TAX CARRYOVERS: IMPORTANT ASSETS TO CONSIDER IN HIGH INCOME AND HIGH ASSET DIVORCE CASES OR VALUATION NIGHTMARE

by
Wayne P. Kerr‡

I. Introduction

High income and high asset divorce cases present challenges and complications to divorce lawyers not encountered in most divorce cases. Among a myriad of legal issues, tax consequences such as tax carryovers are sometimes significant and must not be overlooked. Divorce lawyers and courts sometimes overlook or choose to ignore the possible value inherent in capital loss carryovers, charitable contribution carryovers, and passive loss carryovers due to complications in valuation. This article will focus on each of these types of tax carryovers. These tax carryovers are property rights that have value and must be considered in the divorce proceeding. This article will focus on each of the aforementioned tax carryovers.

II. Capital Loss Carryovers

A. *Discussion*

The Internal Revenue Code provides that the aggregate of all capital losses are allowed only to the extent of the aggregate of all capital gains plus $3,000 ($1,500 in the case of a married individual filing a separate return).[1] To the extent that the capital losses exceed the capital gains plus $3,000, then the excess is

‡ Mr. Kerr practices in Philadelphia.

1 I. R. C. § 1211 (b)(1) (2001). Individuals are not permitted to carryback capital losses. Corporations are permitted to carryback capital losses for three years and carryforward for five years.

available for carryover indefinitely until it is exhausted.[2] This is known as a capital loss carryover. Each carryover loss retains its short-term (capital asset held less than a year) or long-term (capital asset held more than a year) characteristic.

The real difficulty in dealing with capital loss carryovers results not when a joint return is being filed, but when separate returns follow a filing of a joint return, such as in a divorce. If husband and wife file a joint return in the year of capital loss and then in year two file separate returns, query how the capital loss carryforwards are allocated. According to the Treasury Regulations, the carryover is allocated to the husband and wife on the basis of their individual net capital losses for the preceding year.[3] This requires a determination of the capital losses of each spouse and then making an allocation based on each grouping as short-term capital loss carryover or long-term capital loss carryover.

The distinction between short-term capital loss and long-term capital loss will be useful in the valuation process. Since short-term gains are taxed at the maximum rates and may be offset against short-term losses, arguably short-term losses have greater value than long-term losses. Long-term losses can also be offset against short-term gains and so the question arises as to how they should be valued. Conservatism would dictate that they should be valued at the long-term capital gain rate but what if the parties have a year in which they have short-term capital gains and long-term capital losses. An expert would possibly value these long-term losses at the short-term rate since that was the savings that resulted.

The other difficult valuation question is when will these losses be utilized since the carryover period is indefinite. Assuming that the expert can decide on a rate to use, the next issue is when will these losses be utilized in the future so that the experts can apply a present value analysis to determine value as of the valuation date. These are all difficult questions that lawyers and their expert witnesses and courts must confront.

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2 §1211-1(b)(2). The $3,000 is limited further to the extent of the taxable income but not below zero.

3 Treas. Reg. § 1.1212-1(c) (1983).

B. *Case Law*

The year 2000 was remarkable for several reasons. It seems likely that history will possibly describe the stock market of 2000 as the great bear market. Under such market conditions, investors typically sustain heavy stock losses. On the one hand, this obviously creates a diminished marital estate, but it also may present the opportunity to value the unused capital losses generated by the marketable securities in which losses must be carried over to future years.

In a recent decision, the appellate division of the New York Supreme Court held that a capital loss carryover was a marital asset subject to equitable distribution.[4] This case resulted from an appeal by the husband from an order by the Supreme Court of New York that granted judgment in favor of the wife in the amount of $155,785.60, which represented the amount of the capital loss carryover.[5] The court concluded that the capital loss carryover constituted marital property largely on a rationale that marital property should be broadly construed and consist of "things of value arising out of the marital relationship".[6]

The court did disagree with the value of $155,785.60 that the Supreme Court had placed on the asset.[7] Apparently the wife's expert witness testified that the husband's taxes would be reduced in 1996 and 1997 by $70,000, but offered no testimony as to the value going forward.[8] Accordingly the court reduced the judgment to $70,000.[9]

In another decision, the Missouri Court of Appeals sustained the trial court's finding that the long-term capital loss carryover was marital property.[10] The trial court in this case

4 Finkelstein v. Finkelstein, 701 N.Y.S.2d. 52, 54 (2000).

5 *Id*. at 53.

6 *Id.* The court in *Cerretani v. Cerretani*, 634 N.Y.S.2d. 228 (1995), in examining Domestic Relations Law § 236 (B) found that a capital loss carryforward was not the type of property that was contemplated by the statute. The court found that tax consequences were a factor in equitable distribution, but only relating to the consequences of such distribution.

7 *Id*.

8 *Id.* Counsel for the wife opined in a post-trial letter that the approximate federal and state tax benefit of her share would be approximately $155,785.60. The court found this not to be competent evidence.

9 *Id.*

10 Mills v. Mills, 663 S.W. 2d 369 (Mo. Ct. App. 1983).

distributed one-half of a $32,897 long-term capital tax loss carryforward to the wife.[11] The wife testified that the capital loss carryover resulted from the sale of stock of companies acquired by the husband during the marriage.[12] The court affirmed the trial court's order after a finding that this order did not violate the federal regulations in any manner.[13]

The husband argued that the trial court's order of awarding one-half of the loss carryforward violated section 1.1212-1(C) of the Treasury Regulations.[14] The Regulations provide that if husband and wife file a joint return for a year in which a net capital loss arises and separate returns are filed for the following year, the carryover is allocated to the husband and wife on the basis of their individual net capital losses for the preceding year.[15] In the instant case, the trial court made an equal allocation of the loss carryforwards even though the losses were generated by the husband's capital losses.[16] The order appears to contravene the Regulations.

III. Charitable Contributions

A. *Discussion*

Another area of importance in marital property tax carryovers is the charitable contribution carryover. Contributions to charitable organizations are deductible as itemized deductions. These deductions are limited to a certain percent of adjusted gross income.[17] Whenever an individual's charitable contributions exceed the percentage limitations, a contribution carryover results that can be deducted over the five following years or until it is fully utilized, whichever is earlier.[18] These carryovers operate to reduce future tax liability and may have significant value in high-income cases.

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11 *Id.* at 371.

12 *Id.* at 372.

13 *Id.*

14 *Id.*

15 Treas. Reg. § 1.1212-1(c) (1983).

16 *Mills*, 663 S.W.2d at 372.

17 I. R .C. § 170(b)(2001).

18 § 170(d)(1).

The dilemma lawyers often confront is how to allocate the excess charitable contribution deduction generated by a joint tax return when followed by separate returns. The Regulations provide that the excess must be allocated between husband and wife by determining how much would be attributable to each spouse if each had filed a separate return in the original contribution year.[19] The Internal Revenue Service has ruled that the allocation of excess charitable contribution between spouses cannot be made by agreement between the parties but must be in accordance with the method set forth in the Regulations.[20] For purposes of the percentage limitations, these excess contributions retain their characterizations after it has been determined what each spouse's excess contribution would have been if separate returns had been filed. The following formula is utilized.

$$\frac{\text{Spouse's share of excess Charitable contributions}}{\text{Total excess of charitable contributions for the year for both spouses}} \times \text{Excess charitable contribution} = \text{Spouse's share of excess charitable contribution}$$

The issues surrounding valuation of charitable contribution carryovers are certainly less complex than the capital loss carryovers since the calculation concerns a finite carryover period of five years, as compared with an indefinite period for capital losses. As the court indicated in *Dombrowski v. Dombrowski*, there is often the luxury of looking back and valuing the carryover based on the filing history of the husband and wife.[21] Sometimes a consistent pattern of taxable income arises that can be used to project future taxable income. In addition, any computation of future tax savings must include the phase out of itemized deductions, which is always an issue in high-income cases. Once the marginal tax difference has been determined, then the expert must reduce to present value the projected future tax savings stream to the valuation date. This computation involves fewer unknown variables and is much easier then the capital loss carryover and the passive loss and credit carryover discussed in the next session.

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19 Treas. Reg. § 1.170A-10 (d)(4)(i) (1983).
20 Rev. Rul. 76-267, 1976-2 C.B. 71.
21 559 A.2d 828 (N.H. 1989).

B. *Case Law*

The Supreme Court of New Hampshire was asked to reconsider a marital master's property finding that involved the carryover value of a charitable contribution deduction of $688,976.[22] The charitable contribution carryover was the result of a donation of 180,000 shares of common stock by the husband to his former preparatory school.[23] The value of the common stock on the date of donation was $765,735.[24] The husband took a tax deduction in two separate return years of $60,000 and $22,000, which left $688,976 to be carried over.[25] The Supreme Court of New Hampshire held that the value of the carryforward is the tax savings that results when the deduction is subtracted from gross income.[26]

The court agreed that the master erroneously valued the carryforward at $688,976 and remanded the issue of the valuation of the carryforward deduction.[27]

The importance of this decision is that the court found that the carryforward deduction does have economic value and should be included in the marital estate despite difficult valuation issues. The court in this case was not troubled by the complexity of making the computation of the value of the carryover and suggested that courts are often confronted with difficult issues of valuation. The court did suggest in dealing with the issues of value that the master on remand should consider subsequent filed tax returns, the husband's income over time, the maximum tax savings of the carryforward, and the Internal Revenue Code in assigning value.[28]

IV. Passive Loss and Credit Carryover

A. *Discussion*

The final area of focus in the tax carryover area is the passive loss and credit carryovers. These losses and credits may be

22 *Id*. at 830.
23 *Id.*
24 *Id*.
25 *Id.*
26 *Dombrowski*, 559 A.2d. at 830.
27 *Id.*
28 *Id*. at 830.

substantial and present difficult issues of valuation The passive loss rules arose under the Tax Reform Act of 1986 and were an attack on tax shelters.[29] These rules limit the ability to use deductions and credits from passive activities against other income such as wages, interest and dividends. Unless the individual has other passive income, a passive loss or credit is not currently deductible against other income. These losses or credits are carried forward to future years and may be deductible upon certain conditions.[30] Counsel and experts upon reviewing a tax return must be aware of the potential value that are inherent in these losses and credits. Since they are not a line item on the Form 1040, counsel and financial experts should carefully analyze them.[31]

Passive loss and credit carryovers present difficult valuation issues. If counsel or experts are confronted with a case where the passive loss is not divided, how should a passive loss or credit carryover for purposes of equitable distribution be valued. The valuation process possesses the same complexities as the capital loss carryovers. Counsel and its expert should analyze the tax returns to determine what has occurred since the date of valuation. In high-income cases, the carryover losses or credits are generally utilized upon the termination of the passive loss activ-

29 Tax Reform Act of 1986, Pub. L. No. 99-514, 1986 U.S.C.C.A.N. (100 Stat. 2085). Tax shelter has been defined as any investment in which a significant portion of the taxpayer's return is derived from the realization of tax savings.

30 I. R .C. § 469(1)(A) (2001). Passive losses can be used to shelter nonpassive income upon 1) disposition of passive activity 2) former passive activities and 3) the $25,000 rule for rental real estate. Former passive activities do not trigger the immediate allowance of losses and credits but are used against net income (and allocable tax liability) from years after the activity ceases to be passive. Unlike suspended losses, suspended credits are not allowed upon disposition but must be carried forward to offset tax attributable to passive income. Noteworthy is that if the taxpayer disposes of his entire interest in a fully taxable transaction and has a suspended passive activity credit, he may elect to adjust the basis of the asset upward. I. R. C. § 469(j)(9)

31 Form 8582, Passive Activity Loss Limitations which computes net loss or income from each passive activity and determines the passive activity loss amount and Form 8582-CR, Passive Activity Credit Limitations, which is used to calculate passive activity credits and related worksheets should be carefully reviewed to determine the amount of carryover losses and credits.

ity or the sale of the interest in the passive activity.[32] If the losses or credits can be utilized in the future, then the value is simply the present value of the future realizable tax benefits. If such losses or credits cannot be used, then the expert must project when the asset will be sold and compute the present value of the tax benefit.

B. *Case Law*

The Missouri Court of Appeals was presented with the question of whether the passive loss carryforward was marital property and should be divided between husband and wife.[33] The facts were that the husband had generated approximately $134,000 of passive loss carryforward during the marriage.[34] The trial court did not include the loss carryforward as marital property.[35] The wife appealed contending that the trial court erred in failing to distribute the passive loss carryforward created during the marriage.[36] The Court of Appeals held that the passive loss carryforward generated during the marriage was a marital asset and that the trial court should have divided it.[37] The court cited *Mills* as support of its proposition.[38]

The tax question not answered by *Silverstein* was if the trial court had divided the passive loss carryforward what would have been the tax consequences to the parties. To the extent that the husband transferred an interest in the passive activity to his wife, it would be treated as a gift.[39] As a gift the transfer would not trigger the allowance of carryover losses, but would simply add to the basis of the property transferred before the gift.[40] The

32 *See* Richard B. Malamud, *Allocation of the Joint Return Marriage Penalty and Bonus,* 15 VA. TAX. REV. 489 (1996). Difficult issues of allocation are presented.

33 Silverstein v. Silverstein, 943 S.W.2d 300 (Mo. Ct. App. 1997).

34 *Id.* at 303

35 *Id.*

36 *Id.* at 300.

37 *Id.* at 303

38 *Mills*, 663 S.W.2d 369.

39 I. R. C. § 1041(b) (2001).

40 § 469(j)(c)(B). Wife would only be able to deduct losses when she disposes of her interest. The Senate Finance Report to Pub. L. 99-514 provides that if a taxpayer gives any less than all of his interest in an activity, an allocable portion of any suspended losses is added to the donee's basis.

wife would therefore receive one-half of the basis in the property prior to the transfer and increase that basis by one-half of the carryover losses.[41]

V. Conclusion

Despite difficulties in valuation, tax carryovers are important assets that should not be overlooked by counsel. It is imperative for counsel to be aware of these carryovers and request during the discovery process the information necessary to assist in the valuation of these carryovers. After identifying the tax carryovers, counsel in conjunction with an expert, should arrive at a value for these attributes. Even though the valuation issues may be complex, there is no reason to abandon the process of including carryovers as assets in the marital estate.

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41 *Tax Reform Proposals: Tax Shelters and Minimum Tax: hearing before the Joint Committee on Taxation,* (JCS-39-85), Aug. 7, 1985, at 2. For purposes of determining donee's loss in subsequent transaction, the donee's basis may not exceed the fair market value of the gift at the time it was received. (citing I. R. C. § 1015(a) (2001).