Tax Planning For Divorce

© 2013[1] David L. Silverman, J.D., LL.M. (Taxation)
Law Offices of David L. Silverman
2001 Marcus Avenue, Suite 265A South
Lake Success, NY 11042 (516) 466-5900
www.nytaxattorney.com
dsilverman@nytaxattorney.com
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Law Offices of David L. Silverman
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www.nytaxattorney.com
dsilverman@nytaxattorney.com
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I. Introduction. In an action for divorce, property is subject to “equitable distribution” pursuant to Domestic Relations Law (DRL) §236. New York distinguishes between “marital” property, which is subject to equitable distribution, and “separate” property, which is not. The distinction is crucial, because the Court of Appeals has held that marital property includes items that under the common law would be considered the separate property of one spouse. A common example would be a professional license. In *O’Brien v. O’Brien*, 66 NY2d 576 (1985), the Court of Appeals held that a professional license or the value of a professional career constitutes marital property. The trend of the cases expands the concept of marital property and circumscribes that of separate property.

A. Separate Property May Be Transformed Into Marital Property. Some qualification is necessary: Even though property may begin its life during marriage as separate property, it may be transformed into marital property upon the occurrence of an event. For example, if separate property is retitled during marriage, it will become marital property. Another act that will result in the creation of marital property is the commingling of assets.

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3 David L. Silverman graduated from Columbia Law School and received an LL.M. in Taxation from NYU School of Law. He was formerly associated with Pryor Cashman, LLP, and is a former editor of the ABA Taxation Section Newsletter. Mr. Silverman practices encompasses all areas of federal and New York State taxation, including tax and estate planning, federal and NYS tax litigation and appellate advocacy, criminal tax, probate and estate administration, wills and trusts, will contests, trust accounting, like kind exchanges, asset protection, real estate transactions, and family business succession. Mr. Silverman is the author of *Like Kind Exchanges of Real Estate Under IRC §1031* (*Rev’d*, 2013), now in its third edition, and other tax publications. Mr. Silverman writes and lectures frequently to tax professionals in his areas of practice. His office also publishes *Tax News & Comment*, a federal tax quarterly journal. Articles, treatises and publications may be viewed at www.nytaxattorney.com.

B. Importance of Prenuptial Agreement. The issue of whether property is commingled is one of fact. A prenuptial agreement may clarify whether specific property is or is not separate property. If no prenuptial agreement is in place, then it is especially important for that separate property not to be commingled, if an important objective of the spouse is to preserve the nature of separate property. If, for example, a spouse applied an inheritance to purchasing a marital residence, the residence would by virtue of taking title to the property jointly, becomes marital property.

C. Appreciation of Separate Property as Marital Property. Another important point regarding the character of separate property relates to the distinction between separate property an the appreciation in value of separate property during marriage: Although the *property itself* may be separate property*, appreciation in the value of separate property* may be *marital property*. In general, passive appreciation in separate property will not cause that property to transmute into marital property. However, the *active participation* of a spouse in connection with the business of separate property may cause the *appreciation on the property* to become marital property. In *Price v. Price*, 69 NY2d 8 (1986), the Court of Appeals held that where separate property has increased in value because of the efforts of the titled spouse, the non-titled spouse may claim some of the appreciation through that person's "contribution or efforts," including being a parent and homemaker.

D. Failure of Prenuptial Agreement. It is important to remember that the equitable distribution law is the default rule. As in other legal contexts, the parties are free to alter the default rule by executing a prenuptial or postnuptial agreement. However, prenuptial agreements are made to be challenged, and one entering a marriage in New York should be aware that New York courts have shown little tolerance for, and have refused to place a judicial *imprimatur* on, not only agreements that are unconscionable, but also on agreements which are not unconscionable *per se*, but are the product of one-sidedness in the negotiation process. The element of surprise is also a factor which could militate against the enforcement of an otherwise unobjectionable prenuptial agreement.

E. Asset Protection Methods. One method of fortifying the asset protection intended by a prenuptial agreement is to utilize a trust funded by a parent, or by implementing a self-settled trust established in another jurisdiction, such as Delaware or Nevada, that recognizes the right of a settlor to establish a self-settled spendthrift trust. New York does not recognize the validity of self-settled spendthrift trust.

II. Taxation of Alimony. IRC §71, as amended by the Deficit Reduction Act of 1984, applies to payments made under a divorce or separation instrument entered or executed after December 31, 1984. Under IRC §71**,** alimony payments are includible in income of the recipient spouse. IRC §215 grants the paying spouse a corresponding deduction. However, designating a payment as "alimony" is not sufficient to invoke the tax treatment of Sections 71 and 215.

A. **Summary of Requirements for a Payment to be "Alimony."** For alimony payments to be deductible by the paying spouse for federal income tax purposes, the following requirements must be met:

1. The payment is made in cash;

2. The payment must be made pursuant to a divorce or separation agreement;

3. The payment is received by (or on behalf of a spouse) under a divorce or written separation instrument;

4. If the spouses are divorced or legally separated, they reside in separate households when payment is made;

5. If payments are made to a third party, those on behalf of the payee spouse are must be evidenced by a timely executed writing;

6. The payor spouse's liability to make the payment must not continue for any period after the payee spouse's death;

7. The payor and payee (if married) must not file a joint return;

8. The divorce or separation instrument must not designate non-alimony treatment;

9. The payments must not be for child support; and

10. The payments may not be "front loaded."

B. Payment Must Be in Cash. The term "cash" includes currency, checks, or money orders payable on demand. Treas. Reg. §1.71-1T(b)(A-5).

C. Pursuant to a Divorce or Separation Agreement. For a payment to a former spouse to be treated as alimony, there must be an obligation to pay. That obligation may arise by a decree of divorce, or by an agreement for separate maintenance. IRC §71(b)(2). Payments made prior to the time an agreement or decree is executed or entered are considered voluntary payments, except if the Court issuing the decree makes the ruling nunc pro tunc. Rev. Rul. 71-416. Voluntary payments, even if they meet the other criteria for alimony, may not be treated as alimony.

D. **Former Spouses Must Live Apart.** IRC §71(b)(1)(C) provides that former spouses may not be "members of the same household" at the time of payment. Treas. Regs. §1.71-1T(b), Q & A-9 states that this requirement is only met if the former spouses live in separate dwellings. However, the requirement of separate dwellings applies only to divorced or legally separated spouses. Payments pursuant to a memorialized separation agreement or a support order can qualify as alimony even if the parties live in the same dwelling. IRC §§71(b)(2)(B), (C).

E. **Payments to Third Party Must be Evidenced by a Writing.** Payments on behalf of the payee spouse may qualify as alimony. For example, cash payments of rent, mortgage, tax or tuition liabilities of the payee spouse made under the terms of the divorce or separation instrument will qualify as alimony, provided the other requirements for alimony have been met. Such payments must be made at the written request, consent or ratification of the spouse for whom such payments are being made. Treas. Regs. §1.71-1T(b), Q & A-7.

F. **Payments Must Cease Upon Death of Payee Spouse.** IRC §71(b)(1)(D) provides that for a payment to be defined as "alimony," there must be "no liability to make any such payment for any period after the death of the payee spouse and . . . no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse." Thus, divorce instruments establishing alimony payments should clearly state that the duty to pay alimony is terminable upon the death of the payee, and that there shall be not be substitute payments in cash or property following the death of the payee. Note, however, that there is no corresponding limitation with respect to the payor spouse: The payor's estate may continue to be obligated under the terms of the divorce agreement.

G. **There Must Have Been No Non-Alimony Election.** Even though payments will fail to qualify as alimony if the requirements are not met, and therefore the parties may essentially elect non-alimony treatment by not complying with the sundry statutory requirements, the parties may also affirmatively elect non-alimony treatment. Furthermore, Treas. Regs. §1.71-1T(b), Q & A-8, states that if a written separation agreement or temporary order providing for alimony payments fails to state that the parties do not desire non-alimony treatment, they may nevertheless do so by the expedient of executing a signed writing at a later time referencing the original divorce agreement and clarifying that non-alimony treatment is desired under Sections 71 and 215.

H. **Payments Must Not be for Child Support.** IRC §71(c)(1) provides that payments to a recipient spouse will not be treated as "alimony" to the extent that any portion of that payment is fixed as a sum payable for the support of the children of the payor spouse. Treas. Regs. §1.71-1T(c), Q&A-16 provides that a payment is fixed as payable for the support of a child if the divorce agreement specifically designates some sum or portion as payable for the support of a child. Where a contingency relating to the child reduces a payment, the payment may also be designated as child support. Treas. Regs. §1.71-1T(c), Q&A-17 provides that a contingency relates to a child if it depends on any event relating to that child, regardless of whether such event is certain or likely to occur. Events that relate to the child include a child reaching a certain age or income level, marrying, graduating or departing from school, death of the child, or leaving the spouse's household.

1. **Six Month Presumption.** Treas. Regs. §1.71-1T(c), Q&A 18 provides a presumption that payments ending within six months of an identifiable contingency relating to the child will be considered as child support. To avoid the presumption, the parties may purposely state that the reduction is not conditioned on a contingency relating to the child.

I. **Alimony Payments Must Not Be Not "Front Loaded."** IRC §71(f) provides a formula for recapturing as income payments that diminish rapidly after the first year. Those payments are recharacterized as being non-deductible for the payor, and not includible for the payee. Recharacterization is intended to discourage divorcing parties from attempting to gain a tax benefit in the form of a deduction for the payor, from property transfers that would otherwise have no income tax consequences. Recapture can be avoided if payments diminish by no more than $15,000 in each of years two and three.

1. **Example.** Husband is required to make the alimony payments:

   (1) Year 1: $100,000
   (2) Year 2: $50,000
   (3) Year 3: -0-

b. **Year 2 Excess Alimony Payment**[4] = Year 2 alimony payment - (Year 3 alimony payment + $15,000).

   (1) Year 2 Excess Alimony Payment = $35,000

c. **Year 1 Excess Alimony Payment[5] = Year 1 Alimony Payment - [(Year 2 payment - Year 2 Excess Payment) + Year 3 Payment]/2 + $15,000**.

d. **Year 1 Excess Alimony Payment** = $100,000 - [($50,000 - $35,000)/2] + $15,000

e. **Year 1 Excess Alimony Payment = $77,500.**

f. **Year 3 Recaptured Amount = Year 2 Excess Alimony + Year 1 Excess Alimony.**

g. **Tax Reporting Result:**

   (1) Payor deducts $100,000 in Year 1 and $50,000 in Year 2 (actual payments made). Payee reports $100,000 in Year 1 and $50,000 in Year 2 (actual payments received).

   (2) Payor reports excess alimony payments of $112,500 in Year 3, and Payee deducts $112,500 in Year 3.

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4 The permitted reduction is Year 2 to Year 3 is $15,000. Anything above $15,000 is "excess."

5 Excess Year 1 alimony is defined as (i) Year 1 alimony payments less (ii) (Year 2 payments less Year 2 excess payments) over 2 (iii) plus $15,000.

2. **Recapture Exceptions.** There are three exceptions that recognize that a diminution in payments may be the result of something other than a disguised property transfer.

   a. Payments that cease because of the death of either party'[6];

   b. Payments cease upon remarriage of payee[7];

   c. Payments made under court order;[8] or

   d. Payments set as a percentage of income or based upon the compensation of the payor[9].

J. **Flexibility of IRC §71.** Section 71 provides divorcing spouses with considerable flexibility. By structuring support obligations to continue beyond what would normally be a terminating event, difficulties associated with illiquid marital estates may be alleviated. Or, if the parties contemplate that payments should diminish as children mature, the regulations provide a safe harbor preventing the application of IRC §71(c), which would otherwise nullify the deduction by recharacterizing the payments as one for child support. The structuring of alimony payments thus presents an opportunity to achieve a fair and tax-favored result for both parties.

III. **Property Transfers Between Divorcing Spouses**. The Code addresses the issue of whether property transfers between divorcing spouses are subject to income tax, or are gratuitous transfers potentially subject to gift tax. In general, Congress has decided to grant divorcing spouses a tax pass. With proper planning, most transfers between divorcing spouses should not result in income tax liability, nor should they result in the transfer being subject to the gift tax. Note that we are not speaking of alimony or child support *payments*, which indeed have income tax consequences, but rather the taxation of *property transfers* between divorcing spouses, such as the transfer of a marital residence, which would otherwise result in a sale or exchange under IRC §1001(a), resulting in capital gain under IRC §1221 if the

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6 IRC §71(f)(5)(A)(i),(ii).

7 IRC §71(f)(5)(i),(ii).

8 IRC §71(b)(2)(C).

9 IRC §71(f)(5)(C).

property is a capital asset, or ordinary income under IRC §61, if it is not. IRC §61(a) imposes income tax on all income from whatever source.

A. **IRC § 1041 Narrowly Defined.** It should be noted that IRC §1041 applies only to transfers between spouses and divorcing spouses *themselves*. Thus, the transfer by one spouse of shares of a closely held family entity would not be within IRC §1041 and would result in a sale and exchange with the normal attendant requirement of reporting capital gain or ordinary income on the exchange, depending upon the nature of the property transaction. Section 1041 also overrides some other tax rules. For example, Rev. Rul. 2002-22 held that the assignment of income doctrine is inapplicable with respect to transfers of nonstatutory stock options or rights to deferred compensation between divorcing spouses. Instead, IRC §1041 dictates the counterintuitive tax result that the recipient spouse will be taxed when the options are exercised or the deferred compensation is received.

B. **Transfer of Property Defined.** A "transfer" of property occurs either when there is a transfer of title or a shift of the benefits and burden of ownership. IRC §1041 includes all property in the marital estate that is transferred between spouses because of divorce. Property cannot be selected for Section 1041 treatment because this section is mandatory for all transferred property. In *Grodt & McKay Realty, Inc.*, 77 T.C. 1221 (1981) the Tax Court stated that when considering whether a transfer has occurred for tax purposes, the Service is not limited by the four corners of any particular agreement, but instead must consider all surrounding circumstances, including the terms of any side agreements or related contracts.

    1. **Factors to be Considered.** The Tax Court listed the following factors that should be considered in determining whether there has been a sale: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity is acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.

C. **Nonrecognition Extends to Divorced Spouses.** Section 1041(a) provides that no gain or loss is recognized on the transfer of property between spouses. Section 1041(a)(2) adds the same benign rule to **former spouses**, provided the transfer is **"incident to divorce."** Section 1041 provides that no gain or loss is recognized on a transfer of property from a spouse or a former spouse to a spouse or former spouse if the transfer is incident to a divorce. The tax treatment described by this section is mandatory and applicable to U.S. citizens and resident aliens. The parties cannot elect out of it. The section is applicable even if the spouse or former spouse pays consideration for the property by giving up rights, transferring other property, or paying cash.

D. Definition of Term "Incident to Divorce" Elaborated in Code and Regulations.

1. **IRC §1041(c) Safe Harbor**. For a transfer to "incident to divorce," IRC §1041(c) provides that the transfer must occur "within 1 year after the date on which the marriage ceases," **or much more liberally,** that the transfer **(merely be) "[be] related to the cessation of the marriage."** Since the one year safe harbor rule may be difficult to meet, the cynosure must often be on whether the requirement that transfer be "related to the cessation of the marriage" has been satisfied.

   a. **Treasury Regulations View of Term Related to Cessation of Marriage."** Treas. Reg. §1041-1T, Q & A 7 provides that a transfer of property "is treated as related to the cessation of the marriage if the transfer **is pursuant to a divorce or separation agreement[10]. . .and the transfer occurs not more than 6 years after the date on which the marriage ceases."**

      (1) **Presumption Arises Against Taxpayer if Transfer Not Within 6 Years.** The Regulations add that "any transfer not pursuant to a divorce or separation agreement and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage.

         (a) **Rebuttal of Presumption.** The presumption may be rebutted by proof showing that the transfer was not made within the prescribed time period because of factors which "hampered an earlier transfer . . . such as a legal or business impediment," and that transfer was "effected promptly after the impediment to transfer [was] removed."

2. **IRC §1041(c) Inconsistent With Regulation.** Treas. Reg. §1.1041-1T[11], Q & A 7 appears to impose a stricter definition of "incident to divorce" than IRC §1041(c) – the statute itself – for the first year after cessation of the

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10 This requirement is not within the statutory dictates of Section 1041. This conflict is addressed below.

11 Temporary regulations have the same force of law as do final regulations. Proposed regulations are generally not binding on the IRS or the taxpayer.

marriage by creating a presumption that a property transfer not pursuant to a divorce or separation agreement is not related to the cessation of the marriage.

a. **Administrative Regulations.** Since IRC §1041 does not expressly direct the Treasury to implement regulations in furtherance of the statute, the Regulations under Section 1041 are "administrative regulations." Administrative regulations are less authoritative than legislative regulations[12] which are drafted by Treasury pursuant to a directive contained within the statute itself. In addition, it might be argued that regulations which appear as "questions and answers," as does Treas. Reg. §1041-1T, might be less authoritative than regulations not drafted in question and answer form.

b. **Safest Course.** The safest route for divorcing spouses would be not to rely on the language of Section 1041(c)(1) which blesses transfers between divorced spouses within one year as "incident to divorce," but to memorialize the transfer in a divorce or separation agreement in order to satisfy the stricter requirement found in the regulations.

E. **IRC §1041(b).** IRC §1041(b) places transfers not subject to income tax into a basket of transfers ***potentially*** subject to gift tax. Under the statute, the donee spouse acquires the basis as well as the holding period of the transferor, whether the adjusted basis is less than, equal to, or greater than, the fair market value of the property at the time of transfer. In other contexts, the basis of a donee is determined under Code Section 1015. This difference can be significant in the case of loss property. Where basis is calculated under Code Sec. 1015, the donee's basis for computing loss is limited to the lesser of (i) the fair market value of the property at the time of the gift or (ii) the adjusted basis of the property.

1. **No Cost Basis if IRC §1041 controls.** Even if the transfer constitutes a *bona fide* sale, in a transaction governed by Code Sec. 1041 the transferee does not acquire a cost basis in the transferred property. Treas. Reg. §1.1041-1T(c).

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Legislative regulations generally carry the same weight of authority as the statute itself. Interpretative or Administrative Regulations explain the position of the IRS on various Code sections. Interpretative regulations are issued under the general authority of the IRS to interpret language of the Code, but they are not specifically authorized by statute. Therefore, they are subject to challenge if they violate the statute. Courts deciding tax controversies defer to administrative regulations in a manner similar to that in which courts deciding other controversies defer to administrative regulations of other administrative agencies.

F. **Change in Character of Property.** Taxpayers should be aware that a 1041 exchange may cause side effects, such as a change in the character (as a capital asset or not). For example, assume wife, who owns a Monet sketch which she holds for investment, as part of the divorce agreement, sells the Monet to her husband, who is an art dealer. If the husband later sells the painting at a gain, the gain will be taxed as ordinary income under IRC Section 1221(1). Had wife sold the painting, the gain would have been capital gain. The reverse of this is also true: The character of the property in the event of a later sale or exchange can transmute from ordinary income to capital gain as well.

G. **Recordkeeping.** A transferor is required at the time of §1041 transfer, under Treas. Regs. §1.1041-1T(e), Q & A-14, to provide to the transferee sufficient records to determine the adjusted basis and holding period of the property as of the transfer date.

H. **Tax Planning.** Despite the lack of current tax consequences when intra-spousal transfers are made pursuant to a divorce, tax planning is nevertheless important. If marital assets consist of properties with varying degrees of appreciation, equity would suggest that each party receive a mix of property with the same relative degree of built-in gain. If this is not possible (*e.g.,* one spouse retains the personal residence with a higher basis), the parties may wish to compensate the spouse who takes the lower basis property since the sale of that property will generate future capital gains tax. That compensation would not be gratuitous, and would therefore not be subject to gift tax. If the requirements of IRC §1041 were met, that compensation would also not be subject to income tax. Nonrecognition of both gain and loss under §1041 may be utilized by spouses in different marginal tax brackets to obtain overall tax savings by allocating higher gain assets to the lower bracket spouse and lower gain assets to to the higher-bracket spouse. Even where spouses are in the same marginal income tax bracket, the ability to assign potential gains and losses between themselves may be advantageous.

I. **Examples:**

1. A and B are married and file a joint return. A is the sole owner of a condominium unit. A sale or gift of the condominium from A to B is a transfer which is subject to the rules of Code Sec. 1041. Treas. Reg. §1.1041-1T(a).

2. A and B are married and file separate returns. A is the owner of an

independent sole proprietorship, X Company. In the ordinary course of business, X Company makes a sale of property to B. This sale is a transfer of property between spouses and is subject to the rules of Code Sec. 1041. Note however that if X Company were instead a corporation owned by A, the sale would not be a sale between spouses subject to the rules of Code. Sec. 1041, unless the step-transaction doctrine were invoked. Treas. Reg. §1.1041-1T(a).

3. Taxpayer and spouse enter into a legal separation agreement, the terms of which require the taxpayer to transfer to spouse certain low-basis real property worth approximately $30,000. Taxpayer transfers the real estate, pursuant to the agreement, four years after the final divorce papers are approved by the Court. No gain is recognized. The transfer is related to the cessation of the marriage since it was made pursuant to a divorce or separation instrument and occurred within six years after the date in which the marriage ended. Treas. Reg. §1.1041-1T(b), Q & A # 7. If, however, the transfer occurred seven years after the divorce became final, the transfer would be presumed not to be related to the cessation of the marriage, a presumption that could be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.

4. Taxpayer and spouse own as equal tenants in common a condominium in New York City which has appreciated since it was purchased for $100,000. They are contemplating divorce. Taxpayer sells his interest to spouse for $500,000 in an arm's length transaction. If taxpayer had sold the interest to an outsider, he would have recognized $450,000 of gain. The sale is within Code Sec. 1041, since a "transfer" includes not only a gift, but a sale as well. However, the spouse takes the entire property with a basis of only $100,000. Treas. Reg. §1.1041-1T.

5. Taxpayer and spouse are getting divorced. In structuring their division of property, they should take into account the basis of each item. The division should, if practicable, reflect the bases of all property. If one spouse receives most of the high basis property and the other receives the low basis property, the parties may wish to make an adjustment so that the transferring spouse pays a portion of the capital gains tax to which the property is or may become subject to in the hands of the spouse who acquires predominantly low basis property.

6. Taxpayer decides to elope with her fiancé. However, after a month of marriage, they are advised by their attorney that their marriage in Tahiti was void *ab initio* under New York State law. They decide that the marriage was not meant to be, and part ways. The taxpayer permits his former fiancé to keep a rental apartment, which he owns. The cessation of a marriage that is void *ab initio* under state law is nevertheless considered a divorce within the meaning of Code Sec. 1041. The apartment is treated as a transfer incident to divorce under Code Sec. 1041 from the taxpayer to his former fiancé, who will take a transferred basis in the apartment. Treas. Reg. § 1.1041-1T(b), Q&A #8.

7. Wife owns rental property in Hilton Head worth $300,000 which has been fully depreciated. Wife and husband are contemplating divorce. Wife proposes to sell her interest in the rental property to husband for $225,000 in exchange for his promise not to contest the divorce. Wife would incur a capital gains tax of $75,000 if she sold the property (*i.e.*, unrecaptured Code Sec. 1250 gain taxed at 25 percent; Code Sec. 1(h)(1)(B). The transfer as contemplated would be within Code Sec. 1041 and the wife would not recognize income. The property would be treated as a gift to the taxpayer's spouse, who takes a carryover basis, which is zero. Husband accepts the offer. Since husband will have no depreciable basis he could consider reselling the property for its fair market value of $300,000, payable in installments over ten years, and reporting the gain using the installment method. Since the property was previously depreciated on a straight-line basis, the property would not be subject to "excess" depreciation recapture under Code Sec. 1250. Each year, husband would report $30,000 of capital gain, and would incur a capital gains tax of $7,500. The $22,500 in after-tax cash flow could more than cover the mortgage payments for new rental property. New rental property would also provide depreciation deductions that would offset rental income.

8. Taxpayer and spouse execute a separation agreement. Pursuant to the terms of the agreement, taxpayer is to transfer the marital residence to spouse. The basis of the residence is $100,000, and its fair market value is $1,100,000. Prior to transferring the property, the taxpayer takes out a home equity loan of $1,000,000. Under Code Sec. 1041, since the transfer is incident to divorce, no gain or loss is recognized. This is true even though the equity loan may have been motivated by a desire to reduce income taxes. *See* Treas. Reg. §1.1041-1T(d).

9. Husband owns a rental apartment with a basis of $500,000 and a fair market value of $400,000. In 2013, Husband sells the apartment to Wife for $400,000. Since the transaction is governed by IRC Section 1041, Husband cannot deduct the loss. Wife takes a transferred basis of $500,000. If wife sells the apartment in a month for $375,000, she may deduct a $125,000 loss. Now assume the same facts except Husband gifts apartment to his son. If the son later sells the apartment for $375,000, his loss will be limited to $25,000 under IRC Section 1015(a).

J. Retirement Plans. Qualified retirement plans are subject of a plethora of requirements imposed by the Code, and the simple act of dividing a retirement account between divorcing spouses would without question violate sundry qualified plan rules established in Code Sections 401 through 409 since qualified pension plans are required to contain stringent anti-alienation provisions. The loss of qualified status for a retirement plan would have devastating tax consequences. For this reason, Congress has carved out an exception to the qualified plan rules that would otherwise preclude divorcing spouses from transferring interests in retirement plans.

1. **Qualified Domestic Relations Order.** In accordance with federal law, a New York court may issue a "qualified domestic relations order" (QDRO), which will permit the severance of a qualified plan. If the Order meets federal tax requirements, the result will be that the severance will be deemed not to violate Code provisions that would otherwise result in loss of qualified plan status. If property passes to a spouse without a QDRO, the distribution will be taxable to the account holder, and premature withdrawal penalties will apply if the account owner is under age 59½.

2. **Requirements for Valid QDRO.**

   a. The order must specify the amount or percent of benefits to be paid to the alternate payee.

   b. The order must not change the form of benefit or provide for an increased benefit.

   c. The order should state that it is being established under New York Domestic Relations Law, and in accordance with IRC §414(p). Thus, the spouse may become a co-beneficiary of the retirement account.

K. IRAs & SEPs.

1. **No QDRO Requirement.** No QDRO is necessary to transfer interests in IRAs and Simplified Employee Pension Accounts (SEPs) upon divorce. IRC §408(d) expressly provides for transfers of IRAs between spouses, or between former spouses, if made pursuant to a divorce or separation agreement.

2. **Agreement Language Must be Explicit.** The divorce or separation agreement must expressly state "[a]ny division of property accomplished or facilitated by any transfer of IRA or SEP account funds from one spouse or ex-spouse to the other is deemed to be made pursuant to this divorce settlement and is intended to be tax-free under Section 408(d)(6) of the Internal Revenue Code." If IRA funds are transferred to a spouse without proper memorialization in the divorce agreement, the funds will be immediately taxable to the IRA account holder and may again be subject to an early withdrawal penalty if the IRA account holder is under age 59½.

L. Residences.

1. Possible Local Transfer Tax Liability. The transfer by a divorcing spouse of an interest in a residence will result in no income tax consequences under IRC §1041, provided the requirements discussed earlier are met. Nevertheless, the transfer could result in local transfer tax liability. *See* N.Y.C.R.R. §575.11(a) and *In the Matter of Tobjy*, NYC Tax Appeals Tribunal 93-2128 (1995). If the transfer is structured as a sale with interest payments, and the note is secured by the residence, the IRS has stated that the interest on the note may be deductible. PLR 8928010.

2. Sale of Primary Residence.

a. **IRC §121 Exclusion.** The exclusion of gain rules under IRC §121 are effective with respect to qualifying sales occurring after May 6, 1997. IRC §121 provides for a "rolling" two-year capital gain exclusion allowance of $250,000 per taxpayer resulting from the sale of a primary residence. To exclude gain under §121 (subject to certain limited exceptions) a taxpayer must satisfy the following requirements:

(1) The taxpayer (or, if married taxpayers filing a joint return in the year of sale, his or her spouse) has owned and used the

home as his or her principal residence for periods aggregating two of the five years immediately prior to the sale; and

(2) The taxpayer has not excluded gain under §121 with respect to a sale occurring within the two years immediately proceeding the current sale.

b. **Exceptions.** IRC §121(c) permits a taxpayer who has not owned and used the current home for the past two of five years or who excluded gain on the sale of a former home within two years to exclude a reduced portion of the gain if the sale results from a change in place of employment, health, or unforeseen circumstances.

(1) Divorce is an "Unforeseen Circumstance." Treas. Regs. §1.121-3(e) provides that an unforeseen circumstance arises if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. Divorce or legal separation under a decree of divorce or separate maintenance is identified in the regulations as an unforeseen circumstance. Reg. §1.121-3(e)(2) (T.D. 9152, 69 Fed. Reg. 50302 (8/16/04)).

c. Importance of Timing. If a highly appreciated primary spousal residence is sold during the tax year in which the parties are still married, a $500,000 exclusion will be available. However, once a divorce decree has been issued, only a single $250,000 of gain exclusion will be available. The loss of a $250,000 capital gains exclusion might be avoided by simply being aware of the requirements imposed by IRC §121. The potential problem arising under IRC §121 illustrates the broader importance of proper tax planning in the divorce context. For example, planning is necessary to ensure that adverse tax consequences do not arise by reason of the inability to file a joint income tax return. No joint income tax return may be filed if the spouses are not married on December 31 of the taxable year.

d. Divorced and Separated Taxpayers. IRC § 121(d)(3) contains two special rules applicable to separated and divorced taxpayers selling a principle residence.

(1) **Holding Period Tacked.** If the selling taxpayer previously obtained the home from his or her spouse or former spouse in a §1041 transaction, the taxpayer's holding period with respect to such property will include the period his or her spouse or former spouse owned the property.

(2) **Use by Spouse Imputed to Other Spouse.** If one spouse or former spouse is granted use of the home under a divorce instrument, that occupant spouse's use of the property as his or her principal residence during the occupancy period granted by the instrument is imputed to the other spouse.

M. **Dependency Exemptions.** Individual taxpayers are permitted to claim a deduction for one or more personal exemptions. §151(a); Regs. §1.151-1(a). A taxpayer is entitled to a personal exemption for himself, his spouse under certain circumstances, and for each qualifying dependent. A child qualifies as a dependent if the child satisfies requirements prescribed in §152. Under the default rule, the dependency exemption is now attributed to the custodial parent. However, IRC §152(e) grants the noncustodial parent the dependency exemption if there is an agreement granting the noncustodial parent the exemption.

N. **Filing Status.** Marital status is determined under IRC §1(a)(1), (d). That section references IRC §7703. Martial status for purposes of §7703(a)(1) is determined on the final day of the year. The law of the state controls whether and when a divorce is final. In the case of a foreign divorce, provided that the divorce has not been declared invalid, it will be deemed valid for federal tax purposes. Rev. Rul. 67-442. Spouses legally separated are not considered married for tax purposes, and may not file a joint return. §7703(a)(2). In addition, a married but separated spouse who is not "legally separated" within the meaning of §7703(a)(2) may nevertheless be treated as unmarried under the "abandoned spouse" rule. §7703(b).

IV. Gift Tax. In property law, a completed gift requires three elements:

1. The donor must **intend** to make a gift;

2. The donor must **deliver** the gift to the donee; and

3. The donee must **accept** the gift.

Whether these elements have been met is a question of local law.

B. No "Donative Intent" Requirement for Gift Tax. Congress (and the IRS) has dispensed with the requirement of donative intent. Thus, although divorcing spouses are not generally altruistically inclined with respect to their spouse, transfers made pursuant to settlement agreement may nevertheless spawn gift tax issues. If spouses are still married, then transfers that would otherwise constitute taxable gifts will be neutralized by the full marital deduction available under IRC §2523.

C. Property Transfer May Constitute Taxable Gift. A transfer between divorced spouses could be subject to gift tax, since IRC §1041(b)(1) provides that transfers between divorced or divorcing spouses are "gifts". If the divorcing spouses are already divorced, no protection would no longer be accorded by the marital deduction available to married spouses. In any event, since the lifetime gift tax exclusion for federal gift tax purposes is now $5.25 million and New York has no gift tax. Still, the issue of transfer constitutes a taxable gift is important.

D. IRC §2516 Provides Gift Tax Protection. IRC §2516 provides a measure of protection from adverse gift tax consequences by stipulating that

> where spouses enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement . . . to either spouse in settlement of his or her marital or property rights or to provide a reasonable allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money's worth.

1. Agreement Must be in Writing. IRC § 2516 requires the marital agreement to be in writing. Neither §2516 nor the regulations define "written agreement" for purposes of §2516, but presumably the term encompasses any writing memorializing a meeting of the minds as to the terms of the marital settlement.

E. Alternative Means of Avoiding Taxable Gift if IRC §2516 is Inapplicable.

1. Adequate Consideration Existed for the Transfer.

a. **Release of Ownership Rights.** If a transferee spouse has an enforceable ownership interest in specific property at the time of the settlement, the release of those rights may constitute adequate consideration for transfer. Treas. Regs. 25.2516-2.

b. **Satisfaction of Obligation of Support.** An obligation arising under state law may provide adequate consideration for a transfer, thus negating a gift. However, merely ascribing a payment the moniker of an obligation of support in the agreement will not be sufficient to create an obligation where none actually existed. Rev. Rul. 68-379.

c. **Contrast the Relinquishment of Other Rights.** The relinquishment of other marital property rights, such as dower, or the right to receive a statutory share of the estate of a deceased spouse, does not constitute adequate consideration for a transfer in the context of divorce. Treas. Reg. §25.2512-8.

V. Estate Tax. In determining whether a divorce-related transfer is subject to estate tax, the issue will be the same as in the gift tax context, *i.e.*, whether there was a complete transfer for transfer tax purposes. This inquiry often involves a determination as whether adequate consideration existed for the transfer.

A. Complete Versus Incomplete Transfers. Generally, a completed gift will result in the asset being transferred out of the decedent's gross estate for estate tax purposes. However, if the gift is incomplete, meaning that the transferor has retained incidents of ownership over the property, this will result in gross estate inclusion under IRC §§ 2036, 2037 or 2038. These sections reference transfers in trust for where the transferor retains a beneficial interest in the property, such as a right to income, or merely the retained right to determine who enjoys the income. As in the case of the gift tax, a release of marital rights such as dower or curtesy will not constitute consideration so as to prevent inclusion under IRC §§2036 through 2038. However, a release of *genuine* support rights, or rights with respect to specific property could well constitute valid consideration for the purposes of IRC §§ 2036, 2037, or 2038.

B. Deductibility by Estate of Payments and Obligations. IRC §2053(a)(3) permits an estate to deduct as a claim an obligation to pay alimony or make another payment pursuant to a divorce agreement. Under IRC §2053(a)(3), alimony may be claimed as an estate deduction. Distributive Net Income (DNI) rules apply for purposes of fiduciary accounting under Code Sections 651 and 661.