

Divorce Property Divisions And Income Taxes

By Tom Norton, CPA, CDFA

When you divide property in a divorce, the general rule is that there is no income tax effect. Each party takes whatever assets they have been awarded, and neither one owes taxes nor gets a tax deduction as a result.

The other major rule is that when you receive property in a divorce, you get the same "tax basis" as you had when you were married. Your "tax basis" is essentially your cost. So if you and/or your spouse paid \$5,000 for some stock in Google, your cost is considered to be \$5,000. This is true even if your spouse actually paid for it, or if you each paid \$2,500. You are considered to have paid \$5,000 for it.

Why is that important? Because if you sell the stock for \$20,000, your taxable gain is \$15,000. If your basis were zero, you would have a \$20,000 gain, and owe more in taxes.

Without these rules in place, some asset divisions might be considered a sale of the asset from one spouse to the other. If it were considered a sale, the spouse "selling" the asset might owe taxes as a result. To avoid that problem, Congress enacted Internal Revenue Code Section 1041 in 1984 to make it clear that a property division incident to a divorce or legal separation is not a taxable event.

In order to get this special tax treatment, the transfer of the property must generally occur within one year of the divorce. After a year has gone by, it will no longer be considered incident to divorce, so it will be considered a taxable event.

An exception to the one year rule is granted if a written divorce decree spells out that the transfer is incident to the divorce even though it occurs more than one year after the divorce is final. In that case, the transfer must occur within six years of the divorce.

If you don't meet the requirements for either the one year or six year rules, you can still argue your case to the IRS. To be successful, you will need pretty convincing proof that the property transfer really was part of the divorce.

For more information:

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