Taking Taxes into Account in Property Settlement Involving "Pre-Tax" Assets

Huggler v Huggler, Mich App. No. 343904 (6/25/19)

By Joseph W. Cunningham, JD, CPA

Facts

- Of their marital estate of around $800,000, the parties agreed as follows:

	W	H	Total
Real Estate, Investments, Bank Accounts, and Personal Property	71,488	384,929	456,417
Retirement Assets – Pre-Tax	273,896	71,488	345,384

- Because W was to receive a disproportionate amount of pre-tax assets, they further agreed that (1) H would pay W $154,618 of "Non-Retirement Assets" and (2) W would assign to H via a QDRO $101,204 from her retirement assets.
- This would result in the following equal division of pre-tax retirement benefits:

	W	H	Total
Real Estate, Investments, Bank Accounts, and Personal Property	226,106	230,311	456,417
Retirement Assets – Pre-Tax	172,692	172,692	345,384

- Notwithstanding this agreement, H and W disagreed as to how the $154,618 balancing payment would be made. W wanted to receive the $154,618 in non-retirement assets. But H wanted to pay her $54,618 in cash and net the other $100,000 against the $101,204 retirement transfer due him from W.
- W objected because it would leave her with a disproportionate share of pre-tax assets, as follows:

	W	H	Total
Real Estate, Investments, Bank Accounts, and Personal Property	126,106	330,311	456,417
Retirement Assets – Pre-Tax	272,692	72,692	345,384

- W claimed that she intended to access the $100,000, which in doing so would result in both income taxes and a penalty tax leaving her considerably less than what she had coming per the agreement.
- She stated that she would "incur predictable and foreseeable tax penalties to cash in the retirement funds."
- The trial court ruled in H's favor ruling that it would not consider the tax consequences of the division of assets because "it would be forced to speculate when – or even if – she would cash in the accounts."
- W appealed.

Court Of Appeals Decision

The Court upheld the trial court decision, ruling in part that W "had not established that the tax consequences were reasonably likely to occur and were not merely speculative."

Comments On The Case

1. **General Practice in Michigan**—Michigan family law judges do not typically reduce the value of assets by future tax unless the tax is imminent or otherwise not subject to speculation.

   Nor are they required to, as the Court stated, under *Nalevayko v Nalevayko,* 198 Mich App 163 (1993).

2. **Pre-Tax Assets** - But, certain assets – employee benefits such as 401(k) accounts, IRAs (other than Roth IRAs), bonuses, and various forms of incentive pay – (1) are **certain to be taxed** and (2) generally provide no benefit to the employee spouse until he or she squares off with Uncle Sam and pays the tax.

   Thus, unlike other investments, real property, and closely-held businesses, the various forms of retirement benefits and employee/executive compensation are generally tax affected for divorce settlement to the extent they are not divided equally.

   Not to do so would result in an inequitable settlement to the party receiving more than half of pre-tax benefits, such as W in *Huggler*.

   Simple Example – If one party receives a $10,000 bank account and the other a $10,000 pre-tax IRA, the division is not equal. Before the IRA funds can be converted to spendable cash, a tax must be paid resulting in a net amount of considerably less than $10,000.

3. **Calculation of the Tax** – The calculation of the tax can, however, be subject to dispute.

   One approach is to allocate a portion of the total tax on a pro rata, or proportional, basis - the Average Tax method.

   Another is to calculate the tax resulting from adding subject benefits on the tax return – the Marginal or Incremental Tax method. This calculation usually involves (1) calculating tax with the benefits included and (2) running the calculation without them. The difference is the tax attributable to the benefits.

   The theory supporting the Average Tax method is that who is to say what component – or layer - of income is taxable at the lower rates on the tax rate schedule and which are taxable at higher rates. Hence, using an average rate is fair – treating all dollars of income the same. It seems the average rate approach is better suited to elements of income routinely received by and taxable to the taxpayer spouse – such as a bonus received each year.

   Correspondingly, the marginal approach seems more apt for items not part of the annual pay package, such as stock options issued periodically or, certainly, severance pay.

Illustration

	Taxable Income Assuming:		
	Basic Comp Only	Add Non-Recurring Incentive Pay	Total
Taxable Income	100,000	50,000	150,000
Federal Tax (Rounded)			35,500
Average Tax Rate			23.7%
Marginal Tax Rate			28%

Tax Affected Value of $50,000:

- Less average tax: 50,000 – (23.7% x 50,000) = 38,150.

- Less marginal tax: 50,000 – (28% x 50,000) = 36,000.

And, of course, the difference is more dramatic if larger non-recurring benefits result in taxation at the top rate of 37%, vs. 28% in the example.

About the Author

Joe Cunningham has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy, though his practice is statewide.

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