Allocation of the Value of a Business in Divorce

Probably as a truism, a business run and owned by one spouse is rarely divided equally, even in a long marriage. Reasons for unequal allocation, other than something to the effect "That's just the way it is" include the tax burden, if any, that goes along with the one that keeps the property; maybe an implicit belief in the double dip; maybe a built in bias/prejudice in favor of the business owner.

Probably the clearest "quantifiable" reason for this unequal allocation is the tax burden that remains with the one who keeps the property. There are at least a few issues in the application of a tax burden:

- How much will the tax rate be – do you use today's tax rates (which is probably the most likely), do you try to speculate as to what rates might be in the future (and, if so, when in the future), do you do some historical tax rate blend.

- How much will the tax be – it's not only a matter of tax rates but, depending on the asset, a calculation needs to be done as to the basis (which in a sense means the first dollars coming out are a return of your money and are not taxable); is the remainder to be taxed at capital gain rates, ordinary income rates, some kind of blend; is there depreciation recapture. What about not only the federal tax rate but a state tax rate - and if so, which state (it is not always so obvious).

- Will there be a tax - It is not clear on certain assets whether or not there will be a tax. To that extent, we are dealing with what is perhaps only a hypothetical tax.

- When will the tax be incurred – is it imminent (in which case it is fairly well accepted that you apply the tax burden before allocating the net proceeds - but in that case, maybe we are looking at a 50/50 allocation). In most cases there is no idea when the asset in play will be sold. The relevance here, in one sense, is that until the asset is sold, the one who retains the asset continues to have the benefit of the full value of the asset working for him/her and does not suffer the tax burden (if any), until the asset is sold some years (unknown) down the road. Is it fair to apply a tax burden (the "full" tax burden) against the portion of the person being bought out? In a sense, it is a present value of the tax burden issue.

With the preceding as a backdrop, let us consider a few possible scenarios. Assume we have an asset (a business) valued at one million dollars. The question at hand is "What kind of tax burden might be attached to that value?" We will present four different situations – involving a zero basis (meaning that the entire one million dollars is taxable gain), and a basis of $300,000, $600,000 and $800,000 (the last meaning that only $200,000 of the one million dollars is a taxable gain). We will also provide two tax alternatives – one at 25% (representing the combination of federal and New Jersey capital gains tax rates), and the other at 40% (representing a potential likely blend of partly capital gains and partly ordinary income) for an upper income person. Of course, there can be a myriad of possibilities – depending how a deal is structured, there can be many components, each with a differing tax treatment. However, these two scenarios will cover a reasonable amount of ground, and provide an understanding of the issue at hand.

40%
Blended
tax rate

Tax basis	Gain	Tax	Net after tax	50% share of net value	% of total value represented by 50% of net value
$ 0	$ 1,000,000	$400,000	$600,000	$300,000	30%
300,000	700,000	280,000	720,000	360,000	36%
600,000	400,000	160,000	840,000	420,000	42%
800,000	200,000	80,000	920,000	460,000	46%

The above illustrates that, depending on the basis in the property, which is another way of saying depending on the amount of the value that is not subject to tax, a "fair" allocation might mean anywhere from 46% of the total value down to 30%.

25%
Blended
Tax Rate

Tax basis	Gain	Tax	Net after tax	50% share of net value	% of total value represented by 50% of net value
$ 0	$1,000,000	$ 250,000	$750,000	$ 375,000	37%
300,000	700,000	175,000	825,000	413,000	41%
600,000	400,000	100,000	900,000	450,000	45%
800,000	200,000	50,000	950,000	475,000	47%

The above illustrates, under the optimum use of today's tax rates, that in order to provide one spouse with 50% of the net after tax value, the percentage allocation of the total value might range anywhere from 47% down to 37%. Keep in mind that these are merely hypothetical illustrations, and each and every case requires its own set of calculations.

One of the reasons justifying less than a 50% share is that the one who retains the property continues with the burden of the risk of that property. That is, the one being bought out is now safe and secure, and can do whatever he/she wants with the money – while the one retaining the property (assume a business) has all the headaches, aggravations and risks associated with that business. How valid is that position? After all, those factors, including the risks, were considered in the valuation process when that business was valued. Therefore, whatever risks go along with that business, in theory, have been adequately accounted for in the valuation process. To argue that less than 50% is valid because of the risks of staying with that business is perhaps to allow for risk twice – unless the issue is not really the same type of financial risk that we're talking about, rather more the emotional/personal issue.

Despite the numerical illustrations above, if indeed the concept is to divide a business in some fair or equitable way, then doing an arithmetic calculation in line with the above illustrations, so as to determine the actual net after tax value, doesn't quite do it. We are still left with the issue that - even if a tax is believed to be in the offing (and not merely hypothetical), and even if we were to assume that within a narrow range, today's tax rates are reasonably representative of what the rates will be when the business/asset eventually sells - should the spouse being bought out today suffer his/her full share of a tax burden which is years away? Should the spouse who is retaining the asset be allowed to keep not only his/her "half", but also an additional amount representing a tax which is years away and thus not a present financial hit or burden? Would it be more equitable to in some way attempt to present value what the tax will be – which is probably impossible unless you know when the tax will be incurred? Thus, most likely we are looking at some imperfect compromise between allowing the tax burden in full, and not allowing it at all.