Realizing the Full Value of Hard to Value Assets

by
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I. Introduction

Matrimonial attorneys spend a significant amount of time and client resources valuing assets in a dissolution of marriage matter. Some assets, however, are almost impossible to value accurately. Every good matrimonial attorney knows valuing even slightly unique assets involves a heavy quotient of “artfulness,” “subjectivity,” or even “educated guessing.”

Further, valuing some assets, even though not particularly unique, can carry significant risks of inaccuracy simply due to ordinary circumstances, including valuation timing.¹ For the spouse who owns the property, valuation poses the risk of being too high, and for the spouse who does not own the property, the risk is that the valuation is too low. More importantly, there are situations in which valuing property carries a built-in risk of a substantially inequitable property allocation result that cannot be fairly addressed with a mere discount rate that factors in the risk.

Whenever a valuation is difficult or speculative, the attorney and valuation expert also have exposure to claims of malpractice.² No one wants to receive the call two years after the divorce

² See e.g., Spolar v. Datsopoulos, 66 P.3d 284 (Mont. 2003).
that the asset valued in the divorce at $500,000 just sold for $10,000,000.

Compounding the problem of difficult valuations is the judicial position regarding the value and appropriate allocation of unique or speculative value assets. The case law is inconsistent in the treatment of such assets, making professionals wary that the asset will not be treated appropriately. Courts may deem the asset’s value so speculative that it is not even an asset worthy of consideration. Courts have wide discretion in determining how an asset is valued, from choosing the standard of value to deciding or altering the inputs used in the valuation, or even the timing of valuation and allocation. Courts can choose to value and divide assets at the time of divorce, defer a specific division until a stated triggering event, or simply rule that upon the occurrence of a stated triggering event the parties must return to court. Submitting the valuation and division issues to the trial court always carries its own quotient of risk.

There are times in a divorce when neither party wants to sell or divest themselves of an asset. Other times, an asset cannot be divided and allocated between both spouses due to prohibitions on transfer and assignment or other practical issues. Sometimes the parties both wish, or need, to retain an asset for some period of time to achieve full value. In other circumstances, a family’s long term wealth plan can only play out by maintaining the status quo, and an early exit, sale, or termination of interests will significantly diminish the efficacy of the plan.

For example, a couple may have jointly owned and operated a business that they believe they will transfer someday to their children. A couple’s investment strategy may include private equity investments held by one spouse and locked up for the next eight years; there may ultimately be little value in such assets, or substantial value. One spouse may have recently received a patent on an invention years in the making. A spouse may have ownership in a company that is likely to go public or be acquired by a special purpose acquisition company. A fund manager spouse may be four years away from the completion of the investment horizon for a fund.

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This article is written for a special segment of clients - clients who are more interested in preserving their overall wealth than spending their resources on disputes about imperfect valuations. In our experience, these are clients who have a history of working closely together with wealth management professionals and estate planners. Most of the time, they have been in long term marriages, and their only children are children of their marriage. In many cases, these are clients who have had businesses that they have owned and operated together. In divorce actions, it is standard to take all steps possible to financially separate a couple as soon as possible in order to avoid ongoing conflict. This article is written for clients whose negotiations and divorce settlement agreements are not driven primarily by a need to eliminate all ties, but rather, who are attuned to the concept that continuing to cooperate in some respects can allow them to both fully realize the value of an asset. Thus, the suggested divorce settlement agreement terms discussed below do not assume the other spouse is a bad actor who should never be trusted. In fact, they assume the opposite, and that there are ways of maintaining the alignment of interests even with divorced spouses.

Maintaining ongoing relationships with the parties’ joint estate planners, financial advisors and accounting professionals is a key component to the success of this ongoing joint financial relationship, for consistency in recordkeeping and reporting. To the extent the spouses wish to have separate advisors as additional resources, that can be a good adjunct to the joint planning, as a way to assure compliance, but if the spouses wish to have separate advisors at the outset, that may signal caution in pursuing what may be a long term, ongoing economic partnership.

In those circumstances where a divorcing couple believe it would serve their interests best to not simply sell or value and divide an asset, they will construct an in-kind division of some sort. There are a number of ways to do this. For instance, one party may hold the asset in a constructive trust for the other. Other times, the parties will continue to simply co-own an asset and enter into a detailed joint ownership agreement. One solution for an asset that cannot be transferred is to use a trust with a trusted independent trustee, who uses the trust as a liquidating trust to collect, account for, and distribute the income and proceeds of an asset to the parties as determined in the divorce set-
tlement agreement. This can work if the asset is transferable, if the parties are able to agree on a third party, and if there is a third party willing to accept the fiduciary responsibility for care-taking the assets until final distribution. Sometimes, the asset is transferable, but the party spouse who owned the asset must remain the owner, as trustee. Another solution involves the creation of a limited liability company ("LLC") which contains appropriate management, distribution, investment, and tax provisions and can provide more appropriate fiduciary standards and details. This is often most appropriate where the original owner of the asset must remain as the titular owner of the asset, but a new entity and taxpayer identification number is acceptable. The LLC can streamline the income tax contributions and reporting for the parties often better than a trust.

Matrimonial lawyers should identify the possibility of these kinds of property resolutions early, and they should strongly consider engaging a trust and estates attorney, accountant and potentially a wealth manager at the beginning of a representation. This helps to ensure that all issues related to the asset's eventual disposition are addressed early and can continue to be actively monitored until finally liquidated.

This article identifies many of the types of assets that may produce a more optimal outcome if the parties do not value and divide such assets at the time of the divorce. The type of asset is defined, potential issues that may frustrate the ability to divide the asset even if desired are discussed, and the applicable law involving such assets is set forth to discuss how courts have addressed the type of asset, to demonstrate the problems inherent with leaving the valuation, division, and allocation to the courts. Additionally, specific tax issues are addressed, and suggestions regarding divorce settlement agreement terms are provided. Part II of this Article examines stock options, restricted stock units, and performance shares. Part III addresses co-operated and co-owned businesses. Part IV offers suggestions around imminent business sales. Private equity interests, venture capital and hedge fund investments are discussed in Part V, intellectual property is explored in Part VI, and irrevocable trusts are considered in Part VII. We analyze cryptocurrency in Part VIII, outline considerations for co-owned real estate in Part IX, and make suggestions for agreements around pre-embryos in Part X.
Finally, in Part XI, we provide further suggestions for issues that should be considered in most all divorce settlement agreements and ongoing business agreements that are applicable to many of these assets.

II. Stock Options, Restricted Stock Units, and Performance Shares

Stock options are an asset that divorcing couples have been dividing in-kind for decades. Trial courts have recognized that with respect to these assets, because valuation and allocation at the time of a divorce may be very unfair to one party, a type of in-kind division is most equitable.

A. Defining the Asset

Employee stock options are a type of compensation granted by a company to employees. Stock options are either incentive stock options (ISOs), which the Internal Revenue Service considers qualified for special income tax treatment or nonqualified stock options (NQSOs), which the IRS does not deem qualified for such treatment. NQSOs may be granted to members of boards of directors and advisors, but ISOs only may be granted to employees.

Options are received via a written grant plan established by the company. The grant gives an employee a conditional right to buy company stock at a specified price for a finite period of time. Typically, the options will “vest” over a period of time, and only vested options may be exercised by the employee. Stock options commonly vest over a period of three to five years, because vesting schedules are intended to reward employees who remain with the company for an extended period of time. Stock option plans typically contain vesting acceleration clauses for events outside the employee’s control, such as acquisition of the company or death of the option holder but ceasing employment for other reasons will result in forfeiture of unvested options.

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4 See Boris Bittker & Lawrence Lokken, Statutory Stock, Federal Tax of Income, Estates and Gifts 60.7 (2020).

5 26 U.S.C.S. § 423(b) (2018); see also Bittker & Lokken, infra note 4, at 60.7.1.

Stock option plans are applicable to both public and private companies. Part of an executive compensation package may be annual grants, each of which is a grant of a certain number of options every year for a certain number of years. If at the time the employee may exercise the option to purchase the stock, the stock price is greater than the exercise price (also called the “strike price”), the employee may wish to purchase the stock at the exercise price. At that point, the employee may sell the stock at a gain or may choose to hold it.

Stock options have been treated in a variety of ways in the divorce context. Some states have held that options that are not vested at the time of a divorce are not property because they are too speculative or because they may be forfeited. In most states, though, employee stock options are, at least in part, marital property. In those states, the granted options are marital property if they were awarded as compensation for past employment performance or service, and not marital if they are granted for future services, as an incentive. California, a community property state, has employed a number of coverture formulas to cal-

8 See Richardson v. Richardson, 659 S.W.2d 510, 511 (Ark. 1983); In re Marriage of Hug, 154 Cal. App. 3d 780, 794 (1984); In re Marriage of Miller, 915 P.2d 1314, 1319 (Colo. 1996); Bornemann, 752 A.2d at 984; Otley v. Otley, 810 A.2d 1, 8 (Md. Ct. Spec. App. 2002) (holding that “in line with the majority of other states, and consistent with federal tax treatment . . . unexercised and unvested stock options can constitute marital property.”); Baccanti v. Morton, 752 N.E.2d 718, 794-796 (Mass. 2001)(concluding that if “unvested stock options could not be considered marital assets, we would be denying one spouse the right to share in what may be the most valuable asset between the spouses, and one to which both may have contributed.”); Davidson v. Davidson, 578 N.W.2d 848, 851-52 (Neb. 1998); Pascale v. Pascale, 660 A.2d 485, 499 (N.J. 1995); Hall, 363 S.E.2d at 196; Fisher v. Fisher, 769 A.2d 1165, 1169 (Penn. 2001) (treating unvested stock options identically with unvested pensions and concluding that the stock options acquired during marriage were marital assets); Golden v. Cooper-Ellis, 924 A.2d 19, 25 (Ver. 2007); In re Marriage of Short, 890 P.2d 12, 17 (Wash. 1995).
9 See Miller, 915 P.2d at 1318; Salstrom v. Salstrom, 404 N.W.2d 848, 851 (Minn. Ct. App. 1987); DeJesus v. DeJesus, 687 N.E.2d 1319, 1324 (N.Y. 1997); Hall, 363 S.E.2d at 196.
calculate what portion of stock options should be distributed to the non-employee spouse.10

Restricted Stock Units ("RSUs") are grants of actual shares at the date of grant, subject to vesting and other requirements, instead of the grant of the right to acquire shares at a later date. Grants of RSUs are the promise by an employer to deliver the shares to the employee at a time in the future once the vesting conditions have been met.11 Performance Shares are also actual shares of stock; they are promised via a grant, and are issued only upon reaching certain milestones, such as the company reaching certain sales or revenue projections and/or the employee’s continued employment through a particular date. The employer grants the RSUs and Performance Shares to the employee via a grant document. Like stock options, if the employee’s employment is severed before the RSUs or Performance Shares vest, the employee’s right to the stock terminates. If a private company goes public, typically the vesting schedule is uninterrupted. But if the company is acquired, the acquirer may accelerate vesting, issue RSUs to the acquirer, or even convert them to options or buy them out.

B. Valuation Difficulties

For a number of reasons, employee stock options are difficult to value. While one way to value options is simply to subtract the exercise price from the current stock price, there are other, less simplistic (and arguably more accurate) ways of valuing options.12

First, the present value of stock options depends on the value of the stock at several points in time in the future. For instance, if the employee stock options were granted on a five-

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year vesting schedule and the divorce occurs during the first year of the vesting schedule, the value of the stock options at the time of the divorce will depend on the value of the stock in each year for the next four years. Second, if the employee leaves the company, the employee forfeits the unvested options, and there may be a curtailed period for exercise of vested options. As a result, the risk of a loss of the full potential value of the options must be factored into the value. Various methodologies have been employed to value employee stock options, such as the Black-Scholes Model, the Internal Revenue Service methodology, and reference to the options market.13

Employee stock options are often granted by startup companies to attract talent and provide value where ordinary compensation would not adequately compensate the employee. For an early-stage company, the company’s determination of the fair market value of the stock itself is at best an educated guess, particularly in a highly regulated industry. For example, a biotech company may have a promising new drug, but if late-stage tests do not result in FDA approval, the value of the company’s stock likely will plummet. In addition, there are times when the exercise price of the stock options is greater than the stock price at the time of a divorce, but the non-employee spouse has a strong feeling that the stock price will eventually exceed the exercise price significantly. Because the non-employee spouse may have sacrificed significantly to enable the employee spouse to work at the startup company during the marriage, the non-employee spouse may not want to forego the possibility of high future value. Additionally, it is not always clear whether, as a legal matter, a grant of employee stock options creates property at all, creates marital property, or creates separate property.14

RSUs and Performance Shares, as conditional equities whose value is determined at a future time, share the same valuation difficulties.

Given the valuation uncertainties and the uncertainty of how a court will characterize certain employee stock options, RSUs and Performance Shares, the most cost-efficient way of dealing with them can be an in-kind division. Because most NQ-

13 See Id.
SOs, RSUs and Performance Shares are not transferable, it is important to address transferability, how the economics of the asset will be shared when realized, and tax consequences. For Non-Qualified Stock Options, the income tax treatment for future tax reporting by the company, discussed below, is not necessarily reflective of the value of dividing assets.

C. Income Tax Considerations

The inability to make an in-kind division of stock options means that income related to the stock options must be reported as income of the employee spouse. Some NQSOs are transferable by the terms of the stock option plan, but the transfer terms under the plan will require the income tax obligation to remain with the employee spouse. NQSOs are not transferable if the plan does not so provide, with the result that the employer cannot permit a one-off transfer. By contrast, ISOs are never transferable. In most cases, neither type of option is taxed at the time of grant, nor at the time of vesting. When exercised, the excess value over the strike price for NQSOs is not taxable for regular income tax or employment tax purposes, but may be taxable for alternative minimum tax (“AMT”) purposes. When the shares are later sold, the value in excess of basis is taxed as long term capital gain so long as the shares are held for at least one year after exercise of the option; otherwise, the excess value will be taxed as ordinary income. The excess value is treated as additional compensation, and will be reported by the company on Form W-2 or 1099. The taxation of proceeds from the sale of shares acquired by exercise of ISOs will depend on whether the sale occurs more than two years from the date of grant and whether the shares have been held for more than one year, in which case capital gains tax rates apply; otherwise ordinary in-

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come tax rates apply.\textsuperscript{19} For stock that was acquired from the exercise of ISOs, any disposition of the shares before satisfying the ISO holding period is treated as a sale, whether or not the transfer is actually a sale.\textsuperscript{20} This can complicate a division of assets, although the divorce settlement agreement can contain a promise to transfer the shares once the holding period has been satisfied.

RSUs and performance shares are taxed as employment income at the time of vesting, based on the fair market value of the shares at that date.\textsuperscript{21} When shares are later sold, the usual rules of whether the gain is taxed as short term or long term capital gain apply. Note that care should be taken to identify which shares are being sold if there are multiple grants since the income tax basis will be different for each tranche. In addition, transfer of stock from one spouse to the other must take place no later than six years post-divorce to be a nontaxable event.\textsuperscript{22} Special considerations to keep in mind apply if the receiving spouse is not a U.S. citizen. The nontaxable treatment for transfers incident to divorce under Section 1041 of the Internal Revenue Code do not apply to transfers to non-citizen spouses. For resident non-citizen spouses, transfers will be subject to gift tax\textsuperscript{23}; allocation of assets to a non-citizen non-U.S. resident spouse are deemed sales by the transferring spouse.\textsuperscript{24}

D. Language for the Division of Employee Stock Options, RSUs, and Performance Shares

Divorce settlement agreements dividing stock options between the spouses typically provide that the owner of stock options holds some portion of them for the other spouse on a constructive trust theory. But, because there is no actual trust instrument, the responsibilities of the option holder are not spelled out, creating a significant potential for disagreement where the expectations of the parties about decision making are

\textsuperscript{20} Id.
\textsuperscript{21} 26 U.S.C. § 83(a).
\textsuperscript{23} 26 U.S.C. § 1041(b).
\textsuperscript{24} 26 U.S.C. § 1041(d). In such cases, the disposition is treated as a deemed sale to the recipient spouse, who obtains a new basis in the asset for U.S. tax purposes.
at odds. An agreement to divide employee stock options should include the following: First, there should be a very clear identification of what grants are subject to the divorce settlement agreement. Employees generally hold their options in brokerage accounts that hold all options, including options that are granted after the divorce. One way to clearly identify the grants subject to the agreement is to attach to the agreement the grant schedule that describes the options to be shared. The divorce settlement agreement should include a notice provision that requires the employee spouse to notify the non-employee spouse at least ten days before any grants vest. Additionally, if the employer requires that cash be tendered to the employer to exercise options, that notice period should be significantly increased to allow the other spouse to identify funds to use for the purchase. There should also be an agreement that the employee spouse notify the non-employee spouse of the value of the options at the vesting date, notify the non-employee spouse of the receipt of any correspondence regarding the options, and finally, notify the non-employee spouse of all employer withholdings when stocks are sold.

The divorce settlement agreement should identify how options are exercised. For instance, will the employee spouse be required to exercise options that are “in the money” (meaning, the strike price is lower than current share price) when the options vest? Or will both parties make a decision at that time? Will the employee spouse have sole discretion as to whether to exercise? Will each party be able to direct the exercise on “their” portion of the options? If one party does not wish to exercise the options, will the other party have the option to do so and retain the upside? \textsuperscript{25} Will the potential income tax consequences, and the potential that one spouse’s exercise of options put them into another tax bracket or subject them to additional Medicare tax or AMT, be a factor in the decision-making process?

If the exercise of stock options is not a cashless exercise, when must the other spouse be required to tender cash to the employee spouse? The divorce settlement agreement should cover what happens if either spouse does not have cash on hand needed for a cash exercise when the options vest. If the exercise

\textsuperscript{25} If payment is made to the non-exercising party, such party will recognize gain; if the non-exercising party permits the other party to exercise and retain the shares, the usual rules for transfer will apply.
is a cashless exercise, the agreement should set forth whether all
the options when exercised should be immediately sold (although
the company may require this), whether all that can be held
should be held, or whether the parties need to come to that
agreement when the options vest.

What happens after the exercise of the options is the next
issue to memorialize in the divorce settlement agreement. If the
company is a public company, most agreements will state that the
non-employee spouse’s shares should be distributed to such
party. If it is a private company, the non-employee spouse
should be given the opportunity to sell shares to the employee
spouse or to the company. If the private company shares cannot
be sold to the employee spouse, the company, or a third party,
and cannot be assigned to the non-employee spouse, the divorce
settlement agreement should cover the terms of continued reten-
tion of shares in a constructive trust.

Because RSUs and Performance Shares are the promise of
actual shares when granted, and when they vest the shares are
delivered to the employee, they are generally easier to address in
divorce settlement agreements. If the stock is transferable, the
stock can be assigned to the non-employee spouse when the right
to the stock vests.

The divorce settlement agreement should cover the possibil-
ity that the company will be acquired before all of the options
vest, are exercised, and the shares sold. In particular, the em-
ployee spouse should commit to receiving the full value of the
options and shares in cash, as opposed to other employee com-
ensation or benefits from the acquiring company that would not
redound to the non-employee spouse. This should also be in-
cluded in agreements about RSUs and Performance Shares.

Until the non-employee spouse can own shares in his or her
own name, all income related to the shares will be reported only
to the employee-spouse. Thus, the divorce settlement agreement
must provide that the non-employee spouse is responsible for the
income tax on such party’s portion of the options or shares. In
general, the parties should agree that income tax returns for the
employee-spouse be prepared with and without the non-em-
ployee spouse’s share of income related to options, and the non-
employee spouse will be responsible for the difference. Income
taxes are withheld from options related events, and thus there
will need to be a true-up of income taxes over-withheld or under-withheld. Agreements should include calendar deadlines for these determinations and true-ups, as well as who will determine the amount of true-up, and whether such determination will be binding on the parties.

The divorce settlement agreement should address whether the income that is related to the options, RSUs, or performance shares will be income for support purposes for either party.26

Finally, the divorce settlement agreement should provide that if the employee spouse dies before the non-employee spouse receives the employee spouse’s portion of the options, RSUs, or performance shares, the non-employee spouse will have a creditor’s claim against the employee spouse’s estate for the value as determined under the agreement. If a plan permits designation of a beneficiary, which would be unlikely, the divorce settlement agreement may require that the non-employee spouse be named irrevocably as beneficiary to secure the benefit. Finally, the agreement must address what should occur with respect to any shared decision-making if the non-employee spouse predeceases the employee spouse.

III. Co-Operated and Co-Owned Businesses

A. Defining the Asset

An operating business is a business which provides a product or service to the marketplace and the primary source of revenue for an operating business is the providing of that product or service. One or both of the spouses may have an ownership stake in the business and/or may apply their time, effort, and skills to the management of the business. For example, a non-owner spouse may devote unpaid services to the business and/or tangential benefits by hosting social events for marketing purposes, taking charge of social media feeds, and assuming other responsibilities inside and outside the home to permit the business owner to devote time and attention to the business. The business may take the form of a sole proprietorship, a partnership, a limited

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26 For a discussion regarding the issue of treating options as assets or income for support purposes, see Robert J. Durst, II, *Stock Options: A Significant but Unsettled Issue in the Distribution of Marital Assets*, 17 J. AM. ACAD. MARRIAGE FAM. LAW. 275, 299-302 (2001).
liability company, or a corporation. Generally, interests in a business acquired after marriage are marital property and subject to division in equitable division jurisdictions, even if the business interest is owned in the name of only one spouse, although efforts of the non-owner spouse during the marriage to support the business enterprise may convert some portion of the business interests acquired before the marriage into marital property.

In some cases, parties co-own or co-manage a business that neither wishes to relinquish after a divorce. In these situations, the attorney will often hear that the parties may not have a good intimate partner relationship, but they have a very good working relationship. These are parties who acknowledge that a marital business is enhanced by the skills or attributes of each party, and the business value would be diminished if one of the parties were no longer involved. Additionally, adult children may be involved in the business and the parties’ long term estate plan may involve the gradual transfer of business interests over time to the children. In some cases, both parties may be needed to develop the adult children as owner/operators of the business. The business interests of each party may already be held by irrevocable trusts as part of the parties’ estate planning, making divestment of one party’s interest at divorce impossible, or even if possible, complicated and not optimal in light of the larger family estate planning picture, potentially pitting the senior generation against later generations.

This is not to suggest that matrimonial attorneys should generally advise clients to continue to own and operate a business together. In the majority of circumstances, divorcing spouses will be unable to continue operating a business together as co-owners without being locked into continuing conflict. For the right clients though, matrimonial attorneys who are knowledgeable and creative can facilitate the wishes of parties who really are able to


continue to co-own and operate a business together even post-divorce with a detailed course of conduct they will follow for transparency and to minimize conflict, rather than just assuming that the parties cannot and should not continue to co-own a business, or that it is a terrible experiment doomed to fail.

B. Valuation Difficulties

When the parties have co-operated a business, they will have their own thoughts about the value of a business, and those valuations are not likely to be the same as that of a valuation by an expert. Their own views, industry experience, and risk tolerance will color the factual information. The ownership of a business, and the parties’ respective titles and roles in it, likely provide a number of tangible and intangible values to each of them. The business may be an integral part of the parties’ overall lifestyle, identity, and, sometimes, social life. The business likely provides valuable, tangible benefits, such as the ability to expense items that have become “personal” to the operator while still being legitimate business expenses. The business may be the best employment opportunity for one or both spouses in terms of compensation, and no job available in the marketplace will be able to replace either or both spouses’ share of business profits and autonomy. Consider the example of a jointly owned, jointly operated inn, equestrian center, and wedding venue in a rural area, located partially on a civil war battlefield. Consider further that the wife does not have a college degree but is a remarkable wedding planner. Because the area is rural, the parties live in the area and their friends and family are also local. Both parties are equestrians. The parties see the property as a legacy property. The parties may determine that the value of the property to them is much higher than any expert will ever determine, and the advantages to both of them retaining the business outweigh the negatives of possible conflict later.

Valuing an operating business is an art, and not a science. The value will depend in part on factors within the control of the principals, and in part on factors outside their control, including among other things, changes in taxation, regulatory changes, and unique events, such as the COVID pandemic, which has decreased demand for some products and services, and increased demand for others. Value may depend on the dedication and ef-
fort of the parties who actively work in the business, and whether that dedication and effort will continue unabated following divorce.

C. Language for Co- Owning and Co- Operating a Business

When parties agree to co-own a business after divorce, they must shift their expectations, and agree to be legal business partners, with arm’s-length terms. If they do not already have a sophisticated corporate attorney, they should retain one to review current corporate documents such as articles of incorporation, bylaws, operating agreements, partnership agreements, buy-sell agreements, and director agreements. It is very common for spouses to not have all or even many of the necessary corporate documents in place and up to date. Even the most basic decisions, such as who will serve as officers and directors should be examined, as well as whether having outside board members will facilitate the ongoing co-ownership of the business in a successful manner.

A certified public accountant (“CPA”) with expertise in advising the type of business also should be consulted. Spouses very often pay personal expenses from the business without accurately reporting those expenses as income. The CPA should help establish the rules regarding what expenses are and are not deductible business expenses, and what expenses the parties will continue to pay from the business.

The parties should have detailed agreements about compensation. Not only must compensation in the form of regular wages be discussed, but there are other forms of compensation that should be considered as well, including retirement plan allocations, individual plan life insurance and disability premium payments, auto leases, memberships, credit cards, and similar benefits. A procedure and structure for regular review of these items is important. In the case of limited liability companies and certain corporations, there may be distributions made annually for the payment of personal income taxes, as well as distributions that are a return on capital, in excess of routine compensation. In many family businesses, actual compensation has been minimized in favor of leaving funds in the company to enhance growth potential, with the business treated as the family “piggy bank” for distributions as needed. Post-divorce, incentives and
financial needs naturally change. In some cases, spouses working in the operating business feel entitled to take a market wage (or more), sometimes attempting to disguise the distributions, or to take less in order to leave more in the company for expansion plans. An independent consultant can confirm reasonable compensation, and approval levels can be agreed upon for distributions that would exceed customary reasonable compensation, similar to what a corporate acquirer would require in a corporate deal.

The newly established business agreements should address a wider variety of issues than might otherwise be dealt with in the context of unrelated co-owners, such as what each party’s responsibilities in the business will be (e.g., human resources, marketing, business development, operations), the compensation for each party, whether profits will be retained by the business for investment and development, how net profits will be distributed, and how financing will be acquired. Agreements should include identification of each party’s role in the company (e.g., CEO, CFO, CIO, full-time employee, or part-time employee) and obligations to the company (i.e., restrictions on competition and dissemination of company information).

There are other key business decisions that should only be implemented following agreement of the parties after full discussion. Those decisions include, but are not limited to, relocating the business, transitioning the business from a brick-and-mortar business to an on-line business (whether partially or completely), hiring certain high-level employees, purchasing software for use in the business, acquiring another business or its assets, and borrowing money or entering a new lending relationship. Keep in mind that the business may lease space or equipment from one or both of the parties. During the marriage under market rent may have been paid; it is not uncommon to charge the business only enough to cover the operating costs for the real estate.

The parties may also wish to come to an agreement regarding the time and attention that either or both of the parties will be required to dedicate to the business. Similarly, the agreement should address retirement, decisions about business management succession, and decisions about any potential future sale of the business or its assets. The parties should agree how to address the incapacity or death of the other party, and whether incapacity or
death should trigger an optional or mandatory buy-out of the incapacitated or deceased party’s interest in the business by the other party or require sale of the business.

Finally, the parties must determine what constitutes a breach of their business agreements, and the mechanism for how the breaching party will exit the business if needed or desired.

If, ultimately, the parties do not wish to continue to co-own the business, or if the agreement provides that the disability or death of a spouse will require a buy-out, how the value of the exiting party’s interest will be determined is critically important. The discussion about fair value is applicable here, since the selling party expects to be paid fair value, which ignores discounts. In fact, the selling party may even claim that fair value should include a premium for the ability of the purchasing party to have control over the entire business. Note that the use of fair value without discount will impact the value used for transfer tax purposes for gifts during life, and sales during life to related parties and at death because the IRS will assume that the valuation methodology used in an agreement between former spouses is reflective of an arm’s-length valuation.

Many of the same issues discussed above apply to a sale to a third party in close proximity to the purchase of one party’s interest by the other party. If, however, the buyout of one party was at a discounted value due to breach, it would not be reasonable to have any sort of claw back for future upside, unless the ouster were contrived.

D. Income Tax Considerations

When married, or incident to divorce, one spouse’s purchase of interests in a business from the other spouse is not treated as a sale for income tax purposes, meaning the selling spouse does not realize a taxable gain on the sale of interests, and the purchasing spouse receives carry-over basis from the selling spouse.29 A later sale of the business may result in gain, making it important to consider unrealized gains.30 However, the spouses

may wish to continue to co-own the business, or may need to in order to fairly divide their marital property if a buyout cannot be achieved, and only after the period has passed for nontaxable treatment for a sale between them has occurred, determine that the arrangement is no longer desirable. If the business has non-U.S. operations, care should be taken to understand any foreign tax issues.

E. Liability Considerations, Including Those Incorporated in the Purchase and Sale Contract

The same liability considerations apply in a sale between the parties but are often not given sufficient attention as compared to a sale to a third party since the parties will assume they are knowledgeable. In fact, one of the parties may have been more involved in certain aspects of the business and have a greater appreciation for the liabilities of the business.

Again, the parties’ new relationship will simply be as business partners, but as former spouses, it is advisable for the business documentation to cover a wider range of issues and do so with more precision than might otherwise be the case. This ensures the expectations of both parties are known to one another; otherwise, a party may simply assume that conduct during the marriage will or should continue, or, conversely, will change, post-divorce. Unrelated parties assume the other party will behave in a businesslike manner; sometimes former spouses unreasonably assume that their former personal relationship will make the business relationship less rigorous.

The divorce settlement agreement need only reflect that the parties will each be allocated a share of the business and that income will be derived from a co-owned business. Divorce courts should not have responsibility for interpreting or enforcing business agreements. The business agreements should be completed and signed before the divorce is fully settled and may be referenced in the divorce settlement agreement. Business operating documents and the divorce settlement agreement each should contain a dispute resolution clause, including venue.


F. Change of Corporate Structure or Business Focus Should Not Negatively Impact Agreement

The spouse working in the business should not be able to relinquish or delegate decision-making over the business or change the corporate structure of the business without the consent of the other spouse. This includes changes in structure that would change the flow of funds from the business or alter the manner in which business decisions are made, especially if doing so would in any way be contrary to the divorce settlement agreement. This would include, for example, a change in corporate tax structure from a C corporation to an S corporation. While that may be advisable for overall income tax planning, an S corporation must allocate its profits to the shareholders for tax purposes, but is not required to actually distribute those profits to the shareholders.32 Depending on the terms of the agreement, this phantom income can create significant imbalance in the parties’ respective financial positions and upset the parties’ expectations as outlined in the divorce settlement agreement. Because changes to corporate tax structure may impact other portions of the divorce settlement agreement, such as spousal support, an amendment to the divorce settlement agreement may be required in addition to requiring the other party’s consent in the ordinary business sense.

IV. Imminent Business Sales

A. Valuation Difficulties

The best means of determining the value of an asset is by selling it on the open market. One of the hardest assets to value is a closely held private company.33 At divorce, the owner-spouse will generally claim it is worth much less than what the non-owner spouse has heard about the value during the marriage. There is no shortage of attorney war stories about the businesses sold shortly after a divorce for much higher than the divorce valuation.

What is very difficult to incorporate into a determination of fair value (and fair market value as well) are potential future corporate events. That includes a public offering, or an acquisition for cash and/or an interest in the acquiring entity. The owner-spouse will be concerned that a valuation will fail to take into account certain liabilities imposed on the seller, including corporate taxes, the value of contractual obligations, rent, and similar matters. While those known at the time of divorce should be considered by the appraiser, there also may be extraordinary liabilities, including a tax audit, an employment claim, an environmental claim, or a patent infringement claim. Of course, an appraisal can only make reasonable assumptions based on facts certain or very likely to occur.

While a sale may provide a potentially exponential upside, a portion of the upside may be held in escrow or subject to an earn-out schedule for benchmarks met post-closing over a period of time, as well as reduced liabilities for unknown events that the acquirer will not assume. Most sales are structured as a sale of the assets of the business, rather than a sale of shares because the buyer will not agree to acquire the liabilities of the business, but if they are limited in nature, a buyer may purchase the shares, but the purchase agreement may impose a reserve for liabilities the buyer does not intend to assume.

B. Considerations for the Imminent Sale of a Business

1. Claw Back

To protect against a sale in close proximity to the divorce producing a substantially different value than determined by appraisal or agreement, a claw back provision can be included in the divorce settlement agreement. The claw back provision would provide that if the business is sold shortly post-divorce at a markedly different value, the non-owner spouse would be entitled to an additional settlement amount based on the increased value of the business over what was assumed at the time of divorce. A claw back provision should be limited in time, most commonly between twelve and eighteen months; otherwise, it may be argued that the increased value is due to the services of the owner, changed market conditions, or other, new factors than existed at the time of divorce.
What is rarely considered is the situation where the business sells for less than the appraised or agreed upon value, and whether there should be a claw back for the owner spouse. If it is contemplated that a business will be sold soon after the divorce, the more equitable approach for both parties may be to have a non-owner spouse’s share of the asset allocated when value is realized. In a sense, this makes the non-owner spouse a silent partner until the sale occurs, and may suggest that in the divorce settlement agreement, certain rights typically held by co-owners apply, such as decisions about sale price and terms. Because third parties cannot be bound by a divorce settlement agreement between the parties, the divorce settlement agreement might contain indemnification provisions between the spouses to address potential unknown liabilities that might be retained by the seller in a sale to a third party.

In the case of division at the time of divorce with a claw back provision, it would be unusual to have the other party need to consent to a sale, but disclosure provisions are essential.

2. Deferred Division

If the division of assets is deferred, pending a sale to a third party, the divorce settlement agreement should specify who makes decisions about timing and terms of a sale, what disclosures are required to be made to the other spouse, and what value adjustments will be made. There is a balance between disclosure and having a silent partner with veto power over a sale.

The party who is the sole owner of the business naturally will want to have sole control over decisions about whether to sell the business, and all of the details for a sale. However, that may disadvantage the other party. For example, the owner may be perfectly happy receiving shares of the acquirer, or payment in part with a promissory note, both of which effectively make the acquirer the “bank.” The owner may want to sell the business to key employees on more favorable terms than the market might achieve, out of a sense of loyalty to longtime employees, or may wish to hold out for a strategic buyer, even if none is on the horizon. What disclosures and consents must be obtained from the other spouse should be clear in the business agreement, and it may be agreed that the decision about what is the “best” sale may be subject to the business judgment rule, as distinct from a
fiduciary standard of care. The parties’ expectations about the timing of a sale and how the price will be established should be agreed upon, as well as how much of the detail the non-owner spouse must approve before a sale is consummated. An important issue to consider is the need for confidentiality so as not to chill the market.

The non-owner spouse will be concerned that the owner spouse may not adequately protect the value that will be delivered to the non-owner spouse. Even though their interests would seem to be aligned to maximize value, there are matters that may be more appropriately determined jointly to assure that the economic result achieved is what the parties intend.

The purchase agreement may also contain so-called “golden handcuffs,” to assure that the owner of the business remains actively engaged in the business for some period of time following the sale, assuring continuity for the purchaser. It is rare for a business owner accustomed to running a business without oversight to remain employed for the entire duration of a golden-handcuffs term. Should the future compensation paid by the acquirer be treated as part of the value of the business to be divided, or simply compensation to the selling spouse in the ordinary course, separate from the value of the business? The buyer may sweeten the deal by including options or warrants in the acquiring company. Other less obvious personal benefits to the selling party may include the ability to retain assets of the corporation, including receivables, tangible assets (equipment, vehicles, and the like), and agreement for a new consulting business established by the seller to provide certain services to the buyer, or an unusual non-compete provision.

C. Income Tax Considerations

The sale of a business or the assets of a business is generally classified as capital gain for tax purposes. A stock sale is taxed


once, at the shareholder level. An asset sale, often preferred by buyers, will be taxed differently, depending on the corporate structure. C corporations are subject to potential double taxation, once at the corporate level, and then again by the shareholder as ordinary dividend income when the net proceeds are distributed. If, on the other hand, the entity is taxed as an S corporation for tax purposes, while there is no double tax, some of the gain may be taxed as ordinary income due to depreciation recapture, and it is possible that if the corporation had previously been taxed as a C corporation, there may be some portion of the proceeds that are not taxed at all. For partnerships, including LLCs, an asset sale requires careful consideration of the particulars to confirm whether any portion will be taxed as ordinary income.

Ideally the parties will do their tax reporting in a consistent manner, and while the divorce settlement agreement and business agreements might obligate them to consult with one another, they should not obligate themselves to take a tax reporting position that may be incorrect if one party has a higher risk tolerance for gray areas than the other.

V. Private Equity, Venture Capital and Hedge Fund Investments – Investor and Principal

A. Defining the Asset

A person holding an interest in a private equity, venture capital, or hedge fund may be simply an investor without management responsibilities or that person may be a principal who actively participates in management in order to generate returns for the fund.

Private equity funds obtain capital contributions from wealthy investors in exchange for a limited (non-managing) ownership interest in the fund. An investor typically makes a commitment at the outset to make contributions of capital to the

36 Id.
fund at certain points in time to facilitate investment by the fund. The fund will use raised capital to purchase interests in existing businesses, often controlling interests, with the goal of increasing the value of the acquired business over time and eventually selling those interests off for a profit. Because increasing the value of an operating business takes time, funds often have long investment horizons, with investor capital unable to be withdrawn for several years after the initial investment.

Venture capital funds can be thought of as a type of private equity fund, typically investing in newer, less mature businesses. Venture capital funds typically spread investments across a large number of start-ups, acquiring minority positions in each. The expectation is that a majority of the businesses invested in will fail, but if the fund “hits” on the next Facebook, for example, returns could be exceptional. Private equity funds typically look to create value by acquiring a controlling stake in an existing business and actively working to increase the value of the business, whereas venture capital funds simply try to identify early-stage companies with great growth potential and try to ride that growth to strong investor returns.

Hedge funds are pooled investment vehicles that, like private equity funds, obtain capital contributions from investors. Unlike private equity funds, hedge funds invest in securities and other assets, taking long and/or short positions, with the goal of outperforming the returns of the broader market in such assets by taking an aggressive position about the strength or weakness of the particular investment sector, or minimizing downside risk. Hedge fund managers do not typically seek to acquire a controlling stake in a business. The fund typically will focus on a particular industry segment, or strategy for investment (long or short term, for example). Hedge fund investments typically are more liquid in nature than private equity investments, but the fund still depends on maintaining the contributed capital, with the result that withdrawals will be subject to calendar windows and capital requirements for transfer or redemption. Redemption timing limitations can cause the interests to be subject to valuation discount for the lock up periods and future volatility. For example, a fund may have one annual notice for withdrawal by, say October 1, with payment to be made the following January 15. If an investor fails to provide capital to the fund following a call on
commitments by fund management, the investor may forfeit the interest in the fund.

For all three, an investor must be an accredited investor and qualified purchaser, as defined in regulations established by the Securities and Exchange Commission (“SEC”).\footnote{17 C.F.R. § 230.501 (2020).} The ability of an investor to transfer the interest in the fund may be severely restricted. The partnership agreement governing the relationship between the general and limited partners often restricts transfer of an investor's interest such that it may only be transferred to another limited partner in the fund. Even if an investor’s interest may be transferred, the transferee must qualify as an accredited investor and qualified purchaser under SEC regulations, and the investor’s spouse may not qualify as an accredited investor or qualified purchaser even after a division of other marital assets.\footnote{See Id.} Because of the limited transferability of the investor’s interest in the fund, and speculative future value, the fund interests likely will be subject to steep discounts for valuation purposes.

Fund principals have additional potential economic upside in the form of “carried interest,” which is typically structured as a percentage return once the limited partners have either received back their initial investments, or their initial investment plus a stated return. Economic interests in the management entities likely will be subject to a vesting schedule and may not be easily transferred for the obvious reason that fund principals want to work with specific persons who are knowledgeable in the particular business and limited partners want management to be in the hands of competent, knowledgeable individuals recognized as having industry experience and talent.

B. Valuation Difficulties

Most private equity and venture capital funds provide periodic statements that project future value, since there is no ready value until the fund has completed its investment commitment, completes the exit strategies for the investments by selling or liquidating the investments, and winds up. As a result, it may be impossible to obtain from the fund current fair market value information. Even where information may be available, there is
often a substantial lag time for information to be disseminated to investors.

Hedge funds do provide periodic statements to investors, but the value reflected on the statements does not take into account the lock up period. In addition to the timing issues, market forces can severely impact the value of the asset. Current examples include the impact of day traders running up the value of GameStop and AMC, \(^{41}\) and the impact of volatile oil prices.\(^{42}\)

In addition to a lack of good information about current market values, when these interests are valued for divorce purposes, they are subject to very high discounts for lack of marketability and lack of control. Thus, for example, an owner spouse can invest $500,000 on January 2, receive a statement that shows a value of $520,000 and a projected value of $700,000, but the divorce valuation on January 3 will be $275,000. That often seems extremely inequitable to the non-owner spouse.

C. Language for the Division of Private Equity, Venture Capital, and Hedge Fund Investments

When dividing these assets in kind, look first to the subscription agreements and operating agreements to determine restrictions on transferability of the interests. Look also for provisions specific to transfers by operation of law, including the divorce of an interest holder. If partial interests are transferable to the spouse, be sure all transfer rules are followed, such as obtaining consent from the manager, agreeing to and signing all necessary agreements that the owner of the interests agreed to, meeting investor requirements, and during transferring an open window for transfer (usually at the end or beginning of a calendar year). The parties may agree that the economics before a permitted transfer date will be shared by them.


If an outright partial transfer is not allowed, determine if a transfer of all interests can be made to an LLC. If so, the spouse who owns the interests may create an LLC to hold the interests, with the spouses as members in whatever percentage membership interests they determine. Note that not all funds will permit a transfer to an LLC, and it may be that the parties will need to agree that the fund interests will be held as though they had been transferred to such an LLC. Even where the fund permits a transfer to an LLC, it is likely the fund will require a single manager to serve as the point of contact between the LLC and the fund. The fund will likely require that the manager be the spouse who is the initial investor or principal of the fund, as opposed to the spouse who may receive an interest in the fund incident to the divorce proceeding.

In addition to management considerations, the LLC operating agreement should address the following issues: timing of distributions to the spouses, including specifying reserve requirements; LLC distribution triggers, including for tax payments owed by the members; transferability of LLC membership interests; management of the LLC and management succession in the event of the manager’s death or disability; anticipated duration of the LLC and whether further investments can or should be made; and how retained cash for reserves should be invested. Because of the complex nature of the assets, it will be important to carefully consider a reserve for claw back liabilities to the fund, and, if the spouse is a principal in the fund, for other liabilities, as well as indemnification if the reserve is insufficient. Some principals wish to make charitable transfers of stock to be received and how that will be treated for LLC distribution purposes should be spelled out in detail in the operating agreement. For example, will a charitable contribution from the LLC be treated as a charitable contribution pro rata by the members, or a distribution to one of the members, who in turn is deemed to have made a charitable contribution.

Finally, for fund principals, there may be multiple fund interests transferred to the LLC, with future vesting and reinvestment opportunities. The spouses may determine that interests vested as of a date certain will be shared via the LLC structure, but interests that vest after a certain date will not be shared in the same proportion. However, if fund management cannot or
will not bifurcate the marital portion to be shared via the LLC, then the entire interest can be transferred to the LLC, and the operating agreement can address how distributions will be made between the parties.

As with co-owned and managed businesses, rather than stating all of the above details in the divorce settlement agreement, the operating agreement should control and will be governed by state corporate law. The parties will be members of an LLC, not spouses or ex-spouses. However, the operating agreement can be an exhibit to the divorce settlement agreement that should certainly be completed and signed before the divorce settlement is complete.

D. **Income Tax Considerations**

For interests that cannot be transferred, but will be shared by the parties, the value shared should be the net after tax value. The utility of the LLC arrangement is that income taxes can be paid by the LLC and net value can be distributed to the parties. It is very common to include in the operating agreement that the tax impact of the distributions will be certified by an accounting firm and the parties will rely on that certification.

For fund principals, recent changes to the Internal Revenue Code alter the income tax treatment of carried interest from capital gains to ordinary income under certain circumstances and can accelerate gain recognition on transfers of carried interests to “related parties.”

Fortunately, the Final Treasury Regulations issued on January 7, 2021 clarify that the gain acceleration on the transfer of a carried interest applies only where gain would otherwise be recognized. As a result, acceleration of gain is not triggered on gifts or transactions that would otherwise be tax-free. Assuming assets are distributed between spouses incident to the divorce and are otherwise exempt from current income tax recognition, the final regulations clarify that gain is not accelerated on the transfer of carried interest.

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44 *Id.*
45 *Id.*
46 *Id.*
E. Monitoring/Management

Reporting for these interests are often subject to substantial time lags in reporting from the fund itself. Both spouses and their advisors should review the reporting and the resulting value shared and tax reporting on an agreed upon schedule. There is often little or no transparency from the fund itself, unless the fund is very small and wholly owned for management purposes by one or both of the parties. The ability to obtain different reporting from the fund itself, therefore, may be non-existent. If the flow of funds is transparent from the reporting, that will allow each party to trust and verify the distributions.

VI. Intellectual Property

A. Defining the Asset

Intellectual property is defined as intangible rights protecting the commercially valuable products of the human intellect. It is also “the set of legal rights to an expressed idea—it is property that results from the fruits of mental labor.”

In the divorce context, courts have divided intellectual property that includes rights granted via patents, trademarks and trade secrets, and copyrights. Underlying those rights are the creations themselves, such as software developed, technology or

47 The authors have intentionally omitted personal goodwill such as celebrity goodwill.


51 See Teller, 53 P.3d at 247.

52 See Berry v. Berry, 277 P.3d 968, 969 (Haw. 2012); see Rodrigue v. Rodrigue, 218 F.3d 432, 443 (5th Cir. 2000).
devices invented,\textsuperscript{53} plant varieties invented, paintings painted,\textsuperscript{54} books written,\textsuperscript{55} movies made,\textsuperscript{56} and music composed.\textsuperscript{57} Finally, courts can divide the income that is derived from the intellectual property by allocating royalties, income from licensing agreements, income from franchise agreements, and proceeds from sales of the property.

Often the work behind the creation of intellectual property represents an enormous effort and sacrifice during a marriage. In fact, it can be the reason for a divorce. Take the example of the spouse who quit a lucrative job as the CIO of a large company to start developing her own software as a service (SAS). The spouse has used all of the family’s savings to develop the SAS and keep the family afloat during the time there was no income. The spouse dedicated all working time during the marriage toward development efforts for the intellectual property. The other spouse undertook more of the family responsibilities and perhaps took a less interesting job solely to provide economic support, rather than intellectual stimulation, all to support the family and the efforts of the spouse developing the intellectual property. If the divorce occurs before the SAS has produced anything tangible or is capable of being valued, the supporting spouse will want recompense if the SAS ultimately sells for millions, as the parties always assumed it would.

\textsuperscript{53} See \textit{In re} Perkel, 963 S.W.2d 445, 451 (Mo. Ct. App.1998) (noting that the software written by the husband during the marriage was marital property); see \textit{Hazard v. Hazard}, 833 S.W.2d 911, 916 (Tenn. Ct. App. 1991).

\textsuperscript{54} See \textit{Rodrique}, 218 F.3d at 443.

\textsuperscript{55} See \textit{In re} Worth, 195 Cal. App.3d 768, 773 (Cal. App. 1987) (noting that “there seems little doubt than any artistic work created during marriage is community property”); see \textit{Gallo v. Gallo}, 440 A.2d 782, 788 (Conn. 1981); see \textit{In re Marriage of Heinze}, 631 N.E.2d 728, 731 (Ill. App. 1994) (reasoning that where contract rights to future book royalties were acquired during marriage, those royalties are fruits of the shared enterprise of marriage subject to equitable distribution); see \textit{In re Marriage of White}, 537 N.W.2d 744, 747 (Iowa 1995).

\textsuperscript{56} See \textit{Canisius v. Morgenstern}, 35 N.E.3d 385 (Mass. App. Ct. 2015); see \textit{C.G. v. R.G.}, 9 N.Y.S.3d 592 (N.Y. Sup. Ct. 2015) (holding that proceeds from selling the husband’s film will be divided between the parties 70% to the husband and 30% to the wife).

\textsuperscript{57} See generally \textit{Zander v. Zander}, No. FA 970074587S, Aug. 30, 1999 WL 711503 (Conn. Super. Ct. 1999) (holding that a husband was not entitled to royalties from the sale of his wife’s song recordings, because of the future efforts that would be required of the wife to retain the royalty stream).
In divorce cases, intellectual property is often analogized to and treated similarly to pensions. Like a pension, intellectual property is property, as opposed to a mere expectancy, but whether and how much value a person may actually receive from the asset is uncertain. Like a pension, intellectual property may have components of its value that accrued before the marriage, during the marriage, and after the marriage. Value accrued during the marriage is marital property, but value accrued before and after the marriage is separate property.

Like the history of the treatment of pensions in divorce matters, intellectual property is not universally deemed “property.” One federal district court held that a copyright is the separate property of the creator due to the federal preemption by copyright law, but the proceeds from the copyright are subject to division between spouses. On appeal, in a threading of a proverbial needle, the federal appellate court determined instead that the creator “maintains exclusive managerial control” of the copyright, but the economic benefits thereof can be divided at divorce. Another court held it was not error to fail to place a value on patents when the future of the income was too specula-

58 See e.g., Heinze, 631 N.E.2d at 731 (reasoning that similar to pension rights, future book royalties are the fruit of the shared enterprise of marriage and should be divided as marital property). However, “[u]nhke pensions and other professional goodwill, rights in intellectual property are highly transferable, and title may thereafter be placed in the name of one who not originally produce them.” In re Monslow, 912 P.2d 735, 743 (Kan. 1996).


60 See Worth, 195 Cal. App. 3d at 776; see also Curtis v. Curtis, 208 Cal. App. 3d 387 (Cal. Ct. App. 2d. Dist. 1989); Monslow, 912 P.2d at 743; Perkel, 963 S.W.2d at 45 (“All property acquired by either spouse subsequent to the marriage and prior to a decree of legal separation or dissolution of marriage is presumed to be marital property.”); Hazard v. Hazard, 833 S.W.2d 911, 916 (Tenn. Ct. App. 1991); Alsenz v. Alsenz, 101 S.W.3d 648, 655 (Tex. App. 2003); Rodrigue v. Rodrigue, 218 F.3d 432, 443 (5th Cir. 2000).

61 Rodrigue, 55 F. Supp.2d 534 (E.D. La. 1999), rev’d, 218 F.3d 432 (5th Cir. 2000).

62 Rodrigue, 218 F.3d at 436.
tive to consider. Still another queried whether proceeds from pre-marital intellectual property should be considered the return of that property (like an annuity) or income, such as the income from a pre-marital investment. Finally, some courts have determined that if a future income stream from property is too speculative, it does not need to award interests in the intellectual property as part of the property division.

The moment when an idea, concept, code, or scribble becomes property is more difficult to identify than when a pension becomes property; however, there are different times that the property right can be said to have accrued or vested: when the concept is sufficiently developed to generate a plan to create the intellectual property; when the intellectual property can be said to have been made or created; or the when the intellectual property is actually linked to something that can generate income, like a patent, a production transaction, or a contract. Thus, separating premarital from marital intellectual property can be challenging, and the question may arise as to when the idea was sufficiently formed to be something that has the nature of property and when it had value. One court has noted that a property right vests when the right in a trade secret vests, and there can be a second vesting date for the same intellectual property when a patent is received.

It can also be difficult to separate marital property value from post-marital property value added to intellectual property. One of the most famous examples of this is the dispute between actor Michael Douglas and his ex-wife regarding the movie “Wall Street.” The Douglasses divided royalties and sales from Mr. Douglas’ movies that were made during the marriage. One of those movies was “Wall Street.” Ms. Douglas claimed an interest in the sequel, “Wall Street: Money Never Sleeps.” She argued it

63 Yannas v. Frondistou-Yannas, 481 N.E.2d 1153, 1160 (Mass. 1985) (holding that a patent on artificial skin was too speculative for division).
64 Alsenz, 101 S.W.3d at 653 (holding that the husband’s inventions patented before marriage were revenue and the fruit of his separate property and thus community property).
67 Id. at 254.
was a spinoff derived from marital intellectual property. Mr. Douglas claimed the movie was a distinct work and only post-marital efforts were in play.68 Ms. Douglas’ bid for an additional award was denied on the grounds of improper venue.69 A more pedestrian example is In re Marriage of Heinze, where the co-author of speech therapy books successfully argued to the Third District Appellate Court of Illinois that she should be awarded a greater percentage of post-marriage royalties from her books because her post-marriage marketing efforts would help generate the royalties.70 Courts tend to take a rather blunt force instrument to the issue, however. Often, the court simply awards the non-owner spouse a lower than equal percent of future income from the property when the owner spouse will be exerting efforts to produce the income after marriage.71

Just as the intellectual property can be divided in a divorce, so can the debt related to the development of intellectual property when it was incurred during the marriage.72 Similarly, courts have held that the parties should share income taxes on the funds received from the property in an appropriate manner.73

B. Valuation Difficulties

Intellectual property can be very difficult to value, especially if it has not yet started to produce income. When valuing intellectual property, the valuation must take into account the highest and best usage in light of the most reasonable and legal use of

71 See Heinze, 631 N.E.2d at 732; see In re Monslow, 912 P.2d 735, 747 (Kan. 1996); see generally Dunn v. Dunn, 802 P.2d 1314, 1319 (Utah Ct. App. 1990).
73 See Wozniak, supra note 72, at § 6[a]; See Heinze, 631 N.E.2d at 733; In re Marriage of White, 557 N.W.2d 744 (Iowa 1995).
the intellectual property, that is physically possible, appropriately supported, and financially feasible, and that results in the highest value.\textsuperscript{74}

The usual valuation methodologies are not easily applied to intellectual property. For instance, the cost approach may be problematic because the cost to develop intellectual property may include failed or inefficient “first tries.” The market approach is not likely to yield a supportable valuation because there are not often comparable sales for unique intellectual property. Some courts use an investment value approach, asking what an investor would pay for the foreseen return, but this is just a fair market value approach and therefore has the same weaknesses.\textsuperscript{75} The income approach is too speculative if the intellectual property is not already receiving an income stream. In addition, a competing intellectual property may be introduced to the marketplace and reduce the income stream. Finally, there may be unforeseen costs in the future that will need to be expended to protect the income stream, such as patent infringement suits.\textsuperscript{76} In short, each valuation methodology is susceptible to significant inaccuracy due to the lack of information regarding the net value of intellectual property both during development and at all stages of the property’s useful lifetime.

Due to valuation difficulties, some courts have determined that to equitably divide the property, the court should award the non-owner spouse a percentage of future net profits.\textsuperscript{77}

Case law on the valuation of intellectual property can be found more readily in federal cases involving copyright law.\textsuperscript{78}


\textsuperscript{75} See Precision Plating & Metal Finishing, Inc. v. Martin-Marietta Corp., 435 F.2d 1262, 1263 (5th Cir. 1970); Teller, 53 P.3d at 254.

\textsuperscript{76} See, e.g., Matter of Marriage of Monslow, 912 P.2d 735, 747 (Kan. 1996).

\textsuperscript{77} See Monslow, 912 P.2d at 737(reasoning that it was proper for the trial court to divide the property so that the patent was awarded to the husband and the wife for all future profits from the patent); Heinze, 631 N.E.2d at 787 (concluding that future book royalties should have been classified as marital property and allocated between the parties).

\textsuperscript{78} See CCC Info. Servs., Inc. v. Maclean Hunter Mkt. Reports, Inc., 44 F.3d 61 (2d Cir. 1994).
patent law,\textsuperscript{79} tax law,\textsuperscript{80} and criminal law\textsuperscript{81} than domestic relations cases.

C. Income Tax Considerations

Intellectual property is taxed as an intangible asset. A taxpayer’s basis in intellectual property will either be what the taxpayer paid to acquire it from a seller, or, if self-created, what the taxpayer put into it, so long as those costs were not deducted. For a profitable, on-going business, some research and development or research and experimentation expenses can be deducted from that year’s income.\textsuperscript{82} Other costs must be capitalized,\textsuperscript{83} and some, like research and experimental costs, may be capitalized.\textsuperscript{84} Capitalization of these costs can be helpful for companies that have not yet started earning an income. Also helpful for startups is the provision of the Internal Revenue Code that allows for the deferral of deducting certain expenses until the business is active.\textsuperscript{85}

Copyrights and patents can be amortized because they are deemed to have a limited useful life. Since trademarks are typically renewable indefinitely, they are not amortizable because they do not have a limited useful life. The transfer of all rights to intellectual property is the sale of a capital asset,\textsuperscript{86} and thus proceeds from the transfer will be taxed as capital gains or losses, subject to recapture rules.\textsuperscript{87} Royalties, income derived from a license to use intellectual property, are taxed as ordinary income.\textsuperscript{88} Whether the transfer of intellectual property is deemed

\textsuperscript{79} See \textit{In re Villena}, 745 F. App’x 374 (Fed. Cir. 2018).
\textsuperscript{80} See Amazon.com, Inc. v. Comm’r, 934 F.3d 976 (9th Cir. 2019).
\textsuperscript{82} I.R.C. §§ 162, 174.
\textsuperscript{83} I.R.C. §§ 263, 263A.
\textsuperscript{84} I.R.C. § 174 (Starting in 2022, however, these research and experimental costs cannot be deducted, and must be capitalized.).
\textsuperscript{85} I.R.C. § 195.
\textsuperscript{86} I.R.C. § 1235.
\textsuperscript{87} I.R.C. § 1245.
\textsuperscript{88} Bell Intercontinental Corp. v. United States, 381 F. 2d 1004, 1016 (Ct. Cl. 1967).
a sale or a license depends upon whether all rights to the property have been transferred.\textsuperscript{89}

There can be some actions that impact taxes when intellectual property is involved. For instance, manipulating when and what costs are deducted from income can reduce income and reduce income taxes, or reduce or increase basis. If an agreement is reached whereby the non-owner spouse’s interest in income or the asset reduces over time, and the non-owner spouse does not participate in sale proceeds after a certain amount of time, there should be some non-spouse consent required for certain tax elections.

D. \textit{Language for the Division}

A divorce settlement agreement that divides intellectual property in-kind should start with a clear definition of the property to be divided, to include whether the asset is, for instance, merely income from licensing of a patent, or the patent itself. If the intellectual property is still in development, the agreement should identify the phase it is in, and the steps to be taken for full development. The agreement should also include the date on which the property is being divided. If there will be a sunset provision, i.e., a date at which the property’s marital property component is depleted or expired, that date should also be clearly in the agreement.

The agreement should include provisions similar to those concerning the division of unvested stock options. The owner spouse should be deemed to hold the non-owner spouse’s interest in a constructive trust.

The duties arising out of the owner holding the property in a constructive trust should be included in the divorce settlement agreement and should be specific and limited in nature. The agreement should include a provision that no fiduciary duty is owed to the non-owner spouse. Duties would usually include a quarterly accounting of cash flows; providing notice of all communications from any source regarding the intellectual property within a certain number of days; providing notice of all offers to purchase; creating an affirmative duty to take actions required to preserve the intellectual property insofar as possible and reason-

\textsuperscript{89} I.R.C. §§ 1221, 1231.
able; and providing annual income tax analysis prior to filing deadlines.

As should be clear from the discussion about taxes and intellectual property above, tax issues are complex. The agreement must include a commitment to use a joint CPA, who has full access to all information requested, and who is directed to ensure that parties are treated equally as to divided interests in the property, and fairly as to divided interests versus non-marital interests of the owner, if any.

The agreement should address who has authority to initiate, conduct, and settle lawsuits involving the intellectual property. The agreement should address how decisions to sell an asset outright shall be determined. Will only the owner spouse have authority to decide to sell? Who will have authority over terms of sale decisions? The agreement must state how net sale proceeds will be divided. A definition of “sale proceeds” should be written into the agreement. The non-owner spouse’s obligations should be spelled out in the agreement. For instance, the non-owner spouse should be required to contribute to all fees and costs associated with preserving the asset.

If there will be out of pocket costs for the owner spouse that are required to monetize the asset to the greatest extent, such as attendance at trade shows or travel for book signings, identification of reimbursable expenses should be included in the agreement, and methods of reimbursement identified. Consideration should be given to the owner spouse being entitled a salary from proceeds if that is the most appropriate or easiest means of compensating the owner spouse for post marital efforts.

The agreement should clearly state how the parties will share net income over time. Will the sharing be based upon a formula where the non-owner spouses’ share decreases over time? Will the non-owner spouse’s share decrease over time if the owner spouse contributes additional property to the intellectual property?
VII. Irrevocable Life Insurance Trusts and Spousal Lifetime Access Trusts

A. Defining the Asset

Wealthy spouses often use irrevocable trusts in their estate and gift planning to accomplish various objectives, including, but not limited to, minimizing the impact of transfer taxes on assets and protecting their assets from creditors. Irrevocable trusts can be structured in different ways to accomplish these objectives. While the parties are married, the tax planning can work exceedingly well from the perspective of transferring wealth. Estate planners have come up with descriptors for trusts having certain characteristics as a way of communicating about those trusts. For example, there are irrevocable life insurance trusts, spousal lifetime access trusts, grantor retained annuity trusts, intentionally defective grantor trusts, and charitable remainder trusts. Each of these types of trusts is defined by a set of characteristics and objectives. This is not an exhaustive list of the different types of trusts estate planners use to accomplish their clients’ goals and there is much overlap among and between those trusts in terms of their characteristics. The many different varieties of trusts as well as the characteristics of those trusts and why they are used is beyond the scope of this article. Below is a discussion of two common types of trusts that a wealthy donor may establish for the benefit of the other spouse and descendants, either contemporaneously or sequentially, and issues to consider at the time of divorce.

B. Irrevocable Life Insurance Trusts (“ILITs”)

Irrevocable life insurance trusts (“ILITs”) are a widely used estate planning tool that provides an insured’s estate with liquidity at the death without increasing the insured’s estate tax liability. By having an ILIT own an insurance policy on the insured’s life and having the policy payable to the ILIT at the insured’s death, no part of the policy will be included in the insured’s taxable estate. As a result, no estate tax will be assessed on the value of the policy.

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90 See 26 U.S.C. § 2042 (2018); 26 C.F.R. § 20.2042-1 (2020) (This assumes the policy was purchased by the ILIT directly and that ownership was not trans-
ILITs may hold life insurance policies on one spouse’s life or policies on both spouses’ lives (i.e., joint and survivor or second-to-die policies). Often the life insurance policies are whole life or universal life policies, meaning they may have cash value and they are intended to be held by the ILIT until the death of the insured.\textsuperscript{91} Additionally, it is almost always the case that life insurance policies become more valuable as time goes on, because increased age and changes in the health of the insured may make equivalent coverage too expensive or impossible to obtain, even if the type of policy has diminishing surrender (cash out) value. An ILIT may be funded, meaning the trust holds liquid assets or loaned funds from which life insurance premiums may be paid, or unfunded, meaning the trust’s ability to pay life insurance premiums is dependent on ongoing annual contributions to the trust by the donor(s), but otherwise holds no assets other than the insurance policy.

ILITs that include the spouse as a beneficiary may name the spouse by name as a beneficiary (e.g., my wife, Wilma), may name a spouse generically as a beneficiary (e.g., my spouse as existing from time to time, sometimes called the “floating spouse”), or may have an automatic forfeiture of beneficial interest upon divorce (e.g., my spouse shall be treated as though she had then died if we are no longer married). ILITs often name the non-insured spouse as a trustee, may give the beneficiary-spouse the power to remove and replace trustees, and may grant the beneficiary-spouse the ability to alter the identity of the beneficiaries at the beneficiary-spouse’s death through a power of appointment. While the assets of the ILIT may or may not be determined to be marital property subject to division, there are times when one or both spouses wish to keep the insurance in place because it is valuable as part of an overall estate plan for liquidity purposes, and/or because insurance benefits their descendants. However, they may not wish for the non-insured

\textsuperscript{91} In contrast, term insurance policies expire at the end of a fixed term. A term insurance policy may contain a rider to permit conversion to a cash value policy, but typically the premium is expensive as no current medical evidence is required, and, as a result, a conversion is most valuable for an insured whose health has undergone adverse changes.
spouse to remain as beneficiary, trustee, or other fiduciary (e.g., an investment advisor) of the ILIT. They may also wish to limit the definition of descendants to exclude potential future descendants of the insured spouse.

C. Options for Dealing with an ILIT Post-Divorce

1. Removing the Non-Insured Spouse as a Beneficiary of the Irrevocable Trust

If a spouse is a beneficiary of the ILIT and the parties agree that should not continue post-divorce, it may be possible to decant the assets of the ILIT into another trust with substantially similar provisions for the beneficiaries other than the spouse. Decanting is essentially a distribution from the existing trust to a new or other existing trust by the trustee of the ILIT. Decanting requires a willing trustee and trust provisions or local law permitting transfer of assets to another trust.92 When decanting, care should be taken not to trigger the “transfer for value” rules under Section 101 of the Code, which would cause the death proceeds to become income taxable to the recipient (whereas ordinarily death proceeds are income-tax free).93 “Value” for the transfer for value rules does not have to be consideration paid in cash or in kind; it can consist of other bargained-for consideration, including provisions in a divorce settlement agreement.94 An exception to the transfer for value rule is a sale from one grantor trust to another so long as the grantors are the same.95 If decanting is not possible, and if the trust is treated as a grantor trust such that all income of the trust is taxable to the insured spouse for federal income tax purposes, it may be possible for a new grantor trust created by the insured spouse to purchase the policy from the old trust, because a transfer from one grantor trust to another grantor trust established by the same donor is

92 But see Hodges v. Johnson, 177 A.3d 86 (N.H. 2017) (holding that a trustee must give “due regard for the diverse beneficial interests created by the terms of the trust” in decanting). While a trustee selected by a donor-spouse may be inclined to do as the donor-spouse wishes, the trustee should approach a decanting with appropriate caution.


94 Id.

not a transfer for value which would cause the death benefit to be income-taxable to the recipient.96 Of course, the trustee could surrender the policy if the insured spouse remains insurable and life insurance premiums on a policy to be purchased by a new trust are affordable. While it may be tempting to simply have the beneficiary-spouse renounce any further interest in the trust, that may cause unintended gift tax consequences for the beneficiary-spouse.97

2. Leaving Insurance in Place but Cease Funding Premium Contributions

If the spouse cannot be removed as a beneficiary, or there is no desire to maintain the policy, that leaves the trustee to determine what should be done with the insurance policy. It may be possible to maintain a policy that has value for some time without further contributions at the same or a lesser death benefit.

3. Surrendering the Life Insurance Policy

The insurance policy held by the ILIT could be surrendered for its cash value, if any. To the extent the value received from surrender exceeds the basis in the contract, the excess gain will be taxed at ordinary income rates.98 Because the ILIT holds the policy, it will be the responsibility of the trustee to surrender the policy and the proceeds will become an asset of the ILIT. Because the ILIT is a grantor trust as to the insured spouse, any gain on surrender will be taxable to the insured spouse, rather than the ILIT.99

4. Selling the Life Insurance Policy

Finally, it may be possible to sell the policy to a state-licensed third party in what is called a viatical settlement.100 If the insured is chronically or acutely ill, a third-party purchaser may be willing to purchase the policy for an amount greater than the

96 See id.
98 26 U.S.C. § 64.
current cash value in exchange for a lump sum payment up front. Even a term insurance policy may have some value for this purpose, beyond any premium refund. The purchaser becomes the owner of the policy, becoming responsible for payment of future premiums. In 1996, the Health Insurance Portability and Accountability Act (HIPAA) made viatical settlements and accelerated death benefits income-tax free for chronically ill and terminally ill insureds, settling a concern that such proceeds in excess of basis would be income taxable in the same manner as a policy surrendered.

5. The Second-to-Die Life Insurance Policy

ILITs can also own joint and survivor or so-called second-to-die policies. Neither insured spouse is a beneficiary of the trust, and the insurance was most likely acquired to provide liquidity for estate taxes and the surviving spouse’s death under a conventional “postpone estate taxes until the surviving spouse’s death” estate plan. Post-divorce, that sort of insurance is not needed; in fact, each party will likely need to address estate taxes at death independent of the survival of the other party. But determining what to do with the policy may depend on the cooperation of the parties. Some policies can be split into two separate, single life policies. While the single life policy premiums will likely be higher than the second-to-die policy premium, splitting the policy may allow a trustee for each party to deal with a separate policy through the techniques described above, taking care not to run afoul of the transfer for value rules in the case of any purchases. In other situations, the parties wish to maintain the second-to-die policy for their descendants and will need to address the payment of ongoing premiums. Any binding promises to pay premiums in a divorce settlement agreement may constitute a taxable gift, so it will be important to consult with tax professionals.

D. Spousal Lifetime Access Trusts (“SLATs”)

Another popular estate planning technique is to transfer wealth in the name of one spouse to an irrevocable trust for the

benefit of the other spouse, either as sole current beneficiary or as a beneficiary with descendants, using all or part of the donor-spouse’s transfer tax exemption amount. This type of trust is commonly referred to as a spousal lifetime access trust or a “SLAT.” An ILIT that has the non-insured spouse as a beneficiary is a SLAT, but typically a SLAT refers to a trust that owns assets other than a life insurance policy and annual contributions to fund it.

Establishing and funding a SLAT is a popular estate planning technique designed to remove assets transferred to the SLAT from the donor’s taxable estate, while still permitting the non-donor spouse to benefit from the trust assets. SLATs are particularly popular at the time of the writing of this article in no small part due to the historically high unified exemption from the estate and gift tax. Whether or not legislation reducing the available unified gift and estate tax exemption is passed during the tenure of President Biden, the Tax Cuts and Jobs Act provision increasing the exemption to its current level will sunset at the end of 2025. SLATs are grantor trusts, so that the spouse who funded the irrevocable trust remains responsible for paying income tax on trust income. The use of the word “access” in the name “spousal lifetime access trust” actually is a misnomer, since it suggests that the spouse may have unilateral authority to access trust funds for that spouse’s own benefit; that is not the case. The trust may contain ascertainable standards for distributions (i.e., may authorize distributions for the health, maintenance, support, and education of the beneficiary-spouse), or provide for broad discretion for an independent trustee to make distributions in the best interests of the beneficiary-spouse. Sometimes, a spouse will have a limited withdrawal power over a certain amount of the trust without trustee approval.

Valuing the spouse’s beneficial interest in a SLAT may be impractical notwithstanding the fact that the assets of the trust may be easily valued. Other than a limited withdrawal right if

103 In 2021, the unified gift and estate tax exemption is $11,700,000 per individual. Rev. Proc. 2020-45.
there are so-called Crummey withdrawal powers, the grantor spouse cannot compel a distribution, nor can the beneficiary-spouse. Thus, in many states, the interest would not be considered property. However, actual distributions can be required to be shared. If the beneficiary-spouse relinquishes the beneficial interest in the trust, a taxable gift will have been made to the other beneficiaries of the trust, but whether the value of the gift is susceptible to being valued is a separate matter. The trust may be able to be decanted as described with respect to ILITs.

E. ILITs, SLATs, and Important Tax Considerations

An intentionally defective grantor trust allows the grantor to irrevocably transfer at current value for estate tax purposes, while remaining the owner of the assets for income tax purposes. If a trust qualifies as a grantor trust under the Internal Revenue Code, income realized by the trust will be taxable to the donor of the trust and will be reported on the donor’s own income tax return. The hoped-for benefit with a grantor trust is that the grantor’s continued payment of income taxes on trust realized income will allow trust assets to grow unencumbered by income tax, allowing for larger non-taxable gifts to the trust beneficiaries. Grantor trusts are especially useful where the trust donor has exhausted his or her gift tax exemption limits and wishes to transfer additional value to descendants or other family members without application of the gift tax.

If the donor’s spouse is a beneficiary of the trust, if the trust pays premiums for life insurance, if a donor to a trust retains certain administrative powers, or if certain persons who are “related or subordinate” to the donor as defined in the Internal Revenue Code serve as trustee, the trust will be treated as a grantor trust for income tax purposes.

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106 See Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968); 26 C.F.R. § 25.2503-3(b).
110 Id. at (a)(3).
While grantor trusts have been employed successfully to transfer wealth undiminished by taxes to a donor’s family members, future taxation can cause economic hardship when a married couple divorces if grantor trust status continues. If the spouse was a beneficiary of a trust prior to the repeal of Section 682, unless and until Congress addresses other grantor trust rules, the trust will continue as a grantor trust.113 While the trust may contain a discretionary power in the trustee to make income tax reimbursement payments to the donor, the donor cannot retain or compel such distributions.114 As a result, grantor trust status of a trust must be considered and addressed in the divorce settlement agreement. If the spouse will remain a trust beneficiary, the divorce settlement agreement may contain a tax sharing provision.

More complex issues may exist in grantor trusts, and the following discussion is a brief overview; consultation with an expert is essential. If the trust donor makes a gift into a grantor trust with the donor’s spouse consenting to splitting the gift for purposes of gift tax reporting, the donor will nonetheless be treated as the grantor as to the entire gift.115 The reason for this is that grantor trust status is dependent on actual transfer of assets to the trust.116 While the donor’s spouse will be deemed transferor as to half of the value of the gift for gift tax purposes, the spouse will not be treated as the “grantor” for income tax purposes.117 However, it may be the case that the spouses each actually contributed assets to the trust at various times. The name of the donor on the trust instrument is not determinative for grantor trust purposes; the identity of the person having transferred the

113 Charles D. Fox IV, Comments re Repeal of I.R.C. Section 682, ACTEC (July 5, 2018), https://www.actec.org/assets/1/6/ACTEC_Comments_on_Transition_Rule_to_Repeal_of_682.pdf. (Discussion of the taxation of trusts in which the about to be ex-spouse is a beneficiary is beyond the scope of this article, but a good summary of the concerns about potential ongoing grantor trust income tax treatment unless further correction of the tax code occurs can be found in The American College of Trust and Estate Counsel’s comments on guidance in connection with the repeal of Section 682 of the Internal Revenue Code.).
114 See 26 U.S.C. §§ 2036, 2041 (2018). Possession of such a power by the donor could cause inclusion of the trust’s assets in the donor’s taxable estate.
116 See id.
117 See id.
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assets is what matters. While the couple is married and filing a joint income tax return, the status of the trust as being a part grantor trust as to each spouse is not an issue. Once the couple divorces and no longer files jointly, it may come as a surprise to the spouses that each of them is responsible for such spouse’s pro rata share of the taxes. In some cases, the less wealthy spouse asks the wealthier spouse to indemnify him or her by assuming all of the grantor trust tax obligations. However, that ongoing property settlement is difficult to quantify, and does not address what happens if the spouse assuming the obligation dies as the trust would continue to be treated as a grantor trust with respect to the surviving spouse, and a non-grantor trust as to the portion contributed by the now-deceased spouse. The obligation to continue to indemnify for such taxes beyond death is not practical. As a result, it may be necessary to consider whether grantor trust status can be “turned off” for the spouse who no longer wishes to be responsible for taxes. Whether that is possible depends on what causes grantor trust status. If, for example, grantor trust status is achieved by reason of the donor having the power to substitute assets of equivalent value to the trust, the donor can irrevocably relinquish that power.118 If grantor trust status is achieved because the trustee may add beneficiaries to the class of permissible distributees, or make loans to the donor without adequate security, the trustee may be willing to irrevocably relinquish such powers.119 Powers that require relinquishment by the trustee to alter tax treatment for the trust may put the trustee in a position of conflict because relinquishing the power will result in the trust being required to pay its own taxes as to the portion that was formerly reportable by such donor, thereby reducing assets available for the beneficiaries. The trustee may request indemnification from such donor before relinquishing any powers, in order to limit exposure to a claim by beneficiaries for breach of fiduciary duty. In other cases, it is the nature of the assets of the trust that causes grantor trust status, as is the case for a trust that holds life insurance.120

Even if other powers are relinquished, the trust nevertheless may remain a grantor trust for tax purposes. In such cases, it

119 See id.
120 26 U.S.C § 677(a)(3).
may be that with trustee cooperation, the insurance could be distributed or acquired by another trust to eliminate the issue. Because the trustee is not a party to the divorce, and because the parties themselves cannot compel the trustee to act, care should be taken in how to memorialize what is intended and agreed to. Note, however, that decanting some or all of the trust to another trust, or having a different trust purchase assets from the old trust, must be done carefully to avoid transfer for value issues, in the case of life insurance, and may not solve the grantor trust issue at all, depending on the reason. Distributing assets to a new trust which is a grantor trust as to one of the spouses does not result in the assets received from the old trust being treated for grantor trust purposes as having been transferred by the donor of the new trust; the identity of the donor will follow the assets from the old trust to the new trust.\footnote{121}

One significant further point is that many grantor trusts are funded with gifts, whereas others are created in part with gifts and in part by a sale of assets in exchange for a promissory note. Where there is a single donor, the payments on the note during the donor's life and so long as the trust is a grantor trust is a non-taxable event, the theory being that the seller and buyer are one and the same for income tax purposes.\footnote{122} But, in dividing assets, if the note is allocated to the other spouse, the non-taxable treatment will cease as to the note payments. A final caution concerns life insurance subject to a split dollar funding arrangement because changes to ownership of the policy or termination of the split dollar agreement may have substantial tax consequences.

F. Divorce Settlement Agreement Language for ILITs and SLATs

If the irrevocable trust will be decanted to a new trust of which the spouse is not a beneficiary or fiduciary, and has no powers or duties, the divorce settlement agreement may contain a provision that the spouse will not object, and, if requested by the trustee, will consent to the decanting. Because the trustee is not a party to the divorce settlement agreement, the parties can-

\footnote{121}{See 26 U.S.C. § 671; 26 C.F.R. § 1.671-3(a); Rev. Rul. 85-13, 1985-1 C.B. 184.}
\footnote{122}{See id.}
not bind the trustee to take or refrain from taking certain actions. However, if the trustee is on board and is preparing to take certain actions, those actions can be referenced in the agreement. The trustee can also be joined as a party, either voluntarily or involuntarily, pursuant to the applicable state joinder rules.  

Similarly, if the definition of “issue” or “descendants” in the trust is not limited to the issue of the parties’ marriage, decanting can address that point. Estate planning and other tax advisors should be consulted regarding the precise wording so that the spouse whose interest is being reduced is not deemed to have made a taxable gift, as might occur if the spouse renounced future beneficial interests in the trust. The agreement can, however, address the spouse’s resignation as a trustee and/or other fiduciary, as well as the renunciation of any other powers retained by the trust donor or granted to the spouse beneficiary. The relinquishment of certain powers may affect the trust’s treatment in the future as a grantor trust for income tax purposes, and, if that is the intent, it should be clearly stated.

If the spouse will remain a beneficiary of the irrevocable trust, the trust can remain a grantor trust as to the donor-spouse. The trust may or may not contain the discretionary power for the trustee to make a distribution to the donor-spouse to cover such taxes; the trust cannot contain a mandatory tax reimbursement provision without causing inclusion in the donor’s taxable estate. Of course, whether a trustee will exercise a discretionary power is uncertain and cannot be agreed to by the spouses as part of their agreement. However, the spouses can provide in their agreement an affirmative obligation to do what they are able to do, to the extent possible, to terminate grantor trust status, and failing that, the agreement can contain a right of contribution for grantor trust taxes. A spouse beneficiary can agree to refrain from requesting discretionary distributions unless necessary, but the trustee will always have a fiduciary obligation to consider the needs of beneficiaries, and if there are children of the couple’s marriage, a future discretionary distribution to the

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123 E.g., Colo. R. Civ. P. 20, 19.
125 See Fox, supra note 113.
spouse might be advisable for tax planning purposes, so flexibility may be important.

Depending on what the parties agree should occur and what the trustee is willing to do, the parties should agree on what reporting needs to occur, what monitoring may be required, and what provisions should be contained in a separate side agreement and not in their divorce settlement agreement.

VIII. Cryptocurrency

A. Defining the Asset

Cryptocurrency is a peer-to-peer electronic cash system that is not backed by any government or financial institution, is not backed by any physical commodity or precious metal, and is not tangible. It is sometimes referred to as “virtual currency.” It is, however, limited in supply.

The Internal Revenue Service has defined it as digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like “real” currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in any jurisdiction. Cryptocurrency is a type of virtual currency that utilizes cryptography to validate and secure transactions that are digitally recorded on a distributed ledger, such as a blockchain.126

Transactions using cryptocurrency are verified and recorded by “miners” in a public ledger called the “blockchain.” Cryptocurrency is stored by an owner in a digital wallet and is accessed by the owner with a private key. The owner participates in transactions by using a public key, which is something like an email address, to send or receive cryptocurrency. Transactions in cryptocurrency are permanently recorded, are transparent, and can be viewed online at any time using a blockchain explorer. Each unit of cryptocurrency is traceable from the time it came into being. The transactions are recorded by transaction amount, date, and address/public key of the owner. While this sounds

very secure, there have been a number of high-profile cases of cryptocurrency thefts.\textsuperscript{127}

To obtain cryptocurrency, usually one goes to an exchange, such as Coinbase or Kraken. The exchanges also provide the ability to pay for goods and services via an app. There are also hedge funds and publicly traded companies that hold cryptocurrency.

The Internal Revenue Code classifies cryptocurrency as both a currency and an asset.\textsuperscript{128}

B. Valuation Difficulties

Cryptocurrency value is extremely volatile. On February 15, 2021, a Bitcoin’s value was about $49,184.63. On January 12, 2021, it was $33,447. On January 12, 2020, it was $8,033.26.\textsuperscript{129}

However, cryptocurrency is not like publicly traded stock, since there is not one place to go to look at the daily value of, for instance, Bitcoin. There is no closing price on any given day. There are a couple of exchanges where one can buy and sell Bitcoin, but one can also buy and sell it in a parking lot.

A number of factors affect the value of a given cryptocurrency, such as the supply of the currency and the market for it, the cost of producing the currency through the mining process, the rewards to the miners who verify transactions, the number of competing cryptocurrencies, governmental regulations of cryptocurrencies,\textsuperscript{130} the financial stability of governments,\textsuperscript{131} the


\textsuperscript{128} IRS Notice 2014–21.


internal governance of the cryptocurrency, the stability of the computers of the exchange on which the currency is bought and sold, and social media.\textsuperscript{132}

C. Income Tax Considerations

Cryptocurrency is subject to U.S. income tax when it is traded for cash, traded for other cryptocurrencies, or used to purchase goods or services.\textsuperscript{133} It can be taxed as currency, meaning, as income received if the cryptocurrency is received as payment for services. In addition, because cryptocurrency is an asset, gain or loss may be realized upon disposition of the asset.

When cryptocurrency is received as payment for services, it is taxed as regular income at the fair market value of the cryptocurrency on the date received. The basis of that cryptocurrency received as payment for goods or services is the fair market value of the cryptocurrency on the date it was received.\textsuperscript{134} If cryptocurrency is used to purchase property, if the fair market value of the property purchased is greater than the fair market value of the cryptocurrency, there is a taxable gain. If it is less, there is a loss.\textsuperscript{135}

If there is inaccurate reporting of cryptocurrency taxable events, the taxpayer is subject to accuracy related penalties and information reporting penalties.\textsuperscript{136}

D. Language for the Division of Cryptocurrency

cause cryptocurrency is linked to a part of the blockchain, and because it is deemed an asset by the IRS, it should be divided like stock is divided when divided in kind.

When cryptocurrency is being divided in kind, the divorce settlement agreement should include a recitation of the fair market value when all cryptocurrencies were first received so that each party can correctly report to the IRS.

The cryptocurrency can be transferred from one spouse to the other from the exchange that is being used via an app. The transaction works rather like a Venmo transaction.

The separation agreement should include a clause regarding how audits of joint income tax returns will be handled. The U.S. government has increased its interest in tax reporting for cryptocurrency.\textsuperscript{137}

\textbf{IX. Co-Owned Real Estate}

A marital estate may include valuable personal use real estate that has value to the parties outside of just the market value. It may have sentimental value, it may have legacy value, and its continued co-use and ownership may promote harmony with children if both spouses can continue to own and use the property. For instance, consider the ski area vacation home that has been in the family since the children were very young, as is needed by both parents for the children’s competitive ski team participation.

Carefully drafting a use agreement will avoid unhappiness and unpleasant tax surprises. A use agreement may address the following questions and others: What is the expectation for use during high season and off season? What arrangements will be made for stocking supplies and cleaning in between uses? Will

\textsuperscript{137} See FinCEN Notice 2020-2. This notes that “the Report of Foreign Bank and Financial Accounts (FBAR) regulations do not define a foreign account holding virtual currency as a type of reportable account. (See 31 C.F.R. 1010.350(c)). For that reason, at this time, a foreign account holding virtual currency is not reportable on the FBAR (unless it is a reportable account under 31 C.F.R. 1010.350 because it holds reportable assets besides virtual currency). However, FinCEN intends to propose to amend the regulations implementing the Bank Secrecy Act (BSA) regarding reports of foreign financial accounts (FBAR) to include virtual currency as a type of reportable account.” 31 C.F.R. § 1010.350.
friends and others be able to use the property? Are pets permitted? Is smoking permitted? How will routine carrying charges, repairs, and improvements be made? Will there be a right of first refusal or purchase option in the other spouse and/or children? If one spouse pays more than that spouse’s share of the carrying charges, a taxable gift will have been made to the other spouse. For those reasons, it is essential to have an annual budget, a designated account established for the property, and a cash reserve amount held in the account. Neither spouse should have the ability to pledge an interest in the home without written consent from the other.

Parties may also wish to continue to co-own commercial real estate. These properties are usually titled to an LLC or corporation. Both spouses can co-own by being members of the LLC or shareholders of the corporation. There are some things that should be considered, though, before the non-owner spouse agrees to, or even can, receive an ownership interest. For instance, there may be outstanding mortgages, with full or partial personal guarantees, that may require lender consent before a transfer of even a partial interest occurs. Certain real estate may have regulatory oversight mandating that management be approved, as in the case of HUD developments. There may be environmental concerns which would make co-ownership undesirable from a liability shifting perspective if the former non-owner spouse is now considered an owner or operator of the real estate.

If the real estate is leased to an operating business owned by one or both of the spouses, the lease may need to be revised, since rent may have been previously set at below market when the income was “all in the family.” Once addressed and resolved, the non-owner spouse can co-own by receiving a portion of the owner-spouse’s interests, and the entity operating agreements will control.

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X. Pre-embryos

A. Defining the Asset

Many couples have used assisted reproductive technology (ART). One form of ART is in vitro fertilization. When a couple uses in vitro fertilization, pre-embryos\textsuperscript{139} are created outside of the womb and then transferred to the womb, or cryopreserved.\textsuperscript{140} Most of the time, more pre-embryos are created than will be transplanted at a time, and the excess pre-embryos are cryopreserved and stored. Pre-embryos can be implanted, cryopreserved indefinitely, donated to another potential parent, donated for research, or destroyed. The National Embryo Donation Center states that “[a]n estimated 1,000,000 human embryos are stored in the U.S. right now.”\textsuperscript{141}

There is very little legislation in the United States regarding the disposition of pre-embryos. Fertility clinics are not regulated as to how they store or dispose of pre-embryos. The contracts that fertility clinics enter into with patients with respect to the handling of pre-embryos are not regulated at all in most states and only lightly regulated in others.\textsuperscript{142} There are no laws governing the agreements that two or more intended parents might

\textsuperscript{139} A pre-embryo is a fertilized ovum up to fourteen days old, before it becomes implanted in the uterus.

\textsuperscript{140} American Society for Reproductive Medicine, \textit{In Vitro Fertilization (IVF)}, https://www.asrm.org/topics/topics-index/in-vitro-fertilization-ivf/ (last visited July 30, 2021).

\textsuperscript{141} National Embryo Donation Center, \textit{About Us} (2021), https://www.embryodonation.org/about/.

enter into with respect to the disposition of pre-embryos. A committee of the Uniform Law Commission has recommended that there be a study to explore a uniform law governing the disposition of pre-embryos.143

In most states, the case law considers pre-embryos a type of property, albeit a special type.144 When a couple uses a fertility clinic to achieve pregnancy, they sign a contract with the clinic regarding the disposition of pre-embryos before treatment begins. Thus, these contracts are a starting point for a couple’s resolution of how to deal with them after a divorce, and they are documents that may need to be amended after a divorce. However, these contracts should be understood as contracts between the couple and the clinic as opposed to between the couple, and should not be understood as marital agreements between the couple regarding the allocation of this property at divorce.145

Disputes between divorcing couples regarding the disposition of cryopreserved pre-embryos is one of the most interesting areas of matrimonial law.146 Sometimes, though, parties are in


146 See In re Marriage of Fabos & Olsen, 451 P.3d 1218 (Colo. App. 2019) (holding that the party’s interest in donating pre-embryos should not turn on their personal views of the morality of donation and that the trial court abused its discretion in favoring the ex-wife’s interest in donating more heavily than the ex-husband’s interest in avoiding procreation); Szafranski v. Dunston, 34 N.E.3d 1132, 1162 (Ill. App. Ct. 2015) (concluding that the ex-girlfriends’ interest in the use of pre-embryos when she had ovarian failure as a result from chemotherapy outweighed the ex-boyfriend’s interest in the effect that having a child through IVF would have on his existing and future relationships); In re Marriage of Witten, 672 N.W.2d 768 (Iowa 2003) (noting that because the parties’ were unable to reach a new agreement that was mutually satisfactory, there could be no use or disposition of the embryos unless an agreement was reached between the parties); A.Z. v. B.Z., 725 N.E.2d 1051, 1059 (Mass. 2000) (concluding that, as a matter of public policy, the court “would not enforce an agreement that would compel one donor to become a parent against his or her will”);
agreement that pre-embryos should continue to be cryopreserved even after a divorce. Some couples cannot, for religious reasons, abide the destruction of the pre-embryos, but on the other hand, they do not wish to donate them to research or another person to create a child. In fact, the burgeoning dilemma of abandoned pre-embryos demonstrates that couples find it extremely difficult to make a final dispositional decision. Other times, there is a recognition that a time may come when a party may wish to use the pre-embryos, and the other party would not disagree. Such may be the case upon the death of one of the parties, or the continued childlessness of a party. Moreover, a party who originally wanted to preserve the pre-em-

J.B. v. M.B., 783 A.2d 707, 717 (N.J. 2001) (noting that it could not force the former wife to become a biological parent against her will); Kass v. Kass, 696 N.E.2d 174, 182 (N.Y. 1998) (affirming that “when parties to an IVF procedure have themselves predetermined the disposition of any unused fertilized eggs” the law will honor their agreement); Finkelstein v. Finkelstein, 162 A.d.3d 401, 404 (N.Y. App. Div. 2018) (concluding that because one party withdrew consent, the remaining cryopreserved embryos should be awarded to the husband only for the purpose of disposing them pursuant to the parties’ consent agreement); In re Marriage of Dahl, 194 P.3d 834 (Or. Ct. App. 2008) (reasoning that because the party’s disposition agreement designated the wife to be the decision maker regarding the embryos, the trial court’s order to destroy them would not be disturbed); Reber v. Reiss, 42 A.3d 1131, 1137 (Pa. 2012) (concluding that the wife, under a balancing approach, should be awarded the pre-embryos since she did not have an ability to procreate biologically); Davis, 842 S.W.2d at 603-04 (concluding that the ex-husband’s interest in avoiding becoming a genetic parent outweighed the wife’s interest in donating the pre-embryos to another couple); Roman v. Roman, 193 S.W.3d 40, 55 (Tex. 2006) (noting that by awarding the frozen embryos to one of the parties the trial court improperly rewrote the disposition agreement); Litowitz v. Litowitz, 48 P.3d 261 (Wash. 2002) (concluding that under the cryopreservation contract, the husband and wife had to petition the court for instructions when they were unable to reach a mutual decision regarding the disposition of the pre-embryos upon divorce); 2A Mass. Prac., Family Law and Practice § 56:26 (4th ed. 2020).


bryos for later use may no longer wish to do so, perhaps due to a natural pregnancy and birth, or merely due to the passage of time and increased age. As pre-embryos can be cryopreserved nearly indefinitely and successfully implanted as many as twenty-four years after freezing, couples may wish to spell out in their divorce settlement agreement a plan that allows time to elapse and more of life’s circumstances to play out before a final disposition of the pre-embryos is made. Of course, if one of the parties becomes incapacitated or dies, the question for a deferred disposition is who will make the decision for the incapacitated or deceased party.

B. Language for Genetic Material

Agreements about the disposition of cryopreserved pre-embryos should address the following issues: current handling of the pre-embryos (i.e., continue to cryopreserve irrespective of the consent form on file with the clinic); length of time to cryopreserve; responsibility for payment of the clinic fees; what happens if a party with responsibility for payment does not pay clinic fees; who is responsible for communications with the clinic; the effect of the death of a party; the effect of the incapacity of a party; whether an heir, beneficiary, or agent can stand in the shoes of a party with respect to dispositional agreements; what happens if the clinic can no longer store and preserve the pre-embryos; whether a party can unilaterally bring suit against a clinic; how proceeds are allocated if suit is brought against a clinic and there is a settlement or award; whether a party can implant the pre-embryos; whether a third party can implant the pre-embryos; other limitations, if any, on implantation; parentage of any child that results from implantation; whether implantation may take place after the death of a party; if a child results from postmortem implantation, whether that child will be an heir of the decedent; whether the pre-embryos can be donated for re-


150 See Forman, supra note 145, at 70-75 (decisions about disposition of pre-embryos are unstable over time).
search, and, if so, upon what conditions; if pre-embryos can be
donated to another person, and, if so, under what conditions;
and, under what conditions pre-embryos can be destroyed. If the
parties can only agree that the pre-embryos should remain cry-
opreserved until further agreement, that agreement should in-
clude a trigger for one person or that person’s estate to make a
final dispositional decision. Triggers might be a certain number of
years, or the death of a party.

Agreements about the disposition of cryopreserved pre-em-
bryos should be submitted to the fertility clinic and preservation
facility and should expressly supplement and supplant any provi-
sions to the contrary in the original agreement with the fertility
clinic and preservation facility. Agreements about the disposi-
tion of cryopreserved pre-embryos are particularly well suited to
include clauses regarding the review of the agreement every
couple of years.

XI. General Terms for All Divorce Settlement
Agreements

It bears repeating that this article is designed to help matri-
monial and estate planning attorneys work together when divorc-
ing parties are able to cooperate in maximizing the value of their
assets by continuing to have co-interests in assets after divorce.
The authors are not presenting agreement terms for situations
when there is a real or perceived reason to not to have at least
some level of trust in the other party. Nevertheless, future events
can introduce uncertainty, and human instinct is to take expedi-
ent action to protect one’s own interests. Moreover, one or both
of the parties in the future may be represented by someone else
in the form of an agent under a durable power of attorney, exec-
utor, or trustee who is less familiar with what the parties
intended.

1. Rules of Engagement

In general, agreements should reflect terms consistent with
an arm’s length transaction. Agreements should be drafted to
require transparency and full, timely communication of necessary
information. Agreements should be as detailed as possible and
should assume as little as possible concerning the parties’ former agreements and “ways of doing things.”

The agreement should address how decisions regarding the asset will be made, and who will make them. If any decisions are to be made jointly, there should be appropriate notice provisions and timing requirements. For example, notice and timing provisions must be included in agreements regarding the exercise of stock options, the sale of some or all of a business or its assets, the changing the form of business for tax purposes or relocating the situs of a business that may have tax implications. There should be a time certain for responses and agreed upon next steps if the parties fail to reach resolution or one party becomes unresponsive. For some matters, it may be appropriate to have a negative consent provision, so that if no disagreement is sent by a certain date, action may be taken consistent with the notice.

2. Notice Requirements

Agreements should require each party to immediately provide the other party with any and all types of communications regarding the assets, or any issue in any way related to the asset. The form of notice, and obligation to update mail, email, and phone details should be included, as well as whether the expiration of any notice period is triggered from the date notice is sent or the date notice is received.

3. Standards of Care and Loyalties

Agreements should be clear about what standards of care each party is being held to with respect to the asset, and what duties they owe to each other. Is the standard a fiduciary standard? Prudent investor? Reasonable person? Or simply no liability in the absence of negligence or bad faith? In particular, if the phrase “constructive trust” is used to describe how an asset is being held, be sure the agreement discusses whether a fiduciary duty is owed to the non-title holder. Note that the fiduciary standard of care for a trust may be higher than the usual business standard of care for a manager of an LLC,151 although that may be modified in the operating agreement. In the case of businesses and intellectual property in particular, address the expec-

151 See supra note 34.
tations of the parties regarding time and attention to be devoted to the asset, if appropriate, versus the ability of a party to devote time and attention to a new or different endeavor.

4. Liabilities

If there are liabilities associated with a particular asset, what indemnifications will be included to facilitate payment of what may be a joint and several liability, or the sole liability of the current or former asset owner? Liabilities may be tax liabilities, general litigation associated with the asset (as in the case of a claim by an employee), or, for example, an environmental claim. Further, if the asset must remain in the titular name of only one of the parties, that asset will be subject to the claims of creditors of the asset owner unrelated to the asset. The non-owner party will be an unsecured creditor, with no superior claim to the asset value. The agreement should discuss how the non-titular owner will be made whole in such a circumstance.

For liabilities in the nature of debt, the agreement should address whether the estate of a deceased owner will be released from lending agreements, as well as any personal guarantees on business assets, as appropriate.

5. Lawsuits to Defend the Asset

Agreements should outline who shall be responsible for determining whether to hire attorneys and whether to file suit to protect an asset, and how far to take litigation if the initial suit is unsuccessful. Agreements should further define who has the authority to reach settlement agreements. Of course, how lawsuits are funded will be a critical part of this portion of the agreement. Finally, the allocation of any recovery should be set forth, particularly if one party is funding the litigation.

6. Taxes

An important threshold question in structuring agreements is whether the transfer will be treated as incident to the divorce. The transfer must occur either: (a) within one year from the date the marriage ceases; or (b) occur no later than six years from the cessation of the marriage pursuant to a written divorce settle-
ment agreement. The transfer of an asset from an entity to a spouse is not a transfer from spouse-to-spouse incident to divorce, unless the entity is treated as a disregarded entity, as in the case of a single member LLC.

If income taxes must be reported by only one party as the titular owner of the asset or right, as in the case of stock options, what reporting will be given to the other party, and how will any disputes about tax reporting and treatment be addressed? IRS and state tax revenue departments are not bound by the private agreement of the parties and will look to the party who must report the income. That party will in turn have a generic contract enforcement claim against the other party. The agreement can provide that the defaulting party waives claims, defenses, claims for presentment, and the like. Note that if the defaulting party dies, the period for making a claim against the estate may be subject to a shortened statute of limitations. If a 1099 will be issued to the other party to shift tax reporting to the other spouse, the agreement should clearly state that and obligate the parties to report in a consistent manner. The parties should consider designating a professional who will make the decision about tax reporting if they do not agree.

7. Exit Plan

One of the most important terms of the agreement will be the terms concerning how a party exits the agreement if the in-kind division or co-ownership regime is unworkable. Each plan will be tailored to the parties and the circumstances but should include notice provisions regarding a desire to exit the situation, a time and method for the parties to see if an alternative to exit is available, and then a process for the exit. Parties should not be given an incentive to exit, so the exiting party’s entitlement should be significantly less than if the agreement were carried out. Once a party has notified the other that he or she wishes to exit, the notice may trigger limitations on use of funds, distributions, reinvestment of funds, and the like to protect asset value. A voluntary unwinding should be done in an agreed upon manner that will not damage the value of the asset to the other party who may acquire the asset in a buyout, or the sale to a third

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party. Parties may agree to a set amount to be distributed to one party if there is an exit, to a valuation methodology, or to a complete forfeiture of rights and interests. If any payout is given to the exiting party, a time and means for payout should be established, such as a payment via a promissory note over a certain amount of time at a certain amount of interest, or at the time of a triggering event, such as sale of the asset or death of a party. Actions that need to be taken by both parties if there is an exit (i.e., amendment to operating agreements, notice to third parties, retitling) should be identified and each party should agree to cooperate.

8. **Subsequent Spouses**

Parties who will co-own assets after a divorce should be cognizant of the fact that a subsequent spouse of a party may have rights in co-owned assets as a result of the marriage. These rights may be community property rights, rights on divorce, or rights on death. Parties should try to mitigate this extra complexity with spousal waivers regarding co-owned assets, spousal consents to operating agreements, prenuptial agreements, or adequate life insurance paid to the estate to reduce friction.

9. **Transfers During Life and at Death**

The agreement should address what transfers of interests may be permitted during life and at death. For example, can an interest in a business be transferred to a third party? If one party wishes to transfer interests, should the other have a right of first refusal? To a limited class of third parties, such as blood relatives? Descendants only? Must an interest in a co-owned asset be transferred to the surviving other party? Will the survivor have an obligation to the decedent’s estate? Should there be life insurance in place to secure that obligation? Should there be a valuation, or a valuation methodology built into the agreement?

10. **Incapacity and Death**

The agreement should address what happens in the case of a party’s incapacity as it affects management and decision making involving co-owned assets. With respect to these complex assets, do the parties wish to agree on who the designated agent will be for each of them in the event of incapacity? The designated agent
may be different than the designated agent for the parties’ other assets. Whether the other party can or should serve as agent will depend on the level of trust and consideration of conflicts of interest. Naming the other party should not be assumed without due consideration for obvious reasons.

The divorce settlement agreement also should address whether disability or death should trigger a purchase right or obligation to sell the business to a third party if continued ownership of an asset, such as an operating business, is not feasible or optimal for conserving value. There may also be an opportunity for hiring a third-party manager or key employee to manage the asset if that would be preferable, for the short term or indefinitely. Should the operating agreement contain a mandatory or optional buyout provision? If so, how will the interest be appraised, and will the value be discounted for lack of marketability and control?

Similar to the question concerning the identity of the agent in the context of incapacity, do the parties wish to identify who will serve as special trustee or special executor for co-owned assets? Whether the other spouse can serve in this role is dependent on the trust that conflicts of interest will not negatively impact the deceased party’s estate.

Because complex assets likely mean that the estate will be of a size that results in estate tax, will the parties commit to having sufficient liquid assets and/or life insurance so as not to force a sale of the asset simply to raise liquidity for taxes? Even with a mandatory buyout provision, there may be insufficient liquidity to pay estate taxes, which are due nine months from the date of death, as it is likely that a divorce settlement agreement may contain provision for payment in part by a promissory note. Importantly, a buyout that does not discount for lack of marketability or a non-controlling interest in an asset will fix the value for estate tax purposes at the undiscounted value.

Once the terms have been settled, it is important to consider who will be responsible for carrying out the active decisions in the event the party who has the designated responsibility becomes incapacitated or dies. Even where the assets have been transferred, if there are decisions that remain with the transferor spouse, who will succeed to the management responsibilities is important. In situations where the asset cannot be transferred
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due to the issues become more acute since the receiving spouse may have little or no ability to take charge of the asset or management succession. A general estate planning document, such as a durable power of attorney or will does not necessarily give the power holder the right to manage certain assets. For example, an agent under a durable power of attorney does not have the right to assume management responsibilities as trustee or as manager of an LLC but does have capacity to vote shares of a business and LLC interests. Care should be taken to address management succession for particular responsibilities and, in the case of incapacity, how incapacity will be determined, so that there is no prolonged vacancy when exigent decisions must be made. At death, obligations to a former spouse are typically unsecured, and will be subordinate to estate taxes, expenses of administration, and secured debt. As a result, it is critically important to include representations and warranties that the obligor spouse will not intentionally encumber any asset managed for the benefit of the other spouse, including promises that the assets will not be shown on a balance sheet for lending purposes, nor pledged without the consent of the former spouse. An often overlooked but critical issue is the estate tax obligation at death.\textsuperscript{153} Without a marital deduction for asset value passing to a spouse, there may be estate tax due. The estimated tax is due nine months from the date of death. If there is insufficient liquidity, and assuming no mandatory buyout from the surviving owner, the other option for payment of estate taxes may involve obtaining loans, either from a third party or, in some cases, from the IRS under a Section 6166 election\textsuperscript{154} or other deferred payment arrangement. The risks attendant in co-ownership of an ongoing enterprise without a date certain or at least a time frame for exit should not be underestimated.

11. Alternative Dispute Resolution and Reserved Jurisdiction

Agreements should have a robust section regarding alternative dispute resolution ("ADR"). Events or impasses that trigger a requirement to participate in ADR should be clearly defined.

\textsuperscript{153} 26 U.S.C. § 2001 (2020). Note that some states still impose a state estate tax as well.

Deadlines for participating in ADR should be put into the divorce settlement agreement. A default provider should be identified. The agreement should further state that if the default provider is not used, the alternative shall be agreed to, and shall meet certain criteria for expertise and experience. Parties may wish to include other requirements, such as a geographical location. Thought should be given as to whether the provider should have domestic relations experience or experience in the subject of the agreement, such as patents. Failure to timely and in good faith participate in ADR should come with a defined consequence, such as a weekly fine or an automatic attorney fee award. The agreement should include a provision that each party pays one-half of the ADR costs, together with such party’s own legal, accounting, and expert fees. Finally, most ADR provisions will start with a mediation clause. Parties should also agree on the minimum number of mediations to participate in, and if there is no full resolution, that parties will be required to arbitrate. If the parties can, it is a good idea to further agree upon arbitration rules, such as applying the Uniform Arbitration Act as well as venue.

XII. CONCLUSION

A matrimonial attorney’s job with respect to property is to disassemble a marital estate and create two separate estates. It is difficult, as a result, to conceptualize the idea that not everything has to be taken apart or taken apart immediately. Because the segment of people that matrimonial attorneys work for tend to be those with more rather than less conflict, it can be hard to realize that the agreements like those set forth in this Article are entered into by people all the time. Just because people used to be married does not automatically preclude them from successful arm’s-length property agreements. Trusts and estates attorneys are well versed in putting together plans regarding property that are followed through the years, and even through the generations. Collaboration between matrimonial attorneys and trusts and estates attorneys can afford clients a means of dealing with their assets in a way that gives each, and perhaps their children and grandchildren, an ability to realize the full value of the assets created and developed during the marriage.