Tax Implications of Divorce: The Division of Property

Generally, no gain or loss is recognized on a transfer of property or cash (not otherwise characterized as child support or alimony), from an individual to a former spouse if the transfer is "incident to divorce." A transfer of property is incident to divorce if (1) the transfer occurs not more than one year after the date on which the marriage ceases, or (2) the transfer is related to the cessation of the marriage. Under these rules, the property is treated as being transferred by gift (rather than a sale or exchange), so that the basis and holding period of the transferee spouse is that of the transferring spouse. While this "non-recognition rule" applies generally to all property divisions incident to divorce, additional tax rules apply to different classes of property, such as the residence, retirement benefits and business interests. These assets require special attention when planning for the new ownership arrangements.

Personal Residence. If a married couple sells their home in connection with divorce or legal separation, they are able to exclude up to $500,000 of capital gain from taxation (as long as they owned and used the home as their principal residence for two of the previous five years). If, after the divorce, one spouse transfers his or her ownership interest in the home to the spouse who continues to live in the home, one-half of the $500,000 exemption would be lost. If, rather than transferring his or her ownership interest in the home, the transferring spouse simply moves out and retains part ownership of the home, each person may still be able to avoid gain on the future sale of the home (up to $250,000 each). If this is a potential circumstance in a given divorce, then the separation or property settlement agreement should include specially-drafted language designed to protect the exclusion of the non-resident spouse.

For example, assume that Wife, pursuant to a property settlement agreement, receives title to the $575,000 home for which she and her husband paid $200,000 15 years ago. Three years hence, Wife sells the home for $600,000. Although her cost basis in the home is $200,000 (the full amount originally paid for the home), she may only use her capital gains tax exclusion amount of $250,000 on the proceeds of sale. The result is a capital gain of $150,000 ($600,000 – $200,000 basis – $250,000 exclusion), with a corresponding tax liability of $31,125. However, had the property settlement agreement been structured to allow the husband to retain a partial ownership interest in the home, their combined exclusions would have avoided tax on the entire sales price of the home. Needless to say, this arrangement requires some modicum of cooperation and the creative allocation of liquidity (often lacking in such situations), but the opportunity exists for tax savings nonetheless.

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Retirement Plan Benefits. A spouse's qualified retirement benefits (pensions, profit-sharing and stock bonus plans) are nearly always a central focus of property settlements. In these cases, the preferred method for handling the division of these tax-deferred benefits is the "qualified domestic relations order," often referred to as the "QDRO" (pronounced, "quad-dro"). A QDRO is a domestic relations court decree which creates or recognizes the existence of an alternate payee's right to receive, or which assigns to an alternate payee the right to receive, all or some portion of the plan benefits otherwise payable to the participant spouse. The complexity of these decrees arises from the notion that a state court in divorce is attempting to control an asset created by federal law. The importance of having a properly drafted QDRO is that the participant spouse would be taxed on all withdrawals taken from the qualified retirement plan to satisfy property settlement payments (yes, even though distributions are made to the only-recently former spouse). The QDRO uses the court's authority, through reciprocal federal and state laws, to direct the division of the plan account without the involvement of the participant.

A QDRO is not required to divide an IRA, but special care must still be taken to avoid unfavorable tax consequences. For example, if the property settlement agreement directed a divorcing spouse to redeem his or her IRA and pay over some of those funds to the other spouse, the distribution would be fully taxable to the IRA owner (and, if not at least 59 ½ years of age, subject to an additional 10% penalty tax). However, all taxes and penalties may be avoided, if specific IRS-approved methods for transferring the IRA from one spouse to the other are used, and the transfer does not take place before the divorce or separation is final.

Once the retirement plans are divided, it is critical that each former spouse review and renew the beneficiary designations for their plan assets. Failure to address this task will nearly always result in the distribution of the retirement plan or account assets to unintended beneficiaries, with possible negative tax consequences.

Business Interests. Often complicating the division of marital assets is the existence of a closely-held business where husband and wife each own an interest in the company. Often, one spouse has devoted all of his or her time to the running and maintaining the business while the other has had little or nothing to do with it. In order to keep the business running into the future, the divorcing spouses usually want to divest the inactive spouse of all ownership in the business.

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Tax planning for transferring closely-held business interests depends on the type of entity involved, and care must be taken to make sure "tax attributes" are not forfeited and inadvertent tax liabilities triggered. In particular, interests in S corporations may result in "suspended" losses (i.e., losses that are carried into future years) instead of being deducted in the year they are incurred. When these interests change hands in connection with a divorce, the suspended losses may be forfeited.

The transferability of stock in an S or C corporation may be restricted by a stockholder agreement, and failure to follow the terms of the agreement may result in negative tax consequences upon the redemption or transfer of the divesting spouse's stock. Finally, if a partnership interest is transferred a variety of more complex issues may arise involving partners' shares of partnership debt, capital accounts, and built-in gains on contributed property.

Estate Planning Considerations. No discussion of divorce would be complete without the consideration of changes to the estate plan for the former family. The upheaval caused by a divorce in intra-family relationships and property holdings makes it imperative for each party to revise their estate plans. The appointment of fiduciaries and the specific bequests surely will be at odds with the testator's updated intentions. The previously mutual family goals, often stated in reciprocal wills, are likely to have changed substantially. The ownership of property will have been modified making it necessary to establish a new estate plan. For families with minor children, the nomination of guardians and trustees becomes critical to ensure the protection of the minors and management of the assets in trust in the event of the death of the parents.

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