

## Property Settlements and Third Party Transfers

*Although it's important for divorcing spouses to understand the property laws regarding the division of marital property, it's also essential for them to understand the tax implications of their decisions.*

### What are they?

When marital separation occurs and a divorce is contemplated, spouses must decide how to divide their property. Property includes such assets as the family home, rental property, automobiles, pensions, bank accounts, and stocks and bonds. It also includes art and antique collections, furniture, IRAs, life insurance cash values, and family businesses. A formal **property settlement agreement** is usually drawn up and signed by the couple, formally assigning assets to one spouse or the other. In some cases, the **couple may decide to sell one or more assets to a third party, splitting the proceeds**. This type of transaction is known as a third-party transfer.

### How is property classified for divorce purposes?

Assets are divided in accordance with state laws, and states can be divided into two categories, based on their property division rules: **community property states** and **equitable distribution states**.

#### Community Property States

In general, 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**, on the other hand, may be defined as property acquired during the marriage (except for inheritances and gifts received during the marriage).

#### **At present, the following are community property states:**

- Alaska (which has an optional system),
- Arizona,
- California,
- Idaho,
- Louisiana,
- Nevada,
- New Mexico,
- Texas, Washington, and
- Wisconsin
- (and also Puerto Rico).

Separate property can usually be kept by the owner-spouse after a divorce, while community property must be divided equally (50/50) rather than fairly between the spouses.

#### **Tip:**

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

### 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 include separate property (such as inheritances and gifts) in equitable distribution, and some will not.

**Equitable distribution states 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 or when property was acquired, 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 (i.e., gift, inheritance, owned prior to marriage) is often very important in the judge's decision-making process.

#### **Type 3**

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

There are occasions when one spouse has been kept in the dark about financial matters or perhaps chose not to take an active role. 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. Written questions (called "interrogatories") about income, assets, debts, and documentation may be served on (and answered by) the other spouse. Also, depositions of each spouse may be taken.

### How do you Approach Property Distribution?

The division of property will eventually be reduced to a written agreement--**the Property Settlement Agreement**. A property settlement agreement, once it has been signed by the parties, 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 divorce attorney, he or she will want to see financial statements from each spouse. It is necessary to know the amount, the frequency, and the source of periodic income. Likewise, parties must disclose the sources, locations, and fair market values of their assets. Of course, debt must also be disclosed.

### In what ways can property settlements be structured?

#### **Equal divisions**

You begin by listing all of the marital assets (and their corresponding values). In a 50/50 split, of course, each party would be given one-half of the cash value of the assets. But perhaps one spouse might want to keep the entire house and one-half of the savings account, while the other spouse might want to keep the entire pension, one-half of the savings account, and the sole proprietorship.

#### **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, with reasonable interest. The note should be collateralized. **For tax purposes, the note doesn't represent alimony; it's purely a property settlement.** Therefore, the payer can't deduct these payments from income. Likewise, the recipient doesn't include the principal payments in income (but he or she does include the interest portion in income).

#### **States that use equitable principles in dividing property may consider:**

- Financial and non-economic contributions to assets
- Duration of marriage
- Educational degrees and professional licenses .....
- Future financial needs
- Income differential of spouses
- Assets and separate property
- Extent of debts and ability to pay
- Age and health of the spouses
- Employability and future earning capacity
- Tax consequences.
- Financial and emotional needs of the children
- Standard of living during the marriage
- Fault (in some states).
- Conduct during the marriage (in some states)

#### **Caution:**

Keep in mind that a property settlement note can be discharged in bankruptcy, whereas alimony and child support payments cannot.

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
- Use alimony to compensate the nonstudent spouse for financial and emotional support

**Next month's newsletter will cover the  
Tax Implications of Property Distribution...**