

MEMORANDUM

ARE CAPITAL GAINS CONSIDERED “INCOME” IN CHILD SUPPORT ACTION?

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The statutory and rules definitions of “income,” as provided by 23 Pa.C.S. § 4302 and Pa.R.C.P. 1910.16-2(a) include “gains derived from dealings in property” (§ 4302) or “net income from business or dealings in property” (Pa.R.C.P. 1910.16-2). Neither the statute nor the rules specifically mention “capital gains.”

Under the Internal Revenue Code, a “capital gain” is the gain realized upon the sale or exchange of a species of property known as a “capital asset.” Capital assets are all property other than the sales inventory of a business, notes or accounts receivable, depreciable business assets, business supplies, real property used in a trade or business, intellectual property, or derivative commodities. See IRC § 1221. Generally, capital gains realized on the sale of property held more than one year are long-term capital gains.

Frequently, taxpayers who maintain securities or funds in investment portfolios must recognize capital gains when securities or funds that have appreciated in value are exchanged for other securities or funds, even if the profits are not actually distributed to the taxpayer. The main reason why gains must be recognized and taxed immediately, even though the owner of the account receives no distribution of income at the time of sale, is to simplify the determination of tax basis. If stocks or funds were sold and reinvested over many years without recognizing the gains, the owner of the account would have to trace back the tax basis to stocks or funds that he had not owned in many years. This would greatly complicate the determination of taxable gains when the stock or funds were eventually liquidated.

Instead of tracing back stocks and funds, the tax code provides for the recognition of gains and the assignment of a stepped-up basis for the stocks and funds that are purchased from the sale proceeds of other stocks and funds.

The Pennsylvania Domestic Relations Code and rules contemplate the inclusion of all sources of income that are readily available to an obligor to meet his or her support obligations. Still, it is well-settled that in the context of a support action, a party’s taxable income is not necessarily the same as his income for support purposes. See *Com. ex rel Hagerty v. Eyster*, 429 Pa.Super. 665 (Pa.Super.1981). Furthermore, the appreciation in value of a party’s assets are not included in the definition of “income” for support purposes. It would not be proper to consider the increase in value of a party’s residence, art, jewelry, antiques, valuable, or business when setting a support obligation.

To illustrate this point, the Superior Court held that the pass-through income which is reported on the tax return of a shareholder in a subchapter “S” corporation was not “income” for support purposes unless actually received. *Fennell v. Fennell*, 753 A.2d 866 (Pa.Super.2000). In other words, retained earnings (which probably represent an increase in the value of a business) are not income for support purposes.

Capital gains are very similar to pass-through income in that they are recognized and reported on the shareholder's tax return even if they are not actually distributed and received. The Superior Court in *Fennell* held:

Our jurisprudence is clear, therefore, that the owner of a closely-held corporation cannot avoid a support obligation by sheltering income that should be available for support by manipulating salary, perquisites, corporate expenditures, and/or corporate distribution amounts. By the same token, however, we cannot attribute as income funds not actually available to or received by the party.

In *Fennell*, a crucial consideration was the historical practice of the business and the legitimate reasons for retaining earnings in the business. The trial court in *Fennell* had found that the obligor had not cause the business to retain its earnings in an effort to shield income from the obligor's support obligation. Similarly, where a portfolio has been historically managed to achieve growth and gains have not been historically distributed to the owner, the court should not find that undistributed capital gains are "income."

Perhaps surprisingly, the appellate courts of this jurisdiction have rarely addressed the issue of capital gains in the context of a support action. In *Riley v. Foley*, 783 A.2d 807 (Pa.Super. 2001), the Superior Court held that the trial court had correctly considered the father's liquidation of stock options in its determination of his earning capacity. It is important to note that the stock options were actually liquidated and the sales proceeds were received by the father in that case. He did not reinvest the stock proceeds in other stocks or investments.

Similarly, in *Coffey v. Coffey*, 575 A.2d 5887 (Pa.Super.1990), the Superior Court held that the proceeds from the liquidation of limited partnership interests was "income." Again, the *Coffey* case is distinguishable on the grounds that the property in that case was liquidated, not reinvested. It is also questionable whether *Coffey* is still good law, as the Superior Court in that case rejected the appellant's argument that the proceeds from the sale of property were marital property subject to equitable distribution. In light of the Superior Court's subsequent decisions in *Rohrer* and *Miller*, *infra*, such double dipping would not be permissible.

In *Miller v. Miller*, 783 A.2d 832 (Pa.Super.2001), the husband realized a profit on the sale of timber rights that were awarded to him in equitable distribution. The trial court held that the gain was not "income" for support purposes. The Superior Court agreed, holding that such double dipping was not permissible, and income would result only if the asset awarded in equitable distribution were sold for more than its assigned value in equitable distribution.

These cases lead to the same conclusion: that "income" for support purposes may be recognized only when an asset is liquidated. If a taxpayer is required to report a capital gain or pass-through income on his or her income tax return but does not actually receive a distribution of gain or profit, there is no "income" for support purposes.