

Housing Counsel

Benny L. Kass, Columnist for WashingtonPost.com

When a Marriage Ends, Tax Planning Doesn't

By Benny L. Kass

Divorce is not a pleasant topic. But if you and your spouse own a home and are contemplating a divorce, you must do some careful tax planning as early as possible.

Your house is probably your largest asset. You probably would like to keep it. If it has to be sold, you want to pay as little tax as possible.

Married taxpayers filing jointly can exclude from taxation up to \$500,000 of any profit they make when a house is sold, if during the five years before the sale they each lived in the house for at least two years and at least one spouse owned the home for at least two years. Single people or married taxpayers filing separate tax returns can protect only \$250,000 of capital gain.

How does this affect a divorcing couple?

Look at this example: A couple bought a house for \$200,000. It is now worth about \$500,000. They have three children who want to stay in the house until they complete high school. The husband has agreed to move out, but the wife will stay in the house at least until the children reach age 18. (There's no sex bias in this tax law; the treatment is the same whether the man or woman stays in the house.)

In some situations, the husband will agree, pursuant to a divorce settlement, to immediately transfer his half-interest in the property to the wife. Alternatively, the two may agree that the husband will retain ownership of his share of the property until some later time when it is sold, at which time any profit will be distributed pursuant to their divorce or separation agreements.

It is important to consider the tax implications for both scenarios. Where the husband transfers his share of the house to the wife, under certain circumstances the law treats it as a nontaxable event. Since 1984, under Section 1041 of the Internal Revenue Code, transfer of property between spouses or former spouses is considered non-recognized gain and so isn't taxable. However, the transfer has to be during the divorce, or "incident to a divorce."

The concept of "incident to a divorce" is significant. According to Section 1041, a transfer of property is incident to a divorce if it occurs within a year of the date on which the marriage ceases, or is related to the cessation of the marriage.

The IRS has taken the position that if the transfer is specifically spelled out in the divorce or separation agreement, it is incident to the divorce only if the transfer occurs within six years of the date on which the marriage ends.

The non-recognition of gain concept is not applicable for transfers to spouses or former spouses who are nonresident aliens.

For transfers that are not made under a divorce or separation instrument, or that do not occur within six years of the end of the marriage, there is a presumption that the transfer was not related to the ending of the marriage. That presumption can be overcome if the parties can demonstrate facts to support the position that it was part of their divorce obligations.

In our example, the property was purchased for \$200,000. Assuming no improvements were made to the property, the husband's basis in the property is \$100,000. If the husband were to transfer his half-interest in the property to the wife, he would have no taxable consequences. The wife, however, would pick up the husband's basis in the property (\$100,000), and her basis would become \$200,000.

When the wife later sells the property, she alone would pay tax on the gain from the sale. The amount of gain would be calculated by subtracting her basis in the property (\$200,000 in our example) from the selling price of the house. If the value is still \$500,000, she would realize a \$300,000 capital gain. Because her husband no longer owns or lives in the property, she would be considered a single tax filer and, assuming she has met the use and ownership requirements, she would be eligible to exclude only \$250,000. She would have to pay capital gains tax on the \$50,000 difference. Under current tax laws, in most cases the capital gain tax would be 15 percent. There could also be state income tax.

But what happens if, instead of the husband transferring his interest to the wife, the parties agreed that the husband will remain a co-owner of the property and will receive half the proceeds when the property is sold? The tax benefits can be significant.

Even though the husband no longer lives in the property, as long as the wife has been granted use of the property under the separation agreement or divorce decree, and they otherwise meet the use and ownership tests, up to \$500,000 of gain can still be excluded from tax. That is because of a tax rule that treats the husband as using the property as his principal residence during any period that the former wife uses the property as her principal residence. The rule applies, however, only if the husband still owns the property. In addition, the wife's entitlement to use it must be set forth in a separation agreement or divorce decree.

In our example, if the husband remained a co-owner of the property when it sold for \$500,000, all \$300,000 of the gain would be excluded from taxation. If the property is not sold until after the children move out and the property has appreciated beyond its

\$500,000 value at the time of the divorce, the additional gain would still be excluded up to \$500,000.

The most tax effective route is for both husband and wife to stay on the title until the house is sold, to take advantage of the full \$500,000 exclusion.

However, there are factors other than taxes that come into play when there is a divorce. The spouse using the property may not want to have a fixed date for selling and moving out of the property. The other spouse may not want (or be financially able) to have an open-ended agreement regarding the time for sale. For example, if the husband moves out of the house, but remains on the title to the property with his wife, he may have a difficult time getting a mortgage should he want to buy another home.

Thus, husbands and wives who are in the process of separation must look carefully at the tax consequences. If one spouse moves out and can no longer claim the family home as the principal residence, be prepared to pay the tax if there has been considerable appreciation. And, perhaps most important, make sure that your legal documents comply with federal tax laws, as with any tax issue, consult financial and tax advisers if you are not clear on the law.