behalf of **Blatt**. We note, however, that the facts in *Arnes* are easily distinguishable from the facts at hand. First, in *Arnes,* the Court of Appeals stated that McDonald's Corp. required complete ownership of a franchise by an owner/operator after the divorce; no such requirement is present here with respect to ownership of corporation. Second, in *Arnes,* the Court of Appeals stated, in dicta, that the taxpayer's former husband was obligated to become the sole owner of the franchise; such is not the case here. Third, in *Arnes,* the taxpayer's former husband guaranteed the corporation's obligation to the taxpayer; by contrast, **Blatt** did not guarantee corporation's payment to petitioner. Fourth, unlike Washington, Michigan is not a community property State.

We have considered petitioner's other arguments and find them to be without merit. For the foregoing reasons, we hold that the redemption was not a transfer between spouses or former spouses under section 1041.[13]

Decision will be entered under Rule 155.

Reviewed by the Court.

HAMBLEN, CHABOT, SHIELDS, JACOBS, GERBER, WRIGHT, WELLS, and COLVIN, *JJ.,* agree with this majority opinion.

84 *84 HALPERN, *J.,* concurring:

I agree with the result reached by the majority. I write separately, however, because of the majority's treatment of *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992). The majority "easily" distinguish the facts of this case from those of *Arnes.* Nevertheless, the majority "disagree" with *Arnes,* and "refuse to follow it". The majority, however, do not clearly tell us how or why they disagree with *Arnes.* I cannot believe that the majority are speculating on how, if confronted with the admittedly distinguishable facts of *Arnes,* we would decide. Therefore, the majority must be rejecting the reasoning of the Court of Appeals for the Ninth Circuit, in *Arnes,* as that reasoning would apply to the facts of this case. The District Court, in *Arnes,* determined that the redemption there was on behalf of the husband, because he received a benefit from it. The Court of Appeals for the Ninth Circuit (affirming the District Court) added that the redemption relieved the husband of an obligation, but did not explicitly reject the "any-benefit" test of the District Court. As a preliminary matter, the Court of Appeals found a common tax meaning for the term "on behalf of":

"Generally, a transfer is considered to have been made `on behalf of' someone if it satisfied an obligation or a liability of that person." *Id.* at 459. The Court of Appeals for the Ninth Circuit held, however, that "[the wife's] transfer to * * * [the corporation] did relieve * * * [the husband] of an obligation, *and therefore constituted a benefit to* [*him*]". *Id.* (emphasis added). Since we are persuaded that the Court of Appeals had distinguishable facts before it, we cannot say for sure what test the Court of Appeals would apply to facts such as ours, where there is no evidence that the redemption satisfied any obligation of the husband. Inasmuch as it is unlikely that this case will be appealed to the Court of Appeals for the Ninth Circuit, speculation is not required by *Golsen v.* ***Commissioner***, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971). Clearly, the "any-benefit" test of the *Arnes* District Court is one we think to be wrong. If we wish to persuade the Court of Appeals to which an appeal in this case likely would lie (the Sixth Circuit), 85 or the bar in general, then we should *85 clearly state our reasons. Simply saying that we disagree with *Arnes* is inadequate.

BEGHE, *J.,* agrees with this concurring opinion.

BEGHE, *J.,* concurring:

I agree with the majority result. I agree with Judge Chiechi that we need not express the view that the Ninth Circuit Court of Appeals incorrectly decided *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992).[1] The majority having expressed that view, I agree with Judge Halpern that we are obliged to tell why, and this the majority opinion does not do.[2]

Inasmuch as the majority have put the ball in play, and Judge Halpern having brought it to mid-court, I write separately to express my view of how section 1041 should be interpreted and confined in its application to redemptions of the stock of closely held corporations.

I believe there is an interpretation of section 1041 that will properly harmonize the treatment of the remaining spouse and the terminating spouse, both in consolidated cases and where their cases are decided separately. Under a proper interpretation of section 1041 and respondent's regulation, no redemption should be considered to be "on behalf of" the remaining spouse unless it discharges that spouse's primary and unconditional obligation to purchase the subject stock, as summarized and set forth in the examples in Rev. Rul. 69-608, 1969-1 C.B. 42, and the case law on which it relies. See, e.g., *Kobacker v.* ***Commissioner***, 37 T.C. 882, 896 (1962); *Edenfield v.* ***Commissioner***, 19 T.C. 13, 20-21 (1952); *S.K. Ames, Inc. v.* ***Commissioner***, 46 B.T.A. 1020, 1023-1024 (1942); see also *Edler v.* ***Commissioner,*** 727 F.2d 857 (9th Cir. 1984), affg. T.C. Memo. 1982-67. If this condition is satisfied, there will be nonrecognition of gain to the terminating spouse under section 1041 and, under the authorities cited above, dividend treatment of the 86 remaining spouse. See *Hayes v.* ***Commissioner,*** 101 T.C. 593, 597, 602 n.9, 605 n.11 *86 (1993), and cases cited therein. If, as in the case at hand, this condition is not satisfied, the terminating spouse will recognize gain from a sale or exchange on the redemption, and the remaining spouse will have no gain or dividend income. *Edler v.* ***Commissioner****, supra.*

Irrespective of whether the marriage was dissolved in a "romantic waltz" or a "violent apache dance", *Estate of Glen v.* ***Commissioner***, 45 T.C. 323, 353 (1966) (Tannenwald, J., dissenting),[3] respondent should exert every effort to cause the resulting tax cases to be consolidated. If respondent doesn't see to it that the former spouses' tax cases are consolidated,[4] or, as should have occurred in *Arnes v. United States, supra,* brought together on the appeals from this Court and a District Court, there is an unnecessary risk of whipsaw or double taxation. See generally Special Committee on Whipsaw, Section of Taxation, American Bar Association, "Final Report", 30 Tax Law. 127 (1976). Our recent opinion in *Hayes v.* ***Commissioner****, supra,* is the model for the presentation and disposition of such cases. See also *Gaughan v.* ***Commissioner,*** T.C. Memo. 1993-320.

HALPERN, *J.,* agrees with this concurring opinion.

CHIECHI, *J.,* concurring:

While I agree with the result reached by the majority, the instant case is distinguishable, as the majority concludes, from *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992). In the present case, petitioner failed to satisfy her burden of establishing that the redemption was made "on behalf of" **Blatt** as required by section 1.1041-1T, Q&A 9, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984). Therefore, I do not believe that this is the appropriate case in which to express the Court's view as to whether *Arnes* was correctly decided.

COHEN, CLAPP, WHALEN, and BEGHE, *JJ.,* agree with this concurring opinion.

87 *87 PARR, *J.,* dissenting:

I respectfully dissent. I believe *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992), was rightly decided and that its rationale applies here as well.

The majority's reasoning that "petitioner does not claim, and the record does not indicate, that the redemption satisfied any obligation of **Blatt**" because **Blatt** did not personally guarantee the obligation strikes me as hypertechnical at best or disingenuous at worst. The husband had an obligation to obey the court order or be in contempt, as strong a "guarantee" as one could ask.

Moreover, the court's order in this case was pursuant to a *divorce* decree which, prima facie, indicates an obligation to divide the property and to therefore relieve the husband of further marital distributions. In substance (as well as form, in my view) this transaction was a property settlement between the spouses. I would hold under the facts of this case that petitioner's transfer of stock, incident to a divorce decree, was indeed made "on behalf of" her husband, and is thus entitled to nonrecognition treatment under section 1041. PARKER and SWIFT, *JJ.,* agree with this dissenting opinion.

[1] In ***Blatt** v. **Commissioner**,* T.C. Memo. 1993-550, we decided an unrelated issue in this case. The Court severed the issues for separate decision.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for 1987, the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[3] Phyllograph Corp. (corporation) did not issue shares of stock. For the sake of convenience, however, we refer to petitioner's interest in corporation as stock.

[4] In relevant part, the divorce decree provided: "IT IS FURTHER ORDERED and ADJUDGED that the parties, being equal stockholders, shall cause Phyllograph Corp. to redeem plaintiff's stock in said Corporation within ten (10) days after entry of this judgment for the sum of Forty-five Thousand Three Hundred Eighty-four Dollars ($45,384)."

[5] Sec. 1041 provides in part:

SEC. 1041(a). GENERAL RULE.—No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—

(1) a spouse, or

(2) a former spouse, but only if the transfer is incident to the divorce.

(b) TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS.—In the case of any transfer of property described in subsection (a)—

(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

[6] Congress also enacted sec. 1041 to minimize the intrusion of the tax laws into marital relationships. As noted in the House committee report: "The committee believes that, in general, it is inappropriate to tax transfers between spouses. This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single economic unit." H. Rept. 98-432, at 1491 (1984).

[7] We recognize that sec. 1041(a) refers to transfers in trust for the benefit of a spouse or a former spouse incident to divorce. Although such a trust may be a third party, that reference is not relevant here.

[8] For example, where the wholly owned corporation of one spouse sells property to the other spouse, the sale generally is not a transfer between spouses. Sec. 1.1041-1T, A2, *Example (3),* Temporary Income Tax Regs., 49 Fed. Reg. 34452-34453 (Aug. 31, 1984).

[9] Petitioner owned 50 percent of the stock of corporation before the redemption, and merely exchanged this stock for its value in cash.

[10] For example, sec. 6020 allows the **Commissioner** to prepare a return "on behalf of" a taxpayer who has failed to fulfill his obligation to file. See, e.g., *Millsap v. **Commissioner**,* 91 T.C. 926, 941 (1988); see also *Schroeder v. **Commissioner**,* T.C. Memo. 1989-110. Similarly, a shareholder may receive a constructive dividend where the corporation pays an obligation on behalf of the shareholder. See, e.g., *Tennessee Sec., Inc. v. **Commissioner**,* 674 F.2d 570 (6th Cir. 1982), affg. T.C. Memo. 1978-434; *Enoch v. **Commissioner**,* 57 T.C. 781 (1972); see also Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 7.05, at 7-34 (5th ed. 1987). Likewise, the landmark case of *Old Colony Trust Co. v. **Commissioner**,* 279 U.S. 716, 729-731 (1929), is in accord with the principle that a transfer satisfying a taxpayer's obligation or liability is a transfer on behalf of that taxpayer. In *Old Colony Trust Co.,* an employer discharged his employee's legal obligation to pay income tax, and the payment was income to the employee.

[11] Although the divorce degree required both petitioner and **Blatt** to cause corporation to redeem petitioner's stock, **Blatt** was not the guarantor of corporation's obligation in the conventional meaning of the term "guarantor".

[12] We note that petitioner might have contended that she was acting as a representative of Frank J. **Blatt** (**Blatt**), or acting to satisfy an obligation of **Blatt**, at the time she transferred her stock to corporation. Petitioner did not do so; the record does not support these contentions, and petitioner did not argue them on brief or otherwise show that she was acting on behalf of **Blatt**. Petitioner relied mainly on *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992), which we respectfully refuse to follow. (We are not constrained by *Golsen v. **Commissioner**,* 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), to follow *Arnes* because the instant case is appealable to the Sixth Circuit.) Accordingly, we hold for respondent because petitioner failed to sustain her burden of proof. Rule 142(a); *Welch v. Helvering,* 290 U.S. 111, 115 (1933).

[13] The result we reach today harmonizes with the nontaxable treatment accorded the nonredeeming spouse by the Court of Appeals for the Ninth Circuit in *Edler v. **Commissioner**,* 727 F.2d 857 (9th Cir. 1984), affg. T.C. Memo. 1982-67, a case that was decided before the **Commissioner** prescribed the instant regulations under sec. 1041. See also Rev. Rul. 69-608, 1969-2 C.B. 42 (corporation's redemption of its stock from a retiring shareholder results in a constructive dividend to the continuing shareholder only if the redemption is in satisfaction of the continuing shareholder's primary and unconditional obligation to purchase the retiring shareholder's stock).

[1] For a laudatory comment from the redeemed spouse's point of view, see Preston & Hart, "Spouse's Stock in a Divorce Can Be Redeemed Tax Free", 78 J. Taxn. 360 (1993).

[2] What the majority seem to say is that the Court of Appeals in *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992), in holding that the terminating spouse whose stock was redeemed was entitled to nonrecognition of gain under sec. 1041, overexpansively equated any "benefit" to the remaining shareholder spouse with the redemption being on his behalf for the purpose of Q&A 9 of sec. 1.1041-1T, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984).

[3] See Young, "Separation and Divorce and the Tax Laws: `Waltzes' and `Apache Dances'", 22 Tax Law. 551, 572-577 (1969).

[4] There is no indication in the record how Mr. **Blatt's** tax case was handled, or whether respondent ever even determined a deficiency against him with respect to the transaction at issue in this case.

114 T.C. 14 (2000)

CAROL M. READ, ET AL.,[1] PETITIONERS
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 19001-97, 19322-97, 19328-97.

United States Tax Court.

Filed February 4, 2000.

16 *15 *16 *Mark A. Brown,* for petitioner in docket No. 19001-97.

Karen E. Lewis and *D. Michael O'Leary,* for petitioners in docket Nos. 19322-97 and 19328-97.

Robert W. Dillard, for respondent.

OPINION

CHIECHI, *Judge:*

These cases are before us on cross-motions for partial summary judgment filed by Carol M. **Read** (Ms. **Read**) and by William A. **Read** (Mr. **Read**) and Mulberry Motor Parts, Inc. (MMP).[2] (We shall refer to the motion for partial summary judgment filed by Ms. **Read** as Ms. **Read's** motion, to the motion for partial summary judgment filed by Mr. **Read** and MMP as Mr. **Read's** and MMP's motion, and collectively to those two motions as the cross-motions for partial summary judgment.)

A partial summary adjudication may be made that does not dispose of all the issues in a case if, inter alia, it is shown that there is no genuine issue as to any material fact with respect to the question(s) on which partial summary adjudication is sought. See Rule 121(b).[3] We are in agreement with the parties that there are no genuine issues of material fact and that the facts material to the Court's disposition of the cross-motions for partial summary judgment are set forth in those paragraphs of the stipulation of facts and those exhibits attached to that stipulation, which the Court made part of the record in these cases on November 5, 1998.

At the time they filed their respective petitions, Ms. **Read** resided in San Francisco, California, Mr. **Read** resided in Lakeland, Florida, and MMP's principal place of business was in Bartow, Florida.

In 1985, Ms. **Read** filed a petition for dissolution of her marriage to Mr. **Read** (marriage dissolution action) in the Circuit Court of the Tenth Judicial Circuit of the State of Florida, Polk County (Florida court). At the time she filed that petition,
17 Ms. **Read** owned 1,200 shares of voting and *17 12,000 shares of nonvoting, and Mr. **Read** owned 1,300 shares of voting and 13,000 shares of nonvoting, common stock of MMP, a corporation engaged in the business of selling automobile parts.

During the trial in the marriage dissolution action, Ms. **Read** and Mr. **Read** reached an oral settlement agreement (marital settlement agreement) which was **read** into the record in that action on December 5, 1985. The marital settlement agreement provided in pertinent part:

Wife [Ms. **Read**] agrees to convey to husband [Mr. **Read**] all of her stock in Mulberry Motor Parts, both voting and non-voting. And for such stock, husband, or at his option, Mulberry Motor Parts or the Aesop [sic] plan of Mulberry Motor Parts agrees to purchase such stock at its appraised value of $838,724, such purchase to be closed within 60 days of this date and to be paid as follows:

First, $200,000 down to be paid in cash * * * the balance of $638,724 to be evidenced by promissory note, to be signed by the purchaser but if the purchaser is other than William A. **Read**, to be guaranteed by William A. **Read**, and bearing interest at the rate of nine percent, payable monthly, on the principal, due from time to time; and with the principal to be payable $50,000 after twelve months and $50,000 principal each year thereafter until the principal is paid in full, with the right of prepayment at any time without penalty, and such purchase to be secured by a security interest in the stock to be sold, but with husband retaining a full right so long as he is in compliance and not in default on such note, to control such stock and to vote it.

* * * * * * *

* * * Husband agrees to pay the wife as permanent periodic alimony the sum of $2,500 per month and continuing until the death of the wife, the death of the husband, the remarriage of wife or wife's cohabitation with another man to whom she is not related by blood or marriage on a continuing basis for 60 days or more. * * *

* * * * * * *

* * * Additionally provided, however, that such alimony shall increase in amount from $2,500 per month to $3,000 per month at such time as the final principal payment is made by husband on the stock purchase called for on the Mulberry Motor Parts stock.

* * * * * * *

* * * The temporary alimony in the amount of $6,000 * * * the December payment of which has already been made, will terminate and no longer be payable in the event that husband pays the down payment on the stock purchase or causes it to be paid by either Mulberry Motor Parts or the Aesop [sic] plan and pays the consideration for the conveyance of the house and the $100,000 lump sum alimony on or before December 31st, 1985.

18 *18 However, if husband fails to do so in whole or in part, the $6,000 temporary alimony will continue for the month of January, subject to termination only upon the death of the wife.

* * * * * * *

* * * Additionally, as part of the temporary support agreement, but for consideration in addition furnished by the wife, husband has agreed to maintain in force insurance on his life with death benefits payable to wife in the amount of $150,000, and continuing for a period of time that was ascertainable but uncertain.

Parties agree that so long as William A. **Read** owes to his wife any amount of principal on the stock purchase of Mulberry Motor Parts, he will maintain that insurance in force with her as beneficiary with [sic] the death benefits thereof, having the right to cancel such designation when the stock is paid in full.

In the event, however, of his death prior to payment of the stock purchase in full, the insurance proceeds will apply toward the balance then due and owing.

On December 30, 1985, the Florida court entered the divorce judgment dissolving the marriage. The divorce judgment ordered and adjudged in pertinent part that

1. The marriage of Husband, WILLIAM A. **READ**, and Wife, CAROL ELIZABETH **READ**, is hereby dissolved.

2. The Marital Settlement Agreement dictated into the record before the Court on December 5, 1985, is ratified and approved by this Court and the parties are ordered to comply with all terms of that Agreement.

3. Wife shall sell and convey to Husband, or at Husband's election to Mulberry Motor Parts, Inc., or the ESOP Plan of Mulberry Motor Parts, Inc., all of the outstanding stock which she holds in Mulberry Motor Parts, Inc., consisting of 1,200 shares of voting stock and 12,000 shares of nonvoting stock by February 5, 1986. As consideration, Husband, or at his election Mulberry Motor Parts, Inc., or the ESOP Plan of Mulberry Motor Parts, Inc., shall pay to Wife simultaneously with the conveyance of such shares, the sum of $200,000. As additional consideration, Husband, or at his election Mulberry Motor Parts, Inc., or the ESOP Plan of Mulberry Motor Parts, Inc., shall deliver to Wife a promissory note in the principal amount of $638,724, which sum represents the balance of the purchase price to be paid for the stock. The note shall bear interest at the rate of 9%, which interest shall be payable monthly beginning one (1) month after the date of the note. The principal of the note shall be paid at the rate of $50,000 per year, the first payment shall be made twelve (12) months following the date of the note, and each year thereafter until the note is paid in full.

Husband or Mulberry Motor Parts, Inc., or the ESOP Plan of Mulberry Motor Parts, Inc., as the case may be, shall have right of prepayment without penalty. The note delivered to Wife shall be personally guaranteed by Husband.

19 *19 The sale of the stock by Wife and the unpaid balance for the purchase of the stock by Husband shall be secured by a security interest in the stock to be sold for which payments has [sic] not been made, with Husband retaining the full right to vote said stock and control said stock so long as he is in compliance with the terms of this paragraph. The amount of the security interest shall reduce pro rata as principal payments are made.

* * * * * * *

8. Husband has been paying the sum of $6,000 per month as temporary alimony to Wife. Husband's obligation to pay temporary alimony shall terminate on the 1st of the month following the month in which Husband completes the payment on the down payment on the stock purchase plan in the amount of $200,000 and pays the lump sum alimony in the amount of $180,000. The permanent, periodic alimony as provided for in paragraph 9 shall begin the 1st of the month following the payment of such items. Husband's obligation to pay temporary alimony is subject to prior termination upon the death of Wife.

9. Husband shall pay to Wife as and for permanent, periodic alimony, the sum of $2,500 per month until the death of Wife, the death of Husband, Wife's remarriage or until Wife cohabits with a man to whom she is not related by blood or marriage on a continuing basis for at least sixty (60) days, whichever first occurs. On the 1st of the month following the final payment to Wife by Husband of the total consideration owed to her by reason of the transfer of her stock in Mulberry Motor Parts, Inc., such alimony shall increase to the sum of $3,000 per month. These provisions for permanent, periodic alimony provided in this paragraph of this Final Judgment shall not be subject to modification by either party, both parties have expressly waived all right to seek modification of the amounts and terms under which permanent, periodic alimony is payable.

* * * * * * *

11. Husband shall maintain on his life with Wife as beneficiary, life insurance having death benefits in the amount of $150,000. Husband's obligation to continue insurance for the benefit of Wife shall terminate upon the payment in full of the purchase price of the stock in Mulberry Motor Parts, Inc.

At some time on or after December 30, 1985, the date on which the divorce judgment was entered, and on or prior to February 5, 1986, Mr. **Read** elected pursuant to the divorce judgment (1) that the sale and conveyance by Ms. **Read** of all of her MMP stock be made to MMP, instead of to Mr. **Read**, (2) that MMP, instead of Mr. **Read**, pay $200,000 to Ms. **Read** simultaneously with her sale and conveyance of such stock to MMP, and (3) that MMP, instead of Mr. **Read**, issue a promissory note to Ms. **Read** in the principal amount of $638,724 and bearing 9 percent interest.

20

*20 On February 5, 1986, the board of directors of MMP, composed of Mr. **Read**, Ms. **Read**, and J.S. Huggart, Jr., executed a document entitled "ACTION BY WRITTEN CONSENT OF THE BOARD OF DIRECTORS OF MULBERRY MOTOR PARTS, INC." with respect to the foregoing election that Mr. **Read** made pursuant to the divorce judgment (MMP board action by written consent).[4] The MMP board action by written consent stated in pertinent part:

We, the undersigned, constituting all of the members of the Board of Directors of Mulberry Motor Parts, Inc., * * * do hereby take the following action by unanimous written consent, pursuant to the provisions of Section 607.134, Florida Statutes:

RESOLVED, that it is advisable and in the best interest of the Corporation that the Corporation purchase 1,200 shares of its outstanding voting common capital stock and * * * 12,000 shares of its outstanding nonvoting common capital stock from Carol E. **Read** for a purchase price of $838,724.00. The officers of the Corporation are hereby directed to repurchase such stock in accordance with the terms of the certain Stock Purchase Agreement dated February 5, 1986 * * *. The appropriate officers of the Corporation are hereby authorized and directed to execute and deliver on behalf of the Corporation such Agreement, the Installment Promissory Note and Stock Pledge Agreement (referred to in such Agreement) and any other documents necessary to consummate such transaction. The repurchased shares which are not subject to the Stock Pledge Agreement shall be retired on the books of the Corporation. As shares which are subject to the Stock Pledge Agreement are released, such shares shall be retired on the books of the Corporation.

On February 5, 1986, pursuant to Mr. **Read's** election under the divorce judgment, MMP and Ms. **Read** entered into the stock purchase agreement (stock purchase agreement) that was authorized in the MMP board action by written consent. That agreement provided in pertinent part:

WHEREAS, Stockholder [Ms. **Read**] owns certain shares of the common capital stock of the Corporation [MMP];

21 *21 WHEREAS, Stockholder wishes to sell all of her common capital stock of the Corporation to the Corporation, which wishes to purchase such stock.

NOW, THEREFORE, the parties agree as follows:

1. *Sales and Purchases of Stock.* Simultaneously with the execution of this Agreement, Stockholder shall sell, and the Corporation shall redeem and purchase One Thousand Two Hundred (1,200) shares of voting stock of the Corporation and Twelve Thousand (12,000) shares of nonvoting common stock of the Corporation.

2. *Purchase Price.* The purchase price for the stock redeemed by the Corporation shall be Eight Hundred Thirty-Eight Thousand Seven Hundred Twenty-Four Dollars ($838,724.00), such price to be paid in the following manner:

(a) *Down payment.* The Corporation shall pay Two Hundred Thousand Dollars ($200,000.00) in cash upon delivery of the purchased stock by Stockholder.

(b) *Installment Promissory Note.* The Corporation shall deliver to Stockholder an Installment Promissory Note for Six Hundred Thirty-Eight Thousand Seven Hundred Twenty-Four Dollars ($638,724.00), (the "Note"), executed by the appropriate officers of the Corporation and individually guaranteed by William A. **Read**, upon delivery of the purchased stock by Stockholder. Such Note shall be in the form attached hereto as Exhibit A.

(c) *Collateral Security.* To secure the payment of the Note, 10,482 shares of the nonvoting common capital stock redeemed by the Corporation shall be pledged by assignment as collateral security to the Stockholder in accordance with a Stock Pledge Agreement to be executed by the Stockholder and the Corporation contemporaneously with the Note. Such Stock Pledge Agreement shall be in the form attached hereto as Exhibit B.

Pursuant to Mr. **Read's** election under the divorce judgment, on February 5, 1986, Ms. **Read** transferred to MMP her 1,200 shares of voting, and 12,000 shares of nonvoting, common stock of MMP (Ms. **Read's** February 5, 1986 transfer of MMP stock); MMP paid Ms. **Read** $200,000 by check; and MMP issued to Ms. **Read** an installment promissory note in the amount of $638,724 and bearing 9 percent annual interest (installment promissory note). That note provided in pertinent part:

FOR VALUE RECEIVED, the undersigned [MMP] promises to pay to the order of CAROL E. **READ** the principal sum of Six Hundred Thirty-Eight Thousand Seven Hundred Twenty-Four and No/100ths Dollars ($638,724.00), together with interest thereon from February 5, 1986, at the rate of nine percent (9%) per annum. Interest on the unpaid principal balance shall be payable in equal monthly installments, commencing on March 5, 1986, and continuing on the fifth day of each month thereafter until the principal sum and interest have been fully paid. Principal shall be
22 payable in annual installments of Fifty Thousand and No/100ths Dollars *22 ($50,000.00) each, commencing on February 5, 1987, and continuing on the fifth day of February of each year through 1998, with a final installment of Thirty-Eight Thousand Seven Hundred Twenty-Four and No/100ths Dollars ($38,724.00) due on February 5, 1999. * * *

* * * * * * *

The undersigned hereby waives presentment for payment, notice of nonpayment, protest and notice of protest of this note.

The installment promissory note was signed by William A. **Read** as president of MMP. Immediately beneath that signature appeared the following guaranty by Mr. **Read** in his individual capacity, which he signed on February 5, 1986:

INDIVIDUAL GUARANTY

The undersigned [Mr. **Read**] hereby individually unconditionally guarantees the payment of all sums due under this Installment Promissory Note.

The individual guaranty by Mr. **Read** of MMP's installment promissory note expressed in unambiguous terms an unconditional guaranty of Mr. **Read**. Consequently, under Florida law, that guaranty is what is known as an absolute guaranty, see *Mullins v. Sunshine State Serv. Corp.,* 540 So. 2d 222, 223 (Fla. Dist. Ct. App. 1989); *Anderson v. Trade Winds Enters. Corp.,* 241 So. 2d 174, 177 (Fla. Dist. Ct. App. 1970), and Mr. **Read** was secondarily liable on MMP's installment promissory note, see *West Flagler Associates, Ltd. v. Department of Revenue for Fla.,* 633 So. 2d 555, 556-557 (Fla. Dist. Ct. App. 1994); *Scott v. City of Tampa,* 30 So. 2d 300, 302 (Fla. Dist. Ct. App. 1947).

The stock pledge agreement referred to in and attached to the stock purchase agreement was entered into on February 5, 1986 (stock pledge agreement). The stock pledge agreement provided in pertinent part:

WHEREAS, Pledgor [MMP] is indebted to Pledgee [Ms. **Read**] in the amount of Six Hundred Thirty-Eight Thousand Seven Hundred Twenty-Four and NO/100th Dollars ($638,724.00) as evidenced by that certain promissory note from Pledgor to Pledgee dated February 5, 1986 [installment promissory note] * * * and

WHEREAS, Pledgor owns 10,482 shares of its nonvoting common capital stock which it holds in its treasury and which it has purchased from Pledgee; and

WHEREAS, Pledgor, as the owner of the above stock, agrees that it shall be pledged to Pledgee as security for the repayment of such indebtedness.

NOW, THEREFORE, the parties agree as follows:

23 *23 1. *Pledge.* Pledgor hereby grants to Pledgee a security interest in 10,482 shares of its nonvoting common capital stock * * *. Pledgee shall hold the pledged shares as security for the repayment of the indebtedness described above

and shall not encumber or dispose of such shares, except in accordance with the provisions of paragraph 7 of this Agreement.

2. *Term.* The shares pledged hereunder shall remain so pledged to Pledgee until released in accordance with the provisions of paragraph 3 of this Agreement.

3. *Release of Stock.*

(a) Upon each principal payment in the amount of Fifty Thousand and No/100th Dollars ($50,000.00) in accordance with the terms of * * * [installment promissory note], Pledgor shall be entitled to the release from this Stock Pledge Agreement of 820 shares of nonvoting common stock. Upon the demand at any time of Pledgor, Pledgee shall deliver to Pledgor the stock certificate for reissuance of such released shares, and Pledgor shall issue and deliver to Pledgee a new certificate representing the shares which remain subject to the pledge.

(b) Upon the repayment in full with interest of the indebtedness in accordance with the terms of * * * [installment promissory note], Pledgee shall transfer to Pledgor all of the remaining stock pledged hereunder.

* * * * * * *

7. *Default.* If Pledgor defaults in the performance of any of the terms of this Agreement or if Pledgor defaults in the payment of the indebtedness described in * * * [installment promissory note], then Pledgee shall have the following options exercisable at any time following thirty (30) days after any such default:

(a) Pledgee may declare the unpaid balance of the indebtedness immediately due and payable and then sell the pledged shares. * * *

* * * * * * *

Pledgee shall thereafter account to Pledgor for any surplus proceeds, which shall be paid over to Pledgor. Pledgor shall remain liable to Pledgee for any deficiency. * * *

(b) Pledgee may declare the unpaid balance of indebtedness immediately due and payable and retain the pledged shares in satisfaction of Pledgor's obligations under * * * [installment promissory note] and under this Agreement. * * *

(c) Pledgee may declare the unpaid balance of indebtedness immediately due and payable and thereafter exercise all rights and remedies afforded a secured party under the provisions of the Uniform Commercial Code in force in Florida as of the date of this Agreement.

Since February 5, 1986, Mr. **Read** has owned 100 percent of the outstanding voting common stock of MMP. At the time of Ms. **Read's** February 5, 1986 transfer of MMP stock and during the years at issue, MMP's ESOP owned 4,961 shares of class B nonvoting common stock of MMP.

24 *24 MMP classified the installment promissory note as a liability on its balance sheet for each of the years 1988, 1989, and 1990. Pursuant to that note, MMP made the following payments of principal and interest to Ms. **Read** during the years indicated:

	1988	1989	1990
Principal	$50,000	$50,000	$50,000
Interest	49,235	44,735	40,235

MMP deducted the interest payments that it made to Ms. **Read** during each of the years 1988, 1989, and 1990 in its Federal income tax (tax) return for each of those years.

Ms. **Read** did not report any income with respect to her transfer of MMP stock to MMP, except for the interest payments under the installment promissory note that MMP made to her during 1988, 1989, and 1990. She reported those interest payments as interest income in her tax returns for those years.

Mr. **Read** did not report in his tax returns for 1988, 1989, and 1990 any income with respect to Ms. **Read's** February 5, 1986 transfer of MMP stock.

Respondent determined in the notice issued to Ms. **Read** for 1989 and 1990[5] that the principal payment under the installment promissory note that MMP made to her during each of those years constitutes long-term capital gain.[6] Respondent made no determinations in that notice with respect to the interest payments under the installment promissory note that Ms. **Read** reported as interest income in her returns for those years.

Respondent determined in the notice issued to Mr. **Read** for 1988, 1989, and 1990 that the principal and interest payments under the installment promissory note that MMP made to Ms. **Read** during those years are constructive dividends to Mr. **Read**.

Respondent determined in the notice issued to MMP for 1988, 1989, and 1990 that the interest payments under the installment promissory note that it made to Ms. **Read** during those years are not deductible.

25 *25 The underlying common issue presented in the cross-motions for partial summary judgment is whether section 1041 applies to the transfer by Ms. **Read** to MMP of her stock in that company. It is Ms. **Read's** position that section 1041 applies to that transfer, while Mr. **Read** and MMP take the position that it does not.[7] Respondent's role here is that of a stakeholder. Nonetheless, respondent has indicated that "Ms. **Read** has the better argument that she should not recognize any gain from the sale of her stock pursuant to I.R.C. §1041."

Section 1041 provides in pertinent part:

SEC. 1041. TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

(a) GENERAL RULE. — No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) —

(1) a spouse, or

(2) a former spouse, but only if the transfer is incident to the divorce.

(b) TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS. — In the case of any transfer of property described in subsection (a) —

(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

(c) INCIDENT TO DIVORCE. — For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—

(1) occurs within 1 year after the date on which the marriage ceases, or

(2) is related to the cessation of the marriage.

Temporary, but not final, regulations have been issued under section 1041. Those temporary regulations provide that the transferor of property under section 1041 is to recognize no gain or loss on the transfer, regardless of whether the transfer is in exchange for consideration. See sec. 1.1041-1T(c), Q&A-10, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984). The temporary regulations under section 1041 further provide that in all transfers subject to that section the basis of the transferred property in the hands of the transferee is the adjusted basis of such property in

26 the hands of the transferor immediately before the transfer, *26 regardless of whether the transfer is a bona fide sale in which the transferee pays the transferor consideration for the transferred property. See sec. 1.1041-1T(c), Q&A-11, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984).

The temporary regulations under section 1041 also describe the circumstances in which a transfer of property by a spouse to a third party on behalf of a spouse or former spouse qualifies as a transfer to which section 1041 applies. See sec. 1.1041-1T(c), Q&A-9, Temporary Income Tax Regs. (Q&A-9), 49 Fed. Reg. 34453 (Aug. 31, 1984). Q&A-9 provides in pertinent part:

Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. * * * In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

Ms. **Read** contends that her transfer of MMP stock to MMP was a transfer of property by her to a third party on behalf of Mr. **Read** within the meaning of Q&A-9 and that that transfer fits within both the first situation and the second situation described in that temporary regulation. Consequently, according to Ms. **Read**, section 1041(a) prescribes nonrecognition treatment to her with respect to her transfer of MMP stock to MMP. Mr. **Read** and MMP counter that Ms. **Read's** February 5, 1986 transfer of MMP stock was not a transfer of property to a third party on behalf of Mr. **Read** within the meaning of Q&A-9 and that that transfer does not fit within either of the first two situations (or the third situation) described in that temporary regulation. Consequently, according to Mr. **Read** and MMP, section 1041(a)
27 does not provide *27 nonrecognition treatment to Ms. **Read** with respect to Ms. **Read's** February 5, 1986 transfer of MMP stock.

In advancing their respective positions, Ms. **Read** and Mr. **Read** and MMP argue that *Hayes v. **Commissioner***, 101 T.C. 593 (1993), *Arnes v. **Commissioner***, 102 T.C. 522 (1994), and *Blatt v. **Commissioner***, 102 T.C. 77 (1994), prescribe the legal standard that we must apply in order to determine whether Ms. **Read's** transfer of her MMP stock to MMP constitutes a transfer of property by a spouse (the transferring spouse, here Ms. **Read**) to a third party (here MMP) on behalf of a spouse[8] (the nontransferring spouse, here Mr. **Read**) within the meaning of Q&A-9 (on-behalf-of standard). According to petitioners, those cases establish that the on-behalf-of standard may be satisfied in the instant cases only if Mr. **Read** had a primary and unconditional obligation to purchase Ms. **Read's** MMP stock, such that under established principles of tax law (constructive-dividend decisional law), see, e.g., *Sullivan v. United States*, 363 F.2d 724, 728-729 (8th Cir. 1966); *Smith v. **Commissioner***, 70 T.C. 651, 668 (1978), Mr. **Read** received a constructive dividend (to the extent of MMP's earnings and profits) as a result of MMP's payment to Ms. **Read** of the consideration stated in the divorce judgment in redemption of her stock (primary-and-unconditional-obligation standard).

We disagree with petitioners that *Hayes v. **Commissioner**, supra*, *Arnes v. **Commissioner**, supra*, and *Blatt v. **Commissioner**, supra*, require us to apply the primary-and-unconditional-obligation standard as to Mr. **Read** in order to determine whether the on-behalf-of standard in Q&A-9 is satisfied in the instant cases. As respondent correctly points out, this Court has not expressed an opinion on whether the on-behalf-of standard in Q&A-9 is the same as the primary-and-unconditional-obligation standard in constructive-dividend decisional law. See *Arnes v. **Commissioner**, supra* at 529 n.3, which this Court decided after it decided *Hayes v. **Commissioner**, supra*, and *Blatt v. **Commissioner**, supra*. We find petitioners' reliance on those three cases to support their view that in the instant cases

28 the on-behalf-of standard in Q&A-9 is the same as the primary-and-unconditional-obligation *28 standard in constructive-dividend decisional law to be misplaced.

The only issue that we decided in *Hayes v. **Commissioner**, supra,* was whether the redemption by JRE, Inc. (JRE), a corporation owned by the taxpayer Ms. Hayes and the taxpayer Mr. Hayes, who was her former spouse,[9] of Ms. Hayes' JRE stock resulted in a constructive dividend to Mr. Hayes. The role of the **Commissioner** of Internal Revenue (**Commissioner**) in *Hayes,* like respondent's role in the instant cases, was that of a stakeholder. Nonetheless, the **Commissioner** argued in *Hayes v. **Commissioner**, supra,* that the tax incurred as a result of the redemption of Ms. Hayes' JRE stock should be borne by Mr. Hayes. That was because, according to the **Commissioner**, JRE's redemption of Ms. Hayes' stock constituted a constructive dividend to Mr. Hayes since at the time of that redemption he had a primary and unconditional obligation to buy that stock from her. See *id.* at 597. On the facts presented, we held that Mr. Hayes received a constructive dividend as a result of that redemption because when JRE redeemed Ms. Hayes' JRE stock, it satisfied Mr. Hayes' primary and unconditional obligation to purchase that stock from Ms. Hayes. See *id.* at 605. Having so held, we stated:

Respondent has indicated to the Court that, if we find that Mr. Hayes received a constructive dividend in connection with JRE's undertaking to redeem Ms. Hayes' stock, as we have done, she will concede that section 1041 shields Ms. Hayes from recognition of gain on the amount realized from the exchange of her stock. *Accordingly, under respondent's concession, our resolution of the constructive dividend issue in Mr. Hayes' case renders the section 1041 issue in Ms. Hayes' case moot.* [*Id.* at 606; emphasis added.]

We did not decide any issue in *Hayes* under Q&A-9 and section 1041.[10]

Similarly, the only issue that we decided in *Arnes v. **Commissioner**, supra,* was whether the redemption by a corporation known as Moriah, which was owned equally by the taxpayer Mr. Arnes who was before us and his former
29 spouse Ms. Arnes, who was not before us,[11] of Ms. Arnes' Moriah *29 stock resulted in a constructive dividend to Mr. Arnes. See *Arnes v. **Commissioner**, supra* at 527. The **Commissioner's** position in *Arnes* was that at the time of that redemption Mr. Arnes had a primary and unconditional obligation to buy Ms. Arnes' Moriah stock. Therefore, according to the **Commissioner**, he received a constructive dividend as a result of Moriah's redemption of that stock. In support of that position, the **Commissioner** argued that, under *Golsen v. **Commissioner**,* 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), the conclusion of the U.S. Court of Appeals for the Ninth Circuit in *Arnes v. United States,* 981 F.2d 456, 459 (9th Cir. 1992), that the obligation to purchase Ms. Arnes' stock was Mr. Arnes' obligation, and not the obligation of Moriah, controlled our decision in *Arnes v. **Commissioner**,* 102 T.C. 522 (1994). The **Commissioner** did not ask us in *Arnes v. **Commissioner**, supra,* to determine whether the on-behalf-of standard in Q&A-9 was met as a result of the transfer by Ms. Arnes, who was not a party before us in that case, of her Moriah stock to that company. With respect to the **Commissioner's** reliance on *Golsen,* we held in *Arnes v. **Commissioner**, supra* at 529:

*Golsen v. **Commissioner**, supra,* does not apply because *Arnes v. United States, supra,* does not address the legal issue here: whether there is a constructive dividend to petitioner [Mr. Arnes]. That case concerned the tax consequences to Joann [Ms. Arnes] under section 1041. * * * We note that petitioner was not a party in *Arnes* [*v. United States, supra*], and Joann had a possibly3 adverse position to petitioner in that case.[12]

On the facts presented, we found that Mr. Arnes did not have a primary and unconditional obligation[13] to buy Ms. Arnes' Moriah stock at the time Moriah redeemed it. Consequently, we held that Mr. Arnes did not receive a
30 constructive dividend as a result of that redemption. See *id.* at 528-529. *30 We did not decide any issue in *Arnes* under Q&A-9 and section 1041.

The only reported opinion of this Court in which we decided whether a transfer of property by a transferring spouse to a third party was on behalf of the nontransferring spouse within the meaning of Q&A-9 is *Blatt v. **Commissioner**,* 102 T.C. 77 (1994). In *Blatt,* the taxpayer Ms. Blatt and her husband Mr. Blatt each owned 50 percent of the stock of a corporation known as Phyllograph. See *id.* at 78. Unlike the divorce judgment involved in the instant cases, but like the divorce decree involved in *Arnes v. **Commissioner**, supra,* the divorce decree in *Blatt* provided in pertinent part:

IT IS FURTHER ORDERED and ADJUDGED that the parties, being equal stockholders, shall cause Phyllograph Corp. to redeem plaintiff's [Ms. Blatt's] stock in said Corporation * * * for the sum of Forty-five Thousand Three Hundred Eighty-four Dollars * * *. [*Id.* n.4.]

Pursuant to that divorce decree, Phyllograph redeemed all of Ms. Blatt's Phyllograph stock in exchange for cash. See *id.* at 78. Ms. Blatt did not report any of the proceeds that she received from Phyllograph in redemption of her stock. The **Commissioner** determined that Ms. Blatt realized and must recognize long-term capital gain as a result of that redemption. See *id.* Ms. Blatt took the position in *Blatt v. **Commissioner**, supra,* that the redemption of her stock by Phyllograph qualified as a transfer of property to a third party on behalf of Mr. Blatt under Q&A-9 that was not taxable to her under section 1041(a). See *id.* at 80. In support of her position, Ms. Blatt relied principally on *Arnes v. United*
31 *States, supra*.[14] We rejected Ms. Blatt's position and *31 indicated that we disagreed with *Arnes v. United States, supra*.[15] See *id.* at 82-83.

In *Blatt v. **Commissioner**, supra* at 81, we addressed the meaning of the phrase "on behalf of" in Q&A-9. We stated that "The term `on behalf of' means `in the interest of' or `as a representative of', Webster's Ninth New Collegiate Dictionary (1990)". *Id.* We found that Ms. Blatt did not claim, see *id.* n.12, and that "the record does not indicate that petitioner [Ms. Blatt] was acting in the interest of [Mr.] Blatt or as a representative of [Mr.] Blatt at the time of the redemption." *Id.* We also indicated in *Blatt* that "A transfer that satisfies an obligation or a liability of someone is a transfer on behalf of that person". *Id.* We found that "petitioner [Ms. Blatt] does not claim, and the record does not indicate, that the redemption satisfied any obligation of [Mr.] Blatt." *Id.* at 81-82. We further concluded that Ms. Blatt did not otherwise show that she was acting on behalf of Mr. Blatt. See *id.* n.12. We found that Ms. Blatt failed to show error in respondent's determination to treat the redemption involved there as a taxable event to her. We held:

the record in the instant case is devoid of evidence disproving respondent's determination that petitioner's [Ms. Blatt's] transfer of her stock to corporation [Phyllograph] was not on behalf of [Mr.] Blatt within the meaning of Q&A 9. The redemption, in form, was a transaction between petitioner and corporation; she transferred her stock to corporation in exchange for its appreciated value in cash. * * * [*Id.* at 81.]

We did not decide in *Blatt v. **Commissioner**, supra,* that only if the primary-and-unconditional-obligation standard is
32 satisfied as to the nontransferring spouse may a transfer by *32 the transferring spouse to a corporation of such transferring spouse's stock in that corporation be considered to be a transfer of property by a spouse to a third party on behalf of the nontransferring spouse within the meaning of Q&A-9.[16] Moreover, the illustration that we gave in *Blatt* of a transfer of property by a spouse to a third party that satisfies an obligation or a liability of the other spouse, which we indicated in *Blatt* is one type of transfer by a transferring spouse that constitutes a transfer of property to a third party on behalf of a nontransferring spouse within the meaning of Q&A-9, did not implicate the primary-and-unconditional-obligation standard.[17] If, as petitioners contend here, we had concluded in *Blatt v. **Commissioner**,* 102 T.C. 77 (1994), a case which, like the instant cases, involved a corporate redemption in a divorce setting, that satisfaction of the primary-and-unconditional-obligation standard as to the nontransferring spouse is the only way in which the on-behalf-of standard in Q&A-9 may be met in the case of such a redemption, we would have expressly so stated. We did not.[18]

33 *33 We have rejected petitioners' reliance on *Hayes v. **Commissioner**,* 101 T.C. 593 (1993), *Arnes v. **Commissioner**,* 102 T.C. 522 (1994), and *Blatt v. **Commissioner**, supra,* to support their view that in the instant cases the on-behalf-of standard in Q&A-9 is the same as the primary-and-unconditional-obligation standard in constructive-dividend decisional law. We shall now decide whether Ms. **Read's** February 5, 1986 transfer of MMP stock will satisfy the on-behalf-of standard in Q&A-9 only if, as petitioners argue, the primary-and-unconditional-obligation standard is satisfied as to Mr. **Read**. We hold that the primary-and-unconditional-obligation standard is not an appropriate standard to apply in the instant cases in order to determine whether Ms. **Read's** transfer of her MMP stock to MMP was a transfer of property by the transferring spouse (Ms. **Read**) to a third party (MMP) on behalf of the nontransferring spouse (Mr. **Read**) within the meaning of Q&A-9.[19] We further hold that the primary-and-unconditional-obligation standard is not an appropriate standard to apply in any case involving a corporate redemption in a divorce setting in order to

determine whether the transfer of property by the transferring spouse to a third party is on behalf of the nontransferring spouse within the meaning of Q&A-9.[20]

34 *34 In arguing that only satisfaction of the primary-and-unconditional-obligation standard as to Mr. **Read** may satisfy the on-behalf-of standard in Q&A-9, petitioners seem to be suggesting that that temporary regulation requires only that there be a transfer of property on behalf of the nontransferring spouse (here Mr. **Read**), regardless who is making the transfer of property and to whom such property is transferred. Petitioners thus reverse the on-behalf-of standard in Q&A-9 to **read** as follows: A transfer of property *by a third party to the transferring spouse* on behalf of the nontransferring spouse.[21] However, Q&A-9 does not **read** that way and does not address such a transfer. Q&A-9 addresses and requires a transfer of property *by a transferring spouse to a third party* on behalf of the nontransferring spouse.[22]

The primary-and-unconditional-obligation standard does not require analysis of (or even address) the transfer that Q&A-9 requires be analyzed in order to determine whether that temporary regulation applies (provided that the other requirements of Q&A-9 and section 1041 are satisfied). The transfer that must be analyzed under constructive-dividend decisional law in order to determine whether the primary-and-unconditional-obligation standard is satisfied and whether a stockholder whose stock *is not being redeemed* received a constructive dividend is the transfer by the redeeming corporation of the redemption proceeds to the stockholder whose stock is being redeemed.[23] In contrast,
35 the *35 transfer that must be analyzed under Q&A-9 in the present cases (and in any case involving a corporate redemption in a divorce setting) in order to determine whether the on-behalf-of standard in Q&A-9 is satisfied and whether the stockholder whose stock *is being redeemed* (here Ms. **Read**, the transferring spouse) is not required to recognize gain or loss under section 1041 is the transfer by that transferring spouse of the stock being redeemed (property) to the redeeming corporation (here MMP, a third party). Only if that transfer is made on behalf of the spouse whose stock is not being redeemed (here Mr. **Read**, the nontransferring spouse) does the transfer of property (here MMP stock) by the transferring spouse (here Ms. **Read**) to a third party (here MMP) satisfy the on-behalf-of standard in Q&A-9.

The judicially created primary-and-unconditional-obligation standard is well established in the tax law. If in issuing Q&A-9 the Treasury Department had intended that in the case of, and solely in the case of, a corporate redemption in a divorce setting the on-behalf-of standard may be satisfied only by satisfaction of the primary-and-unconditional-obligation standard, the Treasury Department would have expressly so indicated in Q&A-9. It did not.

We have rejected petitioners' argument in these cases that only if the primary-and-unconditional-obligation standard is met as to Mr. **Read** may the on-behalf-of standard in Q&A-9 be satisfied. We shall now determine whether Ms. **Read's** transfer of her MMP stock to MMP was a transfer of property by the transferring spouse (Ms. **Read**) to a third party (MMP) on behalf of the nontransferring spouse (Mr. **Read**) within the meaning of Q&A-9.

We shall make that determination by applying the meanings of the phrase "on behalf of" in Q&A-9 which we cited with approval and on which we relied in *Blatt v. **Commissioner***, 102 T.C. at 81.

We shall turn first to whether Ms. **Read's** transfer of her MMP stock to MMP satisfied a liability or an obligation of Mr. **Read**, one of the ways in which we indicated in *Blatt v. **Commissioner**, supra,* a transfer of property would be
36 considered *36 a transfer of property by the transferring spouse to a third party on behalf of the nontransferring spouse within the meaning of Q&A-9. We find that it did not. Under the divorce judgment, Mr. **Read's** obligation[24] to purchase Ms. **Read's** MMP stock for the consideration stated in that judgment was *owed to Ms. **Read**.* Ms. **Read's** transfer of her MMP stock to MMP (i.e., the transferring spouse's transfer of property to a third party) did not satisfy that obligation of Mr. **Read** to Ms. **Read**.

We shall now determine whether under the common, ordinary meaning of the phrase "on behalf of" which we cited with approval and on which we relied in *Blatt v. **Commissioner**, supra* at 81, Ms. **Read's** transfer of her MMP stock to MMP was a transfer of property by the transferring spouse to a third party on behalf of the nontransferring spouse within the meaning of Q&A-9. We indicated in *Blatt* that the common, ordinary meaning of the phrase "on behalf of" in

Q&A-9 is "in the interest of" or "as a representative of". See *id.* at 81 (quoting Webster's Ninth New Collegiate Dictionary (1990)). Applying that meaning to the facts in the instant cases,[25] we find that Ms. **Read** was acting as Mr. **Read's** representative in transferring her MMP stock to MMP, and that Ms. **Read** was acting in the interest of Mr.
37 **Read** in making *37 that transfer to MMP,[26] in that she was following and implementing Mr. **Read's** direction as reflected in his election under the divorce judgment that she transfer her MMP stock to MMP. Absent Mr. **Read's** election, Ms. **Read** was obligated under that judgment to transfer that stock to Mr. **Read**. We hold that Ms. **Read's** transfer to MMP of her MMP stock was a transfer of property by Ms. **Read** to a third party on behalf of Mr. **Read** within the meaning of Q&A-9.

We shall now consider whether Ms. **Read's** February 5, 1986 transfer of MMP stock qualifies as one of the three situations described in Q&A-9. The first situation in Q&A-9 describes a transfer of property by the transferring spouse to a third party on behalf of the nontransferring spouse that is required by a divorce or separation instrument. We hold that Ms. **Read's** transfer of her MMP stock to MMP was required by the divorce judgment and fits within the first
38 situation *38 described in Q&A-9. Although that transfer was required by the divorce judgment only in the event that Mr. **Read** elected that Ms. **Read** transfer her MMP stock to MMP, instead of to Mr. **Read**, once Mr. **Read** made that election, which he did prior to Ms. **Read's** transfer of her MMP stock to MMP, that transfer was required by the divorce judgment.

We hold that Q&A-9 applies to Ms. **Read's** February 5, 1986 transfer of MMP stock and that, pursuant to section 1041 (a), no gain shall be recognized by Ms. **Read** as a result of that transfer.[27] Mr. **Read** and MMP have indicated that if the Court were to find, as we have, that section 1041 applies to Ms. **Read's** transfer of her MMP stock to MMP, the determinations in the respective notices issued to Mr. **Read** and to MMP relating to that transfer should be sustained. Consequently, those determinations have become moot, and we shall not address them.

To reflect the foregoing and the concessions of the parties in these cases,

An order recharacterizing Ms. ***Read's*** *motion as a motion for partial summary judgment and granting it will be issued, and decision will be entered for petitioner in docket No. 19001-97.*

An order denying Mr. ***Read's*** *and MMP's motion will be issued.*

Reviewed by the Court.

COHEN, CHABOT, PARR, WHALEN, COLVIN, FOLEY, VASQUEZ, and GALE, *JJ.,* agree with this majority opinion.

COLVIN, *J.,* concurring:

I agree with the majority that section 1041 applies to the redemption of Ms. **Read's** stock and with its analysis supporting that result. I also concur in the result as to Mr. **Read** for reasons stated herein.

39 *39 I. *Thesis: Section 1041 and Q&A-9 Apply Broadly and Prevent Nonsymmetrical Treatment of Spouses*

The issue of whether, or how, section 1041 applies to redemptions incident to a divorce has been difficult for private parties, the Government, and the courts.[1] Despite this past difficulty, this concurring opinion argues that section 1041 can provide predictable and fair results, with minimal risk of nonsymmetrical treatment of spouses, based on two principles. The first principle is (a) that Congress intended section 1041 to provide a broad rule of nonrecognition for transfers of property between spouses and former spouses incident to divorce, and (b) that section 1.1041-1T(c), Q&A-9, Temporary Income Tax Regs. (Q&A-9), 49 Fed. Reg. 34453 (Aug. 3, 1984), fully implements that intent for economically equivalent transactions involving third parties, including redemptions of stock held by one spouse. The second principle is that, if applied according to their terms, section 1041(b) and corresponding language in the penultimate sentence of Q&A-9 fully achieve the congressional purpose of avoiding whipsaw to the Government in cases where section 1041(a) applies by specifying how we treat the nontransferring spouse; i.e., "deeming" certain facts to have occurred. That is, under section 1041(b) and the penultimate sentence of Q&A-9, Ms. **Read** is deemed to have transferred her MMP stock to Mr. **Read**, and Mr. **Read** is deemed to have transferred it to MMP to be redeemed. Thus, if section 1041(a) applies, we are required to assume that the stock MMP redeemed was Mr. **Read's**, not Ms. **Read's**.

Application of these two principles will properly implement congressional intent both for section 1041(a), in making transactions between spouses tax free, and section 1041(b), in ensuring against whipsaw of the Government. For convenience in this concurring opinion, I refer to this analysis as the "section 1041(b)-Q&A-9 theory."

The dissenting opinion of Judge Ruwe emphasizes the importance of achieving symmetrical results between spouses in the stock redemption context if section 1041 applies. However, it does not rely on the section 1041(b)-Q&A-9 theory.
40 Instead, it would apply what, for convenience, I will call the *40 "primary and unconditional obligation requirement" theory, derived from law developed before section 1041 was enacted. In this concurrence, I contend that the section 1041(b)-Q&A-9 theory is as effective in preventing whipsaw in the stock redemption context if section 1041(a) applies as the primary and unconditional obligation requirement theory and that the former is clearly incorporated in section 1041, its legislative history, and Q&A-9, and the latter is not. Further, I believe it is not for the courts to create barriers to qualifying for nonrecognition treatment under section 1041(a) and Q&A-9 that were not provided by the Congress or the Secretary.

II. *Section 1041 Applies Broadly to Transactions Between Divorcing Spouses*

No gain or loss is recognized on a transfer of property from an individual to a former spouse if the transfer is incident to divorce. See sec. 1041(a)(2).[2] The phrase "incident to divorce" is broad, suggesting that Congress intended section 1041(a)(2) to apply broadly. See *Arnes v. United States,* 981 F.2d 456, 458, 460 (9th Cir. 1992) (Arnes I); *Blatt v. **Commissioner**,* 102 T.C. 77, 79 (1994). That reading is corroborated by the report of the Ways and Means Committee accompanying enactment of section 1041 in 1984, which states in pertinent part:

The committee believes that, in general, it is inappropriate to tax transfers between spouses. This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single economic unit.

The current rules governing transfers of property between spouses or former spouses incident to divorce have not worked well and have led to much controversy and litigation. Often the rules have proved a trap for the unwary as, for
41 example, where the parties view property acquired during *41 marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property upon divorce triggers recognition of gain.

* * * * * * *

The committee believes that to correct these problems, and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and former spouses should be changed.

[H. Rept. 98-432 (Part 2), at 1491-1492 (1984)].

The Ways and Means Committee also said in its report:

This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged. * * * [*Id.* at 1492.]

Thus, Congress made clear that it intended section 1041(a) to apply broadly to transactions between divorcing spouses.[3]

III. *Q&A-9 Extends Section 1041 Broadly to Transfers on Behalf of the Nontransferring Spouse Incident to Divorce*

Section 1.1041-1T(c), Q&A-9, Temporary Income Tax Regs.,[4] extends section 1041(a) to transfers of property by a spouse (transferring spouse) to a third party on behalf of a former spouse (nontransferring spouse). To qualify, the transfer must be "on behalf of" the transferring spouse. The temporary regulations do not define or limit the term "on behalf of".

42 *42 Q&A-9, as applied to divorcing spouses, properly implements section 1041(a) because it recognizes that section 1041 applies not only to transfers to the other spouse, but also to transfers to a third party "on behalf of" that other spouse. Like section 1041(a), this facilitates the division of a marital estate incident to divorce without taxation to the spouse who is withdrawing assets from the marital estate. There is no suggestion in the regulations that the "on behalf of" language has any purpose other than to make Q&A-9 apply as broadly as section 1041(a) does; i.e., to transactions made to divide a marital estate.

The language of section 1041(a), its legislative history, and the language of Q&A-9 clearly support the view of the majority that the "on behalf of" standard in Q&A-9 is satisfied if the transfer was "in the interest of" or was made by the transferring spouse acting "as a representative of" the nontransferring spouse. Majority op. p. 36.

I disagree with the contention in Judge Ruwe's dissenting opinion, *infra* pp. 46-55, that Q&A-9 applies to redemptions only if the redemption satisfies a primary and unconditional obligation of the spouse whose stock is not being redeemed. As stated by the majority, that requirement is not contained in or implied by the phrase "on behalf of". I also disagree with the contention in the dissenting opinion of Judges Laro and Marvel that Q&A-9 does not apply to corporate redemptions or that it applies only to transfers to a third party to satisfy an obligation owed by the nontransferring spouse to the third party. By their terms, section 1041(a) and Q&A-9 apply broadly to transfers of property "incident to divorce", which are "on behalf of" the other (nontransferring) spouse. By choosing the "on behalf of" language, the Secretary appropriately defined eligibility for section 1041(a) broadly, as did Congress. Q&A-9 does not state that it does not apply to redemptions, or that it applies only to transfers to a third party to satisfy an obligation owed by the nontransferring spouse to the third party. Where the Secretary uses broad language to provide eligibility for a rule of nonrecognition, we need not and ought not supply our own exceptions. Application of section 1041 and Q&A-9 to redemptions furthers the legislative purpose of making a transfer of property incident to divorce tax free in
43 the case of a closely held corporation owned by a married couple. In his dissent, *infra* p. 49, Judge *43 Ruwe points out that in the instant cases and prior cases, "the **Commissioner** has consistently treated Q&A-9 as applying to divorce-related corporate redemptions, and this position has been adopted by the U.S. Court of Appeals for the Ninth Circuit in *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992)."

IV. *Section 1041(b) and Q&A-9 Provide for Avoidance of Whipsaw*

Section 1041(b)[5] is intended to ensure that the Government is not whipsawed as a result of inconsistent positions taken by former spouses. Section 1041(b) provides that, in the case of any transfer of property to which section 1041 applies, (1) the transferee is treated as if he or she acquired the property by gift and (2) the transferee takes the basis of the transferor. The Ways and Means Committee report accompanying enactment of section 1041 clearly stated the importance of avoiding whipsaw in cases where section 1041(a) applies. That committee report states:

Furthermore, in divorce cases, the government often gets whipsawed. The transferor will not report any gain on the transfer, while the recipient spouse, when he or she sells, is entitled under the *Davis* rule to compute his or her gain or loss by reference to a basis equal to the fair market value of the property at the time received.

* * * * * * *

Thus, uniform Federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws.

[H. Rept. 98-432 (Part 2), *supra* at 1491-1492.]

As quoted *supra* note 4, the penultimate sentence of Q&A-9 implements the antiwhipsaw rule of section 1041(b) by providing:

In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party.

44 *44 Thus, under section 1041(b) and Q&A-9, the following is deemed to occur if section 1041(a) applies to Ms. **Read**:

1. She is deemed to transfer her stock to Mr. **Read**.

2. Mr. **Read** is deemed to immediately transfer the stock to MMP.

Pursuant to the divorce judgment, Mr. **Read** elected for MMP to pay Ms. **Read** and to issue a promissory note to her. However, despite these actual facts, because (in my view) section 1041(a) applies here, section 1041(b) and Q&A-9 specifically require us to analyze this transaction as if the stock were Mr. **Read's** at the time of the redemption.[6]

V. *Should the Payment by MMP to Ms. Read Be Deemed To Be Made to Mr. Read?*

Section 1041 and Q&A-9 do not state that the payment from MMP to Ms. **Read** is deemed to be made to Mr. **Read** and then to Ms. **Read**.[7] However, it is undisputed that, because (in my view) section 1041(a) applies, under section 1041(b) and Q&A-9 we are to treat Ms. **Read's** stock redeemed by MMP as if it were Mr. **Read's**. A stock owner would normally have the right to receive payment made in redemption of his or her stock. Since we are required to treat Mr. **Read** as the owner of Ms. **Read's** MMP stock, it is thereby implied that we must attribute normal rights of stock ownership to him. Thus, to give reasonable effect to section 1041(b) and the penultimate sentence of Q&A-9, we should treat Mr. **Read** as having a right to receive any payment MMP makes in redemption of what is deemed to be his stock, and thus he constructively receives any payment MMP makes in redemption of that stock to Ms. **Read** under general income tax principles. See *Lucas v. Earl*, 281 U.S. 111 (1930).

45 *45 ## VI. *How Is Mr. Read Taxed?*

Mr. **Read** and MMP indicated in their motion their belief that the primary and unconditional standard applies to section 1041, and that if section 1041 applies to Ms. **Read's** redemption of her MMP stock, respondent's determinations in the notices of deficiency issued to Mr. **Read** and MMP should be sustained. I concur with that result but for different reasons. Under the analysis of section 1041 and Q&A-9 herein, Mr. **Read** would be taxed on the constructive dividend he received on the transfer of Ms. **Read's** stock to MMP, not as a result of his litigating position in this case. Since Mr. **Read** constructively received MMP's payment to Ms. **Read**, he is taxable on it as a dividend under sections 302(d), 301(a), and 316.[8]

VII. *Primary and Unconditional Standard*

A payment to a shareholder in redemption of stock is a constructive dividend to the remaining stockholder if the nonredeeming stockholder had a primary and unconditional obligation to buy the stock. See, e.g., Arnes II; *Hayes v. **Commissioner***, 101 T.C. 593, 606 (1993); *Edler v. **Commissioner***, T.C. Memo. 1982-67, affd. 727 F.2d 857 (9th Cir. 1984).

The dissenting opinion of Judge Ruwe advocates the primary and unconditional obligation requirement theory to avoid whipsaw. See Judge Ruwe's dissent, *infra* pp. 49-50. Under that view, the remaining shareholder (here, Mr. **Read**) would be taxed only if the transfer of the redemption proceeds satisfied a primary and unconditional obligation of his to Ms. **Read**. Because under that analysis the remaining shareholder would often escape taxation, to achieve symmetry Judge Ruwe would permit the departing shareholder (here, Ms. **Read**) to exclude gain or loss under section 1041(a) only if the transfer of the redemption proceeds satisfied a primary and unconditional obligation of the remaining shareholder.

If followed consistently in cases where section 1041(a) applies, both the section 1041(b)-Q&A-9 theory and the
46 primary and unconditional obligation requirement theory would *46 ensure symmetry. Thus, I disagree with the suggestion that, to achieve symmetry in the treatment of spouses, we need to apply the "primary and unconditional obligation requirement" theory to determine eligibility for section 1041(a) or Q&A-9. Congress clearly specified in section 1041(b) that, if section 1041(a) applies, we must treat the nontransferring spouse as the owner of the transferring spouse's property. Thus, assuming section 1041(a) applies, the question here is not how Mr. **Read** is taxed if MMP redeems Ms. **Read's** stock, even though those are the actual facts; instead, the question is how Mr. **Read** is taxed if MMP redeems his stock, because those are the deemed facts for "all purposes" under the income tax. Sec. 1041(b). The Secretary specifically implemented that concept in the penultimate sentence of Q&A-9. As a result, symmetry is achieved without the need to apply the primary and unconditional obligation requirement to the nontransferring spouse. Further, it is not for the courts to create their own barriers to qualifying for nonrecognition treatment under section 1041(a) and Q&A-9 not provided by Congress or the Secretary (e.g., imposition of a primary and unconditional obligation requirement, or creation of an exception for redemption transactions).

VIII. *Conclusion*

I concur because the analysis of the majority is fully consistent with the analysis in this concurring opinion.

PARR, WHALEN, FOLEY, VASQUEZ, and GALE, *JJ.,* agree with this concurring opinion.

RUWE, *J.,* dissenting:

I disagree with the standards that the majority opinion uses for determining whether Ms. **Read's** transfer of stock to MMP qualifies as a transfer to which section 1041 applies.

When considering whether section 1041 can be applied to a transfer to a third party, it is necessary to examine the tax consequences for both spouses. This is because symmetrical treatment of both spouses is necessary to achieve the purposes of section 1041. The transaction in issue in this case is Ms. **Read's** transfer of stock to MMP. This
47 transaction was a corporate redemption that left Mr. **Read** in control of MMP. *47 A substantial body of case law has developed regarding the tax results of such redemptions.

Long before the enactment of section 1041, courts were required to deal with the tax ramifications of a corporate redemption of one shareholder's stock that left a remaining shareholder in control of the redeeming corporation. From one perspective, such a redemption conferred a control benefit on the remaining shareholder. Based on this, the **Commissioner** argued that the corporation's redemption payment constituted a constructive dividend to the remaining shareholder. On the other hand, the postredemption value of the corporation was diminished by the distribution of corporate funds used in the redemption, suggesting that the remaining shareholder may have received no real benefit from the redemption. From this latter perspective, the redemption simply reflects a shareholder's sale of stock to the corporation. Given these considerations, courts have consistently held that a corporate distribution to redeem one shareholder's stock could be treated as a corporate dividend to the remaining shareholder *only* if the redemption transaction satisfied the remaining shareholder's primary and unconditional personal obligation to purchase the stock. See *Arnes v. **Commissioner***, 102 T.C. 522, 527 (1994) (Arnes II); *Edler v. **Commissioner***, T.C. Memo. 1982-67, affd. 727 F.2d 857 (9th Cir. 1984). As we explained in *Edler:*

The issue is whether the stock redemption resulted in a constructive dividend to petitioner. We are faced with the rule that where a corporation redeems stock which its remaining shareholder was obligated to buy, the remaining shareholder receives a constructive dividend. *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947). However, the rule of *Wall* has been limited to those circumstances where the obligation of the purchasing shareholder is both primary and unconditional. *Enoch v. **Commissioner***, 57 T.C. 781 (1972); *Priester v. **Commissioner***, 38 T.C. 316 (1962). If, on the other hand, the corporation redeems stock which the remaining shareholder was not obligated to buy, no constructive dividend is received by that shareholder. *Edenfield v. **Commissioner***, 19 T.C. 13 (1952).

Applying the above rules, certain disparate tax consequences become apparent. When two shareholders own a corporation, there is no practical economic difference between using a stock redemption and using a dividend distribution to the remaining shareholder to fund the acquisition of the selling shareholder's stock. Nevertheless, the tax consequences to the remaining shareholder are profoundly different. A knowledgeable shareholder could negotiate a dedemption by the corporation and escape harsh tax consequences to himself; whereas, a less knowledgeable
48 shareholder *48 might unwilling commit himself to effect the purchase and be threatened with an unintended dividend. Except for the tax consequences, the shareholder's economic positions are identical. Obviously, in this area of the tax law, the form employed is critical and taxpayers are free to choose the form most beneficial to themselves. It is against this background that the rule of *Wall* has been limited to circumstances where the obligation which has been discharged is both primary and unconditional.

[Fn. refs. omitted.]

If a redemption satisfied a primary and unconditional obligation of the remaining shareholder, the remaining shareholder was generally treated as having received a constructive dividend. See *Hayes v. **Commissioner***, 101 T.C. 593, 599 (1993). While the primary and unconditional standard is often referred to as determinative of whether a redemption of one shareholder's stock is a constructive dividend to the remaining shareholder, this is an oversimplification. The standard really determines only whether a redemption of one shareholder's stock should be treated as a corporate distribution to the remaining shareholder.[1] While treating a redemption of one shareholder's stock as a corporate distribution to the remaining shareholder has generally resulted in a finding that the remaining shareholder received a constructive dividend, dividend treatment also depends on the existence of corporate earnings and profits.[2]

The primary and unconditional standard is applicable to stock redemptions required by divorce judgments. For example in *Edler v. **Commissioner**, supra,* a divorce settlement and judgment required a redemption of the wife's corporate shares, leaving the husband in control of the corporation. This Court and the Court of Appeals for the Ninth Circuit found that the redemption required by the "modified" settlement and judgment did not relieve the husband of a primary and unconditional obligation to purchase his wife's stock, and as a result, the husband did not receive a
49 constructive dividend. In *Edler,* the "original" settlement and judgment *49 required the husband to pay his wife for her stock interest. The Court of Appeals for the Ninth Circuit noted that had the "original" divorce settlement and judgment remained in effect, the corporation's redemption payment to the wife would have satisfied the husband's obligation and would have been treated as a dividend to the husband. See *Edler v. **Commissioner**,* 727 F.2d at 860.

Court opinions dealing with taxable years prior to the enactment of section 1041 generally do not discuss the tax treatment of the stockholder whose stock was being redeemed. This was because there was no question that the person whose stock was being redeemed would be taxable on any gain on the sale of his or her stock, regardless of who paid for the stock or whether the remaining shareholder was treated as having received a dividend. The enactment of section 1041 introduced a broad rule of nonrecognition for transfers of property between spouses and former spouses incident to divorce. Section 1041 makes no reference to transfers to third parties. However, temporary regulations issued under section 1041 explain the circumstances in which a spouse's transfer to a third party qualifies as a transfer to which section 1041 applies. See sec. 1.1041-1T(c), Q&A-9, Temporary Income Tax Regs. (Q&A-9), 49 Fed. Reg. 34453 (Aug. 31, 1984).

Q&A-9 does not specifically address a spouse's transfer of stock to the issuing corporation as part of a corporate redemption that was required by a divorce judgment. However, in this case and prior cases, the **Commissioner** has consistently treated Q&A-9 as applying to divorce-related corporate redemptions, and this position has been adopted by the Court of Appeals for the Ninth Circuit in *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992). See also *Hayes v. **Commissioner**, supra,* and *Craven v. United States,* 83 AFTR 2d 99-1268, 99-1 USTC par. 50,336 (N.D. Ga. 1999), in which Q&A-9 was applied to divorce-related redemptions of stock.[3]

One of the purposes for enacting section 1041 was to prevent divorcing spouses from whipsawing the **Commissioner**
50 *50 by taking inconsistent positions on divorce-related transfers. In *Blatt v. **Commissioner**,* 102 T.C. 77, 79 (1994), we explained:

In part, Congress enacted section 1041 to replace the holding in *United States v. Davis,* 370 U.S. 65 (1962), that a divorce-related transfer of property in exchange for the release of marital claims resulted in recognition of gain to the transferor. H. Rept. 98-432, at 1491-1492 (1984). Before the enactment of section 1041, as a result of *Davis,* the transferring former spouse was taxable on a divorce-related transfer of appreciated property to his or her former spouse, and the recipient received a basis in the transferred property equal to its fair market value on the date of transfer. *United States v. Davis, supra.* Thus, the Government was whipsawed if such a transferor did not report any gain on a transfer of appreciated property. Accordingly, in 1984, Congress enacted section 1041 to remedy this whipsaw. H. Rept. 98-432, at 1491-1492 (1984). [Fn. ref. omitted.]

Q&A-9 specifies the way a transaction will be treated for *both* spouses and requires symmetrical results as to those spouses in order to prevent a whipsaw. Under Q&A-9, if a spouse's transfer to a third party qualifies for nonrecognition under section 1041, then she is *treated* as if she transferred the property to the other spouse (nontransferring spouse). Section 1041(b)(2) provides that the nontransferring spouse's basis in the property is the same as the transferring spouse's basis. The nontransferring spouse is then *treated* as having transferred the property to the third party. Thus if Q&A-9 applies to this case, Ms. **Read** will be *treated* as having transferred her stock to Mr. **Read**, and Mr. **Read's** basis in the transferred stock will be the same as Ms. **Read's** — zero. Mr. **Read** will then be *treated* as having transferred the stock to MMP. It follows that the redemption proceeds should be *treated* as having been received by Mr. **Read** who in turn is *treated* as having paid Ms. **Read**.

Pursuant to Q&A-9, a transfer of property to a third party required by a divorce or separation instrument will be treated as qualified under section 1041 only if it is made "on behalf of" the nontransferring spouse. In order to accomplish this regulatory scheme and the statutory goal of eliminating whipsaws, the phrase "on behalf of" must have the same meaning when applied to each of the divorcing spouses.

There is nothing in Q&A-9 to indicate that the **Commissioner** was attempting to, or *could,* change the existing
51 standards for determining whether a corporate redemption of *51 one shareholder's stock could be treated as a distribution to the remaining shareholder. Indeed, Q&A-9 is a temporary regulation intended only to effect the legislative objective of section 1041. Nothing in section 1041, or its legislative history, suggests that it was intended to displace longstanding principles used in determining whether a corporate redemption of one shareholder's stock could be treated as a distribution to the remaining shareholder. In Arnes II, we specifically held that the enactment of section 1041 did not change the primary and unconditional standard for determining whether a redemption of one spouse's stock can result in a constructive dividend to the other spouse. In Arnes II, 102 T.C. at 528, we stated: "The rationale of *Edler* [the primary and unconditional test] was not affected by the enactment of section 1041, and the case is still the law of the Court of Appeals for the Ninth Circuit, to which this case is appealable."[4] That is undoubtedly why all the parties in the instant cases presented their arguments as if the primary and unconditional obligation standard applied for purposes of determining the inextricably related questions of whether Q&A-9 applies and whether the redemption of Ms. **Read's** stock should be treated as a dividend to Mr. **Read**.[5]

Respondent's position is that Mr. **Read** had a primary and unconditional obligation to purchase Ms. **Read's** stock and
that the redemption of Ms. **Read's** stock (a necessary and integral part of which was her transfer of stock to MMP)
satisfied Mr. **Read's** obligation. Mr. **Read**, MMP, and Ms. **Read** agree that the primary and unconditional obligation
standard should be determinative of whether Ms. **Read's** transfer of stock was "on behalf of" Mr. **Read** within the
52 meaning of *52 Q&A-9. On this point, the parties are all correct.[6] The primary and unconditional standard is still
controlling law for determining whether a divorce-related redemption distribution to one shareholder spouse can ever
be a dividend to the remaining shareholder spouse. See Arnes II, *supra.* Because symmetrical treatment is required by
section 1041, it should be obvious that the same primary and unconditional standard must also be the standard for
determining whether Q&A-9 applies to a redemption transaction.

Arnes II was decided for a tax year to which Q&A-9 was applicable. Indeed, the Court of Appeals for the Ninth Circuit had applied Q&A-9 to Mrs. Arnes, giving her the nonrecognition benefit of section 1041. See *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992).[7] Our majority opinion in Arnes II dealt only with whether Mr. Arnes had received a constructive dividend. In Arnes II, we found that the redemption of one spouse's stock could be a constructive dividend to the other spouse only if the redemption satisfied a primary and unconditional obligation of the nontransferring spouse. In Arnes II, the majority opinion expressed no view on whether the primary and unconditional standard had to be met in order for section 1041 and Q&A-9 to apply to a corporate redemption. That opened the possibility that a different standard would be applicable for purposes of giving section 1041 relief to the transferring spouse. This, in turn, opened the possibility that the **Commissioner** could be whipsawed. However, a total of 9 of the 18 Judges who participated in the consideration of Arnes II (including the author of the majority opinion in Arnes II) indicated in concurring and dissenting opinions that section 1041 and Q&A-9 required symmetrical results with respect to both spouses.

The majority now holds that the "on behalf of" requirement in Q&A-9 is satisfied by a standard that is substantially
lower and less precise than the primary and unconditional obligation test of *Edler v.* ***Commissioner,*** T.C. Memo.
53 1982-67, and Arnes II. The majority holds that the "on behalf of" test is satisfied if the transfer was "in the interest *53
of" or was made by the transferring spouse acting "as a representative of" the nontransferring spouse. This standard
presumably could be met if the nontransferring spouse received some general benefit or if the obligation of the
nontransferring spouse was either secondary, conditional, or both. Based on this lower standard, the majority holds
that Ms. **Read** is entitled to rely on section 1041 and, therefore, need not recognize gain on the transfer of her stock.[8]
I believe this is an error.

One of the problems with simply applying the dictionary meaning of "on behalf of" to a divorce-related corporate redemption is that the redemption will usually, in a general sense, be in the interest of both the spouse whose stock is redeemed and the spouse who is the remaining shareholder. For example, the transferring spouse receives money from the corporation in return for her stock. This receipt of money (especially if it represents a substantial gain as in this case) benefits the transferring spouse. Oftentimes the transfer will also generally benefit the spouse who is the remaining shareholder. This is the same dilemma that courts confronted in trying to determine whether a redemption of one shareholder's stock could ever be considered a constructive dividend to the remaining shareholder. As a result, the courts fashioned the primary and unconditional obligation test that we applied in Arnes II. The fact that Ms. **Read's** transfer was simply "in the interest of" Mr. **Read** or that Mr. **Read** received "some general benefit" is an insufficient reason for us to conclude that Mr. **Read** could have a constructive dividend. See *Ingham v. United States,* 167 F.3d 1240 (9th Cir. 1999), where the court explained that a transfer to a third party would not be considered "on behalf of" the other spouse within the meaning of Q&A-9 unless the transfer relieved the other spouse of a "specific legal obligation or liability." *Id.* at 1244. The fact that the other spouse receives "some general benefit" is insufficient. *Id.*

Because Q&A-9 controls the tax treatment of both spouses, a divorce-related corporate redemption transaction should
54 not be considered to be a transfer "on behalf of" the non-transferring *54 spouse within the meaning of Q&A-9 unless
the nontransferring spouse had a primary and unconditional obligation to purchase the redeemed stock.

The majority's error is compounded by concluding that Mr. **Read** must recognize a constructive dividend but failing to give any legal explanation for this result. How could Mr. **Read** have a constructive dividend in light of our prior Court-reviewed opinion in Arnes II, where we said that section 1041 made no change in prior law and held that a redemption of one spouse's stock cannot result in a constructive dividend to the other stockholder spouse, unless the redemption satisfied the latter's primary and unconditional personal obligation to purchase the redeemed shares? This is a problem that the majority refuses to confront. Instead, the majority simply states that Mr. **Read** and MMP "indicated" that if the Court were to find that section 1041 applies to Ms. **Read**, then respondent's determinations regarding Mr. **Read** and MMP should be sustained. The majority's attempt to extricate itself from this dilemma by latching onto an isolated statement in the motion filed by Mr. **Read** and MMP is unjustified by the record and fundamentally unfair.

The "indication" by Mr. **Read** and MMP is taken out of context. The full argument made by Mr. **Read** and MMP is that Q&A-9 cannot apply to a corporate redemption unless the redemption satisfies a primary and unconditional obligation of the nontransferring spouse. They "indicate" that if this standard is met and Q&A-9 applies, then respondent's determinations should be sustained. To take the latter statement out of context after having rejected the argument on which it is predicated is totally unwarranted. In any event, we should never rely upon and apply a party's statement of law that is contrary to a holding contained in a prior Court-reviewed opinion of this Court that is still binding precedent. [9] No matter how convenient it may be to avoid unreconcilable differences in our opinions, justice demands that we decide issues of law that control the outcome of cases that come before us. Today's majority opinion puts in place one legal standard for determining whether a transferring spouse receives the benefits of section 1041 while leaving in
55 place the different and more stringent standard of Arnes II *55 for purposes of determining whether the corresponding tax burdens can be placed on the nontransferring spouse. This opens the door in future cases for both spouses to escape the tax impact of a divorce-related transfer of appreciated property and therefore contravenes one of the purposes of section 1041.

The question we should ask and answer is whether MMP's redemption of Ms. **Read's** stock satisfied a primary and unconditional obligation of Mr. **Read**. If the answer is yes, we should hold that Q&A-9 applies, Mr. **Read** had a constructive dividend, and Ms. **Read** gets the benefit of section 1041. If Mr. **Read** did not have a primary and unconditional obligation to purchase Ms. **Read's** stock, then we should hold that Q&A-9 does not apply, the redemption of Ms. **Read's** stock did not result in a constructive dividend to Mr. **Read**, and Ms. **Read's** transfer of stock to MMP should be treated as a simple redemption resulting in a taxable capital gain to Ms. **Read**.

BEGHE, *J.,* agrees with this dissent.

HALPERN, *J.,* dissenting:

I. *Introduction*

On February 5, 1986, Ms. **Read** disposed of all of her shares of stock in Mulberry Motor Parts, Inc. (the shares and MMP, respectively), by transferring the shares to MMP (the transfer). In consideration thereof, MMP paid Ms. **Read** $200,000 and agreed to pay her an additional $638,724 in installments (with interest). Ms. **Read's** adjusted basis in the shares was zero, and she realized a gain on the transfer. See sec. 1001(a). That gain must be recognized to her unless some nonrecognition provision applies. See sec. 1001(c). Ms. **Read** relies on section 1041(a) to avoid the recognition of gain. Section 1041(a) provides:

SEC. 1041(a). GENERAL RULE. — No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) —

(1) a spouse, or

56 *56 (2) a former spouse, but only if the transfer is incident to the divorce.[1]

Ms. **Read** is an individual, and she claims that no gain is recognized to her since she transferred the shares (property) to her former spouse (Mr. **Read**) incident to their divorce. Mr. **Read** disagrees that the transfer was to him. Ms. **Read** and Mr. **Read** agree that the question of whether the transfer was to him should be answered by determining whether he had a primary and unconditional obligation to purchase the shares. The majority holds that such an inquiry is inappropriate. I disagree. I further disagree with what seems to me to be the majority's evocation of the principles of ***Commissioner** v. Court Holding Co.,* 324 U.S. 331 (1945), to determine whether Ms. **Read** sold the shares to Mr. **Read**.

II. *Bootstrap Acquisitions*

Mr. **Read** acquired virtually complete ownership of MMP without expending any of his own funds. He did so by arranging for MMP to redeem the shares. Such an acquisition, where the acquirer uses funds of the corporation to aid in his acquisition of control, is sometimes referred to as a "bootstrap acquisition". A part owner of a corporation can use the corporation's funds to acquire complete ownership of the corporation in one of two ways. One, he can arrange for the corporation to purchase the seller's shares. Two, he can purchase the seller's shares and cause the corporation to redeem those shares from him. There is no practical difference between those alternatives. In both cases, the seller receives the same amount, and the remaining owner (sometimes, the buyer) becomes the sole owner of the corporation, whose assets are reduced by the same amount. It is well settled, however, that the difference in form between those alternatives may result in different income tax consequences (at least for the buyer). As Professors Bittker and Lokken put it:

If the buyer purchased all of the seller's stock and later recouped some of the cash outlay by causing the corporation to redeem part of the newly acquired stock, the redemption distribution would be a dividend to the extent of earnings and profits because, as a pro rata distribution, it could not meet the standards of §§302(b)(1), (2), or (3). The buyer,
57 however, *57 avoids dividend consequences where the redemption is from the seller unless the buyer makes the mistake of undertaking a personal obligation to purchase the shares before the corporation agrees to redeem them. [3 Bittker & Lokken, Federal Taxation of Income, Estates, & Gifts, par. 93.1.5, at 93-17 (2d ed. 1991).]

Although the form of the acquisition may be tailored to suit the buyer's tax status (a corporate buyer may prefer the dividend treatment that, given sufficient earnings and profits, generally would accompany the redemption of shares purchased from the seller), once it is tailored, the buyer is stuck with the chosen form. In an early leading case, *Wall v. United States,* 164 F.2d 462 (4th Cir. 1947), the taxpayer contracted to purchase stock from a co-shareholder, agreeing to make a cash downpayment and to deliver his notes for the remainder of the purchase price. The taxpayer made the downpayment and received the stock, which he transferred to two trustees, to be held by them as security for the notes. After paying the first note, he transferred his equity in the stock to the corporation and caused it to pay the remaining notes as they became due. The Court of Appeals for the Fourth Circuit had no difficulty in finding that the taxpayer's transfer of his equity to the corporation in consideration of the corporation's assumption of his liability was a redemption of the underlying stock and that the redemption and the payment of the remaining owner's note that became due in the year in question were essentially equivalent to the distribution of a taxable dividend. See *id.*

In a variation on *Wall,* in *Sullivan v. United States,* 363 F.2d 724 (8th Cir. 1966), the Court of Appeals for the Eighth Circuit held that, if a buyer is subject to an executory, primary, and unconditional obligation to purchase the shares of the seller but instead causes the corporation to purchase those shares, the purchase results in a constructive distribution to the buyer, because it discharges his obligation. In *Sullivan,* the Court of Appeals found that, after the transaction was complete, (1) the taxpayer's personal obligation to purchase the stock had been discharged, (2) the taxpayer owned all of the outstanding shares of stock of the corporation, (3) the corporation's assets were decreased by the amount paid to the seller for his stock, and (4) that stock was held by the corporation as treasury stock. See *id.*
58 at 729. Although the Court of Appeals is not explicit on the point, it *58 appears that it considered the taxpayer as having constructively received the stock from the seller, which stock the taxpayer then transferred to the corporation in consideration of the corporation's constructive distribution to him in redemption of that stock. The Court of Appeals

rejected the taxpayer's argument that he had received a distribution in redemption of shares that was a distribution in full payment in exchange for the stock and not a redemption essentially equivalent to a dividend. See *id.* at 729-730.

Thus, if a buyer wishes to accomplish a bootstrap acquisition, the buyer, once having put the *Wall* type format into legally enforceable form, cannot avoid the tax consequences of a redemption from him of the seller's stock by having the corporation pay the seller directly. Nevertheless, if the corporation simply agrees to redeem the seller's stock and pays for the stock in installments, over time, and the payments do not discharge any obligation of the remaining owner, the payments do not constitute constructive distributions to the remaining owner. See *Edenfield v. **Commissioner***, 19 T.C. 13 (1952). That is true even if the remaining owner guarantees performance by the corporation, pledges his shares as security for the deferred payments, or agrees to buy the shares if the corporation defaults. See *id.; Buchholz Mortuaries, Inc. v. **Commissioner***, T.C. Memo. 1990-269; Rev. Rul. 69-608, 1969-2 C.B. 43, 44 (Situation 5).

The logic of the bootstrap acquisition cases leads to the conclusion that, where the buyer has already purchased the seller's stock, as in *Wall v. United States, supra,* or has a primary and unconditional obligation to do so, as in *Sullivan v. United States, supra,* the transfer of that stock to the corporation is in satisfaction of the buyer's obligation to surrender for redemption stock that, actually, in *Wall,* or constructively, in *Sullivan,* he had purchased from the seller. Any transfer by the seller directly to the corporation would, under that logic, be on behalf of the buyer. Contrariwise, if the remaining shareholder has not purchased the seller's stock, and has no obligation to do so, as in *Edenfield v. **Commissioner**, supra,* the transfer to the corporation should not be viewed as on the remaining shareholder's behalf. Since there is no practical difference between the *Wall* and *Edenfield* type formats, the choice of form by the parties to
59 the transaction plays a dominant role in determining the income tax *59 consequences that will follow, and the crucial distinction is whether the corporation satisfies a legal obligation of the remaining shareholder to purchase the redeemed stock. No matter how close a taxpayer comes to undertaking a legal obligation to purchase the redeemed stock, the *Wall* principle should not apply unless that obligation was in fact undertaken. Thus, in *S.K. Ames, Inc. v. **Commissioner***, 46 B.T.A. 1020 (1942), we construed a contract to purchase stock that provided that the taxpayer would "purchase or cause to be purchased" the stock. We held that the promise to "purchase or cause to be purchased" provided several methods for satisfying the obligation created under the contract, and, therefore, the taxpayer incurred no absolute obligation to purchase the stock. See also *Buchholz Mortuaries, Inc., v. **Commissioner**, supra* (contract accorded taxpayers, "or their assigns" right to purchase stock; purchase by corporation (assignee) did not discharge personal and primary obligation of taxpayers); *Bunney v. **Commissioner***, T.C. Memo. 1988-112 (similar). In *Kobacker v. **Commissioner***, 37 T.C. 882 (1962), the taxpayer negotiated to buy all of the capital stock of a corporation. The purchase agreement contained the following paragraph:

> Buyer * * * is to have the right to assign this Agreement to a corporation, thereby releasing Buyer therefrom, and substituting such Corporation in the place of Buyer under this Agreement, with the same force and effect as if this Agreement were originally made with such Corporation, provided that such Corporation shall, by writing, agree to be bound by all of the terms, covenants and conditions of this Agreement. [*Id.* at 885.]

In *Kobacker,* we held that the taxpayer had assumed no personal obligation to purchase the stock under that contract. See *id.* at 896.

The fact that a bootstrap acquisition is incident to a divorce has no bearing on whether the buyer (for convenience, husband) and seller (wife) are held to the form upon which they have agreed. If the husband's obligation to purchase the wife's shares is primary and unconditional, then he is in constructive receipt of those shares notwithstanding that, on his behalf, the wife has transferred them to the corporation. If the husband does not have a primary and unconditional obligation to purchase the wife's shares, then he is not in constructive receipt of those shares, and the
60 *60 wife's transfer of those shares to the corporation is not on his behalf. If, pursuant to section 1041(a), the wife gains a tax advantage from the form settled upon by the parties (or loses a tax advantage if she realizes a loss on the disposition of the shares), then so be it. The bootstrap acquisition rules are fairly well settled and give the parties the flexibility to negotiate a mutually acceptable format for the wife to dispose of her shares. Those rules are consistent with the construction of section 1041(a) set forth in section 1.1041-1T(c), Temporary Income Tax Regs., 49 Fed. Reg.

34453 (Aug. 31, 1984). I see no reason why the primary and unconditional analysis is inappropriate to an analysis of the tax consequences in this and similar cases.

III. *Facts at Hand*

By agreement incorporated into the divorce judgment, Ms. **Read** was obligated to sell the shares to Mr. **Read** or, at his election, MMP or the ESOP plan of MMP (the ESOP). Mr. **Read**, MMP or the ESOP, as the case would be, was obligated to purchase the shares. Payment for the shares was to be made in installments, with Ms. **Read** retaining a security interest in the shares. Mr. **Read** was to guarantee payment of the installments if he elected to have MMP or the ESOP make the payments. Subsequent to the divorce, Mr. **Read** elected to have MMP purchase the shares. Mr. **Read**, Ms. **Read**, and one other individual constituted the board of directors of MMP (the board). By unanimous written consent, the board consented to MMP's purchase of the shares. Subsequently, Ms. **Read** and MMP entered into a stock purchase agreement, and, pursuant thereto, MMP acquired the shares from her.

Since Mr. **Read** had the right to assign his obligation to purchase the shares, I do not believe that his obligation to purchase the shares was primary and unconditional. The facts here are similar to the facts in *S.K. Ames, Inc. v. **Commissioner**, supra*, *Buchholz Mortuaries, Inc. v. **Commissioner**, supra*, and *Bunney v. **Commissioner**, supra*. Therefore, I would find that the transfer was to MMP, and not to (or on behalf of) Mr. **Read**.

The majority finds that the transfer did not satisfy any liability or obligation of Mr. **Read's**. Nevertheless, the majority
61 finds that Ms. **Read** was, in effect, acting as Mr. **Read's** *61 agent in transferring the shares to MMP. Majority op. pp. 36-37. Without citing any authority, the majority appears to be relying on the principles of ***Commissioner** v. Court Holding Co.,* 324 U.S. 331 (1945), where a corporation was taxed on gain on a sale by shareholders of property distributed by the corporation because the corporation went so far toward the sale before the distribution that the sale was in substance made by the corporation.

In *Court Holding Co.,* the Supreme Court said:

The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. [*Id.* at 334; fn. ref. omitted.]

The majority appears to be applying *Court Holding Co.* principles to determine that, in substance, Ms. **Read** sold the shares to Mr. **Read** although, on his behalf, she transferred them to MMP. That is an inappropriate analysis in the bootstrap acquisition area, where there is no practical difference between the two ways of accomplishing the bootstrap acquisition and the only relevant distinction is form, which is manifest by legal rights and duties. See the discussion by professors Bittker and Lokken at 3 Bittker & Lokken, Federal Taxation of Income, Estates, & Gifts, par. 93.1.5, at 93-19 (2d ed. 1991).

IV. *Conclusion*

Since I believe that Ms. **Read** has failed to prove that the transfer was to Mr. **Read**, I would hold section 1041(a) inapplicable and hold that she recognized gain on the transfer. Mr. **Read**, of course, had no item of gross income on account of the transfer.

WELLS and BEGHE, *JJ.,* agree with this dissent.

62 *62 BEGHE, *J.,* dissenting:

As a long-time continuing proponent of the view that the "on behalf of" standard of Q&A-9 applying section 1041 should be equated with the "primary and unconditional obligation" standard of traditional redemption tax law, see *Arnes v.* ***Commissioner****,* 102 T.C. 522, 531-542 (1994) (Beghe, J., concurring); *Blatt v.* ***Commissioner****,* 102 T.C. 77, 85-86 (1994) (Beghe, J., concurring), I have joined the dissenting opinions of Judges Ruwe and Halpern. However, I write on to express my own views of how the cases of Mr. and Ms. **Read** should be decided and to try to provide some perspective on the variety of expressed views about the decisions and their governing rationales.

Two preliminary observations are in order.

First, it is not accurate to say, as does the majority opinion: "Respondent's role here is that of a stakeholder"[1] (majority op. p. 25). Mr. **Read** and MMP have much more at stake than Ms. **Read** because the combined deficiencies of Mr. **Read** and MMP substantially exceed Ms. **Read's** deficiencies:[2] Ms. **Read** has already reported the interest portion of the deferred payments; Ms. **Read's** only adjustments in issue stem from her failure to include the principal payments in taxable gain for 1989 and 1990. Mr. **Read's** deficiencies arise from respondent's inclusion in his ordinary
63 income as dividends *63 of both principal and interest payments on the stock purchase for 1988, 1989, and 1990.[3] Mr. **Read** also suffers the indirect financial burden of the disallowance of the interest deductions claimed by MMP for the same years.[4] I note, without further comment, as does the majority opinion (*id.*), that "respondent has indicated that `Ms. **Read** has the better argument that she should not recognize any gain from the sale of her stock pursuant to I.R.C. § 1041.'"

Second, about the procedural settings on appeal: An appeal in Ms. **Read's** case would go to the Court of Appeals for the Ninth Circuit; Mr. **Read's** appeal would go to the Court of Appeals for the Eleventh Circuit. Therefore, a whipsaw of respondent is not out of the picture, irrespective of how we decide the cases of Mr. **Read** and Ms. **Read**.[5]

It has been difficult to reach consensus about how to write up this case, much less decide it, because one or another of four different approaches might be used to determine the relationship of the "on behalf of" and "primary and unconditional obligation" standards. A summary and comment follow on each of the possible approaches.

(1) My continuing view is that the "primary and unconditional obligation" standard of traditional redemption tax law and the "on behalf of" standard of Q&A-9 should be construed and applied consistently; redemption tax law should govern the interpretation and application of the "on behalf of" standard. The correct application of this view in the case at hand
64 would result in no taxable income to Mr. **Read** because he never had the primary *and* unconditional obligation *64 to purchase the stock; he was entitled under both the settlement agreement and the divorce decree to lay his purchase obligation off on MMP, which he did. See *Enoch v.* ***Commissioner****,* 57 T.C. 781 (1972); *Kobacker v.* ***Commissioner****,* 37 T.C. 882 (1962); Rev. Rul. 69-608, 1969-2 C.B. 43, 44 (Situation 6). Furthermore, MMP became primarily and unconditionally obligated to purchase and pay for the stock, notwithstanding that Ms. **Read** became entitled to Mr. **Read's** guaranty — his secondary obligation — and a pledge of the redeemed shares to secure the satisfaction of MMP's obligation. See *Bennett v.* ***Commissioner****,* 58 T.C. 381 (1972); *Edenfield v.* ***Commissioner****,* 19 T.C. 13 (1952).

The Reads' settlement agreement and divorce decree, which tied the amounts of Mr. **Read's** obligation to make periodic alimony payments to initial and continued compliance with the provisions for payment for Ms. **Read's** stock, did not saddle Mr. **Read** with the primary and unconditional obligation to purchase and pay for Ms. **Read's** stock.[6] The obligation to purchase and pay for her stock was assigned to and assumed by MMP as its primary and unconditional obligation.

(2) Judges Laro and Marvel believe that Q&A-9 just does not apply to redemptions. Adoption of this approach could cause both individual parties to a redemption of the stock of a divorcing spouse to incur tax liability if they are not well advised. In most cases the departing shareholder ex-spouse would recognize capital gain on the transaction that terminates his or her stock interest. Whether the remaining shareholder ex-spouse has a dividend would depend on whether he or she is considered as having the primary and unconditional obligation to purchase the departing shareholder's stock that was satisfied by the redemption.

If the remaining shareholder is considered to have had his primary and unconditional obligation to purchase the stock satisfied by the redemption, then under general principles of tax law the redemption should be recast as a purchase of
65 the *65 stock by the remaining shareholder, followed by his contribution of the stock to the corporation in exchange for the cash that he constructively received and used to purchase the stock. This recast transaction results in a distribution of cash essentially equivalent to a dividend to him under sections 301 and 302(b)(1), and the departing shareholder ex-spouse should be entitled to nonrecognition of gain under section 1041.

(3) In Judge Colvin's view, the "on behalf of" standard of Q&A-9 trumps traditional redemption tax law. I don't favor this view because it results in almost all cases under current law in a greater total tax liability to the private parties. Its adoption would mean that less will be available to pay off the departing shareholder ex-spouse.[7] However, Judge Colvin's view provides clear and consistent treatment of the ex-spouses and is preferable to the majority opinion. Adoption of Judge Colvin's view by a majority of the Court would provide clear guidance as to how we would resolve the treatment of both private parties in this type of consolidated case.

(4) Maybe the "on behalf of " and "primary and unconditional obligation" standards, in a hard-fought consolidated case with no improvident concession by either private party, can be so applied that both ex-spouses escape tax.[8] Both traditional redemption tax law and section 1041 reflect the same policy of facilitating transactions by removing tax impediments. Maybe respondent, instead of being a putative stakeholder, is left holding an empty bag! I don't think so.

Some concluding thoughts: the parties' motions and memos in the case at hand leave the impression that Mr. **Read's** indication — he loses if Ms. **Read** wins — was based on what the majority opinion now tells the parties was their mistaken belief about the applicable legal standard. If we are not going to adopt the view that the "on behalf of" and
66 "primary and *66 unconditional obligation" standards are to be applied consistently, so that there need not be a winner and a loser as between the ex-spouses, then Mr. **Read** should not be bound by his "indication". My objective in making this suggestion, against the background of what we said and did in *Blatt v. **Commissioner,*** 102 T.C. 77 (1994), *Hayes v. **Commissioner,*** 101 T.C. 593 (1993), and *Arnes* and our unsuccessful efforts to reach agreement in this case, is to resolve it in a way that will result in a holding on the merits of the cases of both ex-spouses that will provide comprehensive guidance for future cases. The parties and their counsel and the public and the tax bar, who are looking to us for guidance in this recurring situation, deserve no less.

Unfortunately, the majority opinion's rejection of a rule of equivalence perpetuates the uncertainty. What "every schoolboy knows," cf. *State Pipe & Nipple Corp. v. **Commissioner,*** T.C. Memo. 1983-339, about how to avoid constructive dividend treatment to the remaining shareholder under traditional redemption tax law will continue, as a result of the variety of views expressed, to fail to provide the guidance that the divorcing spouses and their advisers deserve and need.

I renew my pleas for guidance in the form of an interpretative regulation or a congressional fix. See *Arnes v. **Commissioner,*** 102 T.C. at 542 n.10.

LARO and MARVEL, *JJ.,* dissenting:

The majority holds today that section 1.1041-1T(c), Q&A-9 (Q&A-9), Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984), permits a spouse[1] to avoid recognizing gain which she realized from a redemption of her stock in connection with her divorce. Because we do not believe that section 1041, either textually or as interpreted in Q&A-9, applies to stock redemptions incident to divorce, we respectfully dissent.

We summarize the critical facts of this case as follows. In connection with his divorce from Ms. **Read**, Mr. **Read** agreed to purchase Ms. **Read's** stock in MMP at a stated price, or, at his election, to cause MMP to redeem Ms. **Read's** stock.
67 Mr. **Read** elected under the terms of their divorce judgment to *67 cause MMP to redeem the stock in his stead. MMP authorized the redemption and entered into a binding stock purchase agreement with Ms. **Read**. Pursuant to that agreement, in 1986, MMP redeemed Ms. **Read's** stock, paid Ms. **Read** $200,000 toward the redemption price, and

issued Ms. **Read** a promissory note representing the balance of the redemption price. MMP paid Ms. **Read** $50,000 of the promissory note's principal during each year in issue.

The majority concludes that Ms. **Read** is not taxable on the subject gains resulting from her transfer of stock to MMP. The majority reasons that "Q&A-9 applies to Ms. **Read's** February 5, 1986, transfer of MMP stock and * * *, pursuant to section 1041(a), no gain shall be recognized by Ms. **Read** as a result of that transfer." Majority op. p. 38. The majority fails to discuss persuasively the fact that not only did Ms. **Read** transfer her stock to MMP, but that MMP paid her for that stock as well, nor does the majority explain persuasively why the capital gain that Ms. **Read** realized on the sale of her stock to a third party (MMP) is excluded from her gross income by virtue of either: (1) A statutory provision (section 1041) that applies only to transfers *between* spouses or (2) a regulatory provision (Q&A-9) that extends section 1041's reach to certain transfers *to* third parties on behalf of a spouse.

Congress enacted section 1041 in 1984. Before that time, an interspousal transfer of property for adequate consideration was a taxable transaction for Federal income tax purposes; a transferring spouse was taxed on a transfer of appreciated property to his or her spouse, and the recipient spouse received a basis in the transferred property equal to its fair market value on the date of transfer. See *United States v. Davis,* 370 U.S. 65 (1962). Congress enacted section 1041 to change that result. See H. Rept. 98-432 (Part 2), at 1491-1492 (1984). As enacted, section 1041 applies to defer the recognition of gain or loss on an interspousal transfer of property until the time that the recipient spouse transfers the property outside of the marital economic unit consisting of both spouses together. See *Blatt v. **Commissioner***, 102 T.C. 77, 79-80 (1994). There is nothing in the text of section 1041 that suggests section 1041 applies to cases such as this where one spouse transfers property to a third party and receives payment in return.

68 *68 The **Commissioner** issued temporary regulations under section 1041 pursuant to his general regulatory authority to "prescribe all needful rules and regulations for the enforcement of this title". Sec. 7805(a). These temporary regulations consist solely of section 1.1041-1T, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984), which, in turn, consists of 18 groups of a question and an answer. In one of these groups, namely, Q&A-9, the **Commissioner** set forth his position that section 1041 reaches certain "transfers of property to third parties on behalf of a spouse". Q&A-9 provides:

Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

Nowhere in Q&A-9, or, for that matter, in any of the other Q&A's, do we **read** that a gain arising from a spouse's sale of assets to a third party qualifies for nonrecognition treatment under section 1041. As we understand the majority opinion, a spouse such as Ms. **Read** does not have to recognize the gain from the redemption of her stock by virtue of section 1.1041-1T(c), Q&A-10 (Q&A-10), Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984). We disagree. Although Q&A-10 does state that "The transferor of property under section 1041 recognizes no gain or loss on the transfer even if the transfer was in exchange for the release of marital rights or other consideration", nothing in
69 that Q&A (or in *69 any of the other Q&A's) extends that nonrecognition treatment to a transfer of property that is in

essence a sale of stock by a spouse to a third party. Q&A-10 simply addresses interspousal transfers of property which otherwise would be considered sales for Federal income tax purposes; i.e., when one spouse transfers stock to the other spouse in exchange for its value in cash.

As we understand the breadth of Q&A-9, with a fair reading of our reviewed opinion in *Blatt v. **Commissioner***, 102 T.C. 77 (1994), in mind, Q&A-9 does not reach a transfer of property by a spouse to a third party where the transfer is, in substance and in form, a sale to the third party. Rather, we believe, Q&A-9 is limited to those situations in which a spouse transfers property to a third party in satisfaction of an obligation that is owed (or a gift that is made) by the nontransferring spouse to the third party. In the latter cases, Q&A-9 operates to tax the nontransferring spouse on the transfer to the third party, if and to the extent that the transfer is taxable, as if the nontransferring spouse had first received a gift of the property from the transferring spouse. Q&A-9 says nothing about affording similar treatment to any proceeds which are received by a transferring spouse from a third party pursuant to the property transfer.

While it is true that Q&A-9 recognizes that some transfers of property by a spouse to a third party may qualify for nonrecognition treatment under section 1041, Q&A-9 requires that the transfers must be "on behalf of" the transferor's spouse. The majority essentially takes the position that Ms. **Read's** transfer of stock to MMP was on Mr. **Read's** behalf because, the majority concludes, the redemption benefited him. We disagree. In this case, Ms. **Read's** transfer of stock to MMP was on her own behalf since it allowed her to cash out her interest in MMP at its appreciated value (and it allowed her to do so, under the majority's view, without any tax implications to her).

The critical fact is that Mr. **Read** had no obligation to MMP that was satisfied by Ms. **Read's** transfer of her stock to MMP. Thus, although Ms. **Read** may have transferred her stock to MMP at the direction of Mr. **Read**, we do not believe that she did so "on behalf of" him. In *Blatt,* we held that the redemption of Ms. Blatt's stock pursuant to a
70 divorce decree was not on behalf of Mr. Blatt because Ms. Blatt failed to prove the *70 redemption satisfied an obligation of his. See *Blatt v. **Commissioner**,* 102 T.C. at 81-82. We set forth an example on the top of page 81, wherein we stated that Q&A-9 operates when "H owes a debt to a bank, and W, as part of a divorce settlement, transfers her unencumbered appreciated stock to the bank in discharge of H's debt." We stated that the redemption in *Blatt* was outside of Q&A-9 because "The redemption, in form, was a transaction between petitioner [Ms. Blatt] and corporation; she transferred her stock to corporation in exchange for its appreciated value in cash. * * * A transfer that satisfies an obligation or a liability of someone is a transfer on behalf of that person". *Id.*

The only reported opinion in which this Court has decided whether a corporate redemption incident to a divorce qualified for nonrecognition treatment under section 1041 is *Blatt.* There, as mentioned above, we held that the redemption did not qualify under Q&A-9. We recognized that the Court of Appeals for the Ninth Circuit had afforded nonrecognition treatment to a spouse who had transferred her shares to a corporation pursuant to a divorce, see *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992), but we stated that we disagreed with the opinion of the Court of Appeals for the Ninth Circuit. We stated in *Blatt* that "any putative benefit to [Mr.] Blatt [the nontransferring spouse], such as relief from a possible claim under marital property distribution laws, does not mean that the transfer by petitioner [Ms. Blatt] of her shares to corporation was on behalf of [Mr.] Blatt." *Blatt v. **Commissioner**,* 102 T.C. at 83. But for the Court of Appeals for the Ninth Circuit, we are unaware of any Court of Appeals that has addressed the issue of whether a corporate redemption qualifies under Q&A-9.

We conclude with a final concern about the analysis set forth in the majority opinion. Congress enacted section 1041, in part, to remedy the "whipsaw" that occurred when one spouse failed to report his or her gain on the transfer of appreciated property to the other spouse; the Government was whipsawed because the transferee's basis in the transferred property equaled its fair market value, and the transferor, to the extent that the section 6501 period of limitations had closed, never paid any Federal income tax on the appreciated value underlying that increased basis.
71 See *id.* at 79. Although the majority avoids this "whipsaw" in the instant *71 cases by concluding that Mr. **Read** conceded he was liable for Federal income tax on the redemption, we do not agree that Mr. **Read's** position in this case was a concession of liability or should be treated as one. Mr. **Read's** position was based on a legal analysis that the majority rejects. Mr. **Read** should not be held to that position after the legal principles on which his position was

based are turned aside by the majority, particularly since the tax result to Mr. **Read** may change as a result of their analysis.

But for his "concession", the majority would have had to analyze the tax effect of the redemption on Mr. **Read**. Q&A-9 states that the nontransferring spouse is taxed on the third party transfer; it does not specify when this tax arises. If, in fact, section 1041 applies to the redemption, as the majority concludes, then, under general income tax principles, Mr. **Read** is treated as receiving a dividend which arguably is taxable to him in 1986, the year of the redemption, rather than in the years in issue as held by the majority. See secs. 301(a), (b)(1), (c), and (d) and 302(d). See generally Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 8.23 (1999 Cum. Supp. 1).[2] Thus, under this argument, Mr. **Read's** dividend is taxable to him in a year that most likely is closed by the section 6501 period of limitations. Under the majority's analysis, therefore, the Government may be faced once again with the very same "whipsaw" that Congress intended to remedy through the enactment of section 1041. Although the majority sidesteps this issue in this case by holding that Mr. **Read** conceded his tax liability as to the subject payments, that "concession" only applies to the subject years. We see no judicial or equitable reason why Mr. **Read** will be precluded from arguing in the future that the payments which he receives on the promissory note in other years (with the exception of 1986) are not taxable to him in those years because they were properly taxable to him in 1986, the year of the redemption.

72 *72 THORNTON, *J.,* agrees with this dissent.

[1] Cases of the following petitioners are consolidated herewith: Mulberry Motor Parts, Inc., docket No. 19322-97, and William A. **Read**, docket No. 19328-97.

[2] Ms. **Read** incorrectly characterized her motion as a motion for summary judgment. However, in addition to the determination in the notice of deficiency (notice) issued to Ms. **Read** that we address in this Opinion, respondent made two other determinations in that notice, one of which respondent conceded and the other of which is computational. Consequently, we have recharacterized Ms. **Read's** motion as a motion for partial summary judgment.

[3] All Rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code in effect for the years at issue.

[4] Under Florida law, any action which is required to be, or may be, taken at a meeting of the directors of a corporation may be taken without a meeting of such directors provided that a consent in writing setting forth the action to be taken is signed by *all* of the directors and is filed in the minutes of the proceedings of the board of directors. Any such action by unanimous written consent of each director has the same effect as a unanimous vote of the board of directors. See Fla. Stat. Ann. sec. 607.134 (West 1977) (current version at Fla. Stat. Ann. sec. 607.0821 (West 1993)). By executing the document entitled "ACTION BY WRITTEN CONSENT OF THE BOARD OF DIRECTORS OR MULBERRY MOTOR PARTS, INC.", the three directors of MMP obviated the requirement under Florida law to hold a meeting at which such directors could adopt, by a majority vote, a resolution authorizing MMP, inter alia, to repurchase all of Ms. **Read's** MMP stock. See Fla. Stat. Ann. sec. 607.121 (West 1977) (current version at Fla. Stat. Ann. sec. 607.0824 (West 1993 & Supp. 1999)).

[5] The notice issued to Ms. **Read** did not relate to Ms. **Read's** taxable year 1988.

[6] The parties stipulated that Ms. **Read's** basis in the MMP stock that she owned was zero.

[7] Mr. **Read** and MMP indicated in their motion that if the Court were to hold that sec. 1041 applies to Ms. **Read's** transfer of her MMP stock to MMP, the determinations in the respective notices issued to Mr. **Read** and to MMP should be sustained.

[8] For convenience, we shall refer only to a spouse, and not to a former spouse.

[9] We had consolidated the cases of Ms. Hayes and Mr. Hayes for trial, briefing, and opinion.

[10] Any suggestion in *Hayes v. **Commissioner***, 101 T.C. 593 (1993), that the **Commissioner's** concession under sec. 1041 as to Ms. Hayes is confirmed by Q&A-9 is dictum.

[11] Ms. Arnes was the taxpayer before the U.S. Court of Appeals for the Ninth Circuit in *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992), discussed below.

[12] We stated in n. 3 referred to in the foregoing excerpt from *Arnes v. **Commissioner***, 102 T.C. 522, 529 n.3 (1994):

This majority opinion does not express an opinion as to whether the standard of "on behalf of" the spouse in sec. 1.1041-1T(c), Q&A-9, Temporary Income Tax Regs. * * * is the same as the primary and unconditional obligation rule applicable to a constructive dividend. Suffice it to say that our conclusion in this case [*Arnes v.* ***Commissioner****, supra*] is consistent with our conclusion in *Blatt v.* ***Commissioner****,* 102 T.C. 77 (1994), also a Court-reviewed opinion.

[13] Unlike the divorce judgment involved in the instant cases, the divorce decree in *Arnes v.* ***Commissioner****, supra,* provided that Ms. Arnes and Mr. Arnes were to cause Moriah to redeem from Ms. Arnes her Moriah stock. See *id.* at 524.

[14] The issue in *Arnes v. United States, supra,* was whether the redemption of Ms. Arnes' Moriah stock pursuant to the divorce decree involved there constituted a transfer of property by Ms. Arnes, the taxpayer before the Court of Appeals for the Ninth Circuit in that case, to a third party on behalf of Mr. Arnes within the meaning of Q&A-9. The Court of Appeals for the Ninth Circuit, the court to which an appeal in Ms. **Read's** case would normally lie, noted, inter alia, that "Generally, a transfer is considered to have been made `on behalf of' someone if it satisfied an obligation or a liability of that person." *Id.* at 459. On the facts presented, that court held that the transfer by Ms. Arnes of her Moriah stock to Moriah "did relieve John [Mr. Arnes] of an obligation", *id.,* and that that transfer constituted a transfer to a third party on behalf of Mr. Arnes under Q&A-9, see *id.*

In *Ingham v. United States,* 167 F.3d 1240 (9th Cir. 1999), the Court of Appeals for the Ninth Circuit revisited the meaning of the phrase "transfer of property to a third party on behalf of a spouse" in Q&A-9. In *Ingham,* the Court of Appeals rejected the taxpayer's expansive definition of that phrase, which included "all transfers of property that result in a substantial benefit, in any form, to the nontransferring or former spouse", because it found such a definition to be inconsistent with *Arnes v. United States, supra.* According to the Court of Appeals in *Ingham v. United States, supra* at 1244:

The focus of the court's analysis in *Arnes* [*v. United States, supra*] was not whether the plaintiff's [transferring spouse's] former husband had received some general benefit as a result of the plaintiff's transaction, but rather whether the transaction had satisfied some legal obligation or liability owed *by* her former husband. * * *

The Court of Appeals held in *Ingham v. United States, supra,* that, because the taxpayer's sale in question to a third party did not satisfy any such obligation or liability of the taxpayer's former spouse, the taxpayer was not entitled to nonrecognition treatment with respect to that sale under sec. 1041. See *id.* at 1245.

[15] We stated in *Blatt v.* ***Commissioner****,* 102 T.C: 77, 83 (1994):

we disagree with *Arnes;* any putative benefit to Blatt, such as relief from a possible claim under marital property distribution laws, does not mean that the transfer by petitioner of her shares to [Phyllograph] corporation was on behalf of Blatt. We note, however, that the facts in *Arnes* are easily distinguishable from the facts at hand. * * *

[16] Nor did we indicate in *Blatt v.* ***Commissioner****, supra,* that the common, ordinary meaning (i.e., the dictionary definition) of the phrase "on behalf of" which we cited with approval and on which we relied in that case is to be applied for purposes of Q&A-9 only to factual contexts that were not even involved in *Blatt,* i.e., to factual contexts *other than* corporate redemptions. In addition, we did not indicate in *Blatt* that the additional meaning of the phrase "a transfer [of property] on behalf of" someone which we cited with approval and on which we relied in that case, i.e., "A transfer [of property] that satisfies an obligation or a liability of someone", is the only meaning that can be attributed to the on-behalf-of standard in Q&A-9 in the context of corporate redemptions.

[17] Instead, we gave the following illustration:

To illustrate the operation of Q&A-9, assume that H owes a debt to a bank, and W, as part of a divorce settlement, transfers her unencumbered appreciated stock to the bank in discharge of H's debt. This transfer falls within the first "situation" described in Q&A-9; that is, the transfer is required by a divorce instrument and is made by W on behalf of H. * * * [*Blatt v.* ***Commissioner****, supra* at 81.]

[18] Nor did we conclude in *Blatt v.* ***Commissioner****, supra,* as has been suggested, that Q&A-9 may never apply to a corporate redemption in a divorce setting. To the contrary, as discussed above, we concluded in *Blatt* that Ms. Blatt could have established that she made a transfer of property to a third party on behalf of Mr. Blatt within the meaning of Q&A-9 if she had shown that at the time she transferred to Phyllograph her stock in that company (1) she was acting in the interest of Mr. Blatt, (2) she was acting as his representative, or (3) the transfer of her Phyllograph stock to that corporation satisfied an obligation or a liability of Mr. Blatt. See *id.* at 82 & n.12. If we had concluded in *Blatt* that, as a matter of law, Q&A-9 and sec. 1041 may never apply to a corporate redemption in a divorce setting, we would have expressly so stated. We did not.

The Court of Appeals for the Ninth Circuit in *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992), held that Q&A-9 and sec. 1041 applied in the case of a corporate redemption in a divorce setting. Although in *Blatt* we expressed our disagreement with the holding in *Arnes v. United States, supra,* our disagreement with that holding was not based upon our conclusion that, as a matter of law, Q&A-9 and sec. 1041 may never apply in the case of a corporate redemption in a divorce setting. See *Blatt v. **Commissioner**, supra.*

[19] Consequently, we need not resolve the parties' dispute over whether the primary-and-unconditional-obligation standard is satisfied as to Mr. **Read**.

[20] Our holdings that the primary-and-unconditional-obligation standard is not an appropriate standard to apply under Q&A-9 in the instant cases, or in any case involving a corporate redemption in a divorce setting, do not disturb constructive-dividend decisional law. That law applies the primary-and-unconditional-obligation standard in order to determine in the case of a corporate redemption the tax consequences to a stockholder whose stock is *not* being redeemed and who is analogous to the nontransferring spouse under Q&A-9 and sec. 1041 in the case of a corporate redemption in a divorce setting. Constructive-dividend decisional law does not apply the primary-and-unconditional-obligation standard to determine the tax consequences to the stockholder whose stock *is* being redeemed and who is analogous to the transferring spouse under Q&A-9 and sec. 1041 in the case of a corporate redemption in a divorce setting. In contrast, sec. 1041 prescribes the tax consequences to the transferring spouse of a transfer of property by that spouse to the nontransferring spouse. Q&A-9 addresses a transfer of property by the transferring spouse to a third party on behalf of the nontransferring spouse. In the case of such a transfer, Q&A-9 and sec. 1041 provide nonrecognition treatment to the transferring spouse whose stock is being redeemed (provided that the other requirements of Q&A-9 and sec. 1041 are satisfied). In the case of a corporate redemption in a divorce setting, Q&A-9 and sec. 1041 do not address the tax consequences to the nontransferring spouse whose stock is *not* being redeemed, although Q&A-9 makes it clear that if that temporary regulation applies, the nontransferring spouse is deemed to have immediately transferred to a third party, in a transaction that does not qualify for nonrecognition treatment under sec. 1041, the property that such spouse is deemed to have received from the transferring spouse. However, neither Q&A-9 nor sec. 1041 prescribes the tax consequences to the nontransferring spouse as a result of that deemed transfer. Instead, that tax treatment is determined by other provisions of the Internal Revenue Code.

[21] The inquiry under constructive-dividend decisional law as to whether a transfer of redemption proceeds by the redeeming corporation to the redeeming stockholder satisfies a primary and unconditional obligation of another stockholder is intended to determine whether such a transfer, in substance, is (1) a payment by the redeeming corporation of a dividend to the stockholder whose stock is not being redeemed in an amount equal to such redemption proceeds and (2) an immediate transfer of that same amount by such stockholder to the stockholder whose stock is being redeemed in payment for such stock.

[22] The inquiry under Q&A-9 as to whether a transfer of property by the transferring spouse to a third party is made on behalf of the nontransferring spouse is intended to determine whether such a transfer, in substance, is (1) a transfer by the transferring spouse of property to the nontransferring spouse and (2) an immediate transfer of that property by the nontransferring spouse to the third party.

[23] It has been suggested that the primary-and-unconditional-obligation standard should be adopted as the only standard for determining whether the on-behalf-of standard in Q&A-9 is satisfied in the case of a corporate redemption in a divorce setting because the primary-and-unconditional-obligation standard has served well in distinguishing between the form and substance of corporate redemptions occurring in commercial settings. If that suggestion is intended to mean that adoption of the primary-and-unconditional-obligation standard by the courts has eliminated, or substantially minimized, litigation over whether a stockholder whose stock is not being redeemed receives a constructive dividend as a result of the redemption of the stock of another stockholder, we disagree with that suggestion. The determination of whether the primary-and-unconditional-obligation standard has been satisfied is a fact-intensive inquiry, which has engendered much litigation in which the parties have disputed whether that standard is met as to the stockholder whose stock is not being redeemed. Indeed, in the instant cases, the parties disagree over whether that standard is met as to Mr. **Read**.

[24] In support of their position that Ms. **Read's** transfer of her MMP stock to MMP does not satisfy the on-behalf-of standard in Q&A-9, Mr. **Read** and MMP contend, inter alia, that "Mr. **Read** would not be obligated [under the divorce judgment] to purchase Ms. **Read's** [MMP] stock unless he affirmatively elected to purchase the stock". We find that contention of Mr. **Read** and MMP to be contrary to the plain language of the divorce judgment and a strained and unreasonable construction thereof. The divorce judgment obligated Ms. **Read** to transfer to Mr. **Read**, and Mr. **Read** to purchase from Ms. **Read**, her MMP stock. No condition had to be satisfied under that judgment in order for those obligations to exist. The divorce judgment did permit Mr. **Read** to elect to have Ms. **Read** transfer her MMP stock to MMP or to MMP's ESOP, instead of to him, and to have MMP or MMP's ESOP, instead of him, purchase that stock from her. Mr. **Read** decided to, and did, make that election.

[25] During the trial in the marriage dissolution action that Ms. **Read** instituted against Mr. **Read**, Ms. **Read** and Mr. **Read** reached an oral agreement referred to herein as the marital settlement agreement. The Florida court ratified and approved that agreement in the divorce judgment and ordered Ms. **Read** and Mr. **Read** to comply with the terms of that agreement. The marital settlement agreement provided in pertinent part:

Wife [Ms. **Read**] agrees to convey to husband [Mr. **Read**] all of her stock in Mulberry Motor Parts, both voting and non-voting. And for such stock, husband, or at his option, Mulberry Motor Parts or the Aesop [sic] plan of Mulberry Motor Parts agrees to purchase such stock at its appraised value * * *.

Thus, the marital settlement agreement required (1) Ms. **Read** to transfer her MMP stock to Mr. **Read** and (2) Mr. **Read** to pay Ms. **Read** a specified amount of consideration for that stock. That agreement also gave Mr. **Read**, and only Mr. **Read**, the option of deciding that MMP or MMP's ESOP, instead of him, pay that consideration to Ms. **Read**.

[26] It has been suggested that Ms. **Read's** transfer of her MMP stock to MMP was in the interest of Ms. **Read**, and not in the interest of Mr. **Read**, in that Ms. **Read** wanted or preferred to have MMP, rather than Mr. **Read**, purchase her stock because in that event she would have received from MMP cash and MMP's note that was guaranteed by Mr. **Read**, rather than merely cash and a note from Mr. **Read**. Such a suggestion assumes that the financial condition of MMP was better than the financial condition of Mr. **Read** at the time of Ms. **Read's** Feb. 5, 1986 transfer of MMP stock and that Ms. **Read** wanted or preferred to have MMP, rather than Mr. **Read**, purchase her MMP stock. The record does not support either of those assumptions. In fact, we infer from the record that Mr. **Read's** financial condition at the time of Ms. **Read's** Feb. 5, 1986 transfer of MMP stock was better than the financial condition of MMP. That is because under the divorce judgment the note that Mr. **Read** was obligated to transfer to Ms. **Read** (along with a stated amount of cash) in order to pay her for her MMP stock was not required to be guaranteed by MMP. We also infer from the record that Ms. **Read** did not want or prefer that MMP, instead of Mr. **Read**, purchase her MMP stock. If Ms. **Read** wanted or preferred to have MMP, rather than Mr. **Read**, purchase her MMP stock, we believe that Ms. **Read** would have negotiated a property settlement that would have been reflected in the divorce judgment under which (1) Ms. **Read** would have been required to sell her MMP stock to MMP and MMP would have been required to give her cash and a note that was guaranteed by Mr. **Read** or (2) Ms. **Read** would have been required to sell her MMP stock to Mr. **Read** and MMP would have been required to guarantee the note that Mr. **Read** issued to Ms. **Read** (along with cash) in order to pay her for her MMP stock. At a minimum, if Ms. **Read** wanted or preferred to sell her MMP stock to MMP, instead of to Mr. **Read**, Ms. **Read** would have negotiated a property settlement that would have been reflected in the divorce judgment under which Ms. **Read**, and not Mr. **Read**, would have been given the option of requiring (1) that she sell her MMP stock to MMP and (2) that MMP, and not Mr. **Read**, give her cash and a note that was guaranteed by Mr. **Read**. The record in the instant cases is clear: the only reason Ms. **Read** transferred her MMP stock to MMP was that Mr. **Read** wanted, and directed, her to do so by electing that she transfer that stock to MMP.

Even assuming arguendo that Ms. **Read's** transfer of her MMP stock to MMP was in the interest of Ms. **Read**, and not in the interest of Mr. **Read**, a suggestion that is not supported and is in fact rejected by the record in the instant cases, Ms. **Read** was nonetheless acting as Mr. **Read's** representative—another common, ordinary meaning of the phrase "on behalf of" — in making that transfer to MMP. That is because she was following and implementing Mr. **Read's** direction as reflected in his election under the divorce judgment that she transfer her MMP stock to MMP, which stock, absent Mr. **Read's** direction, Ms. **Read** was obligated to transfer to Mr. **Read**.

[27] We have considered all of the contentions and arguments of Mr. **Read** and MMP that are not discussed herein and find them to be without merit and/or irrelevant to our resolution of whether Q&A-9 and sec. 1041 apply to Ms. **Read's** transfer of her MMP stock to MMP.

[1] Compare, e.g., *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992) (Arnes I), with *Arnes v.* ***Commissioner****,* 102 T.C. 522 (1994) (Arnes II).

[2] Sec. 1041(a) and (c) provides as follows:

SEC. 1041. TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

(a) GENERAL RULE. — No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) —

(1) a spouse, or

(2) a former spouse, but only if the transfer is incident to the divorce.

* * * * * * *

(c) INCIDENT TO DIVORCE. — For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer —

(1) occurs within 1 year after the date on which the marriage ceases, or

(2) is related to the cessation of the marriage.

[3] Sec. 1041 also applies broadly to transactions between nondivorcing spouses, but that situation is not present in the instant cases.

[4] Sec. 1.1041-1T(c), Q&A-9, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984), provides:

Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. * * * In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

[5] Sec. 1041(b) provides:

SEC. 1041(b). TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS.—In the case of any transfer of property described in subsection (a)—

(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

[6] See Arnes I, 981 F.2d at 459, where the U.S. Court of Appeals for the Ninth Circuit used an analysis similar to the see. 1041(b) -Q&A-9 analysis described here; that is, the court treated the transferring spouse as having constructively transferred her stock to the nontransferring spouse, who then transferred the stock to the corporation.

[7] If sec. 1041 and Q&A-9 apply, the transferring spouse recognizes no gain or loss under sec. 1041(a) on that spouse's actual or deemed transfer of property to the nontransferring spouse. This is true even if the transferring spouse receives or is deemed to receive consideration from the nontransferring spouse for that property. See sec. 1.1041-1T(c), Q&A-10, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984). Under sec. 1041(b), the nontransferring spouse (here, Mr. **Read**) who actually receives property or is deemed to receive property from the transferring spouse has a basis in such property equal to the adjusted basis thereof in the hands of the transferring spouse. This is true even if the nontransferring spouse pays or is deemed to pay the transferring spouse consideration for that property. See sec. 1.1041-1T(c), Q&A-11, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984).

[8] MMP had earnings and profits well in excess of the redemption payments during the years in issue.

[1] The constructive "treatment" of the participants in a redemption that satisfied the primary and unconditional obligation of the remaining shareholder under pre-sec.-1041 case law would be the same as that prescribed in sec. 1.1041-1T(c), Q&A-9, Temporary Income Tax Regs., 49 Fed. Reg. 34453 (Aug. 31, 1984); i.e., the transferring shareholder would be treated as transferring stock to the remaining shareholder who would be treated as transferring the stock to the redeeming corporation in return for the corporate distribution.

[2] No one questions that MMP had earnings and profits in excess of the redemption payments. MMP's income tax returns for the relevant years show unappropriated retained earnings in excess of $1 million.

[3] It has been suggested that Q&A-9 can never apply to a corporate redemption. If this were true, a corporate redemption of one spouse's stock that satisfied the other spouse's primary and unconditional obligation to purchase that stock could result in *both* spouse's being taxed on the redemption. Such a result is contrary to the objective of sec. 1041, the **Commissioner's** position, and existing case law.

[4] It has been suggested that Arnes II did not discuss the impact that sec. 1041 and Q&A-9 would have on the spouse who was the remaining shareholder. However, as indicated above, in Arnes II we held that enactment of sec. 1041 had *no* impact on the tax treatment of the spouse who was the remaining shareholder after a divorce-related redemption of the other spouse's stock. This issue was clearly before the Court as shown by the various concurring and dissenting opinions in Arnes II.

[5] It has also been suggested that the primary and unconditional standard has no applicability to sec. 1041 and Q&A-9 because the primary and unconditional standard focuses on the purpose served by the corporate distribution to redeem stock rather than the

spouse's transfer of stock to the corporation. However, a redemption distribution to a spouse that satisfies a primary and unconditional obligation of the other spouse is completely dependent on the transfer of stock to the redeeming corporation. If a redemption distribution that satisfies a primary and unconditional obligation of the nontransferring spouse is totally dependent on the transfer of stock being redeemed, then the transfer of stock to the redeeming corporation is an integral part of satisfying the primary and unconditional obligation of the nontransferring spouse.

[6] Ms. **Read** and respondent argue that the redemption satisfied Mr. **Read's** primary and unconditional obligation, while Mr. **Read** and MMP argue that Mr. **Read** was never primarily and unconditionally obligated to purchase Ms. **Read's** stock.

[7] The Court of Appeals for the Ninth Circuit concluded that the obligation to purchase Mrs. Arnes' stock was Mr. Arnes' obligation, not the corporation's. Thus, the Court of Appeals' opinion is consistent with the primary and unconditional obligation standard.

[8] It has also been suggested that sec. 1041 and Q&A-9 apply to all divorce-related transactions that are made to divide a marital estate. This approach is more encompassing than the majority's approach and is contrary to established precedent. See *Ingham v. United States,* 167 F.3d 1240 (9th Cir. 1999); *Blatt v.* ***Commissioner***, 102 T.C. 77 (1994).

[9] The majority does not purport to overrule or modify Arnes II.

[1] The term "incident to the divorce" is defined in sec. 1041(c), and that definition is not in issue here.

[1] Defined by Black's Law Dictionary 1412 (7th ed. 1999) as: "A *disinterested* third party who holds money or property, the right to which is disputed between two or more parties." (Emphasis supplied.)

[2] The writer observed in *Arnes v.* ***Commissioner***, 102 T.C. 522, 541 (1994) (Beghe, J., concurring):

Hewing to the bright line rules of Rev. Rul. 69-608, *supra,* in the marital dissolution context will reduce the tax costs of divorce for the owners of small businesses held and operated in corporate form. If the shareholder spouses can negotiate their separation agreement with the assurance that the redemption will be tax free to the remaining shareholder and a capital gain transaction to the terminating shareholder, the overall tax costs will ordinarily be less than if the terminating spouse qualifies for nonrecognition under section 1041, but the remaining spouse suffers a dividend tax. This will leave a bigger pie to be divided in setting the consideration for the shares to be redeemed. [Fn. ref. omitted.]

Although for the years in issue in the cases at hand, long-term capital gain and ordinary income were subject to tax at the same rates, the writer's observation in *Arnes* applies to more recent and current taxable years, in which long-term capital gains are subject to tax at lower rates than ordinary income.

Even in cases in which there are other remaining shareholders of the distributing corporation, treating the corporation's payment to the departing shareholder ex-spouse as a distribution in redemption of the purchased stock to the remaining shareholder ex-spouse will cause the constructive distribution to be treated as a dividend to the remaining shareholder ex-spouse under sec. 301 rather than as a substantially disproportionate redemption under sec. 302(b)(2) qualifying as a distribution in payment in exchange for the stock under sec. 302(a), with resulting capital gain treatment. This is because the proportionate interest in the corporation of the remaining shareholder ex-spouse will always be increased as a result of the reduction in the number of outstanding shares that occurs by reason of the redemption.

[3] Mr. **Read** has not put in issue respondent's determination that he is liable to dividend treatment on the subsequent years' payments of interest and principal on the note for years following the year the note was issued. Conceivably, the correct approach would have been for respondent to treat the fair market value of the note as a dividend distribution to him in the year of issuance, see *Maher v.* ***Commissioner***, 55 T.C. 441 (1970), supplemented 56 T.C. 763 (1971), revd. and remanded 469 F.2d 225 (8th Cir. 1972); see also Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 8.23 (1999 Cum. Supp. 1), a year for which the period of limitation on assessment of a deficiency has expired. See also note 2 and accompanying text of the joint dissenting opinion of Judges Laro and Marvel. There is no occasion to comment on how that issue should be decided if Mr. **Read** had raised it in a timely fashion.

[4] It is understood that Mr. **Read** has not raised the point — and it is not in issue in the cross-motions for partial summary judgment before the Court — that if the corporate payments are to be included in his gross income as constructive dividends, then he is entitled to deduct the interest portion of the payments as business interest. There is no occasion here to comment on this point, other than to observe that, under the analysis of the concurring opinion, the obligation to pay interest to Ms. **Read** would be the deemed obligation of Mr. **Read**, rather than that of the corporation. Cf. *Seymour v.* ***Commissioner***, 109 T.C. 279 (1997).

[5] Cf., e.g., *Baptiste v.* ***Commissioner***, 100 T.C. 252 (1993), revd. 29 F.3d 433 (8th Cir. 1994), affd. 29 F.3d 1533 (11th Cir. 1994).

[6] Even if the standard espoused by Judges Ruwe and Halpern and the writer should be adopted, a Judge adopting that standard might conclude that Mr. **Read** did not divest himself of the primary and unconditional obligation to purchase Ms. **Read's** stock. The ground of that conclusion, with which the writer would disagree, is that the integration of and reciprocal relationship between Mr. **Read's** alimony obligations and MMP's continuing obligation to complete the scheduled payments in satisfaction of the obligation to purchase Ms. **Read's** stock left Mr. **Read** with the primary and unconditional continuing obligation to purchase her stock.

[7] See *supra* note 2.

[8] There's another way (a far-out fifth possibility): the Court could hold that both parties escape tax, which the Court has properly rejected. There is a view (disagreed with in the writer's *Arnes v. **Commissioner***, 102 T.C. 522 (1994) (Arnes II) concurrence) that the Court of Appeals for the Ninth Circuit, with whose views the Court expressed disagreement in *Blatt* and Arnes II, has indicated in *Arnes v. United States,* 981 F.2d 456 (9th Cir. 1992) (Arnes I), and *Ingham v. United States,* 167 F.3d 1240 (9th Cir. 1999), that it reads the "on behalf of" standard more expansively than the Court has been willing to do. The Court could have decided in favor of Ms. **Read** under *Golsen v. **Commissioner**,* 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), and decided in favor of Mr. **Read** by applying the "primary and unconditional obligation standard", as Judge Halpern and the writer would do, or the view of Judges Laro and Marvel that the "on behalf of" standard of Q&A-9 does not apply to redemptions.

[1] We use the term "spouse" to include both a spouse and a former spouse.

[2] We note that the installment method of sec. 453 does not apply to the receipt of a distribution taxed as a dividend under sec. 301. The installment method may be used only to report "income" from a "disposition of property", sec. 453(a) and (b)(1), and a "distribution of property" under sec. 302(d) does not meet that requirement, see *Cox v. **Commissioner**,* 78 T.C. 1021 (1982). See generally Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, "Distributions of Corporation's Own Obligations", par. 8.23 at 8-83 to 8-84 (1999 Cum. Supp. 1).

TAB 10

Valuation Concepts

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Stipulated-To Arbitrator/Special Master

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA

IN AND FOR THE COUNTY OF MARICOPA

In Re the Marriage of JUBIE RUESCHENBERG, **Petitioner,** **and** SCOTT RUESCHENBERG, **Respondent.**	**NO. FC 2003-094565** **SPECIAL MASTER'S REPORT**

On December 12, 2005, the Honorable Michael O. Wilkinson signed an Order captioned "Order Appointing Arbitrator." The Order was entered at the request of the parties in their December 7, 2005, "Stipulation to Appoint Arbitrator Barry Brody." The Stipulation was predicated upon Rule 16(g) of the Arizona Rules of Civil Procedure.

Rule 16(g) of the Arizona Rules of Civil Procedure allows the parties to agree to forms of alternative dispute resolution. That Rule further provides that the parties may agree to utilize a specific process of alternative dispute resolution, and the parties did so in requesting the Court to enter its Order Appointing Arbitrator pursuant to Rule 53 of the Arizona Rules of Civil Procedure.

Rule 53 of the Arizona Rules of Civil Procedure provides for the appointment of a Special Master who is granted authority to act under a specific process and procedure. In fact, the Order Appointing Arbitrator makes reference to the appointment of a Special Master, and provides for many of the requirements delineated in Rule 53. Notwithstanding, the body of the Order (and the very caption of the Order itself) makes reference to an Arbitrator.

It seems clear that the language of the Order Appointing Arbitrator is intended to comply with Rule 53 of the Arizona Rules of Civil Procedure, and that a Special Master is to be appointed. In fact, the instant proceedings have been conducted with such in mind. It is also apparent that the parties did not desire to proceed under the arbitration procedures of Arizona Revised Statutes Section 12-1501 et. seq., and the parties cannot proceed under Rule 72 of the Arizona Rules of Family Law Procedures as such rules were not implemented at the time of the parties' Stipulation. *Ergo*, below signed will treat himself as Special Master, and act accordingly.

Although the applicable Order indicates that Findings of Fact and Conclusions of Law are to be submitted by the Special Master, neither party has submitted Proposed Findings or Conclusions. Notwithstanding, the Special Master feels compelled to expand upon and delineate the basis for his rulings. Accordingly, the following Report is offered.

The parties were married on May 15, 1998. At that time, the Husband owned Desert Mountain Medical, Inc. ("DMM").

The Husband has been the sole shareholder of DMM since its formation on August 15, 1995.

The Wife’s valuation expert, Scott Stuart (“Stuart”), estimates that the value of DMM at the time of marriage was $531,000. The Husband’s valuation expert, Frank Pankow (“Pankow”), values DMM at the date of marriage at $38,000.

Service of process was effectuated upon the Husband on October 29, 2003. The parties stipulated to utilize October 31, 2003, as the valuation date of DMM for divorce purposes.[1] Stuart valued DMM on October 31, 2003, at $3,620,000. Pankow valued DMM on October 31, 2003, at $1,510,000.

Wife testified that the parties lived together for approximately three (3) years prior to marriage. During that time, the Husband operated DMM. Wife further testified that at the time of marriage, DMM was experiencing logistical and financial difficulties, and that the Husband was “very stressed” at the situation. Wife suggests that Husband seriously considered closing DMM.

Shortly after marriage, the Wife took an active management role in DMM. The Wife’s actions were necessitated by the departure of several key office personnel. The Wife stepped into the business during what appeared to be difficult times, and operated the accounting, billing, payable and business-end of DMM. The Husband operated the sales side of DMM.

[1] The parties have merely stipulated to the date to be employed. The parties do not agree as to what, if any, portion of the value of DMM, or the increase of equity during the marriage, is divisible.

Through the combined efforts of the parties, DMM not only survived, it thrived enormously. By any analysis, DMM has grown substantially in net worth, and it is apparent that such growth resulted in large part from the joint efforts of the parties.

Throughout its existence, DMM has been barely more than a manufacturer's representative. DMM possesses little equipment or inventory. While the Husband has created a high degree of goodwill with the end user of the products sold, and he has a high degree of goodwill with the product manufacturers, most of his manufacturer's contracts are year-to-year, and the industry is extraordinarily competitive and "cut-throat."

Husband testified that a substantial portion of DMM's revenues are associated with one (1) manufacturer. Husband states that this manufacturer, while satisfied with DMM's performance, is strictly "numbers-based," and that it could refuse to renew the year-to-year contract in any given year. Husband states that the contract with this prime manufacturer is not assignable, and is personal to DMM.

While Husband acknowledges that both parties played an integral part in the growth of DMM, he is quick to point out that various external factors were also responsible for DMM's success. Husband has indicated that the customer population has doubled, that manufacturer marketing has increased demand, and that an added sales force has provided more avenues for sales. Husband further testified that DMM experienced a substantial portion of its growth while Husband was diverting large portions of his energies to other ventures.

It is clear that the vast amount of the applicable valuations proffered by Stuart and Pankow are related to goodwill. The actual book value of DMM at the date of marriage, and valuation date, is but a fraction of the overall value derived by either expert. It is equally clear that the marital community received virtually one hundred percent (100%) of annual earnings of DMM since the date of marriage. The sole issue thusly becomes whether or not the Wife is entitled to any portion of the increase in value (i.e. mostly goodwill) between May 15, 1998, and October 31, 2003.

The analysis of the facts at bar must begin with Cockrill v. Cockrill, 124 Ariz. 50, 601 P.2d 1334 (1979). The parties clearly agree that a so-called "Cockrill analysis" is necessary, however, they disagree as to the methodology to be employed.

Cockrill involved the valuation and apportionment of the Husband's farming operation which existed at the time of marriage. The farm, a "hard" and measurable asset, increased in value during marriage. The trial court was called upon to determine whether the increase was (1) through natural growth of the existing asset, (2) through the efforts of one or both of the marital parties, or (3) some combination of both. The court was also called upon to determine what value could be assigned to the marital community if the court adopted the second or third options.

It is undisputed that when the value of separate property is increased during marriage, the spouse claiming that the increase is separate property bears the burden of proof to show that the increase is the result of the inherent value of the property itself, and not the product of some community work effort. This burden of proof requires clear and convincing evidence. Based on such, the Cockrill court placed the burden upon the Husband to prove his case.

Cockrill departed from the "all or nothing" rule that had been in existence for years prior. The Cockrill court determined that the increase in value of an entity during marriage must be apportioned, and that numerous methods for such apportionment could be considered by the trial court. With respect to the case at bar, the two (2) applicable methods are[2]:

1. The increase in value of the business is apportioned to the marital community in an amount equal to the reasonable value of community services performed. The excess, if any, of such increase in value is apportioned to the separate property owner (i.e. "fair compensation method"); or

2. The increase in value of the business is allocated to the separate property owner to the extent of a reasonable return on the value of such separate property. The increase in value in excess of this amount, if any, is apportioned to the marital community (i.e. "rate of return method").

Cockrill tells us that the trial court is not bound by any single method of allocation. The trial court is required to select whichever method achieves substantial justice between the parties.

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2 Cockrill provides a third valuation method, however, it is applicable to real estate, and is ignored for this analysis.

Wife contends that when the appreciation in value has little to do with sole and separate property, the rate of return method is the better choice. The rate of return method was adopted by the Cockrill court citing the California case of Periera v. Periera, 156 Cal. 1, 103 P. 488 (1909).

Wife, in large part, relies on Dekker v. Dekker, 17 Cal.App.4th 842 (App. 1993), to support her position. In Dekker, the parties utilized $1,000 of the wife's separate property to establish a company during their marriage. Husband devoted all of his energies to the entity during marriage, and reasonable compensation was received. At trial, the value of the company was established at $927,000. The trial court apportioned $1,934 to the wife (wife's original $1,000 investment plus ten percent (10%) annual return) and the balance to the community. This allocation was based on Periera.

The Dekker court rejected the wife's appeal and held that the trial court was free to adopt either the Periera approach or the reasonable compensation approach. The Dekker court chose the former and found that Periera is typically applied where business profits are principally attributed to efforts of the community. The court also held that the reasonable compensation method is applied where community effort is more than minimally involved in a separate business yet the business profits accrued are attributable to the character of the separate asset.

On a more interesting note, the Dekker court stated that because the growth was so substantially attributable to community efforts, that to award the wife a greater share under the fair compensation method would be to ignore California's egalitarian marriage model. Thusly, the Dekker court chose to reward the marital community rather than the wife's separate estate.

The Wife refers to and tries to distinguish Rowe v. Rowe, 154 Ariz. 616, 744 P.2d 717 (App. 1987). In Rowe, husband owned a business for ten (10) years before marriage. Subsequent to marriage, husband devoted substantial energies in maintaining the business. Notwithstanding, the business had been well-established to grow and expand its product lines and revenues at the time of the marriage.

The Rowe court held that when the predominant cause of growth, profitability and value were community efforts, however, growth was also caused in substantial part by other factors including manufacturer or marketing efforts, increased consumer acceptability, population growth, inflation, and the like, that the reasonable value of community services method is appropriate. The Rowe court found that the husband's business had been so established. Apparently, being slightly confused, the court then mis-allocated the growth between community effort and return on inherent value of separate property.[3] Notiwthstanding, the Rowe court seems to indicate that the trial court should not necessarily accept either method in total, and the court is free to allocate valuation changes between methods.

The Wife contends that the facts herein are more akin to Dekker than Rowe. The Wife has testified that at the time of

[3] The allocation percentages utilized do not add up to one hundred percent (100%). There is also an issue as to whether or not goodwill is applied in the before and after valuations, and if so, to what degree.

marriage, the business was close to failing, and that the Husband considered closing it down. Such would support the Wife's position that the business (at marriage) had little inherent value and marginal, if any, growth ability. Thusly, all of the growth would be attributable to the efforts of the marital community.

The Wife also asserts that utilization of the fair compensation method would result in all of the increase in value being allocated to the Husband's sole and separate property. Under Stuart's analysis, the value change from $531,000 to $3,620,000, would reflect a return on investment of nearly seven (7) times during the five and a half (5½) year marriage. Similarly, the return on investment utilizing Pankow's calculations would be nearly forty (40) times the original investment.

The Husband correctly points out that the community does not always share in the growth of a separate entity. The Husband also suggests that the Cockrill analysis should be tempered since it involved a tangible asset (i.e. a farm) and the case at bar involves an intangible asset (i.e. goodwill). Husband relies on his analysis of Rowe to suggest that the fair compensation method is appropriate.

The Husband correctly states that the marital community was fairly compensated. Husband also points out that most of the growth in the instant case was through community effort, but he argues that numerous external factors were present. Husband indicates that these factors were:

1. Manufacturers had implemented extraordinary marketing efforts and sales assistance separate from the community effort;

2. There has become increased customer acceptance of the products sold by Husband;

3. Increased research and development by the manufacturer, and better products have created additional avenues of customer demand and sales;

4. Natural population growth has created an inherent expansion of marketing not associated to community efforts;

5. Other DMM sales people and other manufacturer representatives have expanded the market.

Husband claims that due to the external factors, and the fact that the Husband did not devote his full time and energies to DMM, that the fair compensation method is appropriate. Husband claims that to give Wife all of the benefit of the earnings and a percentage of the hypothetical value (i.e. goodwill) is unfair. Husband calls this a "double-dip."

Husband also relies on Roden v. Roden, 190 Ariz. 407, 949 P.2d 67 (App. 1997). In Roden, the husband used separate property to finance a business operation while both parties worked in the business. The trial court found that the marital community was fully compensated. The trial court chose to apply the fair compensation method in its valuation approach. The appellate court affirmed the trial court's findings.

The opinion in Roden is not necessarily analytical in its approach, and offers little insight into why the court adopted the fair compensation method. Without this analysis, it is hard for the Special Master to understand its underlying rationale, nor how to apply the Roden facts to the facts at bar.

The Special Master believes that although goodwill is clearly an intangible asset, it is measurable, and it is bought and sold on a regular basis. Moreover, goodwill is not distributable as "earnings" or "compensation" until an entity is sold.

Obviously, the efforts of a marital community can create earnings and goodwill. While the hard cash earnings are distributable, the value of the intangible goodwill is not. In the case at bar, the Special Master feels that although the DMM earnings have been distributed, the goodwill has not.

Depending upon which valuation that is accepted, the Husband's sole and separate investment is either $38,000 or $531,000. Similarly, depending upon which ending valuation is adopted, DMM is now worth $1,510,000 or $3,620,000. Under either scenario, the Husband's return on investment for the five and a half (5½) year marriage is nearly seven (7) times or nearly forty (40) times his initial capitalization. Under any analysis, this rate of return is excessive.[4]

To accept the Husband's position would be to acknowledge that all of the goodwill and intangible growth is his. The Husband would have the Wife take nothing since the earnings and other compensation have been fully distributed to

[4] Even Pankow acknowledges in his report the excessiveness of this rate of return. On his Schedule 2.a., he concludes that the imputed rate of return on the initial investment of the Husband is 97.3% per year. This return is nearly four (4) times any rate of return discussed by either expert.

her. This result would not achieve the substantial justice between the parties that Cockrill mandates.

The Special Master believes that the facts at bar should be analyzed under a combined theory of the Dekker and Rowe holdings. Clearly, total compensation should fairly reflect the efforts of the marital community. While these efforts were acknowledged in cash distributions, there is no similar recognition of intangible distributions. At the same time, however, the external factors and other methodologies must be given some credence.

Husband's claim that since the marital community has been fully compensated, the Wife would receive a "double-dip" by a further division is wrong. In actuality, the Husband would receive the "double-dip" since he partook in the full distribution of tangible assets (jointly with the Wife), and now seeks to receive one hundred percent (100%) of the intangible assets. See Dekker.

The Special Master further finds that the analysis in Rowe is not fully applicable. While external factors may have played a part in the growth of DMM, the entity was not on firm ground at the time of marriage, and could not have survived solely based upon such external factors. The very maintaining of the year-to-year contract appears to be wholly predicated upon the community efforts of keeping the business alive, and such greatly outweighs the existence of many of the external factors.

As already noted, the special Master also distinguishes the holding in Roden. While Roden readily affirms the fair compensation method, it does so with little meaningful analysis. The Special Master considers Roden to be applicable to its facts only, and Roden offers little insight to the case at bar.

Further, under the Husband's analysis, a court could never allocate any portion of growth if it was determined that fair compensation was paid. This would seem to tie the hands of the trial court, contrary to Cockrill, and it ignores any right to substantial justice.[5]

Husband indicates that Stuart's analysis is flawed and contains numerous errors. Without citing such errors, and going into considerable detail, the Special Master agrees that Stuart's analysis does not accurately portray the amount of growth to be divided.

Similarly, Pankow's analysis is overly simplistic, and contains similar flaws in the opposite direction. Pankow's analysis cannot be accepted on its face either.

The Special Master finds that the Husband had a barely sustainable business at the time of marriage. Accordingly, most of the growth can only be attributable to community efforts. The

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[5] This would be particularly egregious in a situation where an entity had substantial growth and less than one hundred percent (100%) of the compensation was distributed. If the testimony deduced that fair compensation was paid (for example based upon comparable industry standards), the sole and separate estate would be awarded all of the intangible growth and the undistributed portion of the earnings and compensation. This is far from the result that Cockrill envisions.

Indeed, Pankow's Schedule 3 expands upon this point. In the case at bar, if DMM had hypothetically only distributed the $1,063,322 of his defined reasonable compensation, so that $2,059,199 remained within the entity, under Husband's analysis, reasonable compensation would have been paid, and no further division would occur. Husband would thusly be able to retain not only the $2,059,199 of undistributed earnings, he would be entitled to retain the $1,510,000 of intangible value that Pankow found.

Special Master also finds that external factors had a measurable bearing upon this growth. For these reasons, the return on investment approach is appropriate, however, one-third (1/3) of the additional/excess growth should also be attributed to the Husband's sole and separate investment.

In determining an appropriate rate of return on the Husband's sole and separate investment, Stuart utilized the return on Treasury Bonds averaging 7.6% per annum. Stuart shows a growth from the date of marriage valuation of $531,000 to $781,000 by October 31, 2003. The Special Master finds this amount to be far too low.[6]

Pankow discusses rates of return of 5.8% for long term government bonds, 12.4% for large company stocks, 14.2% for mid-cap stocks and 21.7% for micro-cap stocks. Pankow then arbitrarily assumes 27% as the rate of return in his analysis.[7]

The Special Master has considered all of the approaches for valuation that have been put forth. The capitalization of earnings method offers the fairest analysis in the instant fact situation.

With respect to the valuation on May 15, 1998, the Special Master finds that normalized earnings are $38,000. The Special Master finds that the applicable capitalization rate

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[6] Stuart's May 31, 1998, valuation uses rates of return for various calculation methods of 17.9 to 27.03%. Similarly, Stuart uses a range of 13.69 to 25.64% in his valuation methodologies of October 31, 2003. Each of these approaches recognizes, among other things, risk/reward increases in the rate of return above traditional Treasury Bonds. To the Special Master, it seems inconsistent to apply one rate of return to the return on the Husband's sole and separate estate and another to value the entire entity.

[7] Pankow does not seem to offer an explanation for his adoption of the 27% rate, and such seems to be somewhat inconsistent with his adoption of a 24% valuation rate for his May 31, 1998, analysis and 23% rate employed for his October 31, 2003, analysis.

should be 25%. The valuation result, $152,000, when aggregated with a non-operating asset/shareholder loan of $11,166, yields a fair value at the date of marriage of $163,166.

By utilizing the 25% rate of return for the five (5) years and five (5) months of marriage, compounded annually, the Husband's sole and separate investment of $163,166 becomes approximately $550,000. This amount of appreciation (and initial investment) is and remains the Husband's sole and separate property.

The normalized earnings for October 31, 2003, are found to be $360,000. In applying the 25% capitalization rate, the result is an October 31, 2003, valuation of $1,440,000.

The community portion of the growth is calculated to be two-thirds (2/3) of the result of $1,440,000 less $550,000, or $593,333. One-half (½) of this amount, or $296,667, is the Wife's share.

The Special Master makes no findings nor recommendations with respect to the terms to be employed by the Husband to acquire the Wife's equitable interest in DMM. The parties should negotiate between themselves to determine a fair and equitable method for the acquisition. In the event that the parties cannot agree, however, it is recommended that the parties return for mediation, or stipulate that the Special Master may make recommendations (after oral argument).

Both parties have put forth good faith positions with respect to the law and facts in this case. Both parties established reasonable positions throughout the entirety of this matter. The parties appear to be on relatively equal liquid financial positions. Accordingly, the Special Master finds and recommends that each party pay their own attorney's fees and expert witness fees. It is further recommended that all mediation, arbitration and Special Master fees be shared equally by the parties (as provided for in the Order Appointing Arbitrator).

DATED this _____ day of December, 2006.

BARRY L. BRODY, P.C.

By:___________________________
Barry L. Brody
Stipulated-To Arbitrator/
Special Master

ORIGINAL of the foregoing filed
this _____ day of December, 2006,
with:

Clerk of the Court
MARICOPA COUNTY SUPERIOR COURT
201 West Jefferson Street
Phoenix, Arizona 85003

AND

COPY of the foregoing hand-
delivered this _____ day of
December, 2006, to:

The Honorable Michael Wilkinson
MARICOPA COUNTY SUPERIOR COURT
101 West Jefferson Street
Suite 414
Phoenix, Arizona 85003

AND

. . .

. . .

. . .

COPY of the foregoing mailed this _____ day of December, 2006, to:

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____

IN THE COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

JUBIE RUESCHENBERG, Petitioner/Appellee,	1 CA-CV 07-0300
v.	DEPARTMENT B
SCOTT RUESCHENBERG, Respondent/Appellant.	**O P I N I O N**
	FILED 5-13-08

Appeal from the Superior Court in Maricopa County

Cause No. FC 2003-094565

The Honorable Michael O. Wilkinson, Judge

AFFIRMED

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Attorneys for Petitioner/Appellee

Law Office of Scott E. Boehm, PC — Phoenix
By Scott E. Boehm
Co-Counsel for Respondent/Appellant
and
Jeffrey G. Pollitt, PC — Phoenix
By Jeffrey G. Pollitt
Co-Counsel for Respondent/Appellant

B A R K E R, Judge

¶1 Scott Rueschenberg ("Husband") appeals from the trial court's award of $296,667 to Jubie Rueschenberg ("Wife") as one-half of the community's share in the value of Husband's separate property. For the reasons that follow, we agree with the trial court and affirm.

Facts and Procedural History

¶2 Wife and Husband were married May 15, 1998. Prior to and at the time of marriage, Husband owned a business called Desert Mountain Medical ("DMM"). DMM sells medical hardware, for the repair of human joints, to surgeons and hospitals. It is undisputed that DMM is Husband's separate property.

¶3 The parties resolved all issues regarding the dissolution of marriage through mediation except for the issue of any community interest in the increase in value of DMM over the life of the marriage. On December 14, 2005, the trial court appointed a special master at the request of the parties.[1] On December 22, 2006, the special master filed a report with the trial court.

¶4 The special master's report used the capitalization of earnings method of valuation[2] to find that DMM had a fair value

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[1] The parties actually requested an arbitrator, and the trial court order read "Order Appointing Arbitrator." The court appears to have intended to appoint a special master, and subsequently referred to him as a special master.

[2] One source defines capitalization of earnings as the "[v]aluation of a going concern business on the basis that the operations will continue to yield constant and regular earnings. These earnings (called 'normalized earnings') are multiplied by a capitalization rate (normally the reciprocal of the desired

of $163,166 at the commencement of the marriage. This value was based on the special master's finding that normalized earnings[3] were $38,000 at the time the parties married, that the applicable capitalization rate was 25%, and that there was an additional $11,166 in a non-operating asset/shareholder loan which added to the value. Using the same method, it found that DMM was worth $1,440,000 (having normalized earnings of $360,000) on October 31, 2003.[4] The report then awarded Husband a sole and separate property interest of $550,000. It arrived at this figure by giving what it considered to be a fair rate of return on the original investment of $163,166. The report then subtracted that $550,000 from the value at the dissolution of marriage, $1,440,000, and found that the community was responsible for two-thirds of the resulting increase (i.e. two-thirds of $890,000), which amounts to $593,333. It then awarded Wife half of this amount, or $296,667.

¶5 The report found that the community's labor was only responsible for two-thirds of the increase in the value of the

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rate of return) to arrive at the value of the business." Business Dictionary, http://www.businessdictionary.com/definition/capitalization-of-earnings-method.html (last visited April 16, 2008).

[3] See n.2, *supra*, for a definition of "normalized earnings."

[4] The parties stipulated to use October 31, 2003 as the valuation date for DMM for divorce purposes.

company because external factors were responsible for one-third of the increase. Husband had presented evidence that the company's increase in value was due to an increase in manufacturer marketing and sales assistance, increased customer acceptance of the products, increased research and development by manufacturers, natural population growth in the market area, and other DMM sales personnel expanding the market.

¶6 The special master's report also found that the community had received virtually 100% of the net distributable earnings during the marriage, but did not include a finding as to what that amount was. Wife's expert believed the ***total*** amount of monies distributed to the community during marriage to be $2,875,000 while Husband's expert believed it to be $3,122,521. There was no request, however, by Husband to determine the amount of ***net*** distributable earnings (generally, income less salary and other expenses) generated by DMM during the marriage. Consequently, the report did not consider whether there was an amount of net distributable earnings that had been overpaid to the community and was due Husband as the owner of DMM or should be subtracted as an offset from the community's interest in the value of DMM.

¶7 The trial court incorporated the special master's findings verbatim into its decree of dissolution. Husband filed a timely notice of appeal. We have jurisdiction pursuant to Arizona Revised Statutes ("A.R.S.") § 12-2101(B) (2003).

Discussion

¶8 Husband makes several arguments on appeal: 1) that the court erred in giving the community an interest in DMM's increased value (here, goodwill) when the community had already received the company's profits (net distributable earnings) generated during the course of the marriage, 2) that the trial court erred in awarding the community a further interest in DMM when a fair salary had already been paid to the community, 3) that the trial court abused its discretion in finding that two-thirds of DMM's growth was due to community labor and efforts, and 4) that the trial court abused its discretion in apportioning the increase in value when the community had already received more than its pro rata share of the total increase in net profits and value.

1. Both Profits and Increase in Value Must Be Considered in Order to Effect an Equitable Apportionment.

¶9 Husband argues that Arizona law prohibits the apportionment of both profits and increased value between community and separate property. Specifically, Husband argues that Arizona statutes define all of the increased value of a separate property business as separate property and that Arizona courts have carved out a limited qualification to the statutory scheme that may grant the community some interest in either profits or increase in value but not both. Husband misunderstands the Arizona community property scheme and mischaracterizes the Arizona case law addressing the issue.

¶10 Arizona's statutory community property scheme provides that the "increase, rents, issues and profits" of a spouse's real and personal property "that is owned by that spouse before marriage" is "the separate property of that spouse." A.R.S. § 25-213(A) (2007). It also provides, however, that "all property acquired by either husband or wife during the marriage is the community property of the husband and wife except for property that is . . . [a]cquired by gift, devise or descent." A.R.S. § 25-211 (2007).

¶11 These provisions potentially conflict when a separate property business earns profits and/or increases in value because of community labor. For instance, § 25-213(A) provides that the "increase . . . and profits" of separate property continue to be "the separate property of that spouse." On the other hand, § 25-211 provides that "[a]ll property acquired" during the marriage by husband or wife, with exceptions not applicable here, "is the community property of the husband and wife." Thus, as to "profits" and "increases" from a separate business that are the product of community labor, the competing statutes can render potentially different results.

¶12 When it appears that two statutes conflict, "whenever possible, we adopt a construction that reconciles one with the other, giving force and meaning to all statutes involved." ***UNUM Life Ins. Co. of America v. Craig***, 200 Ariz. 327, 333, ¶ 28, 26 P.3d 510, 516 (2001) (citing ***Lewis v. Ariz. Dep't of Econ. Sec.***, 186 Ariz. 610, 614, 925 P.2d 751, 755 (App. 1996)). Arizona courts have long agreed that the results of a spouse's labor are community property. ***Koelsch v. Koelsch***, 148 Ariz. 176, 181, 713 P.2d 1234, 1239 (1986) ("[I]t is established law that . . . the fruits of labor expended during marriage are community property. . . .") (citing ***Shaw v. Greer***, 67 Ariz. 223, 225, 194 P.2d 430, 431 (1948)). In resolving the specific issue regarding separate property profits and increase in value, Arizona courts have looked to the nature, or source, of the profit from or increase of the separate property business. ***Cockrill v. Cockrill***, 124 Ariz. 50, 53, 601 P.2d 1334, 1337 (1979); ***Rundle v. Winters***, 38 Ariz. 239, 245, 298 P. 929, 931 (1931). The rule is that if the profits and/or increase result from the "inherent qualities of the business," the profits and increase are separate property; if the profits and/or increase result from the "individual toil and application of the spouse," they are community property. ***Rundle***, 38 Ariz. at 245, 298 P. at 931.

¶13 As a further refinement to this rule, prior to the ***Cockrill*** decision in 1979, Arizona followed what is known as the "all or none" rule. That rule provided that either ***all*** of the profits and ***all*** of the increase were separate property or ***all*** of the profits and ***all*** of the increase were community property depending on whether the profits and increase were "***primarily due*** to the toil of the community or primarily the result of the inherent nature of the separate property." ***Cockrill***, 124 Ariz. at 53, 601 P.2d at 1337 (citing ***Porter v. Porter***, 67 Ariz. 273, 195 P.2d 132 (1948)) (emphasis added); ***Anderson v. Anderson***, 65 Ariz. 184, 187, 177 P.2d 227, 229 (1947) (stating that because "the inherent nature of the [separate] business is" such that "the success is due to the management and requires the attention of the owner," all the profits of that business were "community property"); ***In re Torrey's Estate***, 54 Ariz. 369, 375-76, 95 P.2d 990, 993 (1939) ("[I]f profits come mainly from the property, . . . they belong to the owner of the property," but if "profits come mainly from the efforts or skill of one or both [spouses], they belong to the community."); ***Spector v. Spector***, 23 Ariz. App. 131, 140-44, 531 P.2d 176, 185-86 (1975) (holding that all of the profits from a separate business were separate property even though the "increase in value" was ***almost*** all due to the "increases in the value of Arizona real estate during the period" and making no effort to apportion between separate and community property) (emphasis added).

¶14 *Cockrill* did away with the all or none rule and instead instituted an apportionment rule that apportions to the community and to the separate property the profits or increase in separate property attributable to each. 124 Ariz. at 54, 601 P.2d at 1338. The court explained that the purpose of apportioning the profits or increase was to achieve "substantial justice between the parties." *Id.* To do otherwise would "either deprive the [separate] property owner of a reasonable return on the investment or [would] deprive the community of just compensation for its labor." *Id.*

¶15 Husband points to many of the pre-*Cockrill* cases, arguing that some discuss the granting of a community interest in the "profits" of a separate business,[5] while others discuss the granting of a community interest in the "increase in value,"[6]

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[5] Husband argues that the cases which grant only profits include *Rundle v. Winters*, 38 Ariz. 239, 298 P. 929 (1931); *Lincoln Fire Insurance Co. v. Barnes*, 53 Ariz. 264, 88 P.2d 533 (1939); *In re Torrey's Estate*, 54 Ariz. 369, 95 P.2d 990 (1939); *Anderson v. Anderson*, 65 Ariz. 184, 177 P.2d 227 (1947); and *Lawson v. Ridgeway*, 72 Ariz. 253, 233 P.2d 459 (1951).

[6] Husband argues that the cases which grant only the increase in value include *Nace v. Nace*, 104 Ariz. 20, 448 P.2d 76 (1968); *Everson v. Everson*, 24 Ariz. App. 239, 537 P.2d 624 (1975); *Nelson v. Nelson*, 114 Ariz. 369, 560 P.2d 1276 (App. 1977); *Percy v. Percy*, 115 Ariz. 230, 564 P.2d 919 (App. 1977); and *Baum v. Baum*, 120 Ariz. 140, 584 P.2d 604 (App. 1978).

but none grant both. He then argues that ***Cockrill*** intended to allow the apportionment of either profits or increase in value, but not both. Husband points to the phrase "profits, or increased value" employed by the ***Cockrill*** court, ***id.***, and argues that the court declined to give the community an interest in both profits and increase in value, but rather just one of them. He argues that ***Cockrill*** tried to balance the underlying tension between § 25-213(A) (attributing increase in separate property to the separate property) and § 25-211 (providing that all property acquired during marriage is community property). In view of that balance, he argues, ***Cockrill*** permits an award to the community only for profits (net distributable earnings) ***or*** increase in value (here, goodwill), but not both. We reject this interpretation of ***Cockrill***.

¶16 ***Cockrill*** states in pertinent part:

> This Court has also become disenchanted with the all or none rule. To implement the all or none rule and determine the [p]rimary source of the profits, the portion of the profits that resulted from each source must be calculated.
>
> Once this has been done, it is only logical to apportion the ***profits, or increased value***, accordingly. To do otherwise will either deprive the property owner of a reasonable return on the investment or will deprive the community of just compensation for its labor.
>
> We, therefore, also depart from the all or none rule and hold that ***profits***, which

> result from a combination of separate and community labor, ***must be apportioned accordingly.***

Id. (emphasis added). It is true that the language of the holding in the last sentence quoted above refers only to apportioning "profits." For a number of reasons, however, we do not view ***Cockrill*** as holding that ***either*** profits or increase in value may be apportioned but not both.

¶17 First, ***Cockrill*** does not distinguish between profits and increased value; to the contrary, it appears to use the terms interchangeably. The court first says that the "portion of ***the profits*** that resulted from each source must be calculated" and then immediately follows that with "it is only logical to apportion the ***profits, or increased value,*** accordingly." ***Id.*** (emphasis added). By setting "increased value" off with commas, the court implies that "increased value" is a phrase that restates or modifies "profits." The Chicago Manual of Style ¶ 5.49 (14th ed. 1993) ("Unless it is restrictive . . . , a word, phrase, or clause that is in apposition to a noun is usually set off by commas . . . ."). "Apposition" is defined as "a grammatical construction in which a noun or pronoun is followed by another that explains it." The Merriam-Webster Dictionary 50 (3d ed. 1974). This interpretation is strengthened by the fact that the preceding sentence did not even mention increased value.

¶18 Second, language in cases prior to ***Cockrill*** also reinforces the idea that both profits and increase can be apportioned. For instance, this court stated in ***Nelson v. Nelson***, 114 Ariz. 369, 560 P.2d 1276 (App. 1977), that "an increase in value of separate property is subject to the same test as profits from separate property." 114 Ariz. at 372, 560 P.2d at 1279 (citing ***Everson v. Everson***, 24 Ariz. App. 239, 537 P.2d 624 (1975)).

¶19 Third, and most importantly, it would be inconsistent with the supreme court's mandate in ***Cockrill*** to achieve substantial justice for this court to hold that the community has an interest in either the profits (net earnings) or the increased value (treated in this case as goodwill) but not both. For instance, in a situation where the community labor was responsible both for the net earnings generated by a separate business and for the increase in goodwill of that separate business, allowing the community only an interest in one or the other would not achieve substantial justice. It would shortchange the community of either its fair share of the net earnings or its fair share of the goodwill. In addressing the "approaches to the problem of apportionment," ***Cockrill*** endorsed the proposition that "our courts have developed no precise criterion or fixed standard, but have endeavored to adopt a yardstick which is most appropriate and equitable in a particular situation." 124 Ariz. at 54, 601 P.2d at 1338. The entire purpose of rejecting the all or none rule and implementing apportionment was to achieve a more equitable result. It would seem odd indeed if we were to construe ***Cockrill*** to require the exclusion from the apportionment process of an entire category of assets – either net earnings or goodwill - when both the separate property itself and the labor of the community were jointly responsible for increasing them. Each category of property, separate and community, should receive its fair and equitable share.

¶20 Therefore, we hold that when apportioning the increase in value and/or profits from a separately held business, it is not error to apportion both profits (net earnings) and increase in value (whether that is goodwill or a measurable increase in value of some other asset) if the community labor was responsible for a portion of both and if such an apportionment "will achieve substantial justice between the parties." ***Id.*** Rather, as we describe more fully below, we hold that the trial court must equitably apportion the combined total of the profits (net distributable earnings) and increase in value (whether goodwill or otherwise) of the separate business if the efforts of the community caused a portion of that increase and substantial justice requires it.

2. A Finding of Reasonable Compensation Does Not Necessarily Preclude an Award Based on Increased Value and/or Profits.

¶21 Husband next argues that when the community has received a fair salary for the community's labor contributed to the separately held business, the *Cockrill* inquiry ends and no further apportionment is permitted. We disagree.

¶22 Husband's argument is based upon the rule set forth in *Nace v. Nace*, 6 Ariz. App. 348, 354, 432 P.2d 896, 902 (1967), *vacated on other grounds* in 104 Ariz. 20, 448 P.2d 76 (1968), and subsequent cases. In *Nace*, the husband had a separate property interest in the ownership of a chain of movie theaters. 6 Ariz. App. at 349, 432 P.2d at 897. The separate property increased in value during the marriage. *Id.* at 349-50, 432 P.2d at 897-98. The husband actively managed the business during the marriage. *Id.* The trial court determined that the separate property had increased in value both due to the inherent nature of the property and the husband's management skills. *Id.* The trial court awarded the husband the "lion's share" of the increase in the separate property business because it was due to the husband's efforts, as contrasted with the wife's, after the marriage. *Id.* at 354, 432 P.2d at 902. The court of appeals rejected this reasoning because the efforts of the husband on behalf of the community were efforts in which the wife was entitled to share. *Id.*

¶23 In describing the "all or none" rule in place in Arizona, the ***Nace*** court stated that "[i]n the absence of a clear showing that a fair salary for the husband's efforts has been set, Arizona decisions have followed an 'all or none' rule. . . ." ***Id.*** The court reversed the allocation of value as to the separate property and awarded the wife substantially more. ***Id.*** at 355, 432 P.2d at 903.

¶24 In ***Cockrill***, the Arizona Supreme Court noted the rule from ***Nace***. 124 Ariz. at 53, 601 P.2d at 1337. It stated that "[t]his language seems to imply that if the community were paid a fair salary for its labor, the increase or profits from the separate property would remain separate. Only if such a salary had not been paid, or was not reasonable, would the all or none rule be applied." ***Id.*** The ***Cockrill*** court went on to describe this provision as an exception to the all or none rule and "[in] effect, apportionment of the increased value is allowed so long as the parties have segregated the profits themselves by paying the community a salary." ***Id.*** ***Cockrill***, as explained above, then rejected the all or none rule in favor of an apportionment rule, stating that "profits [and/or increase], which result from a combination of separate property and community labor, ***must be apportioned accordingly***." ***Id.*** at 54, 601 P.2d at 1338 (emphasis added).

¶25 Our supreme court then gave several methods of possible apportionment. ***Id.*** The first requires the court to "determine the reasonable value of the community's services and allocate that amount to the community, and treat the balance as separate property attributable to the inherent nature of the separate property." ***Id.*** The second is to "allocate to the separate property a reasonable rate of return on the original capital investment. Any increase above this amount is community property." ***Id.*** The court went on to make explicitly clear that "different circumstances[] requir[e] the application of a different method of apportionment. We, therefore, hold that the trial court ***is not bound*** by any one method, but may select whichever will achieve substantial justice between the parties." ***Id.*** (emphasis added).

¶26 ***Cockrill*** thus rejected any requirement that the trial court follow one method of apportionment over another. The clear direction from ***Cockrill*** is that the method of apportionment applied must "achieve substantial justice between the parties." ***Id.*** We reject the argument that by ***describing*** how the ***Nace*** exception applied in the then-existing law, ***Cockrill*** was ***endorsing*** that exception in future cases. It is not difficult to envision a scenario in which a reasonable salary has been paid, but the community nevertheless has not been fairly compensated for the increase in value (whether reflected by goodwill or net profits) attributable to its effort. We agree with the reasoning and illustration of the trial court in this case in rejecting the continued applicability of ***Nace*** in light of ***Cockrill***:

> [Applying the rule from ***Nace***] would be particularly egregious in a situation where an entity had substantial growth and less than one hundred percent (100%) of the [earnings attributable to the community] was distributed. If the testimony deduced that fair compensation was paid (for example based upon comparable industry standards), the sole and separate estate would be awarded all of the intangible growth ***and*** the undistributed portion of the earnings and compensation. This is far from the result that ***Cockrill*** envisions.
>
> Indeed [one of the current parties' accountant's] Schedule 3 expands upon this point. In the case at bar, if DMM had hypothetically only distributed the $1,063,322 of his defined reasonable compensation, so that $2,059,199 remained within the entity, under Husband's analysis, reasonable compensation would have been paid, and no further division would occur. Husband would thusly be able to retain not only the $2,059,199 of undistributed earnings, he would be entitled to retain the $1,510,000 of intangible value that [the accountant] found.

¶27 The foregoing illustration makes clear that if reasonable compensation for services rendered ended the analysis, the party owning the separate property could retain all the value (profits and goodwill) built by the community labor simply by paying himself or herself a salary that was comparable to industry standards, and accordingly "fair." In that situation, a patently unjust result would arise from the trial court's inability to consider another method of apportionment. The community, though having been fairly compensated for its labor, would not receive any allocation for the increase in value (whether net profits or goodwill) which was directly tied to the community's effort. Thus to the extent that the method applied prior to ***Cockrill*** and described in ***Nace*** limits the trial court's discretion to choose whichever method of apportionment will achieve substantial justice between the parties, we follow our supreme court's decision in ***Cockrill,*** not this court's prior ruling in ***Nace***.

¶28 Husband also points us to ***Roden v. Roden***, in which this court (after ***Cockrill***) stated that "if the community is paid a fair return for its labor, the increase or profits from the separate property remain separate. Only if such return has not been paid, or was not reasonable, would the community have a claim to the growth in value of [the] separate property." 190 Ariz. 407, 411, 949 P.2d 67, 71 (App. 1997) (citing ***Nace***, 104 Ariz. at 20, 448 P.2d at 76). Husband argues that ***Roden*** reaffirms ***Nace*** and supports his argument that the trial court need not engage in an overall apportionment of the total increase in value of separate property due to the community's efforts if a reasonable salary has been paid the community. We disagree with Husband's arguments.

¶29 We appreciate that, on its face, the quoted language in ***Roden*** does support the proposition from ***Nace*** that no apportionment of the community's interest in profits and/or value is required so long as a reasonable salary has been paid to the community. However, this principle was not relied upon in ***Roden***. The wife in that case argued that she was entitled to her share of a community interest in the increase in value of a separate business. 190 Ariz. at 410, 949 P.2d at 70. Rather than finding that the community had been paid a reasonable salary, and therefore was not entitled under ***Nace*** to a community interest in the increase in value of the business, the trial court determined that "the increase in value of [the separate business], which resulted from community efforts, was ***offset*** by the amount of compensation – community property – that each party received during the marriage." ***Id.*** at 411, 949 P.2d at 71 (emphasis added). This court concluded that the trial court did not abuse its discretion in coming to that conclusion. ***Id.*** Although this court set forth that ***Nace*** could preclude the ability to receive an increase in value (if the community is reasonably compensated), neither the trial court nor this court relied on that rule. ***Id.*** at 410, 949 P.2d at 70. Rather, both the trial court and this court applied the underlying holding from ***Cockrill***; namely, that apportionment must be "appropriate and equitable in a particular situation" and "achieve substantial justice between the parties." ***Cockrill***, 124 Ariz. at 54, 601 P.2d at 1338. This took place as the trial court applied, and this court affirmed, an "offset" of the community's share in the increase in value of the separate property in light of the amount of compensation previously paid the community. ***Roden***, 190 Ariz. at 411, 949 P.2d at 710.

¶30 It is instructive to consider, particularly in light of ***Roden*** and ***Nace***, that a different analysis would apply in a typical business setting than one involving both separate and community property. For example, in a typical business, A (the business owner) hires B (the employee) to work for A's company. A is the sole owner of the company. A agrees to pay B a reasonable salary. Assume that over the course of five years A's business increases substantially in value and that 50% of the increase in value can be attributed to B's efforts. The law does not entitle B to 50% of any increase in value or profits because his contractual arrangement was only for the fair salary, which had been paid and received. To grant B a share of the profits and/or of the company's increased value would essentially make B an equity partner with A. This, however, was not the contractual arrangement.

¶31 Now, if we change the facts to reflect a community property scenario, the result is different. Assume that all facts in the hypothetical are the same except that the business is A's separate property and when A hires B, they are married to each other and remain married during the relevant time period. The reason for the different result is the community nature of the property that results from the labor of B. In short, B's labor on behalf of the community makes the community a form of equity partner (to the extent of the community's toil) in A's sole and separate business. The Arizona Supreme Court put it this way:

> Where either spouse is engaged in a business whose capital is the separate property of such spouse, the profits of the business are either community or separate in accordance with whether they are the result of the individual toil and application of the spouse, or the inherent qualities of the business itself.

Rundle, 38 Ariz. at 245, 298 P. at 931. Thus, the company's profits, and as set forth above we construe that to also include its increase in value, become a community asset to the extent "they are the result of the individual toil and application of the spouse." ***Id.*** In essence, our community property laws transform the community into an equity partner with the sole and separate property-owning spouse to the extent the community's efforts have generated net earnings, increased the value, or otherwise increased the net worth and/or market value of the company. Under our hypothetical, the community is apportioned 50% of the total increase (however denominated) of A's company, as that is the amount attributable to B's efforts. The community's share is not eliminated just because the laboring spouse has been paid a fair salary along the way.[7]

¶32 Thus, to the extent the language from ***Roden*** suggests receipt of a fair salary deprives the community of an interest in value and/or profits in a separate business, otherwise due the community, it is contrary to ***Cockrill*** and we decline to follow it.

3. The Facts Support the Finding that Two-Thirds of DMM's Growth Was Attributable to the Community's Labor.

¶33 Husband argues that the trial court abused its discretion in finding that the community was responsible for two-thirds of DMM's growth. He argues that no evidence was presented that anything other than external factors contributed to DMM's growth after 1999.

¶34 Husband misperceives the burden of proof. It was not the responsibility of Wife to present evidence that DMM's growth

[7] In the event A did more than simply own the separate property, a court tasked with determining the community's fair share would also have to determine the company's increase and profits attributable to A's toil during the marriage. Our hypothetical assumes that only B provided effort or contributed to the company's profits and/or increase in value.

was due to the community labor; rather, it was Husband's burden to show that it remained separate property. ***Cockrill***, 124 Ariz. at 52, 601 P.2d at 1336 ("[W]hen the value of separate property is increased the burden is upon the spouse who contends that the increase is also separate property to prove that the increase is the result of the inherent value of the property itself and is not the product of the work effort of the community."). There is a strong presumption that "all earnings during coverture are community in nature" that is overcome only by a showing of clear and convincing evidence to the contrary. ***Barr v. Petzhold***, 77 Ariz. 399, 409, 273 P.2d 161, 167 (1954).

¶35 Here, it was within the trial court's discretion to start with the presumption that all of the growth in DMM was community property and then look to the evidence presented by Husband to see if he had managed to overcome that presumption. Husband did present evidence that DMM's growth was influenced by external factors, including an increase in manufacturer marketing and sales assistance, increased customer acceptance of the products, increased research and development by manufacturers, natural population growth in market area, and other DMM sales personnel expanding the market. However, Wife testified that she served as the manager of operations of DMM from 1999 until the couple separated. Wife's expert testified that the primary factor responsible for DMM's growth was the "work effort of the community." Because there was reasonable evidence supporting the trial court's finding that two-thirds of the growth in DMM was primarily due to community labor, there was no error.[8]

4. There was No Abuse of Discretion in Failing to Apply the Two-Thirds/One-Third Ratio to the Total Increase of DMM During the Marriage.

¶36 Husband argues that the trial court abused its discretion in apportioning the increased value of the company given the prior distribution of net distributable earnings to the community. Specifically, Husband argues that the trial court "exceeded the bounds of reason by ignoring the fact that the community had received 100% of [DMM's] (very considerable) net distributable earnings, and by ruling that the community was also entitled to" a share of DMM's increase in value. *Reply Brief* at 25. We agree with the general principle encapsulated

[8] Wife also argues that Husband cannot object to the adequacy of the trial court's factual findings because he failed to object below. As set forth above, we construe the primary focus of Husband's argument to be as he argued in his Opening Brief, that "[t]he Special Master simply had no basis *in the evidence* upon which to make its ruling." *Opening Brief* at 30 (emphasis in original). We have rejected this argument. Additionally, the trial court's order incorporating the special master's report states that "each party shall have the right of direct appeal to the Arizona Court of Appeals . . . from the decision of the Superior Court Judge (adopting, modifying or rejecting the arbitrator's decision)." Thus, any waiver issue as to the adequacy of the form of the findings is moot.

in Husband's argument but disagree that there has been an abuse of discretion on the facts here.

¶37 The trial court found (and neither party contests) that the marital community received virtually 100% of net distributable earnings during the marriage. If, as a result of its receipt of the funds, the community already had received more than its proportionate share of the total profits and increase in DMM, and the trial court used the reasonable rate of return method to award the community additional monies, that may violate the fundamental rule from ***Cockrill*** to apportion the increase equitably. However, no request was made of the trial court to determine the amount of the net distributable earnings paid to the community. Neither was there a request to determine that the same two-thirds/one-third ratio as to value (goodwill) applied to net earnings.

¶38 In *Rowe v. Rowe* this court also dealt with the issue of apportioning an increase in both profits and value for a separately owned business. 154 Ariz. 616, 618-21, 744 P.2d 717, 719-22 (App. 1987). The trial court concluded that a "fair ratio" to quantify "the overlapping contributions" between community contribution and that attributable to the separate property itself was a three-fourths/one-fourth ratio. ***Id.*** at 620, 744 P.2d at 721. In that case we approved the entire amount of the corporate stock in the sole and separate property to be awarded to the sole and separate property owner. *Id.* at 619, 744 P.2d at 720. This resulted in no further award to the community with regard to the sole and separate property. *Id.* at 620, 744 P.2d at 721. The reason we found no error in this ruling was "[b]ecause the community had received, through distribution and pension and profit-plan contributions, more than 75% of the sum of net distributable earnings and (assumed) goodwill." *Id.* Accordingly, there was no error in the trial court's conclusion that "the community had been fairly compensated for all of its contributions to the growth of [a separate business]." *Id.* Here, the principle from *Rowe* teaches that if the two-thirds/one-third ratio allocating growth in DMM applies to both profits (net earnings) and value (here, goodwill) then it could be an abuse of discretion for either the community or the separate property to receive more than its proportionate share of the combined total.[9]

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[9] A hypothetical example may add clarity. Assume that a ratio of two-thirds/one-third was determined to apply to the share due the community and separate property, respectively, for its contribution to the growth of the business. Assume the amount of net earnings was $80 and increase in value was $20. The combined total of the increase is $100. The community would be entitled to $66.67, and the sole and separate property would be entitled to $33.33. If the community had already received $80 from net distributable earnings, it may not be entitled to any further amounts unless issues such as waiver, commingling, or other equitable considerations required otherwise. In fact, under this hypothetical, the sole and separate property owner may claim monies from the community if there are no other pertinent factors.

¶39 Husband did not make this argument below, and it is questionable whether the argument is set forth in his appellate briefs.[10] Giving Husband the benefit of the doubt, we address the argument but we reject it on the facts before us.

¶40 To prevail on this argument, Husband would be required to show at a minimum[11] that the community received more than its pro rata share of the combined total of net distributable earnings and increase in goodwill. Equally, and conversely, he would have to show that he received less than his pro rata share of the earnings as separate property. As pointed out above, the trial court was never asked to determine, and did not determine, the amount of net distributable earnings (income less salary and other expenses) generated during marriage. Because of this, we are unable to determine the combined total of net distributable earnings and increase in value. Thus, there is no factual basis

[10] Though Husband argues that it was an abuse of discretion to award a share of the increase in value after awarding 100% of the net distributable earnings, the primary arguments he makes to support this contention are (a) ***Cockrill*** permits receiving only an interest in profits or value, but not both and (b) having received a fair salary for services, the community is not entitled to any further interest in the separate business. As we discuss at length in sections one and two above, we have rejected both these arguments.

[11] Additionally, as Wife's counsel pointed out at oral argument, because this argument was not advanced below, certain issues were not developed in the trial court. These issues include commingling, waiver, and whether a different ratio should be applied to net earnings as contrasted with increase in value.

on which to assert error as there is no total figure to which the two-thirds/one-third ratio can be applied to determine – as the court did in *Rowe* – whether the community had already received its proportionate share of the total and no further monies were owed. Thus, there is no error on these grounds.[12]

Conclusion

¶41 For the foregoing reasons, we affirm.

____
DANIEL A. BARKER, Presiding Judge

CONCURRING:

____
PATRICK IRVINE, Judge

____
DIANE M. JOHNSEN, Judge

[12] Wife requests attorneys' fees for the appeal under A.R.S. § 25-324, arguing that Husband's positions on appeal were unreasonable. We consider both parties to have taken reasonable positions in this appeal and decline to award Wife attorneys' fees.

Standard & Premises of Value

Presented to:

October 23, 2015

Arizona Divorce Conference
Advanced Financial Concepts

KOTZIN VALUATION PARTNERS

Disclaimer

- This presentation is intended for informational and discussion purposes only, and is not intended as financial, investment, legal or consulting advice.

- Valuation and litigation services are very much affected by specific facts and circumstances. As such, the views expressed in these written materials do not necessarily reflect the professional opinions or positions that the presenters would take in an assignment, or in providing valuation or litigation services in connection with an actual litigation matter. Every situation is unique, and differing facts and circumstances may result in variations of the information presented.

Standard of Value

The International Glossary of Business Valuation Terms defines the Standard of Value *as the identification of the type of value being utilized in a specific engagement; for example, fair market value, fair value, investment value.*

Premises of Value

As discussed in Standards of Value, Theory and Applications by Jay Fishman, Shannon Pratt and William Morrison – ***the valuation of marital assets fall under two basic premises that form the basis of a continuum of value:***

- **Value in Exchange**
- **Value to the Holder**

Standard and Premises of Value

Value in Exchange

- Valuation is viewed in the context of a sale.
- Assumes a hypothetical transaction for cash.

Value to the Holder

- Considers value in the hands of its owner regardless of whether he or she intends to sell the interest.
- Assumes the titled spouse will continue to enjoy the benefits generated by the business that was created during the marriage.

Standards of Value, Theory and Applications - Jay Fishman, Shannon Pratt, William Morrison.

Standard of Value

- Fair Market Value
- Fair Value
- Investment Value
- Intrinsic Value
- Divorce Value

Standard of Value

Fair Market Value

Fair market value is defined by the American Society of Appraisers' Business Valuation Standards as *the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts*.

The premise of value is going concern and is based on the amount a hypothetical willing buyer would pay for the interest. This premise assumes that the Company is an ongoing business enterprise with management operating in a rational way with a goal of maximizing shareholder value.

Fair market value is defined by Treasury Regulation 20.2031-1(b) [estate tax] or 25.2512-1 [gift tax] as the price at which the property would change hands between a hypothetical willing buyer and a hypothetical willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

Used in all valuations for tax purposes.

Fair Value

Fair value is the standard of value used in the vast majority of dissenters' rights and oppressed shareholder statutes and is the standard of value specifically referenced in Arizona Revised Statutes 10-1434.

***Fair value* is the standard of value used in the vast majority of dissenters' rights and oppressed shareholder statutes. However, the term is rarely legislatively defined and is therefore a judicially determined concept of value. A major issue in many fair value cases is whether discounts for lack of control and lack of marketability are applicable. The current trend appears to be towards not applying discounts for lack of control and lack of marketability in determining fair value in shareholder dissent and oppression cases.**

In the context of a marital dissolution, the application of discounts for lack of marketability or lack of control associated with the subject interest may not be deemed relevant, absent the likelihood of the interest being sold to an unrelated buyer in the near-term.

Investment Value

Investment value is defined by the American Society of Appraisers' Business Valuation Standards as *the value to a particular investor based on individual investment requirements and expectations*.

In other words, investment value refers to the value of the subject business interest to a particular investor (in this case the marital community) without regard to a sale or exchange.

The premise of value is going concern and assumes that the Company is an ongoing business enterprise with management operating in a rational way with a goal of maximizing shareholder value.

Also referred to as value to the holder.

Standard of Value

Intrinsic Value

Intrinsic Value is defined in the International Glossary of Business Valuation Terms as *the value that an investor considers, on the basis of the available facts, to be the "true" or "real" value that will become the market value when other investors reach the same conclusion*.

KOTZIN VALUATION PARTNERS

Standard of Value

Divorce Value

If the business interest is not expected to be sold, or if the business interest is not marketable, then the appropriate standard of value is "**Divorce Value**" defined as the economic value of the business interest to the current owner.

Business Value Standards in Divorce – Business Valuation Review, September, 2000 page 159.

Premises of Value & Standard of Value Matrix

<table>
<tr><td>Premise of Value</td><td colspan="2">Value In Exchange</td><td colspan="2">Value to the Holder</td></tr>
<tr><td>Standard of Value</td><td>Fair Market Value</td><td colspan="2">Fair Value</td><td>Investment Value</td></tr>
<tr><td>Case Example</td><td></td><td></td><td></td><td>Mitchell v Mitchell
Walsh v Walsh</td></tr>
</table>

Standards of Value, Theory and Applications - Jay Fishman, Shannon Pratt, William Morrison.

Standard and Premises of Value

Schickner v Schickner NO.1 CA-CV 13-0513 FC

- For Physicians Surgery Center, LLC ("PSC") Husbands expert #1 provided the following values for a 20% interest: $540,000 not applying any discounts, $490,000 applying minority share and marketability discounts. Implied combined discount 9%.

- For PSC Husbands expert #2 valued a 20% interest at $580,000 applying minority share and marketability discounts.

- The trial court noted "that a minority interest has less value than the total interest of a company on a per – share basis", finding "this distinction significant because the community does not own a controlling interest in either business venture."

- Trial court determined that the "fair market value" of the community's 20% interest in PSC is $536,000.

- On appeal it was determined that for PSC, the evidence reasonably supports the application of a minority share discount.

- Court stated that Husband only owns a 20% interest in PSC and the record did not reveal any basis for concluding that Husbands control over PSC is not substantially limited by the holder of the 80% interest.

- Court stated that because the trial court's application of a minority share discount and corresponding valuation of PSC at $536,000 is supported by the record, we discern no abuse of discretion.

Standard and Premises of Value

<u>Schickner v Schickner NO.1 CA-CV 13-0513 FC</u>

- For Western Medical Eye Center, LLC (“WME”) Husbands expert #1 provided the following values for a 50% interest: $830,000 not applying any discounts, $620,000 applying minority share and marketability discounts. Implied combined discount 25%.

- For WME Husbands expert #2 valued a 50% interest at $475,000 applying minority share and marketability discounts.

- Trial court determined that the “fair market value” of the community’s 50% interest in WME is $602,000.

- On appeal it was determined that for WME, the underlying assumptions justifying the application of a minority share discount are not supported by the record and it was remanded for a revaluation.

- Court referenced In re Marriage of Davis, 880 P.2d 1376 (Mont. 1994) – *concluding that application of a minority share discount was inappropriate when the record reflected the minority shareholder had “broad powers regarding financial decisions” and had “no intention of selling” his interest.*

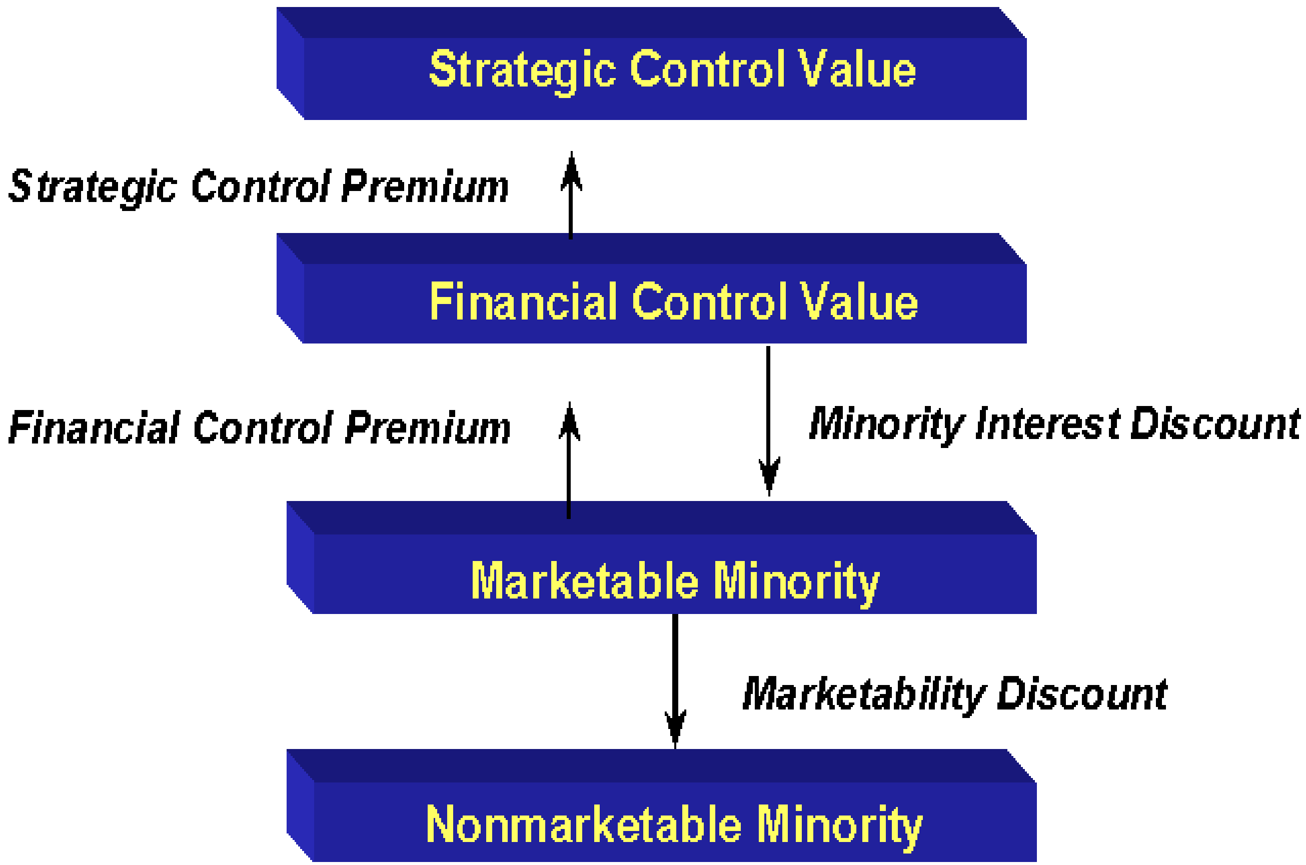
Standard and Premises of Value

Schickner v Schickner NO.1 CA-CV 13-0513 FC

- Because the division of community assets in a marital dissolution proceeding is governed by an equitable division principle (a different standard), *Pro Finish* is inapposite.
- Consistent with the majority of other jurisdictions that have addressed the issue, we decline to adopt such a bright line rule here.
- Minority share discounts may be "used in proper settings" but need not be "applied in all instances"
- Application of "a marketability discount is an appropriate device to use in valuing a party's interest in an asset under some circumstances."
- A trial court has discretion to consider whether a minority discount is appropriate, on a case-by-case basis, considering factors such as the minority shareholder's degree of control, lack of marketability, and the likelihood of a sale of the minority interest in the foreseeable future.
- Application of a minority share discount is a fact specific inquiry that must be considered "on a case by case basis."
- A minority discount may be inappropriate when no sale of a minority share is imminent or planned.

Standard of Value

Levels of Value Chart



Questions

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A New Perspective on the Rueschenberg Passive Rate of Return

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Overview of Rueschenberg Decision

On May 13, 2008, the Court of Appeals of Arizona, Division 1 decided Rueschenberg v. Rueschenberg (1 CA-CV 07-0300). This decision has had a significant impact on the valuation of sole and separate business interests in Arizona marital dissolutions. Business valuators now perform "Rueschenberg Analyses" when ownership of a sole and separate business interest business is found to pre-date the marriage. The Rueschenberg Decision concluded the following with respect to apportioning the increase in value and/or profits from a separately held business.

> …it is not error to apportion both profits (net earnings) and increase in value (whether that is goodwill or a measurable increase in value of some other asset) if the community labor was responsible for a portion of both and if such an apportionment "will achieve substantial justice between the parties."

The Rueschenberg Decision states the following with respect to the methodology utilized to apportion the increase in value of Desert Mountain Medical ("DMM").

> The special master's report used the capitalization of earnings method of valuation to find that DMM had a fair value of $163,166 at the commencement of the marriage. This value was based on the special master's finding that normalized earnings were $38,000 at the time the parties married, that the applicable capitalization rate was 25%, and that there was an additional $11,166 in a non-operating asset/shareholder loan which added to the value. Using the same method, it found that DMM was worth $1,440,000 (having normalized earnings of $360,000) on October 31, 2003. The report then awarded Husband a sole and separate property interest of $550,000. It arrived at this figure by giving what it considered to be a fair rate of return on the original investment of $163,166. The report then subtracted that $550,000 from the value at the dissolution of marriage, $1,440,000, and found that the community was responsible for two-thirds of the resulting increase (i.e. two-thirds of $890,000), which amounts to $593,333. It then awarded Wife half of this amount, or $296,667.

The trial court incorporated the special master's findings verbatim into its decree of dissolution. The Rueschenberg Decision affirmed the trial court's ruling. While the Rueschenberg Decision helped to bring a standard framework to valuing sole and separate business interests, the methodology utilized with respect to the passive rate of return may result in outcomes which are inconsistent with achieving substantial justice between the parties in certain instances.

The Rueschenberg Decision references the Cockrill Decision (124 Ariz. at 53, 601 P.2d at 1337). Cockrill presents the following two relevant methods of apportioning increase in value and profits of a sole and separate business.

> 1. [Determine]The reasonable value of the community's services and allocate that amount to the community, and treat the balance as separate property attributable to the inherent nature of the separate estate.
>
> 2. The trial court may simply allocate to the separate property a reasonable rate of return on the original capital investment. Any increase above this amount is community property.

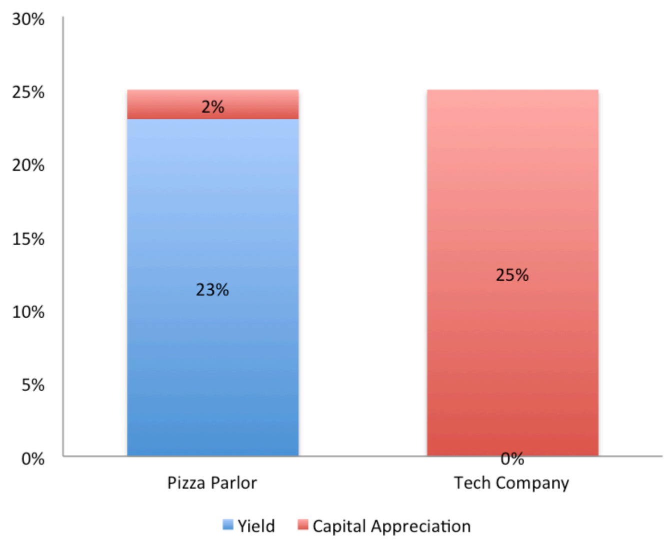
The special master in Rueschenberg utilized the latter method, with an extra step apportioning one-third of the excess appreciation to non-community factors. The special master found that the community had received virtually 100% of the net distributable earnings of DMM, which were between $2,875,000 and $3,122,521. Assuming $3,000,000 of profit distributions, and an increase in value of approximately $1,277,000 the total return of DMM equated to $4,277,000, which equates to a total annual rate return of approximately 81.5% over a five and a half year period.

Due to the fact that DMM was a larger medical device sales representative organization, and its high annual total return of 81.5%, the capitalization rate of 25% was a reasonable benchmark for the increase in value of DMM over a five and a half year period. As the Rueschenberg Decision indicates, the passive rate of return is case specific. For a small business, or over a longer timeframe, applying the capitalization rate may distort the result of the analysis.

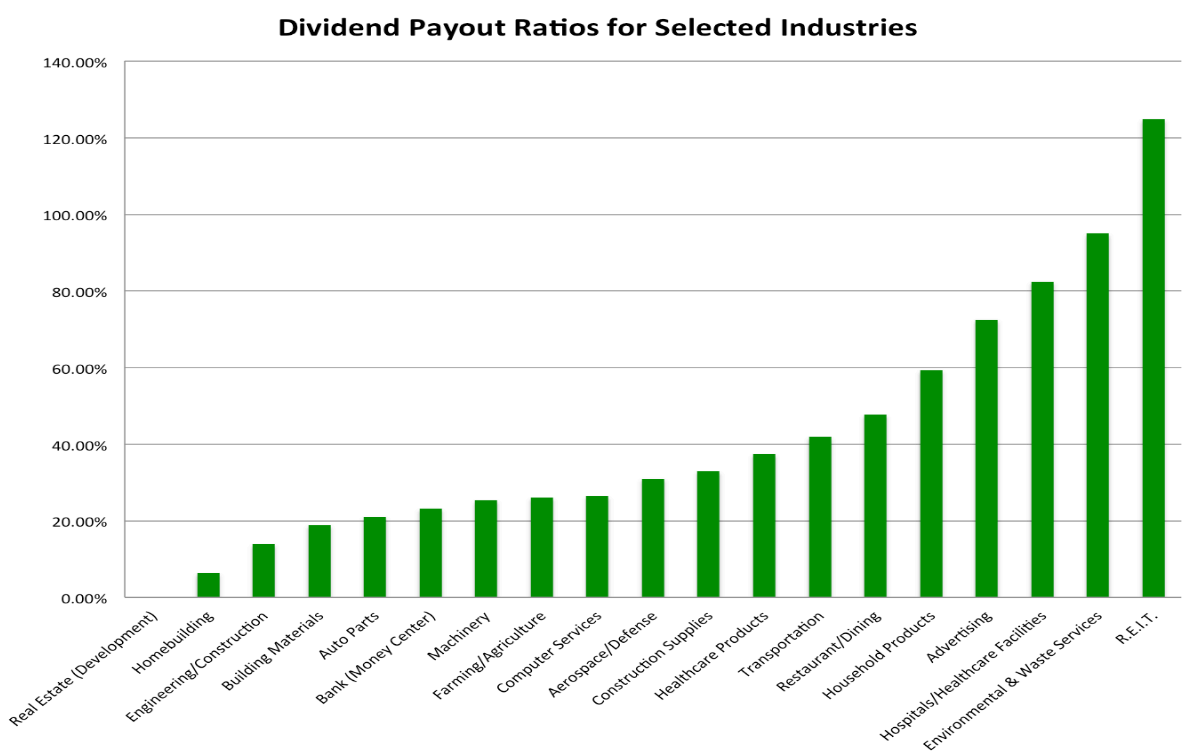
The 25% capitalization rate utilized to value DMM, and applied as a passive rate of return, is a total rate of return. This rate includes both dividends (yield) and capital appreciation (increase in value). In Rueschenberg, the $3,000,000 of profit distributions were treated as community since husband did not assert a separate interest in them at trial. Wife did not assert that the community had been undercompensated for its labor. Due to the fact that these issues were not raised at trial, it remains an open question whether profit distributions above market compensation received by the community are subject to an offset against the community interest in the increase in value.

Passive Rate of Return

It is important to understand that the capitalization rate utilized to value a business is dependent upon expectations of yield and capital appreciation that are specific to the industry and business being valued. To illustrate, a start-up tech company and a pizza parlor may both have a capitalization rate of 25%. The yield expectation for the tech company would be zero, with all of the 25% return being expected to come in the form of compound capital appreciation. Conversely, the pizza parlor would have a yield expectation of 25% and a capital appreciation expectation of minimal growth. This difference in expected return is illustrated as follows.



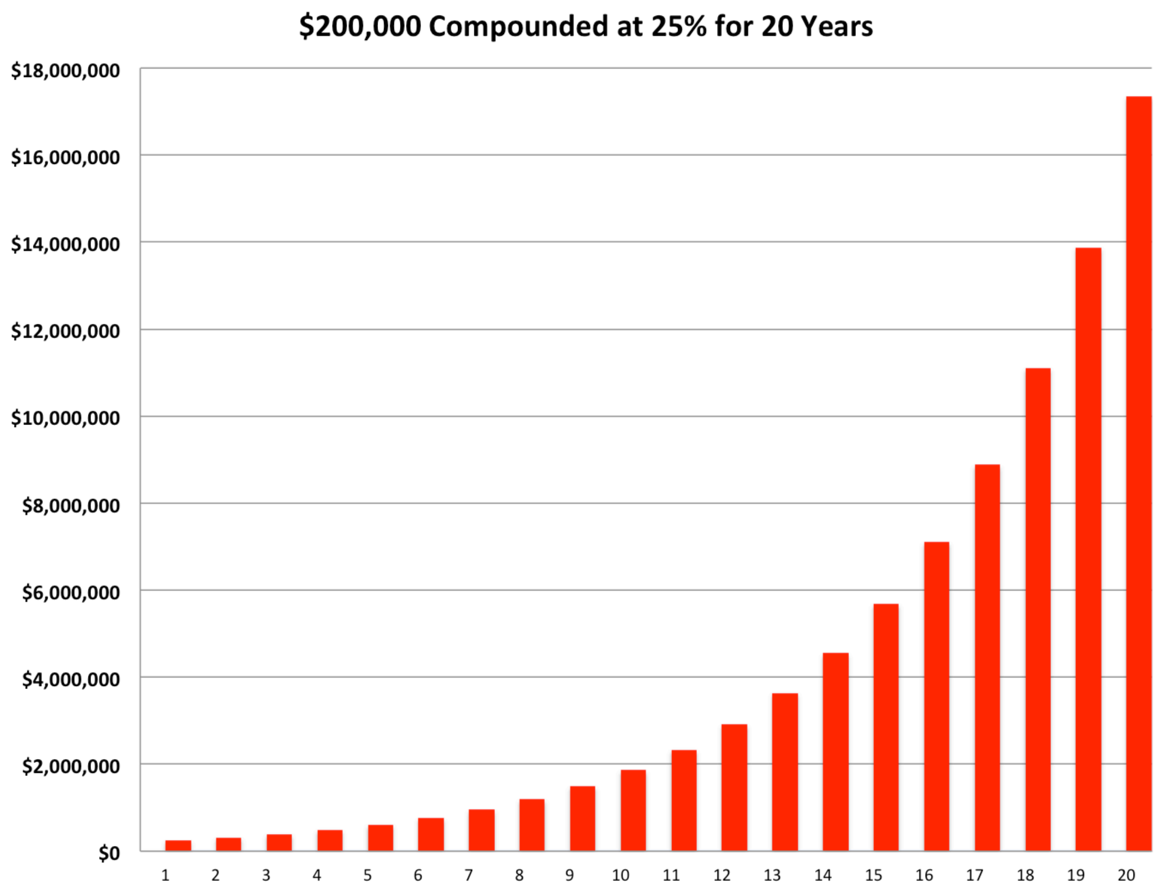
As demonstrated in the following graph, dividend payout ratios (dividends / net income) of publicly traded companies vary widely by industry[1].



1 http://www.stern.nyu.edu/~adamodar/pc/datasets/divfcfe.xls

As shown above, some industries pay out virtually all of their earnings in the form of dividends while others pay no dividends and reinvest all earnings. Owner-operator type businesses often have high dividend payout ratios due to limited growth opportunities and the need to provide income for the owners to live on. Utilizing the company's capitalization rate for a growth-constrained small business assumes a dividend payout ratio of zero and also assumes that the reinvested funds will continue to compound at the capitalization rate over the period analyzed.

The following table illustrates the capital appreciation growth of $200,000 at 25% per year compounded for 20 years.

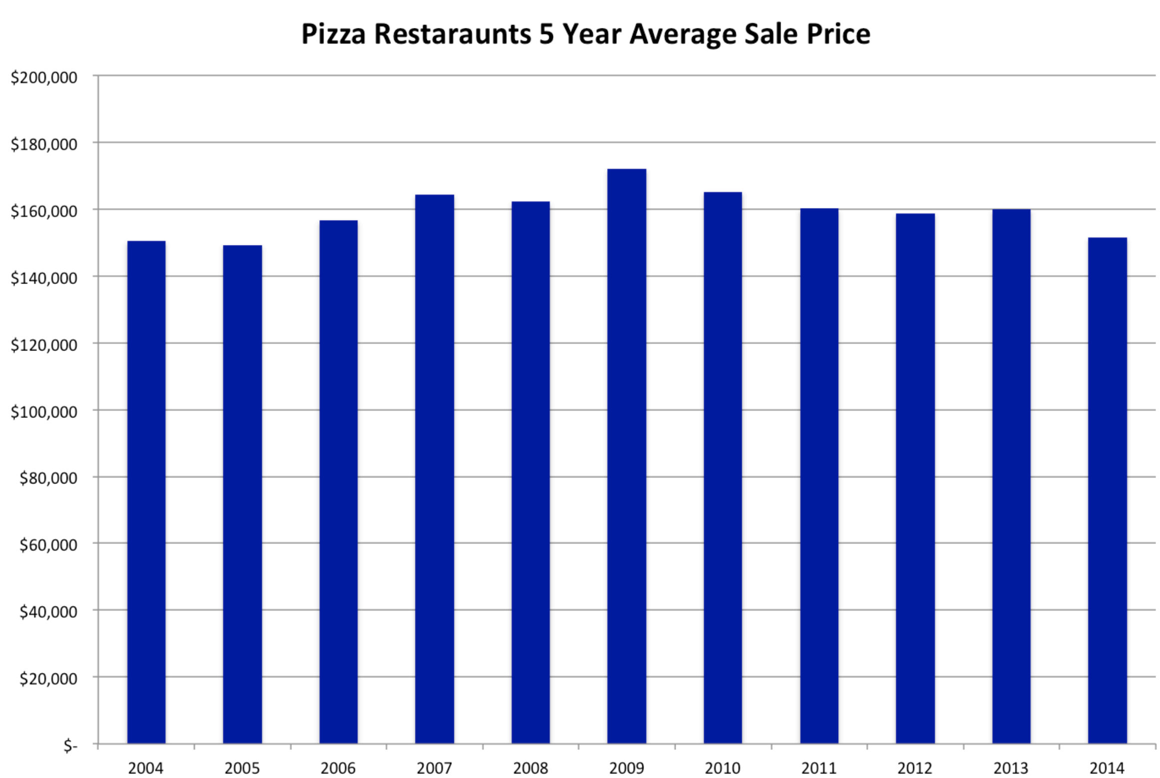


As illustrated above, the law of compounding begins to significantly increase the value around year seven. Due to the five and a half year marriage duration in Rueschenberg, the effects of compounding were somewhat minimized. Rather, for owner-operator business, the expectation and practice is typically to distribute all of the available earnings each year. These distributed earnings do not compound at the company's capitalization rate and do not drive the dramatic compounded value increase illustrated above. Buyers do not purchase a $200,000 single-location pizza parlor with the expectation to sell it for $17,000,000. Therefore, it is illogical to apply the capitalization rate as a passive rate of return for growth-constrained small businesses since it ignores the effects of the dividend payout.

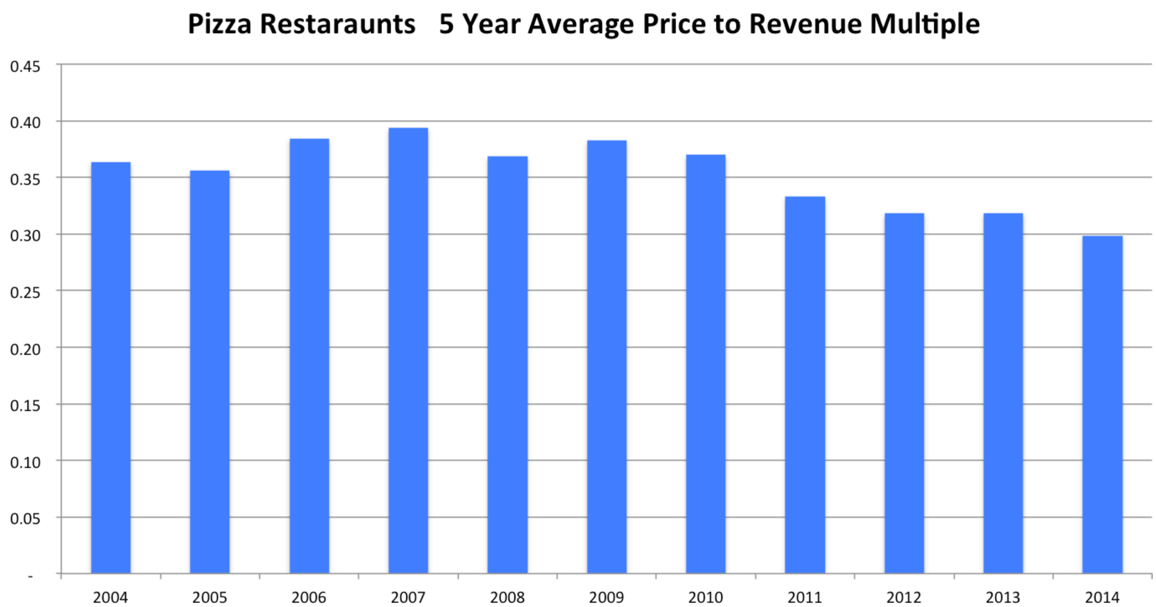
A case can also be made that the capitalization rate for an owner-operator business is not, by its very nature, a passive rate of return. Unlike larger companies that trade on multiples of EBITDA and cash flow, owner-operator businesses typically trade on multiples of seller's discretionary earnings ("SDE"), which is EBITDA plus one owner's salary. The reason that owner-operator businesses transact based upon SDE multiples rests in the fact that the buyer is primarily concerned with the total cash flows that will accrue to him or her and are indifferent as to whether these cash flows come in the form of profits or salary. Typical SDE multiples range from 1 to 4 and, when expressed as capitalization rates, often result in values between 20 to 40 percent. For these reasons, owner-operator capitalization rates represent active rates of return that are based upon buyers who expect to work in the business and receive the economic benefits of this labor each year. This fact provides further justification for selecting alternate passive rates of return to apply in Rueschenberg analyses for owner-operator businesses.

Pizza Restaurant Illustration

Evidence supporting of the lack of significant appreciation in a growth-constrained industry such as a pizza parlor is demonstrated by actual transaction data for pizza restaurants from Pratts Stats and BizComps. The following chart represents a five-year rolling average of the sale price of small pizza restaurants from 2000 through 2014.



The graph above demonstrates that there has not been any significant appreciation in the average sale price of pizza restaurants over the 15-year period. This is largely due to the following downtrend in price to revenue multiples.



Based on the data above, it appears that pizza restaurants may not have even appreciated at the rate of inflation over the last 15 years due to a general decline in industry multiples. This data is presented solely to illustrate the fact that, for certain growth-constrained small businesses, the company's capitalization rate is not an appropriate benchmark for a passive rate of return when the dividend payout ratio is not considered.

Proxies for Passive Rate of Return

Proxies for determining capital appreciation rates for an owner-operator business include industry growth rates, GDP growth rates or inflation over the period analyzed. For companies that operate solely or predominately within a particular metro area, one relevant proxy may be the growth of the local economy. The following graph details the uneven growth of the Phoenix metro economy from 2002 through 2013[2].

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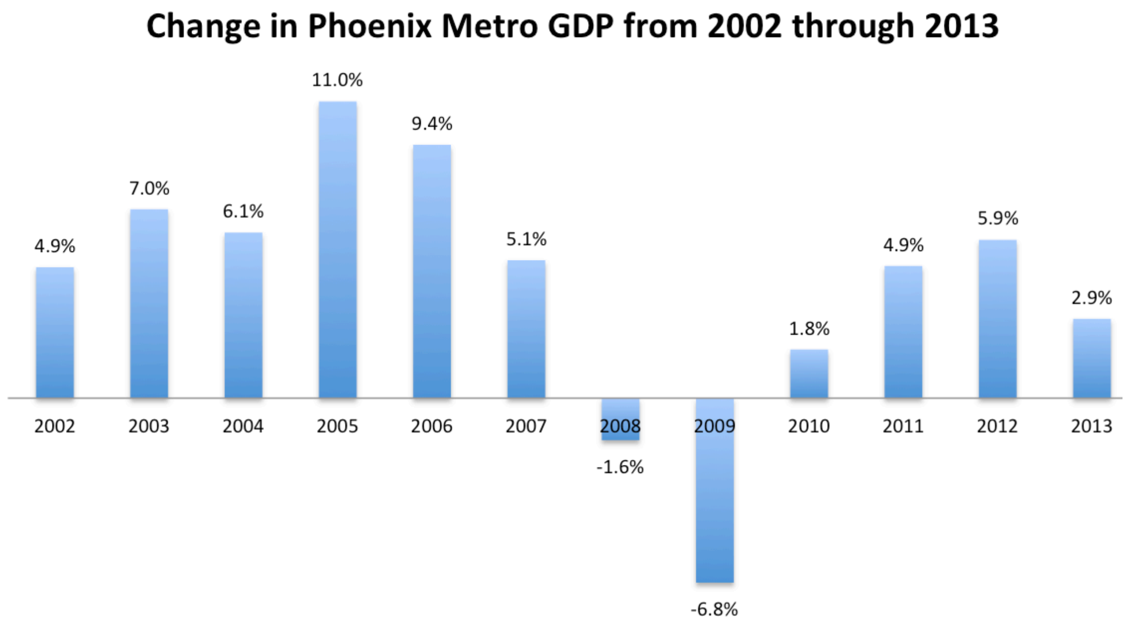
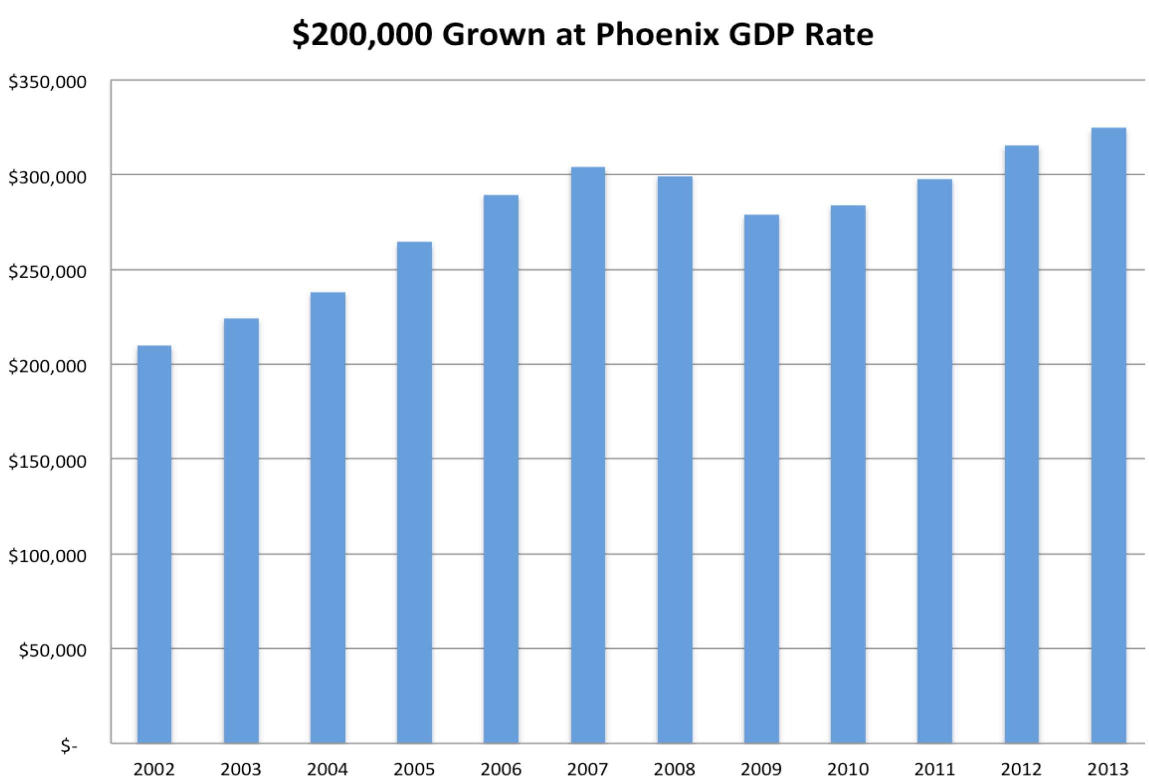
[2] http://www.statista.com/statistics/183876/gdp-of-the-phoenix-metro-area/



For many industries with elastic cyclical demand, the local economy represents a relevant passive rate of return indicator. The following graph details the growth of a $200,000 business over 12 years based upon the Phoenix metro GDP data above.



Conclusion

There is no universal answer to the question of an appropriate passive rate of return to apply in Rueschenberg scenarios. The passive rate of return must be carefully considered based upon the yield and capital appreciation components of a particular total rate of return for a company. For the owner-operator small businesses, the typical practice is to distribute the most of the total return to the owner in each year. This distribution policy, along with the growth-constrained nature of many small companies, results in an expected capital appreciation growth rate that is closer to inflation, industry growth or the growth of the economy.

It should be noted that the special master in Rueschenberg implemented a second level of apportioning the increase in value above a passive rate of return. In the case of DMM, one-third of the excess appreciation was attributed to sources other than the marital community. Given this second step of apportionment, it makes sense to utilize a conservative rate for passive appreciation as any non-community factors can be considered in the second step of the apportionment.

By understanding the dynamics of the yield and capital appreciation that comprise a total return, Arizona business evaluators, attorneys and judges can apply passive rates of return that help to achieve the “substantial justice between the parties” that permeates the Cockrill and Rueschenberg decisions.

A New Perspective on the Rueschenberg Passive Rate of Return

Mark R. Hughes, CPA, ABV, CFF

GORMAN Consulting Group L.L.C.
Valuation • Damages • Forensics • Receivership

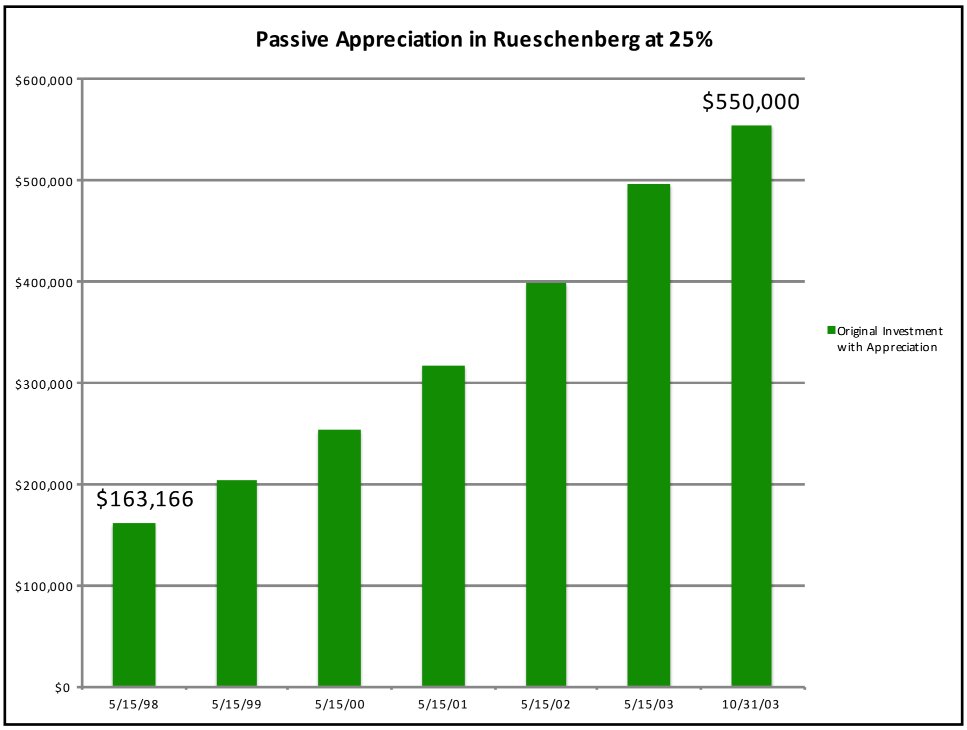
Overview of Rueschenberg v. Rueschenberg

- May 13, 2008 – Court of Appeals of Arizona, Division 1 decided
- A sole and separate business interest can have community value due to community factors
  - Profits / Net Earnings
  - Increase in Value
  - Compensation / Lien

Summary of Special Master's Report

- Date of Marriage 5/15/98
- Capitalization of Earnings Method
- Normalized Earnings = $38,000
- Cap Rate = 25%
- Value = $163,166

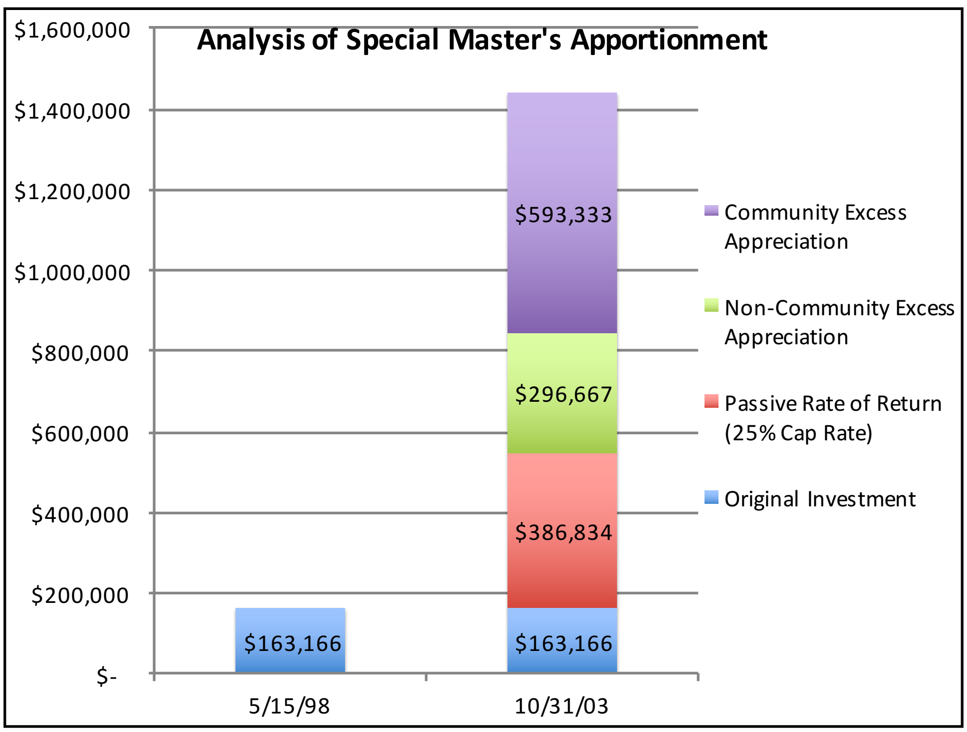
- Date of Separation 10/31/03
- Capitalization of Earnings Method
- Normalized Earnings = $360,000
- Cap Rate = 25%
- Value = $1,440,000



Summary of Special Master's Report

- Awarded Husband a separate property interest of $550,000
- Community was responsible for two-thirds of increase.
- Wife was awarded half of this increase

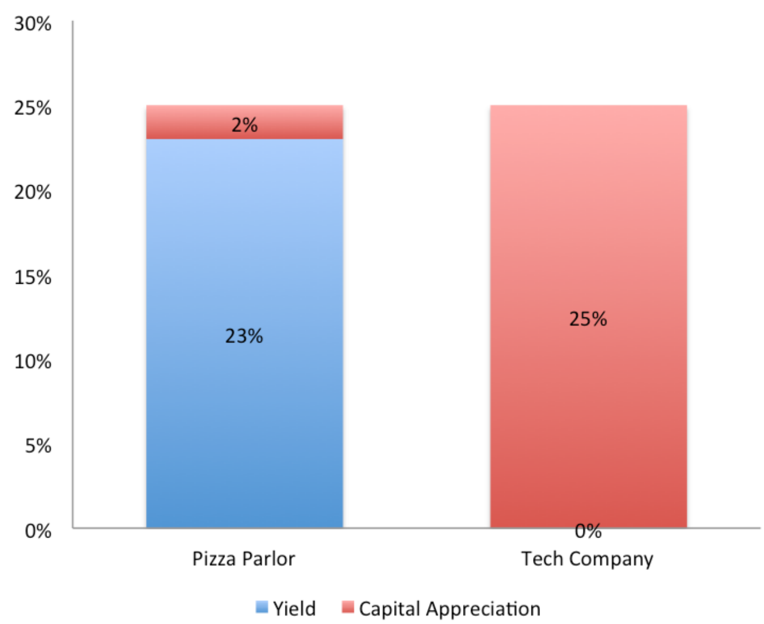
1,440,000
-550,000
890,000
/ 3
593,333
/2
$296,667

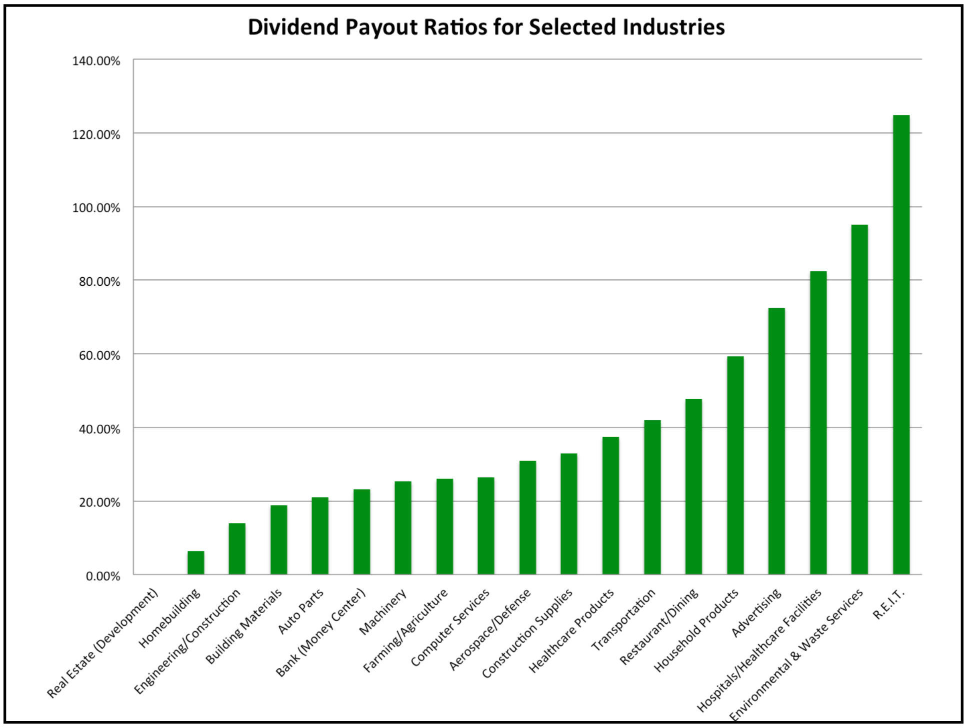


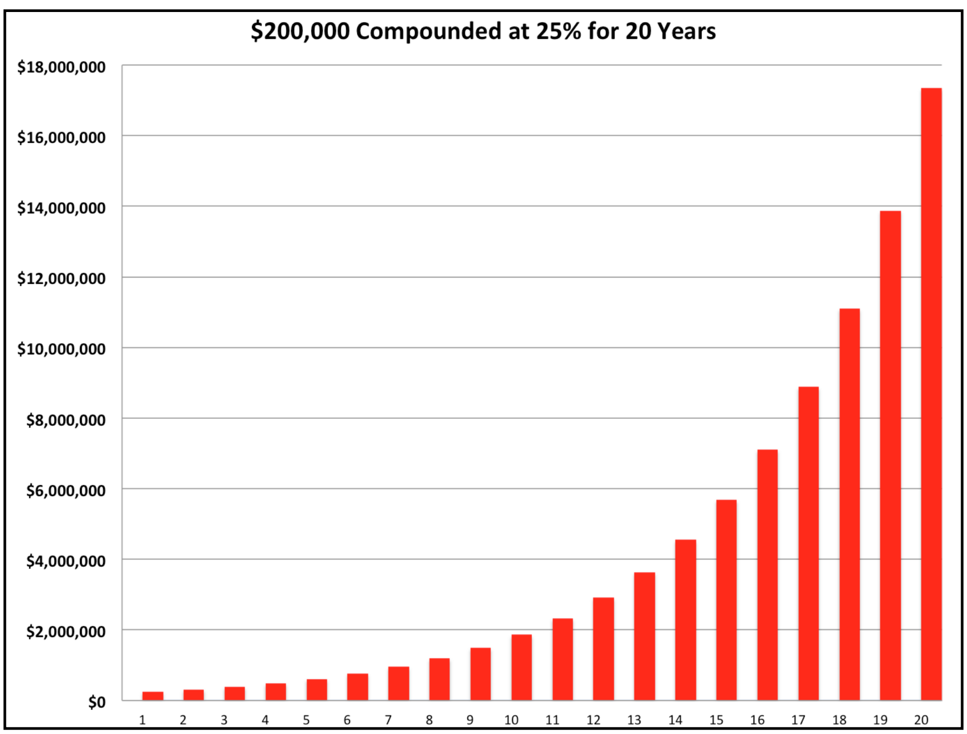
Capitalization Rate Components

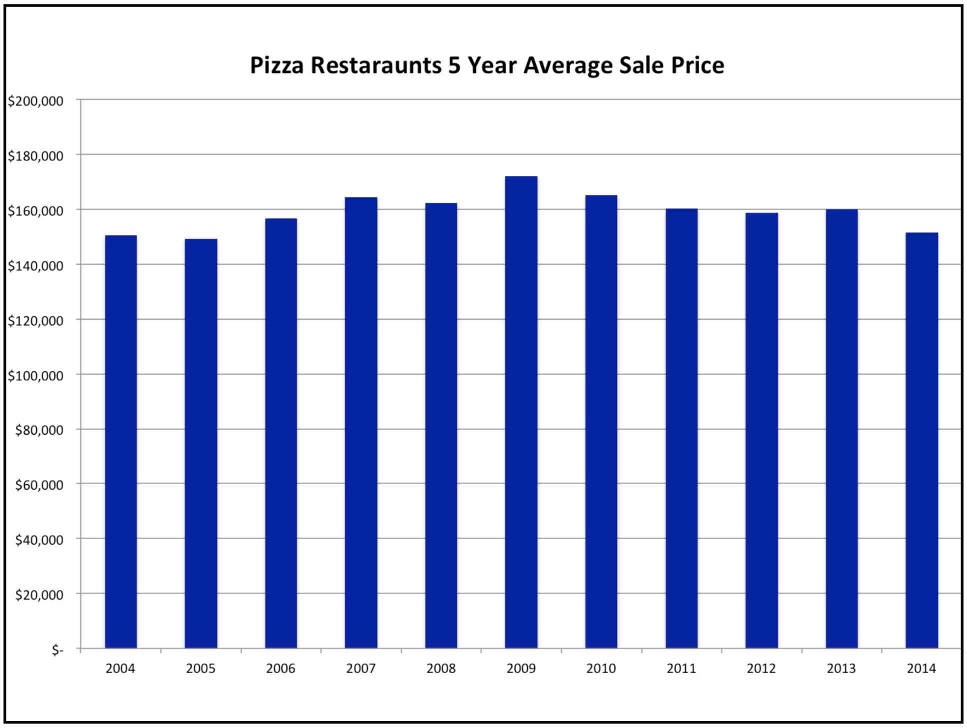
- A Capitalization Rate is a Total Rate of Return of Two Components:
  - Expectations of yield (dividend payout)
  - Expectation of capital appreciation

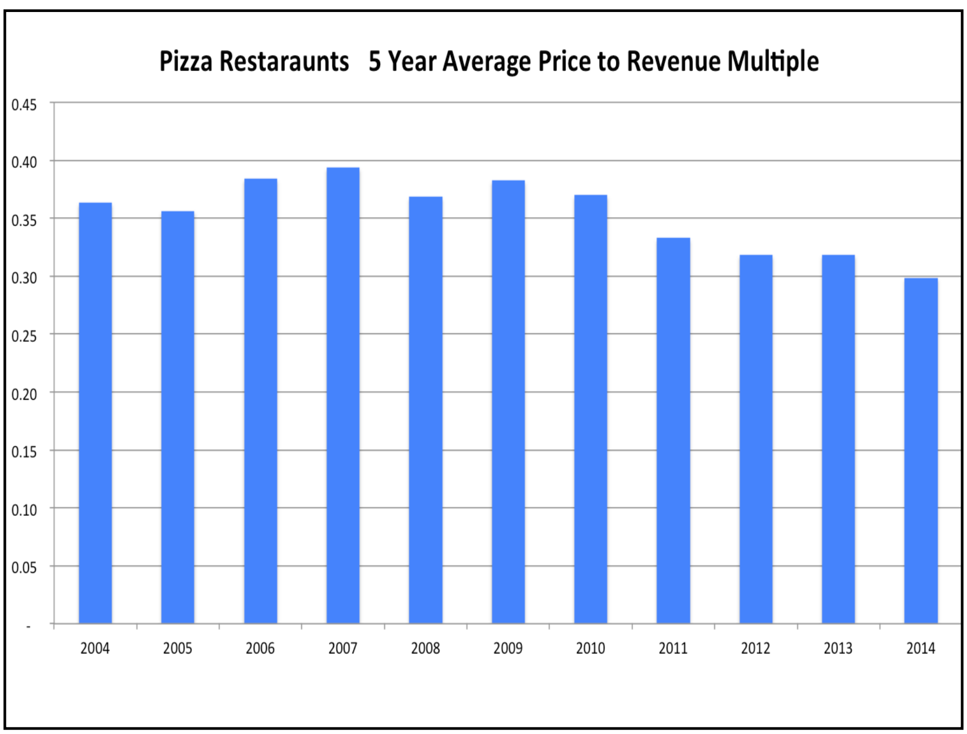
Yield and Capital Appreciation Can Differ Greatly




Dividend Payout Ratios for Selected Industries
140.00%
120.00%
100.00%
80.00%
60.00%
40.00%
20.00%
0.00%
Real Estate (Development)
Homebuilding
Engineering/Construction
Building Materials
Auto Parts
Bank (Money Center)
Machinery
Farming/Agriculture
Computer Services
Aerospace/Defense
Construction Supplies
Healthcare Products
Transportation
Restaurant/Dining
Household Products
Advertising
Hospitals/Healthcare Facilities
Environmental & Waste Services
R.E.I.T.

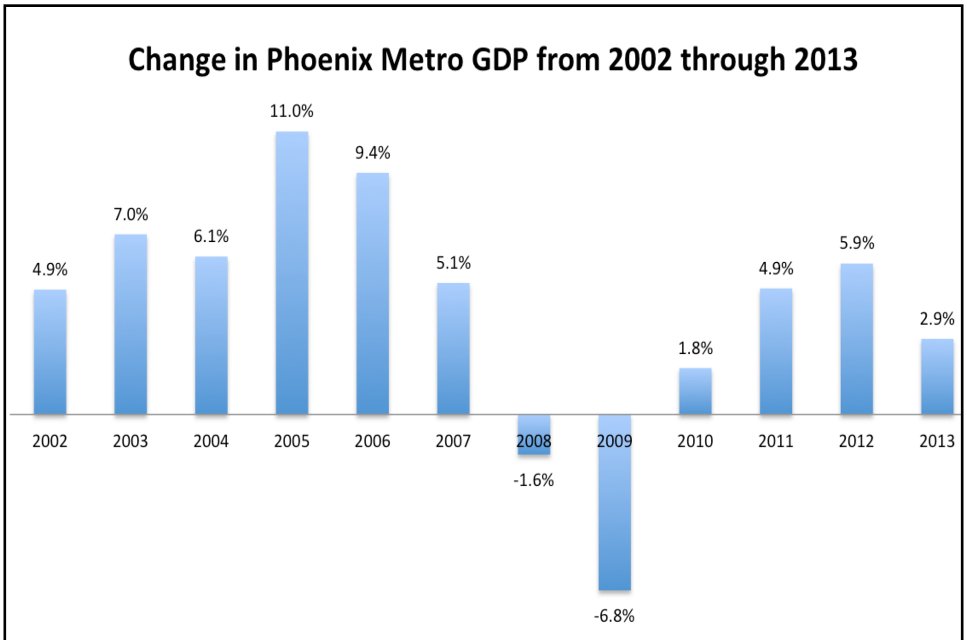

$200,000 Compounded at 25% for 20 Years
$18,000,000
$16,000,000
$14,000,000
$12,000,000
$10,000,000
$8,000,000
$6,000,000
$4,000,000
$2,000,000
$0
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20

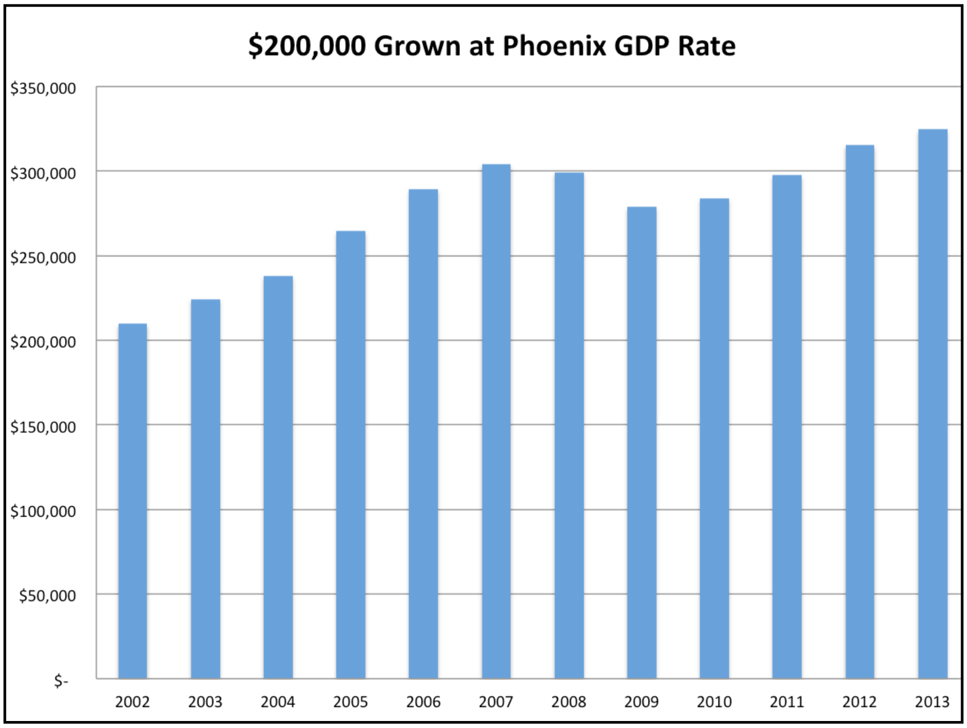

Pizza Restaraunts 5 Year Average Sale Price
$200,000
$180,000
$160,000
$140,000
$120,000
$100,000
$80,000
$60,000
$40,000
$20,000
$-
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014


Pizza Restaraunts 5 Year Average Price to Revenue Multiple
0.45
0.40
0.35
0.30
0.25
0.20
0.15
0.10
0.05
-
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014

Proxies for Passive Rates of Return for High-Dividend Companies

- Industry growth rates
- GDP growth rates
- Inflation over the period analyzed
- Local Economy





Conclusion

- The Passive Rate of Return is Based Upon Specific Facts and Circumstances
- All Capitalization Rates ("Cap Rates") are Total Rates of Return Comprised of Dividends and Capital Appreciation
- Analyze Dividend Payout Ratio and Expectation
- Consider Using Only Capital Appreciation Component or Market Proxy for Passive Rate

REASONABLE COMPENSATION: The Achilles Heel of Business Appraisals

Kathleen A. McCarthy, J.D.

1. REASONABLE COMPENSATION: *A Tiny Phrase that Packs a Mighty Punch.*

One of the most common ways to determine the value of a small business is the income valuation method, which simply capitalizes the net revenue stream that the business produces. Of course, the amount of compensation paid to the owners of the business has a direct effect on that revenue stream. In order to produce a clear picture of how much profit a business actually generates, *reasonable compensation* for the owner must be deducted from total earnings before a conclusion as to *normalized earnings* can be reached. *Valuing Small Businesses & Professional Practices*. Third Edition. Shannon P. Pratt, Robert F Reilly, Robert P. Schweihs, p. 413. 1

In the context of the income valuation approach, an overstatement of reasonable compensation will result in a lower value for the business and an understatement will produce a higher value. Because of the compounding effect of the capitalization rate over time, discrepancies in reasonable compensation skew the final valuation by more than a dollar for dollar amount. For example, if the error in reasonable compensation is $25,000 a year and the cap rate is 20%, the change in the net value will be close to $125,000. Because of the dramatic effects of compounding, the relative accuracy of reasonable compensation is truly the Achilles heel of an otherwise well-reasoned business valuation appraisal.

2. WHAT IS THE STANDARD FOR REASONABLE COMPENSATION? *Hint: There's Room at the Party for More than One.*

The legal and professional standards for determining reasonable compensation are based to a large degree on the cases arising out of an application of Revenue Ruling 68-609, issued by the Internal Revenue Service, which states that:

> "If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business".

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[1] Of course, reasonable compensation also comes up in the context of determining a community property lien on a separate property business. ***Cockrill v. Cockrill,*** 124 Ariz. 50, 601 P.2d 1334 (1979); ***Rowe v. Rowe,*** 154 Ariz. 616, 744 P.2d 717 (Ct. App. 1987); and ***Rueschenberg v. Rueschenberg***, 219 Ariz. 249, 196 P.3d 852 (Ct. App. 2008).

This ruling is normally applied by the IRS in the context of determining the tax consequences to a business based upon the compensation being paid to its owner(s). Essentially, if owner compensation is reasonable, the company gets a tax deduction for the expense. If owner compensation is not reasonable, the company does not get the expense deduction. The IRS is looking at the reasonable compensation model in terms of ferreting out items that artificially reduce tax liability in a manner that is prohibited by the tax code. Some examples of these issues include tax bracket shifting; classification of payments as salary or dividends; determining the proper amount of compensation that is subject to social security and Medicare taxes; and looking at salaries paid to children or other family members to determine whether they are legitimate business expenses, or gifts.

Even though the purpose of determining reasonable compensation may be different in the tax context as opposed to the business valuation context, the concept of reasonable compensation is the same in both arenas. Be aware, however, that although IRS regulations may be instructive in appropriate cases, a court is not bound by IRS valuation standards used for federal income tax purposes. See, for example, an unreported case, ***Coleman v. Robinson,*** No. 1 CA-CV 12-0749, 2013 WL 5676076, at *4 (Ariz. Ct. App. Oct. 17, 2013).

Reasonable compensation is defined by Treasury Regulation §1.162.7(b)(3) as the amount that would ordinarily be paid for like services by like organizations in like circumstances. This standard is adopted in Treasury Regulation §53.4958.4(b)(1)(ii)(A), and published in a document titled ***"Reasonable Compensation Job Aid for IRS Valuation Professionals"***, Developed by a Team of IRS Valuation Professionals from the Large Business and International Division. October 29, 2014 (hereafter cited as ***"IRS Publication"***).2

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[2] Note that in bold letters on each page of this publication appears the following disclaimer: **Not an official IRS position. Prepared for reference purposes only; it may not be used or cited as authority for setting any legal position".**

The preeminent 9th Circuit IRS case on the reasonable compensation issue is ***Elliotts, Inc. v. C.I.R.,*** 716 F.2d 1241, (9th Cir. 1983). 3 In ***Elliotts***, the court held that when evaluating the reasonableness of compensation paid to a shareholder-employee, particularly a sole shareholder, it is helpful to consider the matter from the perspective of a hypothetical independent investor. A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated. This has been described as a "much simpler and more purposive test". *Elliotts, Inc. v. Commissioner, supra*, 716 F.2d at 1245-48; *Exacto Spring Corp. v. C.I.R*., 196 F.3d 833, 838 (7th Cir. 1999). The ***Elliotts*** court then went on to articulate five factors for determining reasonable compensation, which will be discussed later in this article.

In ***Exacto***, the court disdained all of the "multi-factor" tests used throughout various federal circuits, and adopted ***the "independent investor" test***. ***Elliotts*** (see above) approved the independent investor test, and essentially the "five factors" set forth by the court are the Ninth Circuit's methodology for conducting that analysis. ***Exacto Spring Corp. v. C.I.R.,*** 196 F.3d 833, 838 (7th Cir. 1999, emphasis added.)

Shannon Pratt, one of the preeminent authorities in the business valuation realm, defines the standard for reasonable compensation as being the "normal level of compensation generally considered to be the expense of employing a nonowner/employee to perform the owner/employee's services." ***Valuing Small Businesses & Professional Practices.*** Third Edition. Shannon P. Pratt, Robert F Reilly, Robert P. Schweihs, p. 413.

It is critical to compare the owner's compensation to that of his or her **peers**. "It is very important to attempt to compare professionals with like professionals... " But to whatever extent possible, the earnings considered should be on a golden delicious-to golden delicious basis, not on a golden delicious-to-crab apple basis." ***Valuing Small***

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[3] According to Ron Seigneur and Kevin Yeanoplos, co-authors of *Reasonable Compensation: Application and Analysis for Appraisal, Tax and Management Purposes*, 2010 Edition, ***Elliotts*** is the leading authority in the Ninth Circuit…″ [Seigneur & Yeanoplos at page 57.] However, it is important to note that almost all of the cases citing ***Elliotts*** are, in fact, tax court cases.

Businesses & Professional Practices. Third Edition. Shannon P. Pratt, Robert F Reilly, Robert P. Schweihs, p. 593. In this same vein, the standard has also been described as how much compensation would be paid for this same position held by a non-owner in an arms-length relationship at a similar company. ***IRS Publication.***

Other courts have defined the standard as requiring a comparison of the owner's salary to peers deemed to be **average** in the profession where the practice is located. ***In re Marriage of Ackerman,*** 146 Cal. App. 4th 191, 200, 52 Cal. Rptr. 3d 744, 751 (2006), as modified on denial of reh'g (Jan. 23, 2007, emphasis added.). Ackerman involved the issue of husband's medical practice where a capitalization of excess earnings method to value goodwill was used. The analysis of the Ackerman court highlights the quandary that results from imposing the term **average** into the formula: *it is not fair to those who excel at their jobs.*

3. WHAT GOES INTO THE PUDDING?

There are numerous facts to be considered in determining reasonable compensation, but they generally fall within the following broad categories:

a. The employee/owner's role in the business, including the nature and extent of the employee's position and duties performed and the specialized degree of the tasks performed; ***Elliotts, supra; IRS Publication.***

b. The supervisory responsibilities of the owner/employee. ***IRS Publication***.

c. The general importance of the employee/owner to the success of the company, including the employee's knowledge of the business. ***Elliotts, supra***; ***IRS Publication.***

d. The owner/employee's qualifications, including skill, background and experience. IRS Publication.

e. The similarity of other companies (size and type) to whom the employee/owner is being compared. The company's size would be indicated by its sales, net income or capital value. ***Elliotts, supra.***

f. The time devoted by the employee to his or her duties, otherwise known as the "productivity adjustment". ***IRS Publication.***

g. The owner/employee's managerial talent. In ***McCoy v. McCoy,*** 91 Ohio App. 3d 570, 576, 632 N.E.2d 1358, 1361-62 (1993), the issue was the valuation of husband's physical therapy business. In determining reasonable compensation for purposes of valuing the business, the court held that the value of the employee/owner's ***managerial talent*** in addition to other services they provide to the business must be considered. This is what the court had to say:

> In the case at bar, ***the highly successful nature of the business clearly depended on the skills of Mr. McCoy and Majka as "managers," not as "hands-on" physical therapists***. The client base of the partnership relied almost exclusively on referrals from physicians and local medical clinics. Mr. McCoy and Majka are responsible for maintaining and cultivating those client referrals. ***McCoy, supra,*** 632 N.E.2d at 1362 (Emphasis Supplied).

4. GETTING PAST THE ADMISSIBILITY GATE

Arizona's current standard for the admission of expert witness testimony (Rule 702) has undergone varying mutations over the years until it reached a resting point with the rules enacted January 1, 2012, which adopted the Federal Rule of Evidence 702, which is basically the Daubert standard. Under this standard, the trial court assesses both the methodology and conclusions of the expert for reliability. For legal history buffs, a trip down the Daubert and Frye memory lane is an interesting exercise. (See Appendix for such a travelogue written by Thomas Piccioli, Esq.)

For now, all components of the expert's opinion (including the reasonable compensation component) should be analyzed under Rules 702, 703 and 705 of the Rules of Evidence relating to the admissibility of expert opinion testimony:

Rule 702. Testimony by Expert Witnesses.

A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

(A) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;

(B) the testimony is based on sufficient facts or data;

(C) the testimony is the product of reliable principles and methods; and

(D) the expert has reliably applied the principles and methods to the facts of the case.
Amended Sept. 8, 2011, effective January 1, 2012.

Rule 703. Bases of an Expert's Opinion Testimony:

An expert may base an opinion on facts or data in the case that the expert has been made aware of or personally observed. If experts in the particular field would reasonably rely on those kinds of facts or data in forming an opinion on the subject, they need not be admissible for the opinion to be admitted. But if the facts or data would in forming an opinion on the subject, they need not be admissible for the opinion to be admitted. But if the facts or data would otherwise be inadmissible, the proponent of the opinion may disclose them to the jury only if there probative value in helping the jury evaluate the opinion substantially outweighs their prejudicial effect. Amended October 19, 1988, effective November 1, 1988; September 3, 2009, effective January 1, 2010; September 8, 2011, effective January 1, 2012.

Rule 705. Disclosing the Facts or Data Underlying an Expert's Opinion

> Unless the court orders otherwise, an expert may state an opinion-and give the reasons for it–without first testifying to the underlying facts or data. But the expert may be required to disclose those facts or data on cross-examination. Amended October 19, 1988, effective November 1, 1988; September 3, 2009, effective January 1, 2010; September 8, 2011, effective January 1, 2012.

There is an issue as to whether deficiencies in the expert's testimony only affect its weight in the eyes of the trier(s) of fact, or whether such deficiencies can actually preclude the admissibility of the evidence. Arizona law favors the former. In ***Kelsey v. Kelsey,*** 186 Ariz. 49, 918 P.2d 1067 (Ct. App. 1996), the Court held valuation of assets is a factual determination that must be based on the facts and circumstances of each case. The trial court has discretion to rely on various methods of valuing a professional practice, and to qualify expert witnesses who testify regarding asset valuation. If an expert fails to calculate the value of an asset according to standard methodology, that failure goes to the weight of the expert's opinion, not the admissibility.

In Arizona, the qualification of witnesses as experts is left to the discretion of the trial court. A witness may be qualified to give an opinion by reason of his "real world" experience as well as by academic study. The standard is whether the witness has "specialized knowledge [which] will assist the trier of fact ..." Rule 702, Arizona Rules of Evidence. For instance, a witness who is not a certified appraiser may give valuation evidence in a condemnation case. ***Maricopa Cnty. v. Barkley,*** 168 Ariz. 234, 239, 812 P.2d 1052, 1057 (Ct. App. 1990). By the same token, a trier of fact may disregard expert opinion evidence when it is equivocal; when it is contradicted by other expert testimony; when its factual predicates are disputed; or when common experience or conflicting lay testimony provide a basis for disbelief. ***Crystal Point Joint Venture v. Arizona Dep't of Revenue,*** 188 Ariz. 96, 104, 932 P.2d 1367, 1375 (Ct. App. 1997).

5. CROSS EXAMINATION: *Step One: Understand the Vulnerabilities; Step Two: Understand the Vulnerabilities; Step Three: Understand the Vulnerabilities......*

Given the huge impact that the amount of reasonable compensation can have on a business valuation, it is critical to understand the vulnerabilities of the valuation analysis for cross examination purposes.

The starting point in determining *reasonable compensation* is always a data base/survey of compensation, typically as industry/job specific as possible. The number of sources used by valuation experts is literally mind boggling. But not all data bases are created equal, and many business valuation professionals are not careful about making sure that the comparisons are true *comparables*. The following is a list of cross-examination points with respect to drawbacks and limitations arising of the data. However the take home point for all of the potential flaws in determining reasonable compensation can be summed up as: **REASONABLE COMPARED TO WHAT?** Whether you use a strict multi-factor analysis, or the simplified independent investor analysis, the expert has to be able to show why and how the data that was used satisfies the required analysis.

a. Did the expert thoroughly interview the owner/employee to determine the precise qualifications, his or her role in the company, duties beyond basic employment, managerial skills and the like?

b. Did the expert rely on national or regional data?

c. Does the data include business profits as compensation?

d. What is the sample size?

e. SIC Code (Standard Industrial Classification) – how does subject company stack up against broader company classification ranges?

f. How is the job title defined and how do the actual duties of the subject compare with that definition?

g. Is the data presented as an average, or some other statistical variant?

h. Does the data reflect compensation for a particular niche or specialty?

i. Do you need to use multiple job titles from the survey in order to accurately reflect the subject's duties?

j. What is the reliability of the statistics and sources used in the survey?

k. Are all perks reflected in the data?

l. Did all companies in the data base report consistently with respect to retirement benefits?

m. Is the owner a key person / top performer / sales generator or offer other special managerial talent?

n. Is the productivity of the subject comparable to the owner/employee? 4

The *Ackerman* case dealt head-on with the underlying issue of **COMPARED TO WHAT**, and the court summarized several of the foregoing data flaws in criticizing the reports of ***both experts*** who testified in the case. As to the MGMA survey, the court was *"troubled by [what a national survey of the western states has] to do with a plastic*

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[4] Many thanks to Ron Seigneur and Kevin Yeanoplos, co-authors of *Reasonable Compensation: Application and Analysis for Appraisal, Tax and Management Purposes*, 2010 Edition, for giving permission to use material from their excellent book; Yeanoplos,Brueggeman and Johnson Yeanoplos, P.C., 7363 E. Tanque Verde Rd., Tucson, AZ 85715, kry@bjyvalue.com

surgeon who is doing essentially cosmetic surgery in Newport Beach." The court considered it common knowledge that, unlike other types of surgery, cosmetic surgery used discretionary income and the amount of discretionary income in Southern California *"is remarkably different ... than in such places as Pocaltella, Idaho; or Gallow [sic], New Mexico; or Little Rock, Arkansas."* *202. As to Christensen's report, the court was not sure it had "any stronger basis other than the fact he went out and talked to a couple of people as a kind of quality control check...." It noted the difficulty of relying on reasonable compensation statistics for employees, stating, "*it just boggles the mind to think"* anyone making as much money as husband would work for an employer and receive "a third of what he's actually making." ***In re Marriage of Ackerman,*** 146 Cal. App. 4th 191, 201-02, 52 Cal. Rptr. 3d 744, 752 (2006), as modified on denial of reh'g (Jan. 23, 2007, emphasis added.)

Obviously, someone attempting to debunk an expert's report would do well to obtain a result such as the one in ***Ackerman***. The take home point is that the lawyer has to fully understand the owner/employee's role in the company, and then thoroughly examine the data bases relied upon by the expert. In order to do that effectively, it may be advisable to consult with an expert who is specifically skilled in the arena of determining reasonable compensation, such as a vocational expert. The data bases at issue are the stock-in-trade of those experts. If you are well prepared, an expert can help you save time and expense in managing the task of making sure that the data bases used, actually compare "delicious" to "delicious".

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THE LONG AND WINDING ROAD TO RULE 702

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Arizona's current standard for the admission of expert witness testimony (Rule 702) has undergone varying mutations over the years as documented below.

In 1962, Arizona adopted the "Frye" standard. At issue was the interpretation of Federal Rule of Evidence 702, which was identical to Arizona's Rule 702. In ***State v. Valdez,*** 91 Ariz. 274, 277, 371 P.2d 894, 896 (1962), the Court precluded polygraph evidence due to its failure to gain general acceptance and in so doing articulated the standard as follows:

> "Somewhere in this twilight zone the evidential force of the principle must be recognized, and while courts will go a long way in admitting expert testimony deduced from a well-recognized scientific principle or discovery, the thing from which the deduction is made must be sufficiently established to have gained general acceptance in the particular field in which it belongs."

Although a bit complicated, the Frye doctrine was really looking at the underlying science that is used to substantiate a testifying expert's opinion.

As of 2000 in ***Logerquist v. McVey,*** 196 Ariz. 470, 482, 1 P.3d 113, 125 (2000), the Arizona Supreme Court made it clear that Frye remained the underlying test for the admissibility of certain expert testimony: as is illustrated by excerpts from that case:

> "Arizona adopted Frye in 1962. See ***State v. Valdez,*** 91 Ariz. 274, 371 P.2d 894 (1962) (precluding polygraph evidence for its failure to gain general acceptance). We adopted our version of the Rules of Evidence in 1977. Many courts and commentators believed that Frye "could be read into the regulation of expert testimony in Rule 702." 22 Charles Alan Wright & Kenneth W. Graham, Federal Practice and Procedure § 5168.1, at 85 (Supp.1998); see also McCormick on Evidence § 203, at 731 (John W. Strong, ed., 5th ed.1999). Unlike the United States Supreme Court, however, we have left no doubt whether Ariz.R.Evid. 702

was intended to abolish the Frye doctrine, for we have continued to apply Frye since the adoption of Rule 702 and have faced these same questions before."

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"The expert's opinion—the final result—was based on a process or formula established by others and not generally acknowledged by scientists and statisticians in that field." ***Logerquist,*** 1 P.3d 113, 120.

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"Although compliance with Frye is necessary when the scientist reaches a conclusion by applying a scientific theory or process based on the work or discovery of others, under Rules 702 and 703 experts may testify concerning their own experimentation and observation and opinions based on their own work without first showing general acceptance. Such evidence need only meet the traditional requirements of relevance and avoid substantial prejudice, confusion, or waste of time. 188 Ariz. at 127, 933 P.2d at 1195; see also ***California v. McDonald,*** 37 Cal.3d 351, 208 Cal.Rptr. 236, 690 P.2d 709 (1984)." ***Logerquist***, 1 P.3d 113, 123.

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"Frye is applicable when an expert witness reaches a conclusion by deduction from the application of novel scientific principles, formulae, or procedures developed by others. It is inapplicable when a witness reaches a conclusion by inductive reasoning based on his or her own experience, observation, or research. In the latter case, the validity of the premise is tested by interrogation of the witness; in the former case, it is tested by inquiring into general acceptance." ***Logerquist,*** 1 P.3d 113, 133.

The Arizona Supreme Court in Logerquist rejected the application of the then-current federal case law interpretation of Rule 702 as set down in Daubert.

Essentially, Daubert set a "reliability" standard for the review of expert testimony. Daubert was in conflict with Frye because Frye only applied to the methodology used and not necessarily to conclusions of the expert. Daubert extended the reliability standard to both methodology and conclusions:

> “One method of interpreting Rule 702 of the Federal Rules of Evidence is that adopted by the United States Supreme Court in Daubert. It was unclear at first whether Daubert applied only to the methodology used to reach scientific opinions or whether it applied to all opinion evidence offered under Rule 702. The Court subsequently held that a district judge's reliability determination applied to both conclusions and methodology and was reviewable only on an abuse of discretion standard." ***Logerquist,*** 1 P.3d 113, 124.
>
> “Whereas Frye required judges to survey the pertinent field to assess the validity of the proffered scientific evidence, Daubert calls upon judges to assess the merits of the scientific research supporting an expert's opinion." **Logerquist,** 1 P.3d 113, 125.
>
> Rejecting the Daubert standard, the Logerquist Court stated as follows:
>
> "Turning to our rules, nothing in the comments of this court or its committees indicated that a reliability standard was contemplated by our adoption of Ariz.R.Evid. 702. Given the rule's text and cases such as ***Hummert,*** 188 Ariz. 119, 933 P.2d 1187; ***Johnson,*** 186 Ariz. 329, 922 P.2d 294; and ***Bible,*** 175 Ariz. 549, 858 P.2d 1152—all decided after we adopted Ariz.R.Evid. 702—we could not now discover such a standard implicit in the language of the rule, phrased as it is in terms of "specialized knowledge" that will assist the jury "to understand the evidence or to determine" the facts and permitting expert testimony when a witness is "qualified ... by knowledge, skill, experience, training, or education." Nor do we believe we should interpret the rule to include such a standard." ***Logerquist***, 1 P.3d 113, 128.

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> “We thus conclude that we should not and cannot adopt the Joiner and Kumho interpretation of Daubert but will continue to apply Ariz.R.Evid. 702 as written. Our conclusion is not, as the Martone dissent suggests, based on a lack of confidence in or appreciation for trial judges but instead an appreciation for the different functions of the trial judge and the jury. Justice McGregor's dissent points out that there are only seventeen states that have not adopted Daubert and expresses concern that we are overreacting to Kumho so that today's decision will possibly isolate Arizona from the "mainstream of judicial analysis." McGregor dissent at ¶ 99. These are matters of concern, but we believe we adopt the better rule and that in the long run the dangers of Kumho will be perceived and the mainstream of judicial decision will either shift or Kumho 's reach will be confined and Daubert applied as it should be—to questions of novel scientific evidence." ***Logerquist***, 1 P.3d 113.

The Frye / Daubert controversy was ended when Arizona adopted the revised Rule 702 effective January 1, 2012, which adopted the Federal Rules of Evidence 702, which is basically the Daubert standard. Under this standard, the trial court assesses both the methodology and conclusions of the expert for reliability.

The new language of Rule 702 marks a notable departure from Arizona's former test for the admissibility of expert testimony that was detailed in ***Logerquist v. McVey,*** 196 Ariz. 470, 1 P.3d 113 (2000).2 The comment to the new Arizona Rule 702 notes that the change from Logerquist and the former Rule 702 "recognizes that trial courts should serve as gatekeepers in assuring that proposed expert testimony is reliable and thus helpful to the jury's determination of facts at issue." ***State v. Burke ex rel. Cnty. of La Paz,*** No. 1 CA-SA 12-0028, 2012 WL 1470103, at *2 (Ariz. Ct. App. Apr. 26, 2012).

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VALUATION REPORTS
AND VALUATION EXPERTS

Basic Tips and Practice Pointers

2015

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Date of Valuation

- A.R.S. §§ 25-211 and 25-213 (date of termination of community)

- Sample v. Sample, 152 Ariz. 239 (Ct. App. 1986)
  (Valuation date is left to trial court's broad discretion; "'dictated by largely pragmatic considerations,' and that it is 'the equitableness of the result that must stand the test of fairness on review.'")

- Community Business
  - Consider Sample valuation date arguments
  - Date of valuation may extend beyond the date of termination of community
  - Consider operator compensation issues
  - Consider dividend and distribution issues
  - Consider shareholder loans
  - Consider personal perquisites

- Separate Property Businesses
  - Date of Rueschenberg valuation is date of termination of community

- Impropriety of reliance on events occurring after date of valuation
  - Valuation standards of practice prohibit
  - Speculative nature

Asset-Based Approach

- Valuation based on value of assets net of liabilities
- May be adjusted from book value to fair market value

Market-Based Approach

- Valuation based on comparison of subject business with actual sales of similar businesses

    - Comparable Transaction Method
        - Use of actual transactions of similar businesses
        - Develop multiples from similar transactions and apply to subject business
    - Guideline Public Company Method
        - Use of market multiples derived from stock prices of similar businesses that are actively traded on public exchanges

Income-Based Approach

- Valuation based on methods that, based on analysis of past financial performance, convert anticipated future financial performance into a present value

    - Capitalization of Earnings Method
        - Calculate anticipated future earnings from past performance
        - Develop capitalization rate
        - Divide capitalization rate into anticipated future earnings

    - Excess Earnings Method
        - Divides capitalization rate into those earnings determined to exceed normal earnings (e.g., intangible and goodwill values)

            1. Calculate net tangible asset value (realizable economic benefit)
            2. Determine Normalized Earnings
            3. Determine appropriate standard of Comparable Earnings
            4. Calculate Excess Earnings by subtracting the standard of comparable earnings from the normalized earnings
            5. Determine appropriate Capitalization Rate
            6. Divide the capitalization rate into the excess earnings to determine value of intangible assets (e.g., goodwill)
            7. Add the net tangible asset value to the intangible asset value

Rule of Thumb Approach

- Valuation based on simple multiplication of a given figure by, e.g., gross revenues, net profits, etc.

Historical Data Applied to Income-Based Approach to Valuation

- Using Historical Performance to Predict Future Performance
  - Number of prior years analyzed

    -Three to five years is the norm

    -One year is extraordinary

    -New businesses very difficult to value (because history limited)

  - Weighting to make most recent data most relevant

    -Less weight to older data (because more remote in time is generally less relevant to future performance)

    -Do the math for the Court!

  - Economic Climate Affect

    -Evaluate data from each year in context of economy during those years

    -Especially important to predicting future performance when economic climate in major shift

Start-ups

-Less historical data

-Usually more difficult to predict

-Franchises/professional practices may be less affected by short histories

Normalized Income Issues

- Subjective Adjustments to Income
  - In real world, adjusted for potential buyer's preferences
  - Neutralizes current owner's personal preferences
  - Extraordinary Nonrecurring items (of unusual nature or of infrequent occurrence)
    - -Extraordinary expenses added back
    - -Extraordinary income deducted
    - -Sale of capital assets
    - -Lawsuit proceeds
    - -Insurance proceeds
    - -Effects of abnormal price fluctuations
    - -Personal benefits added back
  - Examine inclusions and exclusions to normalized income
  - Challenge evaluator's subjective determinations (inclusions/exclusions)
  - Show actual effects under different scenarios (do the math in court!)

- Lower Normalized Income Yields Lower Value
- Higher Normalized Income Yields Higher Value

- Lower Capitalization Rate Yields Higher Value
- Higher Capitalization Rate Yields Lower Value

Capitalization Rate Issues

- A Subjective Assessment of Risk (of receiving a return on the investment)

- Higher Capitalization Rate Yields Lower Value
  -Greater Risk = Less Willingness to buy/invest; demands greater return on investment

- Lower Capitalization Rate Yields Higher Value
  -Lower Risk = More Willingness to buy/invest; accepts lower return on investment

Build-up Factors of Capitalization Rate Calculation

- Relatively Risk-Free Rate of Return
  -Government Securities

- Risk related to size of business being valued
  -Smaller Size of business = Greater Risk (of a profitable future)
  -Larger Size of business = Less Risk (of a profitable future)

- Published Risk Factors
  -Industry-related (recognizing differing risks of success among different industries)
  -National and local economic outlooks

- Company-specific Risk Factors
  -Company's degree of diversification (greater diversification generally leads to greater chances for success, i.e., less risk)
  -Management depth and competence (greater depth and competence generally leads to greater chances for success, i.e., less risk)
  -Expected growth rate of the business being valued
  -Expected growth rate of industry
  -Expected inflation rate

- Examine Evaluator's Choices
  -Challenge subjective nature of the level of risk assigned
  -Verify the published figures
  -Show actual effects of different figures under different scenarios (do the math in court!)

Discounts (Potentially applicable in Fair Market Value analyses)

- Lack of Marketability
  - Buyers pay less for businesses that are not liquid/not readily saleable (e.g., professional practices, small businesses)

- Lack of Control
  - Buyers pay less for businesses in which they would not have a controlling interest (e.g., two owners, each with a 50% interest)

- Minority Interest
  - Buyers pay less for businesses in which they would have a minority interest (e.g., any number of owners and less than 50% interest being purchased)

- Lack of Voting Rights
  - Buyers pay less for business interest if they have no voting rights/no voice
  - Determine reason for no voting rights
  - Examine if voting rights accrue in future

- Discounts are multiplied individually, not added together (e.g., a lack of marketability discount applied, then the product of that would be multiplied by the next discount, if applicable)

Control Premium

- Reflects the potentially greater value of a controlling interest (e.g., more than 50%), which gives the controlling interest the power to direct the business

<u>Valuation Expert Testimony Issues</u>

- **<u>Credentials</u>**

  -Verify each claim on C.V./Resume/Cover Letter
    -Experts' own websites for consistency and contradictions within a valuation
    -Publications for consistency and contradictions within a valuation opinion
    -Publications for self-publishers (to avoid peer review)
    -Other experts' opinions of the subject expert

  -Waive foundational testimony if well-known and well-qualified (use your limited time wisely)

- **<u>Telephonic or Live Testimony</u>**

  -Always have expert appear personally
  -Direct observation of the witness by fact-finder
  -Visuals and immediate adjustments and calculations if factual assumptions change
  -Exhibits easier to present and explain
  -In-court observations of opposing expert, which may assist in your cross-examination

- **<u>Subpoena and Review Opposing Expert's Entire File</u>**

  -Correspondence and email with opposing party and with opposing attorney
  -Outside materials relied upon for opinion/methodology
  -Billing records
  -Notes, draft schedules, draft reports
  -Dates of materials on which expert relied
  -Dates of data on which expert relied

Emergency Care Dynamics, Ltd. v. Superior Court, 188 Ariz. 32 (Ct. App. 1997).

"We hold that a lawyer forgoes work-product protection for communications with an expert witness concerning the subject of the expert's testimony even if the expert also plays a consulting role." 188 Ariz. at 33.

"Arizona has long favored full cross-examination of expert witnesses." 188 Ariz. at 35.

"Our supreme court agreed, holding that the trial court had erred by 'depriving the defendants of their right to test [the] accuracy [of adversary expert testimony] by throwing upon it the searchlight of a full cross-examination.'" Id. (Quoting Middleton v. Green, 35 Ariz. 205, 212 (1929).)

"Just as an expert witness's sources remain a proper subject of cross-examination . . . so do the expert's relations with the hiring party and its counsel." Id. (Citing Ariz. R. Evid. 705 and State v. Mauro, 159 Ariz. 186, 199 (1988).)

Relevant Rules

Ariz. R. Evid. 702 Testimony by Expert Witnesses

A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

(a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;

(b) the testimony is based on sufficient facts or data;

(c) the testimony is the product of reliable principles and methods; and

(d) the expert has reliably applied the principles and methods to the facts of the case.

Amended Sept. 8, 2011, effective Jan. 1, 2012.

Ariz. R. Evid. 703 Bases of an Expert's Opinion Testimony

An expert may base an opinion on facts or data in the case that the expert has been made aware of or personally observed. If experts in the particular field would reasonably rely on those kinds of facts or data in forming an opinion on the subject, they need not be admissible for the opinion to be admitted. But if the facts or data would otherwise be inadmissible, the proponent of the opinion may disclose them to the jury only if their probative value in helping the jury evaluate the opinion substantially outweighs their prejudicial effect.

Amended Sept. 8, 2011, effective Jan. 1, 2012.

Ariz. R. Evid. 704 Opinion on Ultimate Issue

(a) In General—Not Automatically Objectionable. An opinion is not objectionable just because it embraces an ultimate issue.

(b) Exception. In a criminal case, an expert witness must not state an opinion about whether the defendant did or did not have a mental state or condition that constitutes an element of the crime charged or of a defense. Those matters are for the trier of fact alone.

Amended Sept. 8, 2011, effective Jan. 1, 2012

Ariz. R. Evid. 615 Excluding Witnesses

At a party's request, the court must order witnesses excluded so that they cannot hear other witnesses' testimony. Or the court may do so on its own. But this rule does not authorize excluding:

(a) a party who is a natural person;

(b) an officer or employee of a party that is not a natural person, after being designated as the party's representative by its attorney;

(c) **a person whose presence a party shows to be essential to presenting the party's claim or defense;**

(d) a person authorized by statute to be present; or

(e) a victim of crime, as defined by applicable law, who wishes to be present during proceedings against the defendant.

Amended Sept. 8, 2011, effective Jan. 1, 2012 (emphasis added).

Fair Value v. Fair Market Value

Fair Value

- generally, a valuation without consideration of minority, lack of marketability or lack of control discounts; nor control premiums
- generally results in higher valuation
- generally desired by the exiting spouse, *i.e.*, the one being bought out

Fair Market Value

- includes consideration of minority, lack of marketability and lack of control discounts;
- generally results in a lower valuation
- generally desired by the in-spouse, *i.e.*, the one keeping the business

Pro Finish USA, Ltd. v. Johnson, 204 Ariz. 257 (Ct. App. 2003).

- First published Arizona case that comprehensively considered the concept of fair value in business valuation
- Often (mis)used in family law cases as justification for rejecting application of discounts to valuations
- As a corporate dissenters' rights case (minority shareholders disputing the value of their interest in a buy-out situation), it was governed by Title 10 (business corporations)
- Title 10 requires application of fair value standards under specific statutory situations
- Title 25 is not subject to Title 10 statutory proscriptions, and Title 25 requires application of equitable division standards

Schickner v. Schickner, 2015 Ariz. App. Lexis 46, 348 P.3d 890 (Ct. App. 2015).

- First published case that comprehensively considered the concept of fair value as applied to business valuation in family law cases

- Rejects applicability of Pro Finish to family law cases:

> "*Pro Finish* is a dissenters' rights case applying statutory buy-out provisions that require a "fair value buy-out" under specific statutory situations. *204 Ariz. at 260, ¶¶ 8-9, 63 P3d at 291;* see also *A.R.S. §§ 10-1325(A), - 1301*. Because the division of community assets in a marital dissolution proceeding is governed by an equitable division principle (a different standard), *Pro Finish* is inapposite."
> ¶ 15.

- Holds that trial courts have "discretion to consider whether a minority discount is appropriate, on a case-by-case basis, **considering factors such as the minority shareholder's degree of control, lack of marketability, and the likelihood of a sale of the minority interest in the foreseeable future."** ¶ 17.

- Approves of holding in other states' cases:

  "A discount for a minority interest is appropriate when the minority shareholder has no ability to control salaries, dividends, profit distribution and day-to-day corporate operations."
  <u>In re Davies</u>, 880 P.2d 1368, 1375 (Mont. 1994). ¶ 17.

  "[E]xplaining that application of a minority discount may be applied when it 'accurately reflect[s]' a minority shareholder's lack of control."
  <u>In re Johnston</u>, 726 P.2d 322, 325 (Mont. 1986). ¶ 17.

  "[E]xplaining a minority discount may be inappropriate when no sale of a minority share is imminent or planned."
  <u>In re Tofte</u>, 895 P.2d 1387, 1391 (Ore. Ct. App. 1995). ¶ 17.

TWO CORPORATIONS AT ISSUE AND BEING VALUED IN THIS FAMILY LAW CASE

- In one of the corporations, discounts not applied (Fair Value), in the other, discounts applied (Fair Market Value)

- **<u>Considerations</u>**
  -<u>The less</u> is the <u>degree of control</u> over operations of the business, the <u>more appropriate</u> may be application of a discount
  -<u>The less</u> is the <u>marketability</u> of the business, the <u>more appropriate</u> may be application of a discount
  -<u>The less</u> is the <u>likelihood of a sale</u> of the minority interest in the foreseeable future, the <u>less appropriate</u> may be application of a discount

- **<u>Discounts not applied</u>** to corporation where:
  -Husband's interest was 50%
  -Husband held "significant power regarding financial decisions" (*e.g.*, the amount of his salary and how it was to be characterized)
  -No "substantial limitations on his joint control of [corporation] as a 50% member"
  -Husband presented no evidence that he intended to sell his interest

- **<u>Discounts applied</u>** to corporation where:
  -Husband's interest was only 20%
  -80% held by one other individual
  -Husband's interest "substantially limited by the holder of the 80% interest"
  -Yet, Husband offered no evidence of intent to sell

<u>Practice Pointers</u>

- **<u>If you want the discount</u>**, you must show the evidence that justifies the discount:
  -relative lack of control
  -limited decision-making, day-to-day management and long term planning
  -lack of intent to sell and/or lack of potential market in which to sell interest

- **<u>If you do not want the discount</u>**, counter the evidence presented
  -inside personnel/activities/communications
  -expert opinions

- Make your record
  -to effectively persuade the trial court
  -to preserve your record for appeal, if necessary
  - Offers of proof
  - Effective and timely objections
  - Supporting authority for trial court

<u>Make Your Record/Evidence Is Key</u>

- "Record reflects"
- "Record does not reflect"
- "Record supports"
- "Not supported by the record"
- As evidenced by"
- "Presented no evidence"