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MARITAL PROPERTY

THE TAX CONSEQUENCES OF DIVIDING MARITAL PROPERTY

Family law attorneys assisting taxpayers going through a divorce should collaborate with tax professionals who understand the tax implications of dividing marital property.

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Family law is extremely complex because it involves the interplay of the law, emotions, family dynamics, finance, and taxation, among other things. It is not possible for a family law attorney to have all of the knowledge and skills necessary to provide clients with quality service, unless he recognizes his limitations. The bottom line is that the attorney does not know what he does not know and his clients and their families should not be harmed as a result of this lack of knowledge and skills.

New articles appear almost daily touting the benefits of collaboration in a business context. One of the most recent high-profile examples is what Tim Cook has accomplished as Apple's CEO. Although the collaboration process does exist within the context of family law, that is not the topic of this article. Rather, it addresses some of the adverse consequences that can occur when family law attorneys do not understand the Code and fail to collaborate with a tax professional. "Lack of effective collaboration is a serious risk factor for failure, and a serious risk factor for tragic consequences . . . .Collaboration is not just using project management, teamwork, or collaborative tools . . . Just about every collaborative appearing behavior and process can readily be part of non-collaboration, and sometimes even part of predation."[1] This article discusses collaboration as a concept. As Sam Palmisano, Chairman, President, and CEO of IBM said, "The nature of innovation—the inherent definition of innovation—has changed today from what it was in the past. It's no longer individuals toiling in a laboratory, coming up with some great invention. It's not an individual. It's individuals. It's multidisciplinary. It's global. It's collaborative.'[2]

Tax basis effects economic value

When marital property is divided in a divorce, the spouse that receives any given asset also takes the carryover basis in that asset.[3] Failing to consider the tax and economic effects of the property's carryover basis can have severe consequences.

Example.

Lucy and Ricky divided their marital estate during their divorce. The estate included the following publicly traded common stock:

- 1,000 shares of ABC Company that was given to them as a wedding present 30 years ago. The fair market value (FMV) at the time of division was $100,000.
- 1,000 shares of XYZ company that they purchased for $100,000 shortly before their divorce, which retained the same value at the time of the divorce.

Because the FMV of both stocks was the same, Lucy and Ricky agreed that she would take the ABC stock and he would take the XYZ stock. They both subsequently liquidated their holdings in their respective stocks. The following February, Lucy's tax advisor determined that the ABC stock's basis was $10,000 at the time of the gift. Sections 1015(a) and 1015(d) provide that for purposes of determining gain, when property is acquired by gift, the property's basis will be the donor's basis plus gift tax attributed (if any) to the property.

Lucy and Ricky were both in the combined 30% capital gain marginal tax bracket (20% federal and 10% state), so they paid tax on the stock disposition as shown in Exhibit 1.

Exhibit 1

Tax on the disposition of stock

1 Willis, *Power through Collaboration—When to Collaborate, Negotiate, or Dominate!*, (Willis Consulting LLC, 2012).

2 "The IBM Global CEO Study—Expanding the Innovation Horizon," IBM Global Services, (Somers, 2006).

3 Temp. Reg. 1.1041-1 T(d).

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	Lucy	Ricky
Stock basis	$10,000	$100,000
Sale proceeds	$100,000	$100,000
Realized and recognized gain	$90,000	0
Combined tax rate	30%	30%
Tax	$30,000	0

The property's basis should clearly always be taken into consideration when a marital estate is divided. By failing to do so in the above example, Lucy received stock with an after-tax value of almost 1/3 less than Ricky's stock, even though the FMV was identical. Also, inquiries should be made about recapture items, such as depreciation and tax credits, because the transferee receives the property subject to all recapture rules. This means that property may be taxed as income or ordinary gain, rather than capital gain. If property is fully depreciated for far more than its current value, the amount of some or all of the depreciation taken on the property could be taxed as income. For example, if property used in a trade or business is distributed during its useful depreciable life, it might be necessary to recapture any Section 179 depreciation taken on the property. A Section 179 election is commonly used to expense immediately (rather than depreciate) certain assets used in a trade or business.

Distributing such property to a spouse who was not active in the family trade or business can trigger hundreds of thousands of dollars in unexpected tax via depreciation recapture. Also, if the family business was operated as a C corporation, a property distribution may easily be characterized as dividend income. Thus, the property could carry the double tax curse of income via depreciation recapture and characterization as ordinary dividend income. The combined federal and state tax burden could completely eliminate any ownership benefits to the receiving spouse.

Liabilities in excess of basis

Section 1041 governs the transfer of property in divorce. As a general rule, there is no gain or loss recognized on divorce-related transfers, and the tax basis is carried over to the spouse receiving the property.

However, extreme caution should be taken when encumbered property is transferred. Failing to consider the future tax consequences of the ratio between a property's basis and its liabilities can lead to financial disaster. For example, Ricky and Lucy's divorce involved land with a basis of $100,000 and FMV of $1 million. The land was awarded to Lucy as part of the property settlement. It was encumbered by a $900,000 mortgage. Even though Ricky is relieved of a $400,000[4] liability in excess of his basis, there is no tax on this transfer because it falls under Section 1041.

Shortly after the divorce, Lucy sells the property for $1 million. If she is subject to a combined state and federal capital gains tax rate of 30%, the tax result of the transaction would be as follows:

Sale price	$1,000,000
Basis	$100,000
Realized gain	$900,000
Tax rate	30%
Tax due	$270,000

Because the property was heavily encumbered, Lucy will realize only $100,000 cash from the sale ($1 million sales price - 900,000 mortgage). This will be insufficient to pay the tax due:

Tax due on sale	$270,000
Cash received from sale	100,000

$1 million sales price - $900,000 mortgage = $100,000 net cash received.

4 ($900,000 mortgage - $100,000 basis)/2 = $400,000. Community property interest = $400,000 liability in excess of basis.

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Shortfall	$170,000

It is essential to be aware of not only the above adverse tax liability vs. net cash realized outcome, but also the exceptions to Section 1041 that involve the transfer of assets in which liabilities exceed basis.

When property with liabilities in excess of basis is transferred to a trust, the transferring spouse will recognize gain if the trust assumes the liabilities.[5] The transferring spouse must recognize immediate gain on the excess of the liabilities over basis.

Example.

Ricky owned land as separate property and his basis was $50,000. The land had a FMV of $120,000 and was subject to an $80,000 mortgage. Lucy received the property in the divorce as part of a global settlement agreement.

In accordance with the agreement, the land was transferred to a nongrantor trust for Lucy's benefit with the trust assuming all of the property's liabilities. As a result, Ricky recognized a $30,000 capital gain in the year of transfer:

Land basis	$50,000
Mortgage	$80,000
Liability in excess of basis	$(30,000)

The trust's basis in the property was then increased by the $30,000 gain that Ricky recognized.

Another situation that can occur during a divorce and trigger immediate tax consequences is the transfer of an installment note payable to a trust. The transferring spouse recognizes any untaxed gain, and the trust's tax basis in the installment note is increased by the gain recognized on the transfer. Thus, the transferring spouse gets the worst of both worlds.

Example.

Ricky owns as separate property the right to receive ten payments of $100,000 each for the sale of his interest in the Tropicana Night Club. The face amount of the installment obligation is $600,000 and the deferred gain is $400,000. Ricky transfers the installment note receivable to a trust (The Lucy Trust) for Lucy's benefit. In the year of the transfer, Ricky must recognize the deferred gain of $400,000 as taxable income even though he will not receive the cash.

Neither Lucy nor the Lucy Trust will recognize any taxable gain on the transfer, and the trust's basis in the installment note will increase by the $400,000 gain that Ricky recognized. The result is a tax windfall for Lucy—and a disaster for Ricky.

Practice suggestion.

When dealing with trusts in a divorce, be certain to evaluate the tax implications of property transfers. In addition to immediate income tax consequences, property transfers to and from trusts may have serious estate and gift tax consequences.

Dividing passive activity losses

The Tax Reform Act of 1986 created Section 469, which is a set of complex rules designed to limit the use of losses and credits from passive investments. With limited exception, passive losses are deductible only to the extent that the taxpayer has passive income. Passive losses that are not deducted in the current year may be accumulated and carried forward to future years and are referred to as suspended losses.

Passive losses can be generated from the ownership of rental property or interests in S corporations, partnerships, limited liability companies and other forms of business in which the owner does not actively participate. It is not unusual for passive losses to accumulate over the years into the hundreds of thousands, or even millions, of dollars. The tax benefit of these losses can be enormous and carry significant economic value. The published guidance on the transfer of passive loss carryovers in divorce is anything but voluminous. However, Section 469(j)(6) clearly provides that when a passive activity is disposed of by a gift, the suspended losses are added to the basis of the activity immediately prior to the gift. Section 1041(b)(1) states that in the hands of the recipient, property transferred incident to divorce

5 Section 1041(e).

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will be treated as acquired by gift. Moreover, Sections 469(j)(6) and 1041(b)(1) taken together indicate that a spouse may use the suspended losses only to the extent of their original ownership in the passive activity.

Therefore, when passive activity is divided differently in divorce than the respective ownership during marriage, the associated suspended losses may not be used to offset passive income in future years. Instead the basis in the passive activity is increased by the amount of that portion of the suspended losses. Even when added to the basis of the property, the losses can have significant economic value that should be taken into consideration when dividing a marital estate.

Special rules apply to S corporation losses when stock is transferred between spouses after 2004. Any suspended losses associated with the stock belong to the spouse who receives the stock.[6] In short, the loss follows the stock.

Example.

Lucy and Ricky are divorcing. Lucy owns 50 shares of Ethel Company stock, which is a calendar-year S corporation. The company has not been profitable in recent years and has passed through $100,000 in losses that Lucy has not been able to deduct because of a lack of basis. The shares are transferred to Ricky as part of the divorce property settlement. The $100,000 suspended loss associated with the stock now belongs to Ricky. The company's fortunes subsequently improve and in the second year after the divorce, the company passes through $125,000 in profits to Ricky.

Assuming that he otherwise qualifies, Ricky can deduct the $100,000 passive loss carryover against the $125,000 in current-year income. The result is that Ricky will recognize $25,000 in net passive income for the year.

Conclusion

The primary aim of this article was to provide a better understanding of the interplay between family law and taxation issues and encourage more multidisciplinary collaboration. Clients should not be affected negatively because their attorneys do not know what they do not know, and attorneys should not risk malpractice actions as a result. The time has come for the legal community to embrace the power of collaboration for everyone's benefit.

Failing to consider the tax and economic effects of the property's carryover basis can have severe consequences.

In addition to immediate income tax consequences, property transfers to and from trusts may have serious estate and gift tax consequences.

6 Section 1366(d)(2)(B).