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4/10/14

Basis of Residence in a Divorce

Consider Future Tax Liability When Negotiating Settlements

Divorced couples are faced with many decisions surrounding the distribution of marital assets such as primary and vacation residences. What may seem like a simple matter of asset division can take on more complex tax implications if not handled with care.

The process of divorce can be complicated, particularly when couples own joint assets, such as homes, that have appreciated since the original purchase. To illustrate this point, consider a marital home that was purchased in your joint names for $100,000, and is now worth $400,000. You have agreed that your spouse will retain the home as long as you are given $400,000 in other assets. You might think that the law would consider you to be selling your one-half interest, in which you have a basis (yardstick for measuring gain or loss) of $50,000 (one-half of the home's original purchase price), to your spouse in return for her $200,000 share of the other assets. Fortunately, the law does not work that way. You don't recognize any gain on a transfer to a spouse or former spouse that is “incident to divorce.”

While this treatment would be favorable for you in our posited example, there is somewhat of a downside for your spouse. If there were a sale, your spouse's basis in the home would be $250,000, consisting of $50,000 for the original one-half interest and $200,000 for the purchased interest. The result would be that if your spouse sold the home for $400,000 she would only have a $150,000 capital gain. However, because the transfer to your spouse is not considered a sale, your spouse's basis is limited to the original $100,000 purchase price.

This rule is called a carryover basis rule, because the original basis carries over to the recipient spouse. It applies whether the home was originally owned by both spouses as tenants by the entirety, joint tenants with right of survivorship, tenants in common or community property or a similar form of ownership, or by one spouse alone. The rule also applies regardless of who gets the house and whether or not the recipient pays any consideration to the other spouse.

Divorcing spouses should obviously consider the impact of the carryover basis rule on their potential future tax liability when negotiating their settlement. In our example, you have $400,000 in cash and your spouse has a house worth $400,000 but your spouse faces a $300,000 tax gain when she sells the home. Under the exclusion that applies to gain from the sale or exchange of a principal residence, your spouse may be able to exclude up to $250,000 of gain ($500,000 for certain joint filers) from her gross income when she sells the home. Still, your spouse may insist that you should get less than $400,000 to equalize the fact that she could face tax down the road.

The nonrecognition of gain on transfers “incident to divorce” and the carryover basis rule apply to most types of property transferred in divorce, not just to the marital home. The equalization concern is even greater when splitting highly appreciated assets for which no tax breaks apply when they are sold.

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If you have any questions, please feel free to contact your Seiler professional at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your particular circumstance.

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