

Cantor Forensic Accounting, PLLC
1490 S. Price Rd. Suite 308
Chandler, AZ 85286
480-448-9904
david@dscfac.com
www.dscfac.com

Property Distributions And Income Taxes

As everyone is aware, property transfers related to a divorce proceeding are generally tax free. However, it does not end there. There are often times when these tax free exchanges will result in income taxes down the road. It is important to look at the long term implications of property divisions to ensure that your clients are aware that although there are no tax liabilities today, there may be future tax liabilities on the property being divided today.

Internal Revenue Code §1041 states “No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) – a spouse or a former spouse, but only if the transfer is incident to the divorce”. In addition, the transferor’s tax basis is carried over to the recipient. IRC §1041 is **MANDATORY** and taxpayers cannot elect out of it.

David Cantor, CPA/ABV has been working almost exclusively in Family Law Accounting since 1990 in both Arizona and California.

He has worked on over 1,000 Family Law cases and has experience in all aspects of Family Law Accounting including Business Valuations, Separate Property Tracings, Calculation of Income for Purposes of Determining Maintenance and Support as well as many other financial issues.

Mr. Cantor has testified in Court over 100 times as an expert witness.



In determining if the transfer is related to a divorce, the IRS actually will look at the timing of the transfer.

- Any transfer made within one year of the finalization of the divorce is incident to the divorce. The transfer does not even have to be required by the Court Decree or Settlement Agreement.
- Any transfer made within six years of the finalization of the divorce is presumed to be incident to the divorce. In this case, the transfers must be pursuant to the Court Decree or Settlement Agreement. If there is interest paid by the transferor to the transferee related to delays in transferring the property in question, the interest is taxable income to the recipient.
- Transfers made after six years of the finalization of the divorce are presumed not to be related to the divorce. However, the presumption may be rebutted if the spouses can show that there were extenuating circumstances that prevented the property from being divided earlier and that as soon as those circumstances were rectified, the transfer was made as soon as possible.

As always, there may be unique situations where there are exceptions to IRC §1041 and those would need to be addressed on a case by case basis, but these situations are rare.

The tax implications can raise their head years later, and potentially have a significant impact on the ultimate property division. This is why it is important to pay attention to the components of the division as well as the possible future tax impact. There is the potential for some drastic consequences if the future tax issue is ignored.

As a practice tip, if your client is receiving an asset with a potential future tax gain (remember, the recipient of the asset does NOT get a step up in basis), the burden will be on your client to have the proof of the tax basis and holding period when that asset is sold. By way of example, if your client is the out-spouse and is receiving the residence that has already appreciated to the point of there being a reportable taxable gain, you should assist your client in obtaining all of the records necessary to justify the basis in the house during the divorce proceeding (i.e. purchase escrow documents, records of improvements, etc.).

Drastic Example:

During marriage, parties purchased a \$100,000 apartment complex. Over time, the complex was depreciated for tax purposes down to \$10,000 (adjusted tax basis), but it appreciated to \$1,000,000 and was subsequently refinanced for an \$800,000 interest only loan, leaving a current net equity in the complex is \$200,000. The only other asset in the divorce is \$200,000 in cash. The couple agrees that husband will take the cash of \$200,000 and wife will take the complex with a value of \$200,000 (and an adjusted tax basis of \$10,000). We now have an equal distribution of the assets. A year later, the wife needs to sell the complex. Assuming she sells it for \$1,000,000 net of expenses, after the mortgage is paid off, she is left with \$200,000. All is good and the property division is still equal.....until the following April 15. Wife will now have to report a taxable gain of \$990,000, with a resulting combined federal and state tax liability that could potentially be as high as \$325,000 give or take. So her net result in the divorce will be a negative \$125,000 after she pays the taxes. Not so equal anymore.

FREE CLE CLASSES IN YOUR OFFICE

Cantor Forensic Accounting offers free 2 hour CLE* classes at your office. Working with you, I can customize a class on any Family Law accounting issue to meet your office needs and fulfill a minimum of two hours of CLE. Topics can include:

- ◆ Business valuation issues related to marital dissolutions
- ◆ Calculation of income
- ◆ Separate property tracing
- ◆ Document requests
- ◆ Marital Standard of Living
- ◆ Income tax issues related to marital dissolutions
- ◆ Reimbursement claims
- ◆ Stock option allocations

Please call David to receive more information on these classes.

*The State Bar of Arizona does not approve or accredit CLE activities for the Mandatory Continuing Education requirements of Specialists. This activity may qualify for up to two hours toward your annual CLE requirement for the State of Arizona, including two hours of advanced level training in the area of Family Law. A minimum of 5 attorneys are required to attend.

Some ways to avoid this issue are to divide potential taxable assets in kind. Stocks held in brokerage accounts or investments in passive activities can be split 50/50 so that each party will receive the same value, with the same basis and be responsible for their own tax liability. If an asset is going to be sold by one party in the near future, there can be an adjustment made to the value of that asset to approximate the potential taxes, but this would be speculative and if the sale didn't happen as planned, one party may end up at a financial disadvantage.

The bottom line is that when you are dealing with appreciated assets in a divorce, you need to keep in mind the future tax liabilities to better assist your client.

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