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# Property Settlement

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## Property Settlement

### What is property and how is it classified for divorce purposes?

When a divorce arises, property must be divided. Property includes the family home, rental property, automobiles, pensions, bank accounts, stocks, and bonds. It also includes art and antique collections, furniture, IRAs, life insurance cash values, and family businesses. Assets are divided in accordance with state laws, and states can be divided into two categories: (1) community property states, and (2) equitable distribution states.

#### *Community property states*

Community property states focus on the difference between separate property and community property. Separate property is that which you bring to the marriage, including inheritances and gifts received prior to marriage. Community property may be defined as property acquired during the marriage (except for inheritances and gifts received during the marriage). The owner-spouse can usually keep separate property after a divorce, while community property must be divided equally (50/50 split) between the spouses.

**Example(s):** Frank and Liz are married and live in California, a community property state. Prior to their marriage, Liz received a \$50,000 inheritance from her grandmother. During the course of their marriage, Liz received a \$20,000 inheritance from her aunt. Frank and Liz bought a \$500,000 house together during their marriage and amassed a \$50,000 savings account. If the couple seeks a divorce, both of the inheritances are considered separate property and will go to Liz only. The house and savings account, are considered marital property and must be divided equally between Frank and Liz. That is, each spouse will get \$25,000 from the savings account and \$250,000 in cash (or assets), assuming that the house is worth \$500,000 on the date the spouses select for valuation.

At present, community property states include the following: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin, Alaska (which has an optional system), and also Puerto Rico.

#### *Equitable distribution states*

The majority of states follow an equitable distribution philosophy. These states agree that marital property should be divided equitably (fairly) rather than equally. Some of these states will except separate property (such as inheritances and gifts), and some will not.

Equitable distribution states generally fall into three categories, based on how they identify marital property.

- Type 1--The first type of state identifies marital property as all property except that which either spouse brought into the marriage or obtained by gift or inheritance at any time. This definition is identical to that espoused by the community property states. The difference is that marital property will be divided equitably, as opposed to equally.
- Type 2--The second type of equitable distribution state proclaims that, regardless of how property was brought into the marriage or who has title presently, all property (of both spouses) is subject to division at divorce. These states don't differentiate between marital and separate property. They divide property fairly and equitably and may allow property brought into the marriage by gift or inheritance to go to the other spouse if this form of distribution seems more fair, all things being considered. However, the source of the property (e.g., gift, inheritance, owned prior to marriage) is often very important in the judge's decision-making process.

**Example(s):** Hal owned a \$10,000 savings account and a \$100,000 house. When he got married to Jane in a Type 2 equitable distribution state, he kept title to these assets in his name alone. During the course of their marriage, the couple bought a vacation condominium in Florida and two automobiles and amassed \$100,000 in mutual funds. If Hal and Jane seek a divorce, all of the

property (including Hal's house and personal savings account) will be subject to equitable distribution principles.

- **Type 3--**The third category of equitable distribution state favors a mix of rules. Such states use equity as a means of division but don't exempt from division all gifts, inheritances, and property brought into marriage from division. Instead, they may exempt one or two of these types of property.

**Tip:** To determine which category your state falls into, check the domestic relations laws of your state or consult with an attorney.

## How is property valued?

Once property has been classified as marital or separate, the next step in the process is to establish values for all of the identified property. Valuation may be by mutual agreement of the spouses. Certainly it's a simple matter to ascertain the fair market value (FMV) of bank accounts, stocks, and bonds. And the fair market value of household goods is usually determined by mutual agreement (or even at a garage sale). However, in complicated cases involving pensions, family businesses, real estate, stock options, and the like, both sides may need to hire experts to establish values. This may be particularly true if your state recognizes professional licenses, advanced degrees, and enhanced earning power as marital property.

**Example(s):** Two premed students, Joan and John, got married and agreed that John would complete his education first, while Joan supported him. When he finished, she would then complete her education. After John's second year of residency, he decided to divorce Joan. The court decided that because John's medical school degree and license to practice were both obtained during the marriage, they should be considered marital property, subject to valuation and division. An expert provided the court with present-value calculations of John's future earnings and came up with the figure \$500,000. This amount would need to be divided.

**Tip:** In second marriages, sometimes a house is brought into the marriage. When such a house appreciates in value during the course of the second marriage, valuation can be a problem. Bear in mind that although separate property may not be subject to division in some states, the appreciation in value of separate property during the course of the marriage may be subject to division, particularly if both spouses used the property and contributed to the increased value.

**Example(s):** Lara owned a \$100,000 house with a \$60,000 mortgage when she entered into a second marriage with Matt. Lara kept the title to the house in her name but lived there for many years with Matt. Lara now wishes to divorce Matt. The house is presently worth \$160,000, and the mortgage has been brought down to \$40,000. How should the property be valued? Lara may assert that the only marital asset is the increase in property value--\$60,000. She obtained this figure by subtracting \$100,000 from \$160,000. Matt, on the other hand, could argue that the increase in equity (not the increase in property value) is the marital asset. This figure would amount to \$80,000 (\$120,000 equity minus \$40,000 equity). In most states, there is no definitive answer--the parties (or a court) will have to decide.

**Caution:** The concept of gifting must also be considered when discussing valuation. In the above example, if Lara had added Matt's name to the deed during their marriage, nearly all courts would hold that Lara converted the separate property into marital property. Thus, the entire house would be subject to division rather than the mere increase in appreciation. For more information about valuing primary residences, see [Marital Residence](#). The date of valuation is a matter usually determined by the parties themselves; for example, a couple might agree to value assets as of the separation date or at another mutually acceptable time.

## How do you approach property division?

The division of property will eventually be reduced to a written agreement called the property settlement agreement. A property settlement agreement, once the parties have signed, is a binding agreement and becomes part of the divorce decree. In cases where alimony or child support is needed immediately, a temporary order is

often sought first.

When considering the division of property, both spouses must gather information about their assets. If you hire a family law (or domestic relations) attorney, the attorney will want to see financial statements from each spouse. It's necessary to know the amount, the frequency, and the source of periodic income. Likewise, parties must disclose the sources, locations, and fair market value of their assets. Of course, debt must also be disclosed.

There are occasions when one spouse has been kept in the dark about financial matters or perhaps chose not to take an active role. For example, one spouse may have handled the bills, bank accounts, and securities, while the other cared for children and ran other domestic affairs. In legal terminology, the discovery process will help the less financially savvy spouse gather the necessary information. During discovery, a spouse can request copies of income tax returns, any insurance policies that may exist, credit reports, employee benefit statements and summaries, bank account summaries, and other documents. Also, questions (called interrogatories) about income, assets, debts, and documentation should be served on--and answered by--the other spouse.

## What about hidden assets?

Sometimes, when a marriage has been deteriorating for many years, one spouse will hide the existence of assets from the other spouse with the expectation that a divorce may occur someday. If you find hidden assets, you'll probably want to reveal them prior to trial in order to obtain your spouse's consent to a more equitable settlement. However, you can also choose to disclose them at trial, undermining the credibility of your spouse.

**Example(s):** Oscar handled the finances in his family and secretly stashed away \$50,000 in a bank account during the last years of his marriage. When divorce proceedings began, he wire-transferred the money to his mother, a resident of Colombia. Oscar's wife learned of the money when she found a receipt for the wire transfer in her husband's coat pocket. Since Oscar had not disclosed the existence of this money at discovery or in his financial affidavit submitted to the court, his wife may be able to use this fraudulent transfer to force a favorable property settlement.

There are a number of places where you can look for hidden assets: personal income tax returns, partnership tax returns, corporate tax returns, financial statements, savings account passbooks, canceled checks and check registers, securities statements, uncollected bonuses and commissions, children's bank accounts and phony loans, debts, or employees.

### *Personal income tax returns*

A review of the personal returns filed for the past few years may indicate sources of interest or dividends. They may also reveal unknown sources of income or loss from trusts, partnerships, or real estate holdings. You should review federal, state, and amended returns, comparing them to 1099s and W-2s.

### *Partnership tax returns*

Compare partnership returns (IRS Forms 1065 and Schedules K-1) over a number of years to see whether any sudden changes in the partnership interest or distribution occurred around the time of a marital separation. (Sometimes, compensating adjustments are made after the divorce has been finalized.)

### *Corporate tax returns*

If one spouse is the principal owner of a closely held corporation, he or she may be manipulating salary by taking loans from the corporation or may be charging personal expenses to corporate accounts. Corporate returns should also be checked for excessive retained earnings, as this may disguise available profits or an artificially low salary level.

### *Financial statements*

If your spouse took out a loan for his or her business or for personal purposes, he or she submitted a financial statement to the lending institution. Look back at these statements for a five-year period to find assets that may no longer be accounted for.

### ***Savings account passbooks***

You should acquire the passbooks for any savings accounts opened in the last five years, looking for substantial withdrawals close to the time of separation. Also, periodic withdrawals (or deposits) could indicate mortgages (or income) from hidden sources.

### ***Canceled checks and check registers***

You may come across canceled checks for the purchase of property that you never knew existed. Compare the canceled checks against the applicable bank statement to make sure that you were given all of the canceled checks (some may have been removed by your spouse).

### ***Securities statements***

Brokers furnish periodic statements, indicating transactions involving stocks and bonds. A review of these statements may raise a question about sales proceeds: Where did the money go? You can cross-check securities transactions with bank account information by date and amount to see what may have happened.

### ***Uncollected bonuses and commissions***

By subpoena, check with your spouse's employer to learn if any bonuses or commissions are being withheld.

### ***Children's bank accounts***

Sometimes, a spouse who wishes to hide money will open a custodial account in the name of his or her child. If the annual interest from this account is under \$900, there is generally no requirement to file an income tax return for the child.

### ***Phony loans, debts, or employees***

To keep cash from being divided, a spouse may suddenly announce that he or she needed to pay back a relative or friend for a loan made many years ago. These loans are suspect if made proximate to the marital separation. Also, if one spouse controls the payroll of a sole proprietorship, partnership, or closely held business, he or she may have a relative or friend on the payroll who isn't really providing adequate services for the business. Thus, the business's profits will be reduced, and your spouse may be drawing a lower salary and getting a kickback.

## **In what ways may property settlements be structured?**

### ***Equal divisions***

You begin by listing all of the marital assets (and their corresponding values). In a 50/50 split, each party would be given one-half of the cash value of the assets. But perhaps the wife might want to keep the entire house and one-half of the savings account, while the husband might want to keep the entire pension, one-half of the savings account, and his sole proprietorship. An example will illustrate that one spouse might end up owing the other spouse money if a 50/50 split is necessitated.

**Example(s):** Frank and Liz have been married for 20 years and are now seeking a divorce. They own a house (worth \$150,000), a pension (valued at \$80,000), a savings account (worth \$30,000), and a sole proprietorship (valued at \$100,000). They don't want to sell assets and split proceeds; rather, Liz and Frank have tentatively decided to divide their assets as follows:

Asset	Liz	Frank
House	\$150,000	
Pension		\$80,000

Savings Account	\$15,000	\$15,000
Laslow Industries		\$100,000
Total	\$165,000	\$195,000

**Example(s):** If a 50/50 property split is contemplated, Frank will owe \$15,000 to Liz. In the above example, the appropriate division can be accomplished with a property settlement note. Frank can make monthly payments to Liz (with interest) until the \$15,000 has been paid in full.

### **Property settlement note**

A property settlement note is a promise from the payer to the payee to pay a particular sum, for a particular length of time, and with reasonable interest. The note should be collateralized. For example, you can tie it into a pension by using a QDRO.

For tax purposes, bear in mind that the note doesn't represent alimony; it's purely a property settlement. Therefore, the payer can't deduct these payments from income. Likewise, the payee doesn't include the principal payments in income (but he or she does include the interest portion in income).

**Caution:** Also, while a property settlement note can be discharged in bankruptcy, alimony and child-support payments cannot.

### **Equitable divisions**

A 50/50 split may not produce equal results--or equal standards of living after the divorce--if the two spouses are unequally situated after the divorce. A perfect example involves an older homemaker who sacrificed career for the care of her children and the upkeep of her home. Later in life, her husband may command a top salary, while she has no work history and few marketable skills. Therefore, after a divorce, he will continue to earn a high income, while she will need to drain assets.

Another example involves separate property. If the homemaker wife has \$4 million worth of separate property sitting in a trust fund, a judge may find that a 50/50 split of the marital assets would be inequitable to the husband. States using equitable principles in dividing property may consider a number of factors, including the following:

- **Contribution by the spouses**--Courts will consider financial contribution to assets and also noneconomic contributions such as homemaker services (child-rearing, housecleaning, career-sacrifice, etc.). Some states will assume that the contributions of a homemaker are equivalent to the contributions of the full-time wage earner, while others will admit expert testimony to place a value on homemaker services. Courts will also look at contribution by one spouse to the education of the other spouse. For example, one spouse might work to put another through medical school. The increased earning power of the doctor-spouse might be viewed as "property" in some states.
- **Duration of marriage**--In a short-term marriage, direct financial contribution to assets plays a larger role, whereas in a long-term marriage, greater weight is given to noneconomic contributions, such as homemaker services.
- **Future financial needs**--Some states will consider the future financial needs of the spouses when dividing property. While this is seldom a factor in marriages of very short duration, it can be a factor in long-term marriages.
- **Income**--If the husband's income differs substantially from the wife's, this may influence the judge's division of property. For example, the judge may award a higher percentage of the property to the more dependent spouse, or alimony payments may be ordered.
- **Educational degrees and professional licenses**--When a spouse's education, degree, or training received during marriage substantially enhances that spouse's earning capacity, a court may order that

spouse to compensate the other spouse for financial support and reduced discretionary income during the educational process. For example, the court may: Reimburse money spent on tuition, student loans, books, supplies, and other educational costs

- Allocate balances remaining on student loans solely to the educated spouse for repayment, or
- Use alimony to compensate the nonstudent spouse for financial and emotional support Alternatively, of course, the court may determine that the degree or license is marital property, subject to division. As was mentioned earlier, a present value of future earnings might be divided between the spouses in such a case.
- Financial and emotional needs of the children--A marital home will likely be given to the custodial parent if minor children are involved.
- Tax consequences
- Assets and separate property
- Extent of debts and ability to pay
- Age and health of the spouse
- Employability and future earning capacity
- Standard of living during the marriage
- Fault (in some states)

## What about a family business?

If either spouse owns a business (such as a sole proprietorship, a partnership, or a corporation), that business will probably be a part of the property division. Clearly, the business will be considered marital property if it was started during the marriage with joint funds. If the business was started prior to marriage or financed with separate funds, however, it's necessary to consult state law to determine the rights of the other spouse. And although the rules will vary from state to state, most states mandate that a portion of the business will be considered a marital asset.

For example, the marital portion might be the amount of joint funds used to expand an existing business (plus the appreciation attributed to that contribution). Or, the nonowner spouse may have helped operate the business, and that assistance may have contributed to the growth of the business during the marriage. Because each spouse will probably have a stake in the business, it's typical, in divorce situations, for one spouse to buy out the other's share or to trade assets of equal value for that share.

## How do you value the business?

Once you have determined the marital portion of the business, you need to determine its value. Business appraisers and forensic accountants are qualified to place dollar values on businesses. Their goal is to establish a fair market value for the business; in other words, to fix the amount the business could sell for if it were placed on the open market.

Appraisers use a number of methods. For example, they might total the value of the equipment, analyze the cash flow by reviewing the balance sheets and other financial documents, or compare the company to similar ones on the market. Although competent appraisers should come up with similar values, often each spouse will hire an expert appraiser to value the family business. The date used to fix the business's value is important and can vary from state to state. In some states, businesses are valued as of the date of separation. In others, businesses may be valued at a settlement date agreed to by the parties. A number of factors can cause fluctuations in the business's value, including the state of the economy, market forces, and perhaps the efforts of

the spouse working in the business.

### ***Finding an appraiser***

If you and your spouse are on good terms and are fairly sophisticated about business matters, perhaps you can agree on the business's value. If your business was recently appraised for purposes of getting a loan, you can use that figure. Otherwise, you might wish to consider hiring a certified appraiser. A certified business appraiser is one who has been certified by the American Society of Appraisers. You can find the names of appraisers in your area by calling the Society at (800) 272-8258. Alternatively, you can get a referral to a competent appraiser by asking other small business owners, accountants, financial planners, and attorneys for recommendations. Most appraisers typically charge an hourly fee, although some will charge a flat fee. The appraiser will send you an appraisal report when he or she has completed the valuation process. It should include the following information:

- The fair market value of the business
- The methods used to arrive at the value
- A description of the business appraised
- The name and qualifications of the appraiser
- The documents reviewed and the names of people interviewed
- A list of data analyzed and how analyzed
- The appraisal techniques chosen
- An explanation of why those techniques were chosen
- A list of businesses of comparable value

### ***Methods of appraising the business***

Appraisers use a number of valuation methods. The following are the most common methods:

- **Adjusted book value**--The business's adjusted book value consists of the firm's total assets (including depreciation) minus its total liabilities. This method is often used when a company has substantial capital investments in hard assets, such as machinery.
- **Comparable sales**--A business appraiser can get a rough idea of the value of your business by comparing it to the prices quoted in classified advertisements under the heading "Businesses For Sale." Obviously, this value is only an estimate.
- **Comparable values method**--The appraiser surveys similar businesses and appraisers to establish a basis for buying or selling a particular company. Certain rules of thumb, or "Industry rules" exist. For example, experts generally believe that a retail business is worth one to two times its yearly earnings, and a sandwich shop is worth four to nine times its monthly average sales. In terms of a professional practice, an attorney's practice might be valued at the amount it would take to buy in as a partner in the firm. Obviously, like the comparable sales method, the comparable values method is merely a starting point in valuing the business.
- **Capitalization of excess earnings**--This approach combines the adjusted book value with the value of good will. By capitalizing excess earnings, the appraiser arrives at the good will, an intangible asset which, by itself, can be expected to generate a certain amount of income in the future. Along with name recognition, the good will of a business depends on the length of the business's existence and the extent of its revenues. Most states require that the good will of a business be included as part of the overall appraisal of the business.

## How do you divide the business?

As with assets in divorce, one spouse's interest in a business can be kept, sold, or exchanged for other property. Or, the entire business can be sold and the proceeds divided between the spouses according to their marital interests in the property.

- One spouse keeps the business--If one spouse wishes to keep the business, he or she can buy out the other spouse's share or trade assets of equal value. If there are no assets large enough to trade, a property settlement note can be drawn up, and the spouse can be paid over time. Likewise, one spouse's shares of stock in the business can be purchased over time. Keep in mind the tax consequences if shares of stock are to be purchased over time (more on that later). Additionally, consider the personal difficulties involved in co-ownership.
- Both spouses continue to operate the business--In a family business (typically, a sole proprietorship), both spouses may have enjoyed working for many years, and neither spouse wants to stop working. If they have an amicable relationship, it's possible (though risky) to continue working as long as their financial rights in the business are well documented. Or, they may decide that while they'll both own the business, only one spouse shall run it. In such cases, they'll need to consider the following questions:
  - What constitutes a reasonable salary for the spouse who runs the business, when will profits be paid, how will profits be divided and taxed, what role will the nonmanaging spouse play in decision-making, do both parties have a right to enter the premises and inspect the books, and what personal expenses or perks will be allowed the managing spouse.
- Business is sold--The spouses may sell the business and divide the profits according to their respective marital interests. The problem with this approach is that it may take years to find a buyer. In the meantime, the parties will have to decide who runs the business.

For additional information, see our separate topic discussion, [Planning for Succession of a Business Interest](#).

## What are the tax implications of property dispositions?

Property transfers between spouses during the marriage or incident to divorce generally aren't taxable. But the tax effects of property dispositions can vary greatly, depending on whether you decide to transfer property immediately to your spouse, sell it to a third party, or sell it to your spouse at some future time.

**Caution:** Transfers of qualified or nonqualified retirement benefits and IRA assets incident to divorce are subject to special rules, and may be taxable. Consult a qualified professional.

### *Transfer to spouse incident to divorce*

Neither spouse recognizes gain or loss if you transfer the title of the property to your spouse, incident to a divorce. A transfer of property is viewed as incident to divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. Any transfer of property between spouses that is made pursuant to a divorce or separation instrument and that occurs within six years after the date the marriage ceases is presumed to be related to the ending of the marriage.

You might, for example, wish to use a promissory note to buy out your spouse's share in the family business. As was mentioned earlier, taxation really won't be an issue. The buying spouse can't deduct the principal payments, and the selling spouse doesn't report the principal payments as income (the interest is income). Because the payments are being made to equalize a divorce settlement, the spouse buying the business obtains the selling spouse's tax basis in the business.

### ***Basis***

The spouse receiving the property takes the basis of the transferring spouse and ends up with the combined basis. This result occurs even if the spouse who retains the property pays cash or other assets in return for the property and the transaction is basically a sale.

**Example(s):** Jill sells her one-half ownership interest in their home to her spouse, Jack, for \$85,000 as part of their divorce settlement. Because the property had initially been purchased for \$80,000, Jill's basis was \$40,000, and Jack's was \$40,000. Jill doesn't recognize any gain on the sale to Jack because the sale was incident to their divorce. Jack's basis in the property will be \$80,000.

### ***Sale of property to third party immediately***

Often, a piece of property will be sold to a third party as part of a divorce settlement, with the proceeds being split equally between the spouses. In such a case, both the husband and wife will recognize one-half of the gain on the sale (unless they qualify for a capital gains exclusion). For more information, see our separate topic discussion, *Marital Residence*.

### ***Delayed sale***

The parties might decide that the property will be sold at some point in the future. If sold later than six years from the marriage cessation date, the sale will not be considered incident to the divorce. Thus, the seller will recognize gains or loss. This isn't to be confused with the promissory note arrangement mentioned earlier.

## **What information should you gather before consulting with an attorney?**

Before sitting down with an attorney to work out a property settlement, go through the following list to make sure you disclose all relevant information:

- Your name, address, telephone number
- Spouse's name, address, telephone number
- Each spouse's date of birth
- Names and dates of birth of your children
- Date and place of marriage and length of time in present state
- Existence of prenuptial agreement
- Information about parties' prior marriages, children, etc.
- Date of separation and grounds for divorce
- Current occupation and name and address of employer (both parties)
- Social Security number of both parties
- Income of each party
- Education, degrees, and training of each party
- Extent of employee benefits for each party
- Details of retirement plans for each party

- Joint assets of the parties
- Liabilities and debt of each party
- Life, disability, and other insurance of each party
- Separate or personal assets of each party, including trust funds and inheritances
- Financial records (including bank statements, tax returns, loan applications, and investment statements)
- Family business records
- Collections, artwork, and antiques

Obviously, you won't have all of the above information and documentation at your fingertips. Provide whatever you can; the rest can be ascertained during the divorce discovery process. You'll need to think about a few other questions as well once you've provided your attorney with the basic checklist of information. Consider the following:

- Which assets do you really want and which are you willing to assign to your spouse?
- How do you feel about the family home? Do you feel strongly about living there, or should it be sold or allotted to your spouse?
- With respect to the children (if any), what are your wishes regarding custody, visitation, and child support?
- Do you earn enough money to adequately support yourself, or should alimony be considered?
- Will you have sufficient liquidity to pay the debt on whatever assets you keep?
- What are the income tax consequences of your decisions regarding property disposition?
- Regarding a family business, does your state value assets at the time of separation, settlement, or divorce or at some other time?

Discuss these and other questions with your attorney.



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