2026-OTA-125
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **S. FARAH**	OTA Case No. 220810976

OPINION

Representing the Parties:

For Appellant: A. Lavar Taylor, Attorney
S. Farah

For Respondent: Peter Kwok, Attorney
Nathan Hall, Attorney Supervisor

S. RIDENOUR, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, S. Farah (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $137,171 and applicable interest for the 2015 tax year.

Office of Tax Appeals (OTA) Panel Members John O. Johnson, Andrew Wong, and Sheriene Anne Ridenour held an oral hearing for this matter in Cerritos, California, on September 11, 2024. At the conclusion of the hearing, the record was closed. Thereafter, OTA reopened the record and requested the parties provide additional briefing. After briefing was completed, the record was closed and this matter was submitted for an opinion pursuant to California Code of Regulations, title 18, section 30209(b).

ISSUES

1. Whether appellant's receipt of her community property interest[1] in an arbitration award is includable in her gross income.
2. If the amount appellant received is includable in her gross income, whether it is includable in her gross income for the 2015 tax year.

[1] The parties do not dispute that the amount at issue is appellant's community property interest in the arbitration award. OTA refers to appellant's interest in the arbitration award as her community property interest for ease of reference, noting that unadjudicated community property is held post-dissolution by the parties as tenants-in-common. (*Henn v. Henn* (1980) 26 Cal.3d 323, 330.)

FACTUAL FINDINGS

1. In 1995, M. Farah began working for Wedbush Securities Inc. (Wedbush) as an investment broker.
2. On September 21, 2002, appellant and M. Farah were married.
3. On May 25, 2005, M. Farah filed an arbitration claim under the Financial Industry Regulatory Authority (FINRA) against Wedbush, in which he alleged that Wedbush made misrepresentations relating to investments that he recommended to his clients, causing him to lose clients and annual income.
4. In November 2009, M. Farah filed a petition for dissolution of marriage in the Superior Court for the County of Orange (Superior Court).
5. On February 23, 2011, M. Farah executed a Schedule of Assets and Debts pursuant to the divorce proceedings; however, M. Farah did not list his arbitration claim against Wedbush as a potential asset, community property or otherwise.
6. On August 10, 2011, M. Farah stated during a deposition in the dissolution proceeding that he sued Wedbush for lost income, but he refused to provide any estimate of the amount of lost income because he maintained that appellant had no right to any of the income.
7. In September 2011, appellant and M. Farah entered into a settlement agreement (September 2011 Settlement Agreement) that divided their marital property. The September 2011 Settlement Agreement does not mention M. Farah's arbitration claim against Wedbush.
8. In February 2012, the Superior Court issued a Dissolution of Marriage Judgment on Reserved Issues (Dissolution Judgement) of appellant and M. Farah. While the Dissolution Judgement includes a property division settlement agreement between the parties, which includes an order "to equalize the division of community property," it too does not mention M. Farah's arbitration claim against Wedbush.
9. On September 25, 2013, the FINRA arbitration panel issued a ruling in favor of M. Farah, ordering Wedbush to pay M. Farah a total award of $4,286,123.64, which included awards for lost income, punitive damages, and attorney fees. M. Farah did not disclose the Wedbush arbitration award to appellant.
10. Subsequently, appellant learned about the arbitration award from an industry news article.

11. On October 24, 2013, appellant filed a motion with the Superior Court under Family Code (FAM) section 2556[2] for adjudication of an omitted asset. In her motion, appellant alleged that: (1) the arbitration claim and arbitration award constituted an omitted community property asset since the arbitration award was based on earnings M. Farah lost during the marriage; and (2) M. Farah breached his fiduciary duties to appellant by failing to disclose the arbitration claim before entry of the Dissolution Judgement and by failing to keep her updated about the arbitration claim's status, including the arbitration award.
12. On March 19, 2015, the Superior Court issued a Minute Order in which it ruled that: (1) M. Farah's arbitration claim against Wedbush constitutes a community property claim for loss of income during the marriage pursuant to FAM section 760; (2) $2,937,478.60 of M. Farah's arbitration award against Wedbush constitutes community property, which includes $1,334,387 in compensatory damages for loss of income, $1,439,556.60 in punitive damages, and $163,535 in attorney's fees paid during the marriage; and (3) M. Farah breached his fiduciary duty to appellant by failing to disclose the arbitration claim during the divorce, as well as subsequently failing to disclose the arbitration award, and failing to distribute to appellant her share of the community property interest in the arbitration award pursuant to FAM sections 721 and 1101(a). The Superior Court vacated submission for good cause to set an additional hearing for the issues of whether M. Farah acted with oppression, fraud, or malice, and what remedy should be awarded to appellant.
13. On June 29, 2015, the Superior Court issued a Minute Order that, as relevant to this appeal, ordered the following: (1) M. Farah pay appellant $1,468,739.30 (i.e., 50 percent of $2,937,478.60, which constitutes the community's interest of the arbitration award); (2) there would be no offset for any prior tax payment by M. Farah pursuant to

[2] FAM section 2556 states:

> In a proceeding for dissolution of marriage, for nullity of marriage, or for legal separation of the parties, the court has continuing jurisdiction to award community estate assets or community estate liabilities to the parties that have not been previously adjudicated by a judgment in the proceeding. A party may file a postjudgment [*sic*] motion or order to show cause in the proceeding in order to obtain adjudication of any community estate asset or liability omitted or not adjudicated by the judgment. In these cases, the court shall equally divide the omitted or unadjudicated community estate asset or liability, unless the court finds upon good cause shown that the interests of justice require an unequal division of the asset or liability.

FAM section 1101(g); and (3) M. Farah pay appellant's attorney's fees pursuant to FAM section 1101(g).[3]

14. On October 30, 2015, the Superior Court issued an Order to Release Funds, ordering the following amounts be released: (1) $1,518,233.60 (which constitutes appellant's community interest in the arbitration award, plus interest) to appellant; and (2) $120,769.72 (which constitutes attorney fees, plus interest) to appellant's attorney.

15. On November 9, 2015, M. Farah issued appellant a check in the amount of $1,518,233.60, in conformity with the Orders.[4] M. Farah subsequently appealed the Superior Court's rulings to the California Court of Appeal for the Fourth District (Court of Appeal).

16. Thereafter, the IRS requested that appellant amend her 2015 federal income tax return to include the arbitration award.

17. By letter dated October 13, 2016, appellant responded to the IRS, asserting that the arbitration award was not taxable income but was instead a non-taxable transfer of property incident to the couple's divorce pursuant to Internal Revenue Code (IRC) section 1041. Appellant conceded that she owed tax on the interest portion of the arbitration award and offered to file an amended 2015 federal return reporting the taxable interest in her gross income.

18. On May 24, 2017, the Court of Appeal issued an unpublished opinion, in which it found that the Superior Court's ruling was supported by substantial evidence that Wedbush's conduct did not injure M. Farah until after he married appellant, and, therefore, both M. Farah's claim against Wedbush and the damages he recovered constituted community property.

19. Subsequently, M. Farah filed an amended 2015 California income tax return deducting from his gross income the $1,518,233 he was court-ordered to pay appellant. M. Farah

---

[3] FAM section 1101(g) states:

> Remedies for breach of the fiduciary duty by one spouse, including those set out in Sections 721 and 1100, shall include, but not be limited to, an award to the other spouse of 50 percent, or an amount equal to 50 percent, of any asset undisclosed or transferred in breach of the fiduciary duty plus attorney's fees and court costs. The value of the asset shall be determined to be its highest value at the date of the breach of the fiduciary duty, the date of the sale or disposition of the asset, or the date of the award by the court.

[4] M. Farrah also issued appellant a 2015 Form 1099-MISC, reporting that appellant received "Other Income" of $1,518,233.60.

did not have any 2015 taxable income; therefore, M. Farah applied the claimed deduction to the 2013 tax year as a net operating loss carryback.[5]

20. FTB treated M. Farah's 2015 amended California return as a claim for refund of $201,925 for the 2013 tax year and $0 for the 2015 tax year.
21. By letter dated July 19, 2019, FTB denied M. Farah's claim for refund. FTB stated that M. Farah could not deduct the court-ordered payment to appellant because the payment was a nontaxable transfer of assets incident to his divorce under IRC section 1041.
22. M. Farah subsequently appealed to OTA.
23. On March 27, 2020, M. Farah and FTB executed a stipulation, in which they agreed that for the 2015 tax year M. Farah was entitled to claim a deduction of $1,468,739, which was applied to the 2013 tax year as a net operating loss carryback, resulting in M. Farah receiving a refund of $195,342 for the 2013 tax year. Pursuant to the stipulation, M. Farah's appeal with OTA was dismissed.
24. FTB subsequently audited appellant's 2015 tax year and sent appellant a letter dated February 26, 2020, asserting that the community property portion of the arbitration award was includable in appellant's California taxable income for the 2015 tax year.
25. On October 30, 2020, FTB issued appellant a Notice of Proposed Assessment (NPA) for the 2015 tax year, proposing additional tax of $137,171, plus interest.
26. Appellant timely protested the NPA.
27. On June 28, 2022, FTB issued appellant a Notice of Action affirming the NPA.
28. This timely appeal followed.
29. On appeal, appellant provides her 2013 and 2015 federal account transcripts, dated August 22, 2024. The federal account transcripts indicate that appellant did not include the arbitration award in her gross income or file amended returns for either tax year, and that the IRS did not assess additional tax.

DISCUSSION

Issue 1: Whether appellant's receipt of her community property interest in an arbitration award is includable in her gross income.

It is well established that a presumption of correctness attends FTB's determinations of fact, and that the taxpayer has the burden of proving such determinations erroneous. (*Appeal*

[5] After learning about the payment from M. Farah to appellant, FTB sent appellant a Request for Tax Return for the 2015 tax year on July 25, 2017. Appellant responded by letter dated August 14, 2017, asserting that she timely filed her 2015 return, and that the income FTB was inquiring about was a non-taxable transfer of property from M. Farah to appellant incident to their divorce.

of Head and Feliciano, 2020-OTA-127P.) To overcome the presumed correctness of FTB's findings as to issues of fact, the taxpayer must introduce credible evidence to support their assertions, and if they do not support their assertions with such evidence, FTB's determinations must be upheld. (*Ibid*.)

R&TC section 17041(a) provides that California residents shall be taxed upon their entire taxable income regardless of its source. R&TC section 17071 incorporates IRC section 61, which defines "gross income" to include all income from whatever source derived, including compensation for services, such as fees, commissions, fringe benefits, and similar items, except as otherwise provided by statute. (IRC, § 61(a)(1), (b).) R&TC section 18031 incorporates into California law IRC section 1041, which states that no gain or loss shall be recognized on a transfer of property from an individual to: (1) a spouse; or (2) a former spouse, but only if the transfer is incident to the divorce. (IRC, § 1041(a).) IRC section 1041 does not provide for the exclusion of income; rather, it provides for the nonrecognition of gain or loss under the circumstances described therein. (*Gibbs v. Commissioner*, T.C. Memo. 1997-196.) As in the case of other nonrecognition sections, the income tax consequences of a transaction described in IRC section 1041 are deferred, and the tax deferral is effectuated through the treatment of the basis of the property involved in the underlying transaction. (*Ibid*.)

The purpose of IRC section 1041 is to defer the tax consequences (recognition of gain or loss) of transfers between spouses or former spouses. (*Arnes v. U.S.* (9th Cir. 1992) 981 F.2d 456, 458, citing H.R. Rep. No. 432, Pt. II, 98th Cong., 2d Sess. 1941 (1984), reprinted in 1984 *U.S. Code Cong. Admin News* 697, 1134 ["[spouses] are a single economic unit"].) If IRC section 1041 applies, then the transferee spouse is treated as receiving the property as a gift and the basis of the transferee in the property shall be the adjusted basis of the transferor spouse. (IRC, § 1041(b)(1) & (2).) This rule applies regardless of whether the transferred property is separately owned by the transferor or is a division (equal or unequal) of community property. (Temp. Treas. Regs., § 1.1041-1T(d), Q&A-10.) The transferor of property in an IRC section 1041 transfer recognizes no gain or loss on the transfer even if the transfer was in exchange for the release of marital rights or other consideration. (*Ibid*.) Even if the transfer is a bona fide sale, the transferee does not acquire a basis in the transferred property equal to the transferee's cost (the fair market value). (*Id*. at Q&A-11.) While IRC section 1041 does not explicitly provide for the exclusion of income (see *Gibbs v. Commissioner*, *supra*), property received in an IRC section 1041 transfer is, in essence, excluded from the recipient's gross income upon receipt, and the recipient's basis is then equal to the transferor's adjusted basis. Later, when the recipient transfers the property to a third party, the gain or loss must be

recognized. (IRC, § 1041; *Arnes v. U.S.*, *supra*.) The effect of an IRC section 1041 transfer is to defer the tax consequences (recognition of gain or loss) until the transferee disposes of the property.

The nonrecognition that IRC section 1041 provides is limited to transfers between spouses, or former spouses, but only if the transfer is incident to the divorce. (IRC, § 1041(a)(1), (a)(2).) For purposes of IRC section 1041(a)(2), a transfer is "incident to the divorce" if such transfer either: (1) occurs within one year after the date on which the marriage ceases; or (2) is related to the cessation of the marriage. (IRC, §1041(c); Temp. Treas. Regs., § 1.1041-1T(b), Q&A-6.)[6] While IRC section 1041 does not define "related to the cessation of the marriage," Treasury Regulation section 1.1041-1T(b) provides that a transfer of property is "related to the cessation of the marriage" if: (1) the transfer occurs within six years of the date when the marriage ceases; and (2) the transfer is pursuant to a divorce or separation instrument as defined in former IRC section 71(a)(2).[7] (Temp. Treas. Regs., § 1.1041.1T(b), Q&A-7.) Any transfer occurring more than six years after the cessation of the marriage and any transfer not pursuant to a divorce or separation instrument is presumed to be not related to the cessation of the marriage.[8] (*Ibid.*) A divorce or separation instrument includes a modification or amendment to such decree or instrument. (*Ibid.*) Former IRC section 71(b)(2), which was in effect during the 2015 tax year, provided that the term "divorce or separation instrument" is either: (A) a decree of divorce or separate maintenance or a written instrument incident to such a decree, (B) a written separation agreement, or (C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

The California Supreme Court stated in *Henn v. Henn* (1980) 26 Cal.3d 323 (*Henn*) that when an omitted asset is a community property asset, one's community property interest in the asset is not altered except by judicial decree or an agreement between the parties, and held that a former spouse is not precluded from later claiming an interest in an unadjudicated

---

[6] When applying the IRC for purposes of the Personal Income Tax Law (PITL), temporary Treasury Regulations are applicable as regulations under the PITL to the extent that they do not conflict with the PITL or with regulations issued by FTB. (R&TC, § 17024.5(d).) In addition, it is well settled that where federal law and California law are the same, federal rulings and regulations dealing with the IRC are persuasive authority in interpreting the applicable California statute. (See *J. H. McKnight Ranch v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, fn. 1, citing *Calhoun v. Franchise Tax Bd.* (1978) 20 Cal.3d 881, 884.)

[7] IRC section 71 was repealed by Public Law 115-97, effective December 22, 2017.

[8] This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. (Temp. Treas. Regs., § 1.1041.1T(b), Q&A-7.)

community asset. Specifically, the Court stated that under principles of California community property law, property that is not mentioned in the pleadings as community property is left unadjudicated by decree of divorce, is subject to future litigation, and the parties being tenants in common meanwhile. (*Id*. at p. 330.) The subsequently claimed community property rights must be adjudicated in a separate independent action. (*Id*. at p. 332.) The *Henn* Court not only virtually eliminated res judicata as a defense to a later suit seeking adjudication of a previously unadjudicated community asset in the earlier action for dissolution, but it also implicitly holds that in the limited context of omitted assets, the equitable division of marital property outweighs that of stability and finality of the dissolution.

A former spouse's right to adjudicate community property left unadjudicated by decree of divorce is further enshrined in the California Family Code. FAM section 2556 provides for a court's continuing jurisdiction in dissolution proceedings "to award community estate assets or community estate liabilities to the parties that have not been previously adjudicated by a judgment in the proceeding." FAM section 2556 authorizes a party to file a post-judgment motion "to obtain adjudication of any community estate asset or liability omitted or not adjudicated by the judgment," and directs the court to divide the omitted or unadjudicated asset or liability equally unless the interests of justice require otherwise. The statute imposes no time limit on the post-judgment motion (*In re Marriage of Huntley* (2017) 10 Cal.App.5th 1053, 1060), and it allows post-judgment relief regardless of whether the moving party was aware of the asset or liability during the marriage (*Huddleson v. Huddleson* (1986) 187 Cal.App.3d 1564, 1569).

Henn, its progeny, and FAM section 2556 together establish that community property rights are not extinguished by a dissolution judgment if the property was not previously adjudicated. However, a court's continuing jurisdiction to adjudicate previously unadjudicated community property does not necessitate a finding that the subsequent adjudication results in a transfer that qualifies for nonrecognition under IRC section 1041. The Tax Court, through its various holdings, has elucidated when a transfer that occurs more than one year after, but within six years of, the date when the marriage ceases, qualifies for nonrecognition under IRC section 1041.

In *Balding v. Commissioner* (1992) 98 T.C. 368 (*Balding*), upon the divorce of H and J, the divorce court initially ordered a division of the couple's community property pursuant to a divorce decree and affirmed that J's military retirement pay was his separate property. At the time of their divorce, military retirement benefits were not divisible in a dissolution proceeding as community property; however, Congress subsequently provided that states could retroactively

treat military retirement benefits as community property.[9] Due to a resulting California statutory change, H asked the divorce court to reopen its judgment of divorce from three years prior and award her a community property share of J's military retirement pay. (*Id.* at pp. 368-369.) The divorce court then entered a stipulated settlement, whereby H and J agreed that H relinquished any claim to J's military pay (and agreed not to bring any further claims with regard to marital property) in consideration of J's promise to make three settlement payments to H. (*Ibid.*) The Tax Court, finding that H received the settlement payments from J incident to the divorce (and in consideration of her release of any claim to his military retirement benefits), held that the settlement payments qualified for nonrecognition under IRC section 1041. (*Id.* at p. 373.)

In *Balding*, *supra*, the retirement payments were part of the dissolution proceeding and deemed J's separate property. It was only after Congress provided states with retroactive ability to treat retirement payments as community property that H brought an action for her interest. The *Balding* court stated that transfers of property, or releases of marital rights, incident to the divorce, are subject to a special set of rules found in IRC section 1041. (*Balding*, 98 T.C., *supra*, at p.370.) The Tax Court further stated that regardless of whether it found "[H's] release as constituting (or equivalent to) a transfer of property, or simply a release of marital rights, the transaction whereby [H] received the settlement payments" required the court to analyze H's receipt in light of IRC section 1041. (*Id*. at p. 373.) The *Balding* court found "the settlement payments having been received from [J], incident to their divorce (and in consideration of [H's] release of any claim to his military retirement benefits)" qualified for nonrecognition under IRC section 1041. (*Ibid*.) The Tax Court viewed H's release of rights to the military benefit pay in exchange for the settlement payments as a transfer of property.

The *Balding* court also stated that since the federal notice of deficiency was narrowly drawn, alleging only that the settlement payments were erroneously excluded from gross income, the possible tax consequences to H of retirement payments made by the government on account of J's retirement was not at issue. (*Balding*, *supra*, 98 T.C. at p. 373 fn. 8.) Subsequently, the Tax Court in *Witcher v. Commissioner*, T.C. Memo. 2002-292 (*Witcher*), addressed the tax consequences of retirement payments made to a former spouse. In *Witcher*, the divorce court divided a retirement plan pursuant to P's and M's divorce distribution agreement, and P's portion was paid directly to her six years after the divorce.[10] The Tax Court found that *Witcher* was distinguishable from *Balding*, and held that while P's portion of the

[9] See Uniform Services Former Spouses' Protection Act, 10 U.S.C.A, section 1408.

[10] In *Witcher*, P and M resided in a noncommunity property state; however, the divorce court deemed the retirement plan a marital asset available for equal distribution. (*Witcher*, *supra*.)

retirement plan was distributed to her "incident to the divorce," the resulting payments were nevertheless includable in P's gross income. The *Witcher* court, noting that the taxpayer in *Balding* received cash payments from her former spouse in consideration of her agreement to relinquish all claims to the former spouse's military retirement pay, found that P received her payments "as a result of her retained ownership interest in her former spouse's military pension." (*Witcher*, *supra*, at p. *3.) Referencing IRC section 1041(b), the Tax Court stated that even if it was "to assume, arguendo, that the division of the military pension effected a transfer of property to petitioner subject to [IRC] section 1041, petitioner has no basis in such property, and thus the full amount of the pension distribution to her is includable in her income." (*Ibid*.)

In *Young v. Commissioner* (1999) 113 T.C. 152, *aff'd,* 240 F.3d 369 (4th Cir. 2001) (*Young*), the Tax Court held that a post-judgment written agreement that settled the division of marital property obligations arising from a divorce decree was a written instrument incident to the divorce decree. In *Young*, former spouses (J and L) entered into a Mutual Release and Acknowledgment of Settlement Agreement (Settlement Agreement) to resolve "their Equitable Distribution of Property claim and all other claims arising out of the marital relationship" the year following their divorce. (*Young*, *supra*, 240 F.3d at p. 372.) Pursuant to the Settlement Agreement, J agreed to deliver to L a promissory note, payable in annual installments, which was secured by a deed of trust of property that J received as part of the Settlement Agreement. When J defaulted on his obligations, the court entered judgment for L; thereafter, J paid only a fraction of the judgment, thereby prompting L to initiate steps to execute the judgement. Prior to the execution of the judgment, J and L entered into a Settlement Agreement and Release (Release Agreement) stating that in full settlement of J's obligations, J would transfer to L a tract of land. J retained an option to repurchase the transferred land, which he later assigned to a third party who exercised the option and bought the land from L within six years of the cessation of L's and J's marriage. The parties agreed that the purpose of the Release Agreement was to "resolve disputes arising from" the Settlement Agreement. (*Id*. at p. 373.)

The Tax Court in *Young*, referencing paraphrases of "incident to" previously used by courts (*Young*, *supra,* 113 T.C. at p. 156 [paraphrasing "incident to" as "implementing the terms of the decree," "related to," and "in connection with"]), found that the Release Agreement was incident to the divorce decree and thus related to the cessation of the marriage. (*Ibid*.) The Eleventh Circuit Court of Appeals, in affirming the Tax Court, noted that the Release Agreement "expressly provides that the [Release Agreement] was to 'fully settle all claims under the Judgment and Deed of Trust' that arose out of the [Settlement Agreement]" (*Young*, *supra*, 240

F.3d at p. 373) and found that J transferred the tract of land to L "to satisfy an obligation that originated from the dissolution of [their] marriage" (*Id*. at pp. 374-375). The Court of Appeals further found that had J and L "reached this settlement at the time of their divorce, there is no question that this transaction would have fallen under" IRC section 1041. (*Id*. at p. 375.)

In the present matter, M. Farah issued appellant the check after their divorce was finalized; therefore, as a former spouse, appellant must demonstrate that the payment is a transfer "incident to the divorce." (IRC, § 1041(a)(2).) Moreover, since M. Farah issued appellant the check in 2015, more than one year after their marriage dissolved in 2012, appellant must demonstrate that the purported transfer[11] is related to the cessation of the marriage for it to be deemed "incident to the divorce." (IRC, §1041(a)(2),(c); Temp. Treas. Regs., § 1.1041-1T(b), Q&A-6.) There is no dispute that the purported transfer occurred within six years of the date when appellant's marriage to M. Farah ceased; therefore, to be related to the cessation of the marriage, the purported transfer must be pursuant to a divorce or separation instrument as defined in former IRC section 71(a)(2). (See Temp. Treas. Regs., § 1.1041.1T(b), Q&A-7.)

Before appellant filed her motion for adjudication of an omitted asset, appellant and M. Farah already entered into the September 2011 Settlement Agreement that divided their marital property and, later, the Dissolution Judgement in February 2012; therefore, OTA finds that the Minute Orders the Superior Court issued regarding adjudication of an omitted asset were not a decree of divorce.[12] In addition, appellant does not contend that the Minute Orders were a decree requiring a spouse to make payments for the support or maintenance of the other spouse. Thus, in order for the Minute Orders to be "pursuant to a divorce instrument," appellant must demonstrate the Minute Orders are "a written instrument incident" to her and M. Farah's divorce decree. (Former IRC, § 71(b)(2)(A); Temp. Treas. Regs., § 1.1041.1T(b), Q&A-7.)

If a transfer happens within one year after the marriage ceases (i.e., the date of the divorce decree) and is between divorced individuals, the transfer is sufficient for purposes of IRC section 1041 even if it is not pursuant to a divorce instrument. (IRC, §1041(c); Temp. Treas. Regs., § 1.1041-1T(b), Q&A-6.) However, if the transfer happens more than one year after, but within six years of, the date when the marriage ceases, then the post-judgment transfer must be "pursuant to a divorce . . . instrument" in order for it to be "related to the

[11] The parties disagree whether M. Farah issuing the check to appellant amounted to a "transfer," let alone a transfer "incident to the divorce."

[12] The facts in this matter involve a divorce instrument, as opposed to a separation instrument; therefore, OTA analyzes the law as it pertains to decrees of divorce.

cessation of the marriage," and thus "incident to the divorce." (*Ibid.;* Temp. Treas. Regs., § 1.1041-1T(b), Q&A-7.) As discussed above, a post-judgment transfer may be pursuant to a divorce instrument when the transferred asset is explicitly a part of the divorce distribution agreement (e.g., the division of the retirement plan in *Witcher*, *supra*), or when the asset is transferred to resolve a dispute explicitly arising from the divorce decree (e.g., the transfer of land in *Young*, *supra*). However, even if a post-judgment transfer is found not to be "pursuant to" a divorce instrument, the transfer may nevertheless be "related to the cessation of the marriage," and thus incident to the divorce and qualifying for IRC section 1041 treatment, by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. (Temp. Treas. Regs., § 1.1041.1T(b), Q&A-7.)

Here, the Minute Orders adjudicated an asset that was omitted during appellant's and M. Farah's divorce proceedings. The Minute Orders did not transfer an asset explicitly a part of, nor resolve a dispute explicitly arising from, appellant's and M. Farah's September 2011 Settlement Agreement or Dissolution Judgement. Thus, OTA finds that the Minute Orders are not "a written instrument incident" to appellant's and M. Farah's divorce decree. Consequently, any transfer made pursuant to the Minute Orders is "presumed to be not related to the cessation of the marriage." (Temp. Treas. Regs., § 1.1041.1T(b), Q&A-7.) However, the provided court documents establish that the omitted asset transfer was made to effect the division of property owned by appellant and M. Farah at the time of the cessation of the marriage and, therefore, OTA finds that the presumption is rebutted. Nevertheless, that does not necessitate a finding that appellant's receipt of her community property interest in the arbitration award is not includable in her gross income. Rather, the asset that was omitted from appellant's and M. Farah's divorce proceedings was the arbitration *claim*, not the arbitration award.

Appellant argues that "[t]he transfer of funds to [appellant] from [M. Farah] in 2015 was clearly to 'effect the division of property' owned by [appellant] and [M. Farah] at the time of their marriage," and that she was entitled to the money because their California divorce required all community property to be split equally between the spouses. However, at the time of their divorce, appellant and M. Farah "owned" the pending arbitration claim; they did not, despite appellant's contention, "own" the arbitration award at the time of their marriage—the arbitration award did not yet exist at the time of their divorce. Moreover, at the time of the divorce, the possible outcome of the arbitration claim, let alone any possible community property interest in the outcome, was unknown. As such, appellant and M. Farah could not have "reached this settlement at the time of their divorce." At most, appellant and M. Farah could have reached a

settlement at divorce agreeing that M. Farah would transfer an interest in the arbitration claim to appellant.[13] However, that did not transpire, which resulted in the Minute Orders adjudicating the omitted asset (i.e., the arbitration claim). The courts found that appellant had a community property interest in the omitted arbitration claim, and as such transferred to appellant her portion of the arbitration claim. Since the arbitration claim was already converted to an arbitration award by the time the Minute Orders were issued, the Minute Orders ordered that appellant receive payment from the arbitration award for her retained interest in the arbitration claim. OTA finds that it was the transfer of the arbitration *claim* that qualified for nonrecognition treatment under IRC section 1041, not the resulting payment for appellant's retained interest of the arbitration award.

Moreover, neither appellant nor M. Farah had a basis in the arbitration claim, and both parties concede that M. Farah (and accordingly, appellant) had no tax basis in the arbitration award. Therefore, like the Tax Court found in *Witcher*, OTA finds that while the division of the arbitration claim effected a transfer of property to appellant subject to IRC section 1041, appellant has no basis, transferred or otherwise, in such property, and thus the full amount of the arbitration award she received is includable in her income. Appellant argues that since the cause of action against Wedbush ceased to exist once Wedbush paid the arbitration award, appellant "did not receive 'an arbitration award,'" but rather appellant received cash, and the "tax basis of cash is the amount of the cash." OTA finds appellant's arguments misplaced. While appellant did receive cash, as opposed to a portion of the arbitration claim, it was because of her retained ownership interest in the arbitration claim that appellant received the payment and, similar to M. Farah, appellant had no tax basis in the arbitration award.

Appellant contends that the facts here are similar to *Balding*, *supra*, in that there was a judgment of divorce, a property settlement agreement, and a motion to modify a prior court order. However, in *Balding*, the Tax Court viewed H's release of rights to the military benefit pay in exchange for the settlement payments as a transfer of property. Here, appellant did not release her rights to the arbitration claim, let alone the arbitration award, in exchange for payment; rather, appellant retained her community property rights to the arbitration claim, which is why she subsequently received the payment. Furthermore, the *Balding* court did not make a finding as to the possible tax consequences of receiving the retirement payments, which OTA finds is more akin to the present matter.

---

[13] In such a situation, while the transfer of an interest in the arbitration claim at the time of divorce may have qualified for nonrecognition treatment under IRC section 1041, the amount appellant thereafter received would nevertheless be includable in her gross income. (See *Witcher*, *supra*.)

The Tax Court addressed the tax consequences of retirement payments made to a former spouse in *Witcher*, *supra*. Appellant contends that *Witcher* is distinguishable from the present matter since in *Witcher* there was income generated by an asset, rather than an IRC section 1041 qualifying transfer of assets between former spouses. Appellant states that *Witcher* is not controversial since IRC section 1041 does not allow the income generated from an asset to be treated as non-taxable merely because the income-generating asset was received pursuant to a tax-free transfer under IRC section 1041. However, like in *Witcher*, appellant received her payment "as a result of her retained ownership interest" in the community property portion of the arbitration claim. Appellant also appears to argue that the present matter is distinguishable from *Witcher* since appellant received the payment from her husband;[14] however, irrespective of who paid appellant her community interest in the arbitration award, be it Wedbush or M. Farah, appellant received the payment due to her retained ownership interest in the arbitration award. Furthermore, according to appellant's attempt at distinguishing the present matter from *Witcher*, if M. Farah and appellant agreed to divide an interest in the arbitration claim (i.e., the "asset") at the time of their divorce, and the transfer qualified for nonrecognition treatment under IRC section 1041, the portion of the arbitration award (i.e., "the income generated from the asset") that appellant thereafter received would nevertheless be includable in her gross income. Here, similarly, appellant's and M. Farah's community property interest in the arbitration claim was divided and transferred post-judgement as an omitted asset, which qualified for nonrecognition treatment under IRC section 1041. However, the asset was transferred with a basis of zero; consequently, when appellant received her portion of the arbitration award it was includable in her gross income.

For the foregoing reasons, OTA finds that while appellant's portion of the arbitration claim was distributed to her "incident to the divorce," the resulting payment appellant received from the arbitration award is nevertheless includable in her gross income.

[14] During the oral hearing, OTA asked appellant to clarify her position as to what her tax obligations would be had an interest in the arbitration claim been transferred to her during the divorce and she subsequently received the amount at issue directly from Wedbush. Appellant indicated that had there been a division of the arbitration claim before any money was paid, and appellant subsequently was paid her portion of the arbitration award, then "[i]t may be that she was to report it as income. . ." but that she would "need more facts."

Concerning appellant's focus on M. Farah paying taxes on the arbitration award in 2013, OTA finds that appellant's focus is also misplaced.[15] While M. Farah originally treated the arbitration award as his separate property and paid taxes on the award in 2013, that did not negate the fact that a portion of the arbitration award was community property, in which appellant retained an interest. When the Superior Court held that M. Farah was to pay appellant her portion of the community property interest, M. Farah claimed a 2015 tax deduction for the amount of the arbitration award he previously paid taxes on in 2013 and which he subsequently paid to appellant in 2015. M. Farah's allowed deduction (and eventual net operating loss carryback) was $1,468,739, the amount of the payment which constituted appellant's community property interest.[16] M. Farah and appellant are individually responsible for the taxes on their portion of the community property interest of the arbitration award. The tax treatment of the community property portion of the arbitration award is not altered by subsequent actions of M. Farah or appellant. Just like M. Farah could not elude the California community property laws by incorrectly insisting the arbitration award was his separate property since he received the money after the dissolution of appellant's and his marriage, appellant cannot elude California tax law by incorrectly insisting that the taxes of community property portion of the award "remain paid in full."

Appellant also contends that the Superior Court gave a directive that M. Farah bear the income tax burden on the entire arbitration award, as a form of sanction for M. Farah's breach of his fiduciary duty to appellant, when it stated in its June 29, 2015 Minute Order that "There shall be no offset for any prior tax payment by [M. Farah]" pursuant to FAM section 1101(g).[17] Regardless of the Superior Court's purported intent behind ordering no offset for tax, OTA is not aware of, and appellant has not provided, any legal authority stating that California tax agencies

---

[15] Appellant contends that "[t]echnically, the taxes on the full amount of the Wedbush arbitration aware [*sic*] funds paid to the FTB by [M. Farah] remain paid in full. [M. Farah] has never filed an amended return for 2013 that sought to exclude any portion of the Wedbush arbitration award from his taxable income in 2013." Despite appellant's contention, it appears that the proper procedure was for M. Farah to take a deduction in the year of payment to appellant, rather than amend his 2013 tax return. (See *Brent v. Commissioner* (5th Cir. 1980) 630 F.2d 356, 359-360.)

[16] While appellant disagrees with the outcome of M. Farah's appeal with OTA ("[FTB] foolishly and improperly conceded that [M. Farah] was entitled to a deduction on his 2015 tax return for the payment of funds to [a]ppellant."), OTA's jurisdiction in this appeal is limited to the Notice of Action issued to appellant. (See Cal. Code Regs., tit. 18, § 30103(a).)

[17] In contrast, FTB asserts that the Superior Court likely did not want appellant to reimburse M. Farah since he would be entitled to a refund claim and appellant would be liable to pay her own tax liability and, therefore, appellant and M. Farah would pay their own share of income taxes based on each person's respective income tax situation, including their tax bracket.

are bound by such a court order.[18] Moreover, income tax liability follows ownership (*Blair v. Commissioner* (1937) 300 U.S. 5, 12) and here, the community property portion of the arbitration award was not solely M. Farah's property. Rather, the community property portion was property of the community, of which appellant had an equal ownership interest. Appellant and M. Farah are individually liable for the tax on the income they own after splitting the community property portion of the arbitration award.

In addition, regarding appellant's contention that the IRS contacted her concerning her 2015 federal income tax return but did not ultimately require her to file an amended 2015 federal return or open an audit, the FTB is not bound to follow an IRS decision it believes to be erroneous. (*Appeal of Der Wienerschnitzel International, Inc.* (79-SBE-063) 1979 WL 4104.) Similarly, OTA is not bound by any federal determination. (*Appeals of Lovinck Investments N.V., et al.*, 2021-OTA-294P.)

Having found that the payment appellant received is includable in her gross income, OTA finds that the income is taxable to appellant. OTA next discusses in which year the amount is taxable to appellant.

<u>Issue 2: Whether the amount appellant received is includable in her gross income for the 2015 tax year.</u>

California residents shall be taxed upon their entire taxable income regardless of its source. (R&TC, § 17041(a).) IRC section 451(a), to which California conforms, provides generally that the amount of any item of gross income shall be included in gross income in the taxable year in which it was received by the taxpayer. (IRC, § 451(a); R&TC, § 17551.) For taxpayers using the cash basis method of accounting, the taxpayer's income is to be included in gross income for the taxable year in which the taxpayer "actually or constructively received" the income. (Treas. Reg. § 1.451-1(a).) Taxpayers using the accrual method of accounting include income in gross income "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." (*Ibid*.)

Appellant argues that if the amount of the arbitration award she received is includable in her gross income, the amount was taxable in 2013, as opposed to 2015. Appellant contends that since M. Farah received the arbitration award in 2013, a portion of which was community property, the community also received the arbitration award in 2013, and, therefore, when

---

[18] OTA notes that R&TC section 19006(b) provides that whenever a joint return is filed by spouses, the joint and several liability for a tax may be revised by a court in a proceeding for dissolution of the marriage, if certain requirements are met. However, R&TC section 19006(b) is not applicable in the present matter.

appellant received the funds in 2015 it was a non-taxable event because "obtaining possession of funds that belong to you is not a taxable transaction."[19] Appellant also contends that FTB contradicts itself by arguing that there was no "transfer" to appellant in 2015 since she already owned her interest in the community proportion of the arbitration award in 2013, as well as arguing that her receipt of the arbitration award is taxable income in 2015. Appellant asserts that based on FTB's argument that the amount appellant received in 2015 was already appellant's as of 2013, then those funds should be considered appellant's taxable income for the year 2013, the year in which FTB claims that those funds first became appellant's funds.

Appellant uses the cash receipts and disbursement method of accounting;[20] thus, she must include items of income in her gross income when actually or constructively received. (See Treas. Reg. § 1.451-1(a); R&TC, § 17024.5(d), 17551; IRC, § 451.) Therefore, to prevail on the argument that the amount appellant received was taxable income in the 2013 tax year, as opposed to the 2015 tax year, appellant must demonstrate that she "actually or constructively received" the income in 2013. (Treas. Reg. § 1.451-1(a).) Checks are generally considered income to a cash method taxpayer in the year of actual receipt unless constructively received in an earlier year. (*Lavery v. Commissioner* (7th Cir. 1946) 158 F.2d 859, 860.) Here, appellant received the check from M. Farah, and thus "actually received" the income, in 2015. Accordingly, appellant must demonstrate that she constructively received the amount at issue prior to 2015; otherwise, the amount is includible in appellant's 2015 gross income.

Income not actually reduced to a taxpayer's possession is constructively received by the taxpayer in the taxable year during which it is credited to their account, set apart for them, or otherwise made available so that they could draw upon it at any time. (Treas. Reg. § 1.451-1(a).) However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. (*Ibid*.) Here, appellant's community property interest in the arbitration award was not credited to appellant's account, set apart for her, or otherwise made available so that she could draw upon it at any time prior to 2015. While the court found in 2015 that a portion of the arbitration award was community property, the

---

[19] Appellant also argues that appellant's receipt of her interest in the community property portion of the arbitration award is "a non-taxable splitting of previously taxed income." Specifically, appellant contends that had FTB audited appellant's 2013 tax year in addition to her 2015 tax year, appellant would have been "entitled to a credit against the taxes she owed for 2013 equal to one half of the payment made by [M. Farah] out of the community property Wedbush [arbitration] award towards his own 'overreported' income tax liability." However, as noted above, OTA's jurisdiction in this appeal is limited to the Notice of Action issued to appellant for the 2015 tax year. (See Cal. Code Regs., tit. 18, § 30103(a).)

[20] The parties do not dispute that appellant was a cash basis taxpayer for the 2013 and 2015 tax years.

character of the property does not change the fact that prior to actual receipt, appellant did not have constructive receipt of the funds in this matter.

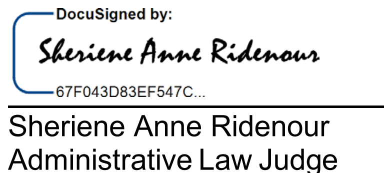
Community property is property owned by the marital community. Once the marriage is dissolved, the marital community no longer exists and, therefore, the "community" cannot own property. (*Henn*, 26 Cal.3d, *supra*, at p. 330.) Upon appellant's and M. Farah's divorce, they were no longer a "single economic unit"— there was no "marital community" between them— such that appellant could be found to have constructive receipt of community property acquired post-divorce and in M. Farah's possession. Moreover, before appellant received the funds from M. Farah, she had to file a motion with the Superior Court, as well as defend its decision at the appellate level, and income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. OTA finds that appellant did not constructively receive the income prior to her actually receiving it in 2015. Consequently, the amount at issue is includible in appellant's gross income for the 2015 tax year, the year appellant actually received the funds.

HOLDINGS

1. Appellant's receipt of her community property interest in an arbitration award is includable in her gross income.
2. The amount appellant received is includable in her gross income for the 2015 tax year.

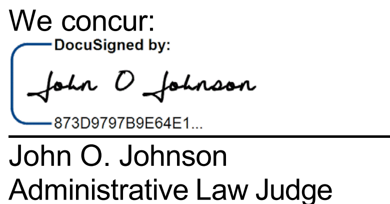
DISPOSITION

FTB's action is sustained.

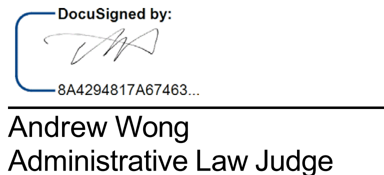


Sheriene Anne Ridenour
Administrative Law Judge

We concur:



John O. Johnson
Administrative Law Judge



Andrew Wong
Administrative Law Judge

Date Issued: 7/10/2025