A Wife's Loss is Not a Husband's Gain: Equitable Distribution of Capital Loss Carryovers

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In 2008 the S&P 500 suffered its biggest decline since the Great Depression.[1] House values continue to slide.[2] Commercial property prices are down nearly half.[3] Just as misfortune and fortune are neighbors, this turmoil can mean capital loss deductions, tax savings which can be carried over years after they are incurred. However, there is a dearth of Florida decisions addressing whether capital loss carryover deductions are marital assets – a "dearth" in this instance, meaning exactly one. This article is a primer on capital loss carryovers, examines the one Florida case which reviewed them, and suggests solutions to the conflict between Florida and Federal law.

The Basics of Capital Losses and Capital Loss Carryovers

Almost all of your personal holdings and investments are capital assets.[4] Losses on personal use assets such as your home are not deductible, but losses incurred on your investments may be. Your "basis" is the starting point to valuing an asset for tax purposes. Your basis is the asset's cost if you bought it. If you inherited or were given the asset, your basis is either the fair market value when you received it, or the adjusted basis of the previous owner.[5]

When you sell a capital asset, the difference between its basis and the amount it sells for is either a capital gain or a capital loss.[6] If you have a net capital gain, the gain is taxed at the capital gains tax rate, which is usually lower than ordinary income tax rates.[7] Capital losses are used to offset capital gains and reduce your taxes.

However, there is a limit to the amount of capital loss deductions you can take in a tax year. The Internal Revenue Code (the "I.R.C.") provides that the aggregate of all capital losses are deductible to the extent of the aggregate of all capital gains plus $3,000.[8] If your capital losses exceed this limit, the excess losses may be deducted in future years until they are exhausted.[9] This ability to deduct a capital loss incurred in one year to offset capital gains in future years is known as a capital loss carryover, or capital loss carry forward (abbreviated as "CLCF").

Treasury Regulations

Federal tax law is derived from the I.R.C.[10] The Treasury Department interprets the I.R.C. through its Treasury Regulations.[11] One complication with CLCFs occurs when taxpayers are divorcing, and start filing separate tax returns after years of filing joint returns with their spouses. In this situation, the Treasury Regulations provide:

> (iv) If a husband and wife making separate returns for any taxable year following the first taxable year . . . made a joint return for the preceding taxable year, any long-term or short-term capital loss carryovers *shall be allocated to the spouses on the basis of their* ***individual*** *. . . capital losses for the preceding taxable year* which gave rise to such capital loss carryovers, and the portions of the . . . capital loss carryovers so allocated to each spouse may be carried forward by such spouse to the taxable year in accordance with paragraph (b) of this section.[12] [Italics and emphasis added].

According to the Treasury Regulations, if a Husband and Wife take a capital loss on a joint tax return, and the next tax year file separate returns, the CLCFs are allocated to the spouse which actually suffered the capital loss.[13] In other words, the CLCFs are allocated to the spouse holding legal title to the underlying asset which incurred the loss.

The allocation of CLCFs by legal title may not be a problem if the underlying asset is non-marital to begin with, or is jointly titled. However, if the underlying asset is marital property titled in one spouse's name, the spouse not on title cannot carryover the loss, and neither the courts nor the parties can allocate the CLCFs differently. This creates a situation in which one spouse gains an unfair advantage – or suffers an unfair burden – and the fair market value of the underlying asset is not determined accurately.

Haley v. Haley

In *Haley v. Haley*, 936 So.2d 1136 (Fla. 5th DCA 2006), the Fifth District decided an issue of first impression in Florida, whether CLCFs were marital property subject to equitable distribution.

Before the Haleys married, the Wife's parents founded the Igo Family Limited Partnership, a non-marital entity which the Wife entered the marriage owning an interest in.[14] They signed a marital settlement agreement which was incorporated into a final judgment. The final judgment reserved jurisdiction to resolve two tax issues which arose after the agreement was signed: the equitable distribution of a tax refund and CLCFs resulting from filing an amended joint tax return.

The trial court held a hearing on the Husband's motion to equitably distribute the refund and CLCFs. The trial court entered an order finding that both the tax refund and CLCFs were marital assets subject to equitable distribution, and divided them equally.[15]

The Fifth District affirmed the distribution of the tax refund. The *Haley* court determined that the Wife failed to overcome her burden of proving that any of the income resulting in the tax refund could be allocated to her nonmarital property.[16]

However, the court reversed the equal division of the CLCFs. The Fifth District noted that the Wife's accountant was able to allocate the CLCFs between different business entities, and a substantial portion of the carryover losses were incurred by the Igo Family Limited Partnership – the non-marital business – to which the Husband had made no special contributions. A smaller number of the losses were incurred by marital entities.[17]

The *Haley* court reversed the equal division of the CLCFs, and remanded for a new valuation and distribution, holding: "[t]he underlying capital losses were incurred during the marriage, and *many* may be attributed to entities created during the marriage. Nevertheless, though the parties' entitlement to the CLCFs arose during the marriage, Igo was a nonmarital asset to which John made no special contribution, and CLCFs attributable to *it* should not be subject to marital distribution." [Italics added].[18]

CLCFs and Federal Conflict

Although not discussed in *Haley*, what if after remand the trial court found some of the CLCFs were attributable to a marital asset, an individual Fidelity account for example, which was created during the marriage, consisted entirely of marital funds, but was titled in the Wife's name alone?

The CLCFs attributable to the hypothetical Fidelity account are marital assets, and an equitable distribution in Florida requires their equal division unless there is a justification for an unequal distribution.[19] Federal law on the other hand, requires that the CLCFs attributable to the Fidelity account be allocated to the Wife alone, and only she could carryover the losses on an individual return.[20]

This conflict between Florida law and the Treasury Regulations raises a preemption issue.[21] Federal law defers to state law when there is no federal question, and Supremacy Clause review is limited to cases in which Congress has: "positively required by direct enactment" that state law be preempted; or state family law has done "major damage" to "clear and substantial" federal interests.[22] In light of the possible preemption, the question becomes: how can a court equitably distribute marital CLCFs titled in one spouse's name?

One way to equitably distribute the hypothetical Fidelity CLCFs is to classify them as marital property, and adjust the division of other assets to give some credit or setoff – or lump sum alimony – to the Husband for the value of the CLCFs the Wife is awarded. This option follows Florida's equitable distribution statute, and accommodates the Treasury Regulations. However, this entails a difficult valuation in that carryover periods can be indefinite, and an expert witness has to apply a present value to the CLCFs to determine their value as of the established valuation date.[23]

The second option is to treat the marital CLCFs titled in one spouse's name as a tax consequence of equitable distribution.[24] The tax consequences in every distribution must be taken into consideration to achieve a fair and equitable result.[25] However, treating CLCFs as a tax consequence may be riskier. A court only has to consider the tax consequences of a distribution, but must actually distribute marital assets, so there is a chance that the CLCFs may not be distributed. There is another risk that if no one presented substantial evidence on the CLCFs, and a trial court ignored these tax consequences, the error might not be correctable on appeal.[26] Finally, treating CLCFs as a tax consequence instead of a property right is inconsistent with our equitable distribution statute. Legal title may be how the Treasury Regulations allocate CLCFs titled in one person's name for tax purposes, but legal title is not the basis for determining marital property in Florida.[27]

Conclusion

The economic downturn has caused significant capital losses. These capital losses can mean valuable tax sav-

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ings which can carryover long after a couple divorces. Federal law limits a court's ability to divide certain CLCFs, creating potential unfairness and conflict with Florida's equitable distribution statute. Treating marital CLCFs as a mere tax consequence of a distribution is risky, unfair, and contravenes Section 61.075. Classifying CLCFs as property however, is consistent with the goals of Chapter 61, and an equitable distribution can be done in compliance with Treasury Regulations. Carryover losses are an under-reported and easily overlooked asset. By recognizing and distributing CLCFs, a marital loss can become a marital gain.

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Endnotes:

1 *See* Standard & Poor's, *Index Research*, http://www.standardandpoors.com/indices/sp-500/en/us (Last visited November 7, 2010).

2 *See* Standard & Poor's, *S&P/Case-Shiller Home Price Indices*, August 2010, http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us (Last visited November 7, 2010).

3 *See* Housingwire.com, *Moody's August CRE price index down another 3.3%*, http://www.housingwire.com/2010/10/19/moodys-august-cre-price-index-down-another-3-3 (last visited November 7, 2010).

4 *See* I.R.C. §1221(a) (2009). See also, Treas. Reg. §1.1221-1 (2009).

5 *See* I.R.S. Publication 550, *Sales and Trades of Investment Property* (2009).

6 *Id.*

7 The maximum capital gains rate for most people is 15%, although special types of net capital gains, such as art, can be taxed at 28%. If Congress takes no further action, the top rate on long-term capital gains may rise to 20% after December 31, 2012. *See* Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. No. 111-312 (2010).

8 For married individuals filing separate returns, the capital loss limit is $1,500. See I.R.C. §1211(b)(1) (2009).

9 *See* I.R.C. §1211(b)(2) (2009).

10 *See* generally 26 U.S.C. et. seq.

11 *See* generally 26 C.F.R. et. seq.

12 *See* 26 C.F.R. §1.1212-1(c)(1)(iv) (2009).

13 *Id.*

14 *See Haley* at 1137.

15 *Id.*

16 *Id. See also* §61.075(6)(a)(3), Fla. Stat. (2010) Generally, personal property jointly titled as tenants by the entireties is presumed to be a marital asset, and the burden of proof is on the party asserting the property is non-marital.

17 *Id.* at 1139.

18 *Id.* at 1140.

19 *See* §61.075(1), Fla. Stat. (2010). Generally, in distributing marital assets, the court must begin with the premise that the distribution should be equal, unless there is a justification for an unequal distribution.

20 *See* Treas. Reg. §1.1212-1(c) (2009) (Long-term or short-term capital loss carryovers shall be allocated to the spouses on the basis of their individual . . . capital losses for the preceding taxable year which gave rise to such capital loss carryovers.)

21 *See Liggett Group, Inc. v. Davis*, 973 So.2d 467, 471 (Fla. 4th DCA 2007) (Holding, that conflict preemption occurs where a federal statute implicitly overrides state law either when the scope of a statute indicates that Congress intended federal law to occupy a field exclusively or when state law is in actual conflict with federal law, (quoting *Freightliner Corp. v. Myrick*, 514 U.S. 280, 287 (1995)).

22 *See Hisquierdo v. Hisquierdo*, 439 U.S. 572, 581 (1979).

23 There are different methods for valuing potential future rights, but the present value analysis is the preferred approach. For pension valuations see *Diffenderfer v. Diffenderfer,* 491 So.2d 265, 269 (Fla. 1986).

24 In New York there is a conflict between Appellate Division Departments over the characterization of CLCFs. See *Finkelstein v. Finkelstein*, 268 A.D.2d 273 (2000) (The First Judicial Department held that CLCFs constituted a marital asset subject to distribution.). *But see Cerretani v. Cerretani*, 221 A.D.2d 814 (1995), (The Third Judicial Department found CLCFs relate only to the tax consequences of distribution.).

25 *See Nicewonder v. Nicewonder*, 602 So.2d 1354, 1358 (Fla. 1st DCA 1992).

26 *See Doyle v. Doyle*, 799 So.2d 499, 504 (Fla. 5th DCA 2001).

27 *See Buttner v. Buttner*, 484 So.2d 1265, 1266 (Fla. 4th DCA 1986).