Important tax rules to know for divorce

By Robert W. Wood

Death and taxes may be inevitable, but for many Americans divorce also ranks high. It is both likely and unpleasant. If you're careful, though, it's possible to divorce and not face major tax bills.

But a surprising number of tax flubs are committed every year during or as a result of divorce, even by professionals. It may be several years later when the tax problems appear. At that point it is usually not easy to fix them and interest and penalties are invariably added.

Very slight differences in mechanics can yield huge tax differences for one or both spouses. What's more, many divorce lawyers are not competent to address these tax rules. Here are five key rules that make divorce less taxing: *Property settlements are tax-free.*

If you divide property between spouses during marriage (or within limits, even post-divorce), 26 U.S.C. Section 1041 of the tax code says there's no tax to either party. Enacted in 1984, this provision reversed a Supreme Court case that ruled property divisions were taxable. This tax-free rule means you can divvy up property between spouses however you want.

That's provided they're both citizens. If one spouse isn't a citizen, there may be income and gift tax issues. But with two U.S. citizens, don't assume tax-free means there are not big tax consequences. When you divide property, you'd better consider *future* taxes and the tax basis of the property in addition to its fair market value.

Example: Al and Betty are getting divorced and own a home worth $5 million, which they bought 30 years ago for $200,000. Betty is awarded the house. A year later Betty sells the house for $5 million. She has a whopping gain of $4.8 million, all of which is taxable to her!

Al and Betty might have cash, securities and other assets to divide, some with a high basis, some with a low basis. It can be more equitable for each spouse to take a mix of high and low basis assets. That way in the future the tax burden too will be equalized.

Transfers "incident to divorce" are covered.

All transfers between spouses during marriage are covered by Section 1041. Transfers "incident to divorce" are covered, too. A transfer is incident to divorce if it occurs within one year after the marriage ceases or if it is "related" to cessation of the marriage.

Any transfer more than one year after the end of the marriage is open to scrutiny by the IRS. However, if the divorce or separation instrument requires that subsequent transfer, it is probably covered. Any transfer more than six years after the end of the marriage is presumed to be outside Section 1041, but this presumption can be rebutted with documentation.

Sometimes you want taxable transfers.

If the parties want to *sell* assets to each other as part of their divorce, can they do so? Yes, but unless you do it very carefully the sale won't be effective for tax purposes. Selling assets would trigger gain or loss so the unequal basis problem can be avoided.

Example: Harry and Wanda are divorcing in California. They own a house worth $1 million with a basis of $200,000, and various other assets they split equally. Under community property law, Harry already owns half the house. Harry "purchases" Wanda's interest in the house from her for $500,000 by borrowing from a bank. Two years later Harry sells the house for $1.1 million. Harry's tax basis is still $200,000, so he's got a whopping $900,000 gain. Under limited circumstances you can orchestrate a true sale to avoid this, but you usually need a third party to help as well as a competent tax lawyer.

Unmarried couples don't qualify.

Section 1041 only applies to *married* couples, so cohabiting couples do not qualify. In some states you can have a lawful marriage under common law, so what constitutes marriage varies.

Example: Billy and Betty have been married for seven years in California and amicably divorce, only to find that unbeknown to them both, Billy's divorce from his first wife wasn't final when he "wed" Betty seven years before! Under California law, their marriage is void, so Section 1041 cannot apply. If they divide property, it is taxable as a sale for its fair market value even though no money changes hands. One of them will have taxable income with no cash to pay the tax.

Very slight differences in mechanics can yield huge tax differences for one or both spouses.

Outside marriage, dividing property usually triggers taxes. That makes resolving palimony and cohabitation cases tough from a tax viewpoint. In extreme cases some people actually get married so they can promptly get divorced to take advantage of Section 1041!

What about same-sex couples who are not legally married? The lack of a legal marriage means there can be no divorce. Without a divorce, Section 1041 does not apply.

Dividing businesses is tricky.

If you're dividing a business, beware. If one party buys out the other, there are different ways to get stung.

Example: Jim and Jane founded Funbook, a social networking site. When they divorce, Jim has Funbook buy out Jane's shares (a stock redemption, for the company buys back its own shares). Jane may think this is a tax-free property division. Jim may think this was a taxable sale. It may be either, depending on the facts. Plus, the IRS may treat Jim as receiving a constructive dividend, meaning he's taxed, too. These tax traps are avoidable, but you must plan ahead and move cautiously.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

Robert W. Wood *is a tax lawyer at Wood LLP in San Francisco (www.WoodLLP.com). The author of more than 30 books including "Taxation of Damage Awards & Settlement Payments" (4th Ed. 2009 With 2012 Supplement www.taxinstitute.com), he can be reached at Wood@WoodLLP.com.*