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Tax Issues When Dividing Property Incident To Divorce

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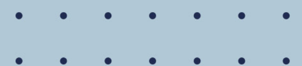

A. Tax-free Transfers Incident to Divorce

Although most transfers between spouses or former spouses in the context of a marital dissolution will be non-taxable, there are some important exceptions. For example, this rule does not apply when the recipient spouse is a non-resident alien. Transfers between former spouses which occur more than six years from the date of the divorce will be taxable unless the taxpayer shows that they are incident to the divorce. And, a person cannot avoid paying taxes on a vested right to income by assigning the right to receive that income to his or her spouse. These exceptions are discussed below. The importance of obtaining records showing the tax basis in the asset received through divorce is also highlighted.

01 GENERAL RULE

Internal Revenue Code section 1041 provides that a transfer between spouses, or former spouses, “incident to divorce” is not taxable in most circumstances. The transfer is treated like a gift. The transferee takes the transferor’s tax basis in the property. The effect of the rule is to defer the tax consequences (recognition of gain or loss) until the transferee disposes of the property.

Sec. 1041

Transfers of property between spouses or incident to divorce. (a) General rule.

No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of):

1. A spouse, or
2. A former spouse, but only if the transfer is incident to the divorce. (b) Transfer treated as gift; transferee has transferor's basis. In the case of any transfer of property described in subsection (a)-
3. For purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
4. The basis of the transferee in the property shall be the adjusted basis of the transferor. (c) Incident to divorce. For the purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer- (1) occurs within 1 year after the date on which the marriage ceases, or
5. Is related to the cessation of the marriage. (d) Special rule where spouse is nonresident alien. Subsection (a) shall not apply if the spouse of the individual making the transfer is a nonresident alien.
6. Transfers in trust where liability exceeds basis. Subsection (a) shall not apply to the transfer of property in trust to the extent that- (1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds
7. The total of the adjusted basis of the property transferred. Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.

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MEANING OF "INCIDENT TO DIVORCE"

Section 1041 applies to all transfers between spouses and also to transfers between former spouses, to the extent made incident to divorce between the former spouses. (IRC § 1041, subd (a).) A transfer of property is "incident to the divorce" if the transfer (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, subd (c).)

Treasury Regulation 1.1041-IT(b) states that a transfer is "related to" the cessation of the marriage when the transfer is required under the divorce or separation instrument, and the transfer takes place within six years from the date of the divorce."

If the transfer is not made pursuant to a divorce or separation instrument, or occurs more than six years after cessation of the marriage, it is presumed to be unrelated to cessation of the marriage. (Treas. Regs. § 1.1041-1T, A-7; see Ltr.Rul. 9306015.) The 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 their marriage ceased. (Regs. § 1.1041-1T, A-7.)

"For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one-and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed." (Id.)

In Private Letter Ruling 9235026 (May 29, 1992), the IRS ruled that the six-year presumption was overcome when the transfer of the Wife's interest in business property to her ex-husband was incident to divorce even though the transfer occurred more than six years after the divorce. The IRS found that the transfer was delayed because of a dispute over the purchase price and payments terms, and that the transfer was effected promptly after the dispute was resolved. The IRS noted that Temp. Treas. Reg. §1.1041-1T, A-7 specifically provides that the presumption may be rebutted if factors such as "disputes concerning the value of the property" to be transferred prevented an earlier transfer.

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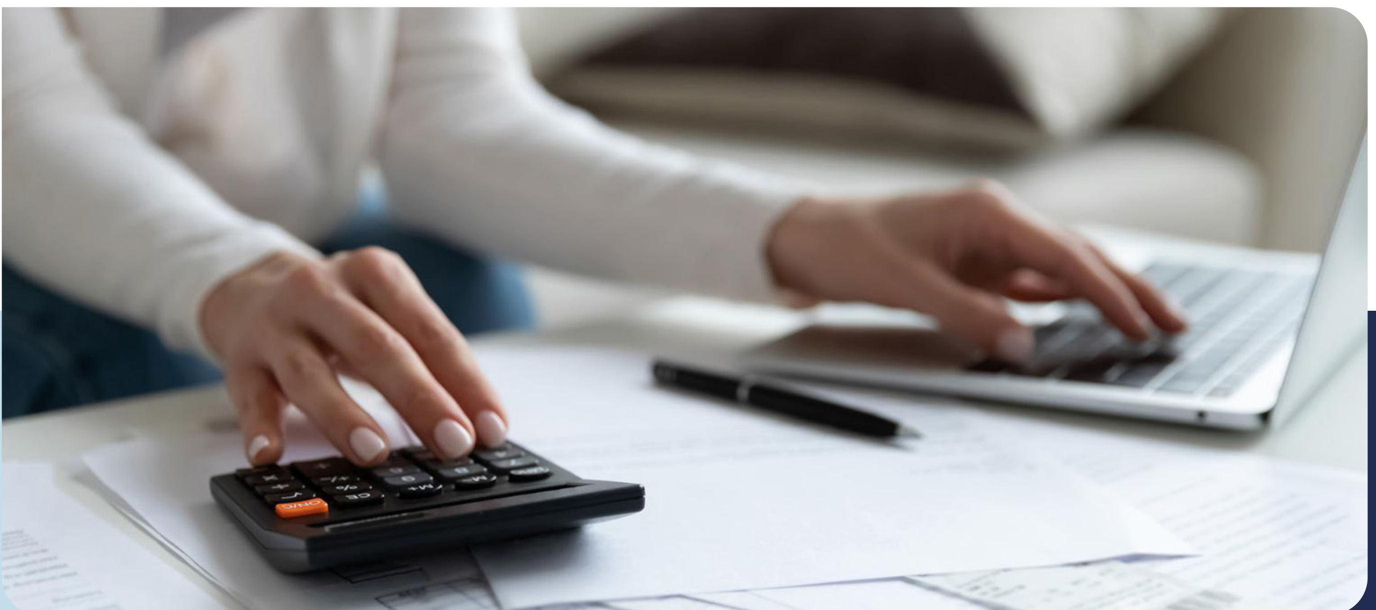
TRANSFER TO NON-RESIDENT ALIEN SPOUSE

When the spouse who receives property incident to divorce is a nonresident alien, taxable gain will be recognized on the transfer. (IRC §1041, subd. (d).) The spouse making the transferor will be taxed on the gain (the difference between the fair market value of the property transferred and his or her adjusted tax basis in the property). The rationale for treating nonresident aliens differently is that the IRS assumes that it will eventually receive taxes on any gain realized when a spouse who receives property incident to divorce sells the property, since the spouse takes the transferor's basis in the property; however, in the case of a nonresident alien, there may be little chance that the gain is ever reported or that tax will be paid.



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ASSIGNMENT OF INCOME DOCTRINE

Income is ordinarily taxed to the person who earns it; one vested with the right to receive income cannot escape taxes by an assignment of the right to receive that income to another. (Lucas v. Earl (1930) 281 U.S. 111 (1930); Harrison v. Schaffner, 312 U.S. 579, 580; IRS Regulations, § 1.454-1(a).) Under the assignment of income doctrine, the transferor remains obligated to pay taxes on the accrued income he or she has assigned.

The assignment of income doctrine applies when the right to receive the income has already accrued, and the parties assign that right to the spouse who did not earn the income. For example, in a transfer of Series E or EE United States Savings Bonds to a spouse or former spouse, the transferor must include the accrued interest on the bonds in his or her gross income in the year of the transfer. (Rev. Rul. 87-112.) IRC § 1041 cannot be used to avoid recognition of the gain by transferring the right to receive the income already earned.

However, when an income-producing asset is transferred, the right to receive future income is transferred along with the underlying asset, such that the spouse receiving the asset is responsible for paying taxes on that income. For example, if a spouse is awarded an apartment building in a divorce, the spouse receiving the building will not recognize any gain on the transfer and will be responsible for reporting the rental income on his or her tax return.

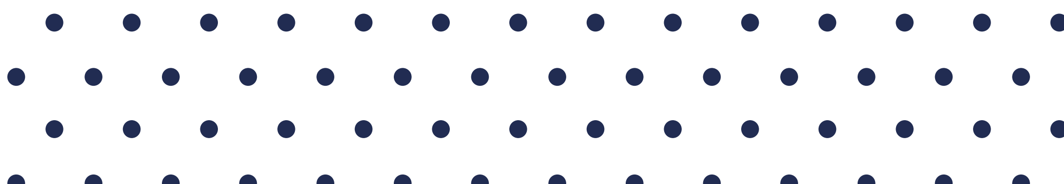
On the other hand, if the parties make an agreement that one spouse will be solely responsible for paying taxes on the past rental income from the building (when it was held as marital property), the assignment of income doctrine will override that contractual allocation and require both parties to report the taxes.

Another example is where Wife agrees to pay Husband 40% of her bonus income as taxable spousal support. When Wife receives the bonus, she will have to report 100% of it as taxable wages, however she gets a deduction for the portion she pays to Husband as alimony. Revenue Ruling 2002-22 held that a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer.

The ruling also concludes that the former spouse, rather than the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

The ruling states: . . . applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible.

Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as Meisner [v. United States, 133 F.3d 654 (8th Cir. 1998] that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.(Rev. Ruling 2002-22, see also Rev. Ruling 2004-60 (FICA taxes are deducted from the payment is made to the non-employee spouse).)



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INTEREST ON EQUALIZING PAYMENTS

If a spouse is required to pay interest to the other spouse regarding an equalizing payment, the interest will be treated as income to the spouse who received it. The spouse who pays the interest can take a deduction for those payments only if the debt was incurred to buy-out the other spouses interest in business or investment property. (See Armacost v. C.I.R. (1998) TC Memo 1998-150.)

The court in Armacost held:Interest on indebtedness must be allocated in the same manner as its underlying debt. [Citation.] Underlying debt is allocated by tracing specific disbursements of the proceeds to specific expenditures. If the underlying debt is incurred as a personal expenditure, the interest on that debt may not be deducted under section 163 except to the extent such interest is qualified residence interest.

[Citations.] But if the underlying debt is incurred to acquire investment property, the interest on that debt is deductible under section 163 as investment interest. [Int.Rev. Code §163 (h)(2)(B).] Investment interest is defined as any interest paid on indebtedness properly allocable to investment property. Section 163(d).

Investment property includes property producing gross income from interest, dividends, annuities or royalties not derived in the taxpayer’s trade or business, or property held in the course of the taxpayer’s trade or business which is neither a passive activity nor an activity in which the taxpayer materially participates. Section 163(d)(5)(A), 469(e)(1).

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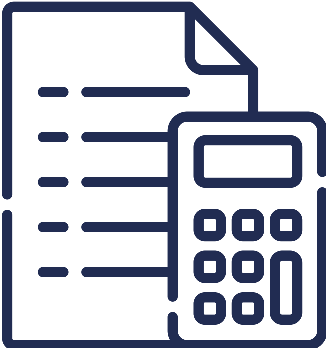
STATE LAW MAY BE DIFFERENT



Section 1041 applies only to taxes under federal law. The transfer could still be taxable under state law.

B. Considering Tax Basis When Dividing Property

Community property laws require the court to divide the community estate “equally” unless required otherwise by law or absent the written agreement of the parties. (See, e.g., Cal. Fam. Code, § 2550.) If tax consequences are not considered when dividing assets, the ultimate division is often far from being equal.

It is the attorney’s role to investigate the tax implications of the proposed division and to advise the client accordingly. In particular, the difference between the fair market value of an asset and its tax basis must be taken into account when evaluating whether there is an “equal” division of the marital estate. In negotiating settlements, the parties are free to discount property based on built-in tax liability associated with an asset.

01 CALIFORNIA RULE

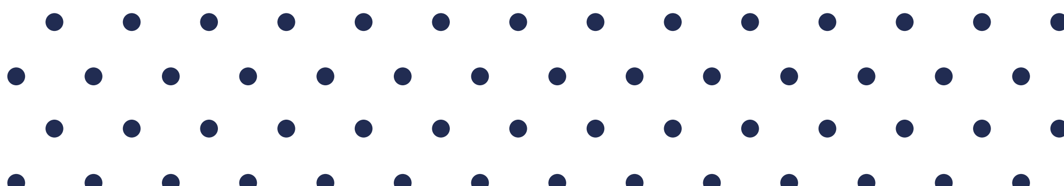
Family courts at least in California, on the other hand, have been reluctant to take tax effects into account except when it is clear that the party will suffer immediate tax consequences from an expected sale of the property or from the transfer itself. An often-cited case in this area is In re Marriage of Fonstein (1976) 17 Cal.3d 738 where the California Supreme Court held.

“Regardless of the certainty that the tax liability will be incurred if in the future an asset is sold, liquidated or otherwise reduced to cash, the trial court is not required to speculate on or consider such tax consequences in the absence of proof that a taxable event has occurred during the marriage or will occur in connection with the division of the community property.” (Id. at p. 749, fn. 5.)

In Fonstein, the trial court assigned husband’s minority interest in a law partnership to him in a marital dissolution action after discounting its value for future tax consequences when sold. Under the partnership agreement, the husband had the right to withdraw from the partnership voluntarily and would receive a sum of money based on a formula set forth in the agreement. Although the husband had no intention of withdrawing from the partnership, the trial court discounted the value of the partnership interest by the taxes he would have to pay if he later decided to withdraw.

The California Supreme Court phrased the issue before it in the following terms:”In valuing Harold’s interest in the law partnership on the basis of his contractual right to withdraw from the firm, did the trial court err by taking into account the tax consequences which he might incur if he did withdraw at some later time, and by reducing the value of his interest accordingly, even though Harold was not withdrawing and had no intention to withdraw?”(Id. at p. 747 (emphasis added).)

The court answered the question as follows:”...[S]ince there is no indication in the record that Harold is withdrawing, must withdraw, or intends to withdraw from his firm in order to obtain the cash with which to pay Sarane her share of the community property, there is no equitable reason for allocating to Sarane a portion of the tax liability which may be incurred if and when he does withdraw. [Citation.]

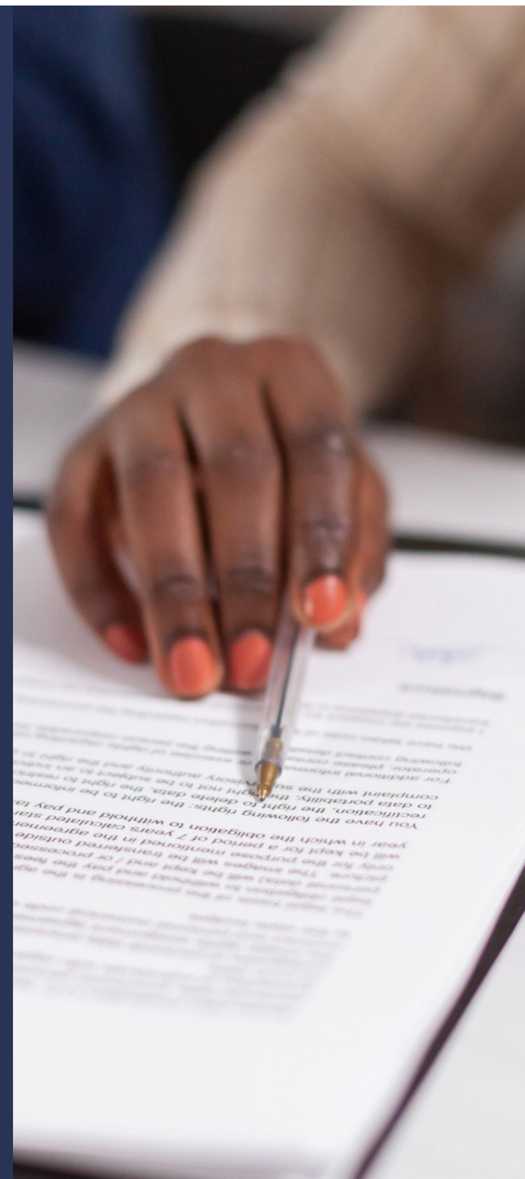


In short, ..., although Harold conceivably may do a number of things concerning his law partnership which may create tax consequences, 'there is no indication that he must or intends to do' any of them." (Id. at p. 750.)In making its ruling, the court referred to the "immediate and specific tax liability" language it used in its earlier decision in Weinberg v. Weinberg (1967) 67 Cal.2d 557. (Fonstein, 17 Cal.3d at p. 749, fn. 5.)

This remains the rule in California, however when property is ordered sold and the proceeds divided, the court must take income taxes on the sale into account. (See In re Marriage of Epstein (1979) 24 Cal.3d 76.) In Epstein, the trial court ordered the family residence sold and the proceeds divided between the parties in such a manner as to equalize the division of the community property.

Since husband received personal property of substantially greater value than that awarded wife, she was due to receive the larger share of the proceeds from the sale of the house. The trial court's order, however, did not mention the possibility that the parties might incur state and federal capital gains tax liability as a result of the sale of the residence. The wife appealed, arguing that the trial court erred by not expressly considering tax liability in its order.

The California Supreme Court agreed with wife that the court's division of community property should take account of any taxes actually paid as a result of the court-ordered sale of the residence. The court explained: "Unlike Fonstein, which involved a speculative future tax liability arising on the hypothetical sale of an asset, in the present case the taxable event, the sale of the residence, occurs as a result of the enforcement of the court's order dividing the community property." (Epstein (1979) 24 Cal.3d at p. 88.)



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EXCLUSION OF GAIN ON SALE OF RESIDENCE

In calculating gain on the sale of a principal residence, Internal Revenue Code section 121 provides that a taxpayer can exclude up to $250,000 of gain from the sale of principal residence if filing a separate tax return, or up to $500,000 for a joint return, if the following requirements are met:

- During the 5-year period ending on the date of the sale or exchange, the residence must have been owned by either spouse and used by both spouses as their principal residence for periods aggregating 2 years or more.
- An individual shall be treated as using property as such individual's principal residence during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument.
- If a residence is transferred to a taxpayer incident to a dissolution of marriage, the time the taxpayer's spouse or former spouse owned the residence is added to the taxpayer's period of ownership.
- The exclusion can only be applied to one residence every two years, excluding pre-May 7, 1997 sales.
- (Treas. Regs. § 1.121-2; California has passed conforming legislation, Cal. Rev. & Tax. Code §17152.)

03

NEED FOR RECORDS

Temporary Regulations provide that “a transferor of property under §1041 must, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer.... Such records must be preserved and kept accessible by the transferee.” (Temp. Treas. Reg. § 1.1041-1T, A-14.)

The judgment should specifically require the exchange of this information.

C. Carryforwards

The right to deduct losses associated with an asset may be transferred together with the asset which generated the loss, or may be personal to the taxpayer and not subject to transfer, depending on the type of asset transferred. This is a complicated area because the loss carryforward was typically reported on a joint tax return during marriage and then, after the divorce, it may have to allocated between the parties for their separate returns. Still, the effort may be worthwhile due to the value of these carryforwards.

01 NET OPERATING LOSSES

A net operating loss from the operation of a business may be carried back to the prior two years (by amending the tax returns for the prior years) or carried over to the succeeding 20 years as a net operating loss deduction. (IRC § 172.) If the spouses filed a joint tax return for each year involved in figuring NOL carrybacks and carryforwards, the NOL is treated as a joint NOL. (IRS Publ. 536, p. 10.) Each spouse may carryover to his or her separate return his or her share of the joint NOL. (Huckle v. Commissioner, T.C. Memo 1968-45.)

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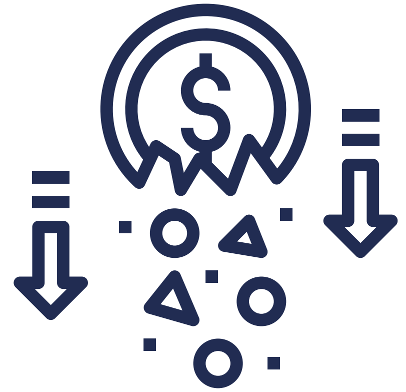
CAPITAL LOSS CARRY FORWARDS



For individuals, losses from the sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges plus up to $3,000 of ordinary income ($1,500 if the return is married, filing separate). (IRC § 1211, subd. (b).) Any capital loss that could not be deducted in one year may be carried over for an unlimited time until fully used up. (Id.)

If separate returns are filed after a net loss was reported on a joint return, the carryover is allocated to each taxpayer based on their individual net long-term and short-term capital losses for the preceding taxable year. (IRC § 1212, subd. (b)(1); Treas. Reg. 1.1212-1(c).) If incurred in a community activity, the losses are split equally on separate returns. Therefore, each spouse may carry forward his or her half of the loss to postdissolution income. (See Regs. § 1.172-7; Rose v. Commr., TC Memo. 1973-207.)

03 SUSPENDED PASSIVE ACTIVITY LOSSES

A passive activity is generally any trade or business in which the taxpayer does not materially participate, including rental activity whether or not there is material participation (subject to special rules for real estate rental activities and real estate professionals). (IRC § 469.) As a general rule, losses from passive activities may only be deducted from income from passive activities, and not against other types of income such as wages, interest or dividends. (Id.)

If a passive activity loss exceeds passive activity income for the year, the loss is "suspended" indefinitely as a deduction from passive activity income in the next succeeding tax years. (Id.)

If the asset which generates the passive activity loss is divided in-kind, the suspended passive activity loss is divided equally between the parties along with the underlying asset. On the other hand, if the passive asset is transferred entirely to one spouse and there is a suspended passive loss associated with that asset, the transferor cannot deduct the accumulated loss but the transferee's basis increases by the amount of the unused suspended loss pursuant to IRC § 469(j)(6)(A). (IRS Publ. 504, p. 19; IRS Publ. 925; but see Pvt. Ltr. Ruling, Tech. Adv. Mem. 9552001 (dealing with S corporations).)

04

SUSPENDED LOSS CARRYFORWARDS RE SUBCHAPTER S CORPORATIONS

In a Subchapter S corporation, the taxable income or loss is passed-through to the shareholders. (IRC § 1366.) Losses which exceed the shareholder's basis in stock and debt in the corporation are suspended and carried forward to the succeeding tax years. (IRC § 1366, subd. (d)(1) (aggregate amount of losses and deductions taken into account by a shareholder for any taxable year shall not exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder).)

When the stock in such a corporation is owned as community property and transferred or divided incident to divorce, the suspended loss carryforwards associated with the stock are transferred along with the stock on a pro rata basis based on the number of shares owned by each spouse during the tax year. (See IRC § 1367.) In an inkind division of the stock which was equally owned by the parties during marriage, each spouse will receive one-half of the suspended loss carryforward.

However, if the stock is awarded entirely to one spouse, the other spouse's share of the suspended loss carryforward is not transferred to the other spouse. The carryforward is personal (having already passed-through to that spouse's tax return when the loss was realized). (IRC § 1366, subd. (d)(2).)

The party receiving the stock will only have the benefit of his or her one-half share of the carryforward; the other half will be lost. It is not added to the basis in the stock, as the loss was disallowed in the year in which it occurred and carried forward. (Pvt. Ltr. Ruling, Tech. Adv. Mem. 9552001.) The spouse receives the transferor's basis in the stock per IRC § 1041, which does not include the loss carryforward associated with the transferee's stock. (See Taft, Tax Aspects of Divorce and Separation, § 5B.03[3][b].)