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# Transfer of Marital Property in a Divorce Proceeding

When Section 1041 was added to the Internal Revenue Code as part of the Domestic Relations Tax Reform Act in 1984, the rules concerning federal taxation of transfers of marital property were greatly simplified. Transfers of property between spouses during marriage or divorce became "nonrecognition" events. What does this mean for persons who are considering or involved in a divorce? The purpose of this article is to summarize how 1041 applies to the most common transfers of property during divorce.

**FACTS:** In their divorce, Herbert and Wanda agree to exchange their assets: W is to receive the residence, which was purchased for \$250,000, with an outstanding mortgage of \$150,000 and an appraised or fair market value at the time of divorce of \$400,000. H is to receive all of the stock in H&W, their business, whose total value might be \$80,000-\$140,000; H also is to receive their rental property, with a mortgage of \$250,00, and an appraised or fair market value of \$450,000. H agrees to pay W \$20,000 (to resolve their dispute over the business/stock's value.)

**QUESTION:** What taxes, if any, will Herbert or Wanda pay?

IRC Section 1041 provides that "No gain or loss shall be recognized on the transfer of property between spouses or incident to a divorce."

1. A transfer of property is "incident to a divorce" if: (1) the transfer occurs within one year of the date on which the marriage ends, by divorce or decree of annulment, determined by reference to state law; or (2) the transfer is "related to the cessation of the marriage." (A transfer to a nonresident alien spouse does not qualify.)

IRS regulations define "related to the cessation of the marriage." A transfer will be treated as "related to the cessation of marriage" if made under a divorce or separation agreement, and

made not more than six years after the marriage ceases. The IRS, perhaps acknowledging that the dissolution of a marriage is an emotional event, often involving children, and perhaps outside the control of at least one of the parties, provides that where a transfer is delayed beyond six years, the transfer may, nevertheless qualify. The taxpayer must demonstrate: (1) the delay was caused by a legal or business impediment to the transfer, or (2) a dispute about valuation of the property, and (3) the transfer was made promptly after the impediment/dispute no longer existed. Thus, if the parties stipulate and agree and/or the Court orders that the marital residence not be transferred until the youngest child is in high-school, or a business cannot be sold because the buyer cancels, the transfer may qualify for 1041 treatment.

2. A qualifying transfer is no longer treated as a sale, which was the rule prior to 1984 under *US vs. Davis* 370 U.S. 65 (1962). Rather, because the transfer is a "non-recognition" event, the transferor does not recognize any gain or loss, regardless of the type of property, or if cash is involved in the transfer to equalize the value of assets transferred.

3. IRC Section 1041 specifically provides that a transfer may qualify for non-recognition treatment if made to a trust for the benefit of a spouse. If as part of a divorce, wife decides to engage in estate planning, and the marital residence is transferred into a family trust where W is the beneficiary, the transfer will qualify as "incident to divorce."

4. The IRS regulations, Regs. Section 1.1041-1T(c), Q&A-9, also provide that a transfer to a third party "on behalf of a spouse" may qualify for non-recognition treatment, in three limited situations: (1) when required by a divorce/separation agreement; (2) when requested in writing by spouse; and (3) where other spouse consents in writing and ratifies the transaction. IRS

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regulations do not define "on behalf of a spouse." Cases construing these terms often focus on whether the transfer satisfies an "obligation" of the spouse because payment was made to a creditor.

5. When a business interest, for example stock in a closely held corporation, is transferred, the application of Section 1041 is uncertain, as legal authority is inconsistent. In *Arnes vs. U.S. 91-IUSTC 50,207 aff'd 981 F.2d 456 (9th cir. 1992)*, Wife transferred her stock in the family corporation which operated a McDonalds back to the corporation, as required by McDonalds' corporate policy that there be a single owner/operator after divorce. The redemption, required by the divorce decree, was held to be non-taxable under Section 1041.

However, in *Blatt vs. Comr. 102 T.C. 77 (1994)*, wife's transfer of her shares to the corporation during the divorce proceeding was found to be "not on behalf of the husband," and therefore section 1041 did not apply. Mr. Blatt, unlike Mr. Arnes, did not personally guarantee the corporation's note, and there was no requirement imposed that the corporation be solely owned after the divorce.

Recently, the Tax Court, in *Read vs. Comr., 114 T.C. 2 (2000)*, addressed a situation similar to Arnes, and imposed a slightly different standard. Husband, in Read (or the corporation if he chose), was required under the divorce judgment to buy wife's shares in their family business; the corporation purchased the shares, and Mr. Read, like Mr. Arnes, guaranteed payment of the redemption note. The court decided that the transfer did not satisfy any obligation of husband, but held that the transfer was a transfer within Section 1041 and not taxable to Mrs. Read because Mrs. Read "in making the transfer," was "acting as a representative of the nontransferring spouse."

6. The transferee, the spouse receiving property (or cash for property), is treated as having received the property by gift, and reports no income. The transferee takes the property with the basis at the time of the transfer. This "carry-over" rule applies in all cases where the spouse receives property, and differs from the normal rules for gifts found in IRC Section 1015(e). The transferee's basis is not limited to the fair market value — the adjusted basis carries over even if the property has liabil-

ities in excess of basis, including a liability that is incurred as part of the divorce settlement.

How do these rules apply to the fact and example above?

1. Transfer of community residence: Wanda receives property — equity of \$250,000 — with no income tax consequence. However, if Wanda were later to sell the property, consultation with a tax professional is advised, as her basis in the property is \$250,000, and the exclusion for capital gains under IRC Section 121 may not exempt all gain if the property appreciates.

2. Transfer of stock: If the stock is transferred by Wanda to Herbert directly, no tax consequences. If the stock is transferred to H&W, or H&W pays Wanda on Herbert's behalf — consultation with a tax specialist is mandatory.

3. Transfer of rental property: No tax. But watch out for capital gains if/when Herbert sells. We don't know what the basis is at time of transfer, as the property probably was depreciated. Transfers under Section 1041 do not recapture prior depreciation.

4. Transfer/receipt of cash. No tax — unless recharacterized by the IRS as "alimony" because the divorce decree or judgment did not identify the payment as required to equalize the division of the community, or marital property.

Summarizing: Most transfers of property during divorce fall within Section 1041, and result in no income tax consequences. However, expert advice should be sought if there is a possibility of later capital gains/losses, or if business property or depreciated property is involved. Because of the "carry-over basis" rule and other regulations, tax planning may result in a different overall settlement, and perhaps tax savings to both parties.



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