

I Want Half

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Divorce & CPAs

The U.S. divorce rate was 4.6 percent last year. Those marriages ending in divorce lasted little less than eight years after first and second divorces. Time following a divorce until remarriage averages about three years. As a CPA, you can expect one or more divorces among your clients in any given year, and it won't be smooth sailing. Guiding clients through divorce involves financial and tax planning, technical community property rules and litigation, as well as coping with anger and volatile emotional states.

Professional Considerations

When clients divorce, you first must decide if you will provide services to one or both spouses. Since, as a CPA, you must be objective, free of conflicts of interest and maintain confidentiality, before providing services to either or both spouses you'll want to consider professional conduct requirements. AICPA Special Report 08-1 "Independence and Integrity and Objectivity in Performing Forensic and Valuation Services" is a useful guide when evaluating acceptance of an assignment.

As with any CPA service, it's important to have a written agreement with your client. It's common for CPAs to become substantially involved in your clients divorce before thinking about an engagement letter. Defining services and a conflict check should be considered during the first phone call. If you are a policyholder, CAMICO offers assistance and sample engagement letters.

Finding a Lawyer

Family law is complex, technical and significantly affects the party's finances. It's imperative for your client to retain a knowledgeable family law attorney. Some clients want to avoid attorneys, particularly when it involves financial matters. But attorneys will become involved at some point and, generally, the sooner the better. Even mediation and collaborative law arrangements, which can be effective, generally involve attorneys.

Family lawyers generally specialize. For attorney qualifications, consider members of the American Association of Matrimonial Lawyers, Family Law Specialist designation; attorneys rated by Martindale-Hubble (www.martindale.com); or referrals from local business attorneys.

Divorce Objectives

The clients' objectives in their divorce may not just be financial concerns. Custody of children, injuries during the marriage and fear of the future make logical, focused thinking intermittent and difficult. The role of both attorney and CPA is to separate the parties legally, physically, emotionally and financially.

Financial Separation: Financial separation generally begins with physical separation and the creation of a second household. This creates a need for temporary child (where applicable) and spousal support. The goal of temporary support is to stabilize the parties and divide available income in an equitable manner. After separation, combined income rarely increases, but the cost of two households increases the party's combined living expenses. So an immediate reduction of the party's standard of living occurs unless the parties borrow. Borrowing is a temporary measure, which in extreme cases can lead to substantial debts. The sooner the parties focus on their new financial circumstances, the better.

Temporary Support: How does the court determine temporary support? Courts are not able to create income to meet the shortfall created by two residences. So a formula was developed that calculates temporary child and spousal support. The formula first computes after-tax income of the parties. Then it computes child support as a percent of after-tax income for the custodial spouse. Finally, the formula computes spousal support. The formula is incorporated in a computer program available in most courts and may be purchased from vendors. CPAs may be asked to determine the income that is used in the support software. But many times temporary support is determined before a CPA becomes involved.

Marital Property Inventory: Marital property must be identified, valued and classified as community or separate. First, a marital balance sheet must be prepared. Property is stated at current value and may include tax basis and cash flow information for each asset. Separate property is confirmed and transferred to the separate spouse, and community property is divided equally by total value. California rules generally ignore imbedded tax gains in property. So dividing community property also attempts to divide the basis equally to share potential tax gains.

Marital Property Rules: There are basic California marital property rules you should know. Separate property is property acquired before marriage, after marriage and during marriage with separate property. It also includes property acquired by gift or inheritance. All other property acquired during marriage is community. These basic marital property rules may be rebutted. An attorney can and should provide guidance in the application of these rules. Second marriages and inheritances generally involve separate property. Titled property claimed to be separate are subject to special rules. Tracing separate cash through bank accounts requires the understanding of complex rules. Personal efforts during marriage create community income. These basic rules apply unless a prenuptial agreement modifies them.

Property acquired before marriage is separate. However, during marriage, community funds or personal efforts may create a community interest in the property. For single titled property, principal payments for down payment, mortgage and improvements are analyzed to determine how much was paid with community or separate funds. The ratio of principal contributions from separate to total principal is then applied to appreciation during marriage to determine the appreciation attributable to separate during marriage. Appreciation before marriage is generally considered separate.

If the property is converted to joint title during marriage, different rules apply. When titled, separate property is converted to joint title—such as during a mortgage refinancing—it becomes community property. The separate interest at the date joint title was created may be reimbursed in a divorce, but all appreciation during joint title is community. Very few clients understand this when they refinance their homes.

Businesses owned prior to marriage may increase in value during marriage. Personal efforts during marriage may produce a community interest in the otherwise separate business. Valuation and determination of the community interest in a separate business involves application of business valuation standards modified by California case law.

Tracing Bank Accounts

Proving separate property frequently involves cash passing through cash accounts on its way to the acquisition of property. Cash is fungible, so what happens when separate and community cash is commingled in the same account? Commingled accounts become community unless they are “traced.” Tracing cash accounts relies on artificial rules developed by case law. Unlike other property, titled property rules do not apply to bank accounts. If traced, cash accounts’ community and separate character may be maintained.

I often hear clients say, “The account is in my name and it’s my money.” This does not apply even for accounts open before marriage once community cash is deposited and commingled in the account.

CPAs often are asked to trace cash accounts. Tracing rules are:

(1) cash at marriage is separate; (2) deposits during marriage are presumed community unless they can be identified from a separate source; (3) disbursements for family living expenses are paid from community funds; (4) community debts are paid from community; and (5) separate debts are paid from separate funds. Application of these rules segregates cash balances at any point as community, separate or mixed character, and overcome the commingled presumption.

In *See v See* (1966) 64 Cal.2d 778 the California Supreme Court stated, “If funds used for acquisitions during marriage cannot otherwise be traced to their source and the husband who has commingled property is unable to establish that there was a deficit in the community accounts when the assets were purchased, the presumption controls that property acquired by purchase during marriage is community property.”

Assembling the Puzzle

Preparing for settlement or trial involves assembling a property list classified by community or separate with a proposal to divide community property. Permanent child and/or spousal support positions are coordinated with custody arrangements. Figure 1 (See Page 14) is useful for settlement or Trial of property issues.

The individual property items in Figure 1 are described below:

House: The house was owned by wife before marriage. During marriage it was refinanced to obtain a lower interest rate. Wife receives a \$340,000 separate property reimbursement reflecting her separate interest at the time of refinance.

Rental: Husband owned the rental at marriage. During marriage rents were deposited into the party's savings account. Rental expenses, including the mortgage, were paid from the checking account, not the savings account. Payment of mortgage during marriage from the checking account from community funds, which resulted in a community interest in husbands separate rental.

IRA: Wife opened her IRA before marriage. The \$81,000 separate interest is the balance at marriage with earnings on the separate portion during marriage.

401(k): Husband opened this account during marriage. The balance was divided unequally to equalize the total division of community property on the last line.

Savings: The checking account was the recipient of paychecks from both parties. However husband was able to trace \$126,000 of his separate rental deposits into the savings account. This was accomplished by a detail See v See type exhaustion tracing.

A refinement of Figure 1 might include basis with potential tax gains and cash flow generated by each asset. Cash flow can be helpful in determining income available for support.

Permanent Support

Permanent child support is also determined by formula, but spousal support is not. The court must consider items listed in Family Code Sec. 4320, which includes actual income of the parties, marital standard of living, income tax consequences of support (deductibility) and needs of the parties. Predicting income available from a business, an annual bonus, income from stock options and other forms of periodic or indeterminate income is difficult. CPAs frequently assist clients in estimating income available for support.

Income Tax

Income tax advice may be required when formulating the property division, determining support, filing tax returns after separation and planning cash flow. Some divorces bring old income tax problems into the mix. Most property divisions are not taxable pursuant to IRC Sec. 1041. But care is required when dividing corporate stock or assets. And achieving an equal division of community basis in the property division may be all but impossible.

Child support is not deductible by the payer or taxable to the recipient, but spousal support is taxable/deductible. Family support (unallocated between child and spousal support) is fully deductible when paid as temporary support. But permanent family support must qualify with rigid IRC requirements for events associated with a child to be fully taxable/deductible. Spousal support payments that decline more than \$10,000 during the first three calendar years of permanent support may lose their deductibility.

Filing income tax returns after separation usually starts with choosing whether to file joint or separate returns. Joint returns may save taxes but they do not further the goal of separating the party's finances. CPAs should also consider the risks and several liabilities on joint returns, particularly since innocent spouse relief is difficult and expensive to obtain.

To compute the benefits of separate returns requires a division of income between community (reported one-half by each) and separate income (reported by one party). After separation, personal efforts become separate income. So, W-2 income and withholding is community up to separation and separate to the earner thereafter. Community income continues on property until it is actually divided (both agree to the division). In some cases it may be difficult to obtain information from the other spouse to allow filing a complete return. The client's attorney may be helpful in obtaining tax information for your client.

Payment of taxes is often a problem for supported spouses. Either they are not aware that quarterly estimates are required or cash shortfalls cause them to simply skip the deposits hoping for a better day when the case concludes. This a common cause of financial fiascos in divorce.

CalCPA has resources available for divorce services and the California CPA Education Foundation (www.educationfoundation.org) provides courses on community property, guiding your client through divorce, income tax in divorce and family law conference. The Family Law Section (www.calcpa.org/lit) is an excellent source for members dealing with divorcing clients on a regular basis or a resource for advice on a particular matter. Membership applications are available at www.calcpa.org/join.

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