The Tax Implications of Divorce Part II-Property Transfers, Home Sale, Dependency Exemption and Administrative Issues

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Taxpayers should be aware of the tax implications of divorce with respect to property transfers and reporting and administrative requirements.

The tax implications of divorce are varied and significant. The first article in this series defined "alimony" from a tax perspective. This article, part two in this two-part series, reviews the tax implications of property transfers, the sale of a marital home, reporting requirements, and administrative requirements associated with separation and divorce. These articles are intended to assist those advising divorcing clients.

PROPERTY TRANSFERS

Prior to 1984, *Davis*[1] was the controlling law with regard to property settlements between spouses. In *Davis*, the Court held that because the husband had the obligation to provide the wife with a "reasonable" share of his property as a result of the divorce, his property transfer should be treated as a "taxable transfer of property in satisfaction of a legal obligation."[2] The Court relied heavily on the lower courts' interpretations of applicable federal statutes, as having clearly contemplated and resolved this issue with no ambiguity and in favor of taxing these property settlements.[3] Therefore, until 1984, a transfer of property in a divorce settlement was treated as a taxable transfer.[4]

However, in 1984, Congress revised the applicable statute.[5] As a result, transfers of property between spouses during marriage, or between ex-spouses as a result of divorce, are not taxable.[6] This applies only to transfers of property, not transfers of services and is true whether the transfer is intended to be a gift or a sale/exchange between spouses acting at arm's-length.[7] In all cases, the transfers are treated as gifts where the transferor does not recognize a gain or loss and the transferee does not recognize any income.[8] However, a transfer to a spouse or former spouse who is a nonresident alien will not qualify for this tax-free treatment.[9] In this case, the gain or loss is recognized by the transferor spouse and the nonresident alien spouse's basis is equal to his or her cost.[10]

A transfer to a former spouse, must be "incident to divorce" in order to qualify for tax-free treatment.[11] A transfer is considered incident to divorce if it occurs within one year after the divorce or is related to the cessation of the marriage.[12] This is true even if the property was obtained by the transferor after the divorce.[13] For instance, Husband and Wife were married in year 1 and divorced in year 7. Pursuant to the property settlement provided for in the divorce decree, Wife is to transfer property worth $140,000 to Husband. In year 8, Wife purchases real estate, part of which is transferred to Husband in Year 9 under the terms of the divorce decree. The fact that the real estate was acquired by Wife after cessation of the marriage does not make the transfer taxable.[14]

A transfer that is wholly unrelated to divorce but occurs within one year of the divorce, will also not be taxable.[15] However, a transfer that is not related to a separation or divorce agreement and occurs more than six years after the cessation of the marriage will be presumed to be a taxable transfer.[16] A transfer of property is considered complete on the earlier of the transfer of title or the shift of the benefits and burden of ownership.[17]

Property received by a transfer that qualifies for tax free treatment is not included in gross income and the transferee takes the transferor's adjusted basis in the property regardless of appreciation or depreciation in value.[18] Further, the transferee's holding period includes the period during which the transferor held the property.[19] For instance, if Wife transfers shares of stock (FMV $100 and AB $80) to Husband, Wife does not recognize the $20 gain and Husband does not recognize any income on the receipt of the stock. Further, Husband's basis in the stock is $80 and his holding period dates back to the date Wife purchased the stock.

This treatment applies to losses, as well as gains.[20] Under general tax principals, a donor cannot transfer a deductible loss for unrealized depreciation in the value of an asset to a donee.[21] Instead, the donee takes a "loss basis" in the property received equal to the lesser of the adjusted basis in the hands of the donor or the property's fair market value (FMV) on the date of the transfer.[22] However, in a tax-free Section 1041 transfer, the transferee spouse recognizes no loss on the transfer of the depreciated property and the transferee spouse receives the transferor spouse's adjusted basis for the asset transferred, even if the FMV at the time of the transfer is less than the adjusted basis.[23] If the transferred asset is an interest in a passive activity, and there are suspended passive losses allocable to such interest, the suspended losses would be added to the transferee spouse's basis in the interest and would not be currently deductible by either the transferor spouse prior to the transfer or the transferee spouse upon receipt of the interest.[24]

There are very strict notice and record keeping requirements associated with these tax free transfers.[25] Most importantly, the transferor, at the time of the transfer, must supply the transferee with records sufficient to determine the adjusted basis and the property's holding period.[26]

Finally, unlike alimony discussed in Part I of this series, which can be treated as non-alimony if certain requirements are met, a transfer that qualifies for tax-free treatment cannot be treated as anything else–even if the transaction is an arm's-length sale.[27]

SALE OF THE MARITAL HOME

Generally, "if you sell property that you and your spouse own jointly, you must report your share of the recognized gain or loss on your income tax return for the year of the sale."[28] Often, the most valuable jointly-owned marital asset subject to disposition at divorce is the marital home.[29] Of course, if the sale happens between the spouses, then as previously discussed, the tax consequences of the transaction are governed by Section 1041.[30] For example, pursuant to a divorce decree, Wife purchases a one-half interest in the jointly owned principal residence from Husband. The adjusted basis prior to the transfer was $125,000. Wife paid Husband

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NOTES

1 370 U.S. 65, 9 AFTR2d 1625 (1962).
2 *Id.* at 68-71.
3 *Id.* at 71.
4 See generally, *Davis*, note 1, *supra*.
5 Section 1041.
6 Section 1041(a).
7 Section 1041(a); Reg. 1.1041-1(T), Q&A-2 and 4.
8 Section 1041(b)(1); Reg. 1.1041(T), Q&A-10 and 11.
9 Section 1041(d); Reg. 1.1041-1(T), Q&A-3.
10 *Id.*
11 Section 1041(a)(2).
12 Sections 1041(c)(1) and (2); Reg. 1.1041-1(T), Q&A-6 and 7.
13 Reg. 1.1041-1(T), Q&A-5.
14 *Id.*
15 Section 1041(c)(1); Reg. 1.1041-1(T), Q&A-2 and 6.
16 Reg. 1.1041-1(T), Q&A-6.
17 *Pittman*, TCM 2015-44, citing *Deyoe*, 66 TC 904, 910 (1976); *Berger*, TCM 1996-76.
18 Section 1041(b)(2); Reg. 1.1041-1(T), Q&A-10, 11, and 12.
19 Section 1223(2); Ltr. Rul. 201648007.
20 Sections 1041(b) and (e).
21 Section 1015(a).
22 *Id.*
23 Sections 1041(b) and (e); Reg. 1.1041-1(T), Q&A-11 and 12; IRS Pub. 17, *Your Federal Income Tax* (2016), p. 105.
24 Section 1041(e); Reg. 1.1041-1(T), Q&A-13.
25 Reg. 1.1041-1(T), Q&A-14.
26 *Id.*
27 Reg. 1.1041-1(T) Q&A-17; *See generally*, Section 1041.
28 IRS Pub. 17, (2016), Chapter 15.
29 Larson, "Dividing the Marital Home in Divorce," www.expertlaw.com/library/family-law/marital-home.html.
30 Section 1041.

$400,000 for the one-half interest. This transaction is not a sale, and Wife will not receive a "step-up" in basis for the money she pays to Husband.[31] Husband's transfer, of the one-half interest to Wife is treated as a gift.[32] Therefore, Wife's basis for the house remains at $125,000.[33] The money she paid to Husband is likewise treated as a gift to him.[34]

However, the sale does not always occur between spouses. In some cases, the agreement includes a provision requiring the marital home to be sold to a third party. The tax consequences of that sale depend on many factors. A taxpayer may be able to exclude up to $250,000 of the gain realized on the sale of a principal residence from income.[35] The exclusion is increased up to $500,000 for certain qualifying joint filers.[36] To qualify for the $500,000 exclusion, joint filers must satisfy certain requirements.[37] First, either the taxpayer or the taxpayer's spouse must have owned the property for two out of the five years immediately prior to the sale.[38] In addition, both the taxpayer and the taxpayer's spouse must have used the home as his or her principal residence for two out of the five years immediately prior to the sale.[39] If the selling taxpayer previously obtained the home from his or her spouse or former spouse in a transaction under Section 1041, the taxpayer's holding period with respect to the property includes the period that his or her spouse or former spouse owned the property.[40] If one spouse or former spouse is granted use of the home under a "divorce instrument,"[41] that occupant spouse's use of the property as a principal residence (during the period granted by the divorce instrument) is imputed to the other spouse.[42] However, a spouse's use of the marital home prior to the entry or execution of the divorce instrument is not imputed to the non-occupant spouse.[43] As such, the timing of a spouse's departure from the marital home could be an important factor in determining whether he or she qualifies for the enhanced exclusion.[44] Assuming the taxpayer has owned and used the home as his or her principal residence for two out of the last five years, the taxpayer will qualify for the exclusion, as long as he or she has not excluded any gain under this section within the two years immediately preceding the sale.[45]

For example, Husband and Wife, newly married, jointly purchase and move into their new home on 1/15/16. In December 2016, they decide to separate and Husband moves out on 1/15/17. On 11/1/17, they enter into a divorce agreement, terminating the marriage, and agreeing to sell the home after the holidays. During the interim period, Wife will continue to have exclusive use and possession of the home. They sell the house on 2/20/18 and realize a $30,000 gain on the sale. At the time of the sale, Wife has owned and used the home as her principal residence for 2 years and 36 days and, provided that she has not used the exclusion in the past two years, she can exclude her entire $15,000 share of the gain.[46] Husband, as of the time of the sale, has also owned the house for 2 years and 36 days, but he used it as his principal residence for only 1 year and 112 days (the one year before he moved out, and the 112 days of Wife's occupancy that is imputed to him, which began on 11/1/17 when they signed the separation agreement). Since Husband failed to meet the two-year use requirement, he must recognize his $15,000 share of the gain in the year of sale.[47] If, instead of divorcing in November 2017, the couple had divorced after the end of the year, they could have filed a joint return for 2017 and utilized the exclusion on the entire gain, as the gain on the sale is less than the Wife's exclusion limit.[48]

DEPENDENCY EXEMPTION

The dependency exemption is often a point of contention between divorced couples or separated couples filing separately. In 2017, the dependency exemption is worth $4,050 per dependent, although it is subject to a phase-out that should be contemplated when fighting a spouse or ex-spouse for this exemption.[49] Generally, the "custodial parent" is entitled to the dependency exemption.[50] The custodial parent is the parent who "shared

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31 *Id.*

32 *Id.* Reg. 1.1041-1(T), Q&A-11.

33 *Id.*

34 *Id.*

35 Section 121(b)(1); IRS Pub. 17 (2016), Chapter 15; IRS Pub. 523, *Tax Information on Selling Your Home.*

36 Section 121(b)(2)(A); IRS Pub. 17 (2016), Chapter 15; IRS Pub. 523 (2016).

37 Section 121.

38 Section 121(a).

39 *Id.*

40 Sections 121(d)(3)(A) and (d)(3)(B).

41 Section 71(b)(2).

42 Sections 121(d)(3)(A) and (d)(3)(B).

43 Cheslow, "Planning for the Disposition of the Martial Home," New Jersey Law Journal, 10/6/08.

44 *Id.*

45 Section 121(b)(3).

46 Section 121.

47 *Id.*

48 *Id.*

49 IRS Pub. 501, *Exemptions, Standard Deduction and Filing Information* (2016).

50 Section 152(e).

51 Section 152.

52 *Id.*

53 *Id.*

54 Section 152(e)(2).

55 Section 152.

56 Trosch, E. and Trosch, W., *Divorce in North Carolina* (Addicus Books, March 2017).

57 Section 152.

58 Reg. 1.152-4(e)(1)(ii).

59 Reg. 1.152-4(e)(1)(i).

60 *Id.*

61 *Id.*

62 *Id.*

63 IRS Form 8332.

64 *White*, TCM 1996-438; Section 152(e)(2); Reg. 1.152-4(T)(a), Q&A-3.

65 Reg. 1.152-4(e)(3)(ii).

66 Section 152(e). .

67 *Id.*

68 Section 152.

69 Section 152(e).

70 *Id.*

71 *Id.*

72 IRS Pub. 504 (2016).

73 *Id.*

74 *Id.*

75 *Id.*

76 *Id.*

77 *Id.*

the same principal place of abode with the child for the greater portion of the tax year."[51] The other parent is then considered the "non-custodial" parent.[52] If neither parent shared the same principal place of abode with the child for a greater period of the tax year than the other, so that there is not one custodial parent, then the parent with the highest adjusted gross income is entitled to the dependency exemption.[53]

A custodial parent may elect to give the non-custodial parent the right to claim the child as a dependent.[54] The election must be in writing.[55] The safest way to do this is by using Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent.[56] However, the writing is not required to be on Form 8332.[57] A written declaration not on the form designated by the IRS must conform to the substance of that form and must be a document executed for the sole purpose of serving as a written declaration of the custodial parent that he or she will not take the dependency exemption to which he or she is entitled.[58] The writing must specifically state that the custodial parent will not claim the child or children as dependents and must be an unconditional release of the custodial parent's claim for the year or years for which the declaration is effective.[59] A declaration is not unconditional if the custodial parent's release of the right to claim the child as a dependent requires the satisfaction of any condition, including the noncustodial parent's meeting of an obligation such as the payment of support.[60] The written declaration must name the noncustodial parent to whom the exemption is released.[61] It also must specify the year or years for which it is effective.[62] Further, the Social Security numbers of both parents and the child or children who are being claimed as dependents must be included in the writing.[63] A court order or decree or a separation agreement may not serve as the written declaration.[64] Likewise, a revocation of this election must be in writing, either on Form 8332 or on a document that conforms to the substance of that form.[65]

In addition to the writing, in order for the non-custodial parent to be eligible to take the dependency exemption, the child must be a "qualifying child."[66] A child is a qualifying child of the non-custodial parent if the parent provides more than one-half of the child's support for the year; the parents are divorced, separated under a decree of separate maintenance or a written separation agreement, or live apart throughout the last six months of the year; and the child is in the "custody" of one or both of the parents for more than one-half of the year.[67]

Transfers of property between spouses during marriage, or between ex-spouses as a result of divorce, are not taxable

For example, Mom and Dad are divorced on 9/1/16. Mom is named as the custodial parent. Child resided with Mom for the entire 2016 year and both parents provided more than one-half of the child's support for the year. Mom is entitled to the dependency exemption, but can execute a writing releasing her dependency exemption and allowing Dad to take the dependency exemption.

Assuming the writing meets all the requirements discussed above, Dad will be able to take the dependency exemption as the non-custodial parent.[68] However, the result is different if the example is changed. Mom and Dad are divorced on 9/1/16 and Mom is named as the custodial parent, but Child resided with Grandma from 1/1/16 until the divorce was completed. Now even if Mom executes a writing stating that Dad may take the exemption for the 2016 tax year, he is not entitled to the dependency exemption because the child is not a "qualifying child."[69] The child did not live with one or both parents for more than one-half of 2016.

While a custodial parent may execute a writing releasing his or her right to the dependency exemption, the writing will not apply to any earned income credit or dependent care credit to which the custodial parent is entitled.[70] In addition, even if the custodial parent releases his or her right to the dependency exemption, that will not affect his or her ability to file using the "head of household" status if he or she otherwise qualifies.[71]

FILING STATUS

Divorce changes a taxpayers' filing status.[72] After a final order of divorce, the "Married" filing status is no longer available. However, if at the end of a tax year, there has been no final decree of divorce, annulment, or separate maintenance, then the taxpayers are still considered married, even if they are separated, executed a separation agreement, or there is a non-final court decree.[73] In this case, the taxpayers must use either the "Married filing jointly" or the "Married filing separately" status.[74]

The Abandoned Spouse Rule permits a taxpayer to be treated as unmarried for filing status purposes without a final decree of divorce or separate maintenance.[75] The taxpayer cannot file a joint tax return for the year; must maintain a home that is the principal residence of a child for more than one-half the year; must furnish more than one-half the cost of maintaining the household for the year; and the spouse of the taxpayer must not have been a member of the household during the last six months of the year.[76] If these requirements are met, then even without a final decree of divorce or separate maintenance, a taxpayer may use the "Head of Household" filing status on his or her tax return.[77]

ADMINISTRATIVE ISSUES

Legal Fees

As a general rule, taxpayers are not allowed a deduction for personal expenses such as legal fees paid to attorneys to obtain a divorce.[78] However, the legal fees for tax advice are deductible.[79] The bill for the tax advice must be specific.[80] If the bill is not itemized and the attorney's testimony does not specifically show the hours worked on tax advice to the taxpayer as compared to other legal services rendered, it will be difficult to determine the amount of the fee that is deductible.[81]

A taxpayer is also entitled to deduct ordinary and necessary expenses paid to attorneys for the collection of alimony arrearages and to increase alimony payments.[82] The attorneys involved must allocate their time between divorce related services and services related to collection of income and tax advice.[83] Taxpayers have the burden of proving whether the legal fees are ordinary and necessary and what portion of the legal fees are entitled to the deduction.[84] The IRS may disallow any deduction if adequate records are not maintained.[85] The spouse who is obligated to pay the alimony and incurs legal expenses in an attempt to avoid or reduce the payments is not entitled to deduct those legal fees.[86]

Withholding Tax

Withholding tax on alimony payments is generally not required.[87] However, a payor spouse must withhold taxes on alimony payments made to a nonresident alien unless the payee's home country is a party to a tax treaty exempting such income from withholding.[88] If withholding is required, the amount to be withheld is 30% of each payment.[89] The payor spouse is personally liable for any taxes that were required to be withheld and remitted.[90] Even if the payee subsequently reports and pays the U.S. tax on the alimony received, the payor can still be personally liable for interest and penalties.[91]

Adjustment to Income Tax Withholding

The changes caused by divorce may require the taxpayer to adjust the amount of income tax that his or her employer withholds.[92] On the final divorce decree, the taxpayer should submit a new Form W-4, Employee's Withholding Allowance Certificate, to his or her employer with revised information, including any change in filing status and any change in the number of exemptions.[93] The fact that deductible alimony payments will be made, or taxable alimony payments received should be considered when revising the information on the Form W-4.[94]

Address Change

Often separation and divorce mean an address change for one or both spouses. The IRS should be immediately notified of any address changes.[95] Form 8822, Change of Address, is used to notify the IRS of the changes.[96] If a taxpayer is divorced and moves after filing a return and the IRS mails a refund check to an old address because the taxpayer failed to notify the IRS of the address change, the IRS will not owe any interest based on the delay in getting the refund check to the taxpayer.

CONCLUSION

The tax implications of property transactions with respect to separation and divorce are complex, but important to understand when advising clients involved in divorce proceedings. It is imperative, as a tax professional, to get the best tax consequences for the client, whether they are the party making the transfer or the party receiving the transfer. Again, the worst possible outcome for any tax professional would be to have the IRS treat a transfer differently than what was intended and for that treatment to result in a negative tax consequence for the client.

NOTES

78 IRS Pub. 504 (2016); Kane, "Pay Your Lawyer and Get a Deduction," Linkedin, 3/23/17, www.linkedin.com/pulse/pay-your-lawyer-get-deduction-gary-kane.
79 *Id.*
80 *Id.*
81 *Id.*
82 *Id.* Section 212.
83 IRS Pub. 504 (2016); Kane, note 78, *supra*.
84 *Id.*
85 *Id.*
86 *Id.*
87 *Id.* IRS Pub. 515 (2016).
88 *Id.*
89 *Id.*
90 IRS Pub. 504 (2016). IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities* (2016).
91 *Id.*
92 IRS Pub. 504 (2016).
93 *Id.*
94 *Id.*
95 *Id.*
96 *Id.*