

## **Potential Tax Consequences Related to Asset Allocation**

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In general, there are no immediate tax consequences as a result of the division of your marital assets (except matters involving nonresident aliens and trusts). However, it's very likely that there are tax consequences lurking, waiting for you in the future. If you are not going to use after-tax values when dividing your assets, you may, even unknowingly, be paying the taxes, that accrued during the marriage, from your half of the assets.

Transfers of property between spouses and former spouses are treated as a gift of property under the Internal Revenue Code. The result is that the cost (or basis) of the property is transferred to the new owner at its historical cost. There is no recognition for the fact that you, essentially, purchased (from your former spouse) an asset either by trading for another asset or with cash. For example, on your marital balance sheet is listed "100 shares of XYZ" stock that you paid \$5 a share for, with a current value of \$10 a share. You decide to keep XYZ stock and will transfer the savings account, with a balance of \$1,000, to your spouse for these shares. You have paid \$1,000 for these shares. When you sell them, though, your gain will be calculated on the difference between \$5 a share (not the \$10 per share price you paid to your former spouse) and the selling price. You would have been better off to take the cash and then buy those same shares in the market place.

When making decisions about dividing your marital assets and liabilities, here are some tax-related factors to keep in mind:

### **The Marital Residence**

Given the current housing market, one of you may be sitting in the marital home for a while, waiting for it to be sold, or perhaps you want to keep the home. In general, the taxable gain, on the sale of a primary residence, is the excess of the selling price over the total of: the purchase price, improvements, selling costs, and the exclusion amount (\$250,000 for single returns; \$500,000 for joint returns; ownership and duration tests apply). If you decide to keep the marital home, realize that you may have reduced your ability to realize tax-free profits. For example, you and your spouse purchased your marital home for \$200,000. You were fortunate to have picked a home in an area where home values doubled. Now the home, at the time of your divorce is worth \$400,000. You decided to keep this home and pay your spouse for half the value, \$200,000. Since the value (selling price to your spouse) of \$400,000 less the purchase price of \$200,000 is less than the \$250,000 exclusion, you might believe that you received an asset with an after-tax value equal to \$400,000. However, your allowable tax-free gain has been reduced from \$250,000 to \$50,000. If this home then increases by another \$100,000 you will pay tax on \$50,000 (\$500,000 less \$200,000 less the exclusion of \$250,000) when ignoring selling costs, even though your actual gain is \$0 (\$500,000 less \$300,000 (half of the original cost plus the amount you paid to your spouse) less the exclusion of \$250,000), again ignoring closing costs. This is due to the fact that, during the marriage, you already used part of the \$250,000 exclusion. There is no increase in the basis of your home for the cost of buying your spouse's one-half

interest at current value. You may have been better off to start anew in a different home. Other items that could have a negative impact on your future tax cost include office-in-home deductions that were taken during the marriage and any reduction in the basis of the home due to prior gain deferrals.

If you decide to sell and split the proceeds, then you would report one-half of the transaction on your individual return and each of you, individually, would need to determine whether you meet the current “2 out of 5 year” rule for ownership and residency, though there are special rules that may apply to divorced taxpayers. For example, if you are the one that moved out, and your former spouse still lives there (as per your divorce or separation agreement), and you still have an ownership interest, that time will be included as your “use” time.

If you are going to keep the marital home, make certain that you have the supporting documents to show the purchase price and cost of any improvements. It is probably best to get this information during your process of divorce.

### **Investment Accounts**

Know the cost basis of the investments you are considering. As shown above, no increase (or decrease) is made to the basis of the investments you retain. Though, typically, your basis is the amount paid for a particular asset, the fact that you “paid” your former spouse more than the original cost for an asset will not increase the basis of that asset nor reduce your future taxable gain or increase your loss.

You might want to consider obtaining copies of records that will substantiate the cost basis of the assets that you will retain, for your future use. It will be your burden of proof to substantiate the amount shown as the cost basis, if asked to do so.

Also related to the sale of stocks and other investments are unused capital losses. The loss carryovers that have not been fully utilized are still available to the account owner. Therefore, if a loss occurred in a joint account, each owner is entitled to one half of the loss carry forward. This could be of considerable value, considering that any realized future gains would first be reduced by the capital loss carryover, which could make those gains tax-free.

### **Retirement Plans**

There are no immediate tax consequences when transferring retirement plan assets between former spouses, when pursuant to a QDRO or other appropriate court order. However, when those funds are withdrawn, the recipient of those funds will be responsible for all tax liabilities associated with the withdrawal.

This may be the time to take advantage of an opportunity to avoid the 10% penalty for early distribution (assuming that you do not meet one of the other exceptions). Distributions from a qualified plan to you, the alternate payee, pursuant to a Qualified Domestic Relations Order (QDRO), are not subject to the 10% early distribution penalty tax. If you find yourself in a position of needing some cash to meet expenses or you simply can't afford to roll over the entire qualified retirement plan distribution, then direct the plan administrator to send to you directly, only the amount needed and rollover the balance (preferably via a trustee-to-trustee transfer) to

an IRA or other acceptable retirement account. In most cases, you will pay income tax on the monies that you receive, so plan accordingly.

Since IRAs are not qualified plans, a QDRO is not required to transfer funds to a former spouse. However, some custodians of IRAs may require one, due to their own internal procedures. A transfer from one IRA to a former spouse's IRA will be a non-taxable event, as long as the divorce decree (or separation agreement) specifically requires the transfer and the transfer is to a spouse or former spouse. Unfortunately, the exception to the 10% early distribution penalty does not apply to distributions from IRAs.

### **Business Property**

In cases where a spouse (or both spouses) may be a business owner, the equipment may have been entirely written off, yet has value. Therefore, the sale of the equipment would result in a taxable gain that is equal to the value of the asset, due to the depreciation deduction taken in prior years. Since any depreciation recapture remains with the property, the property, even if transferred to the other spouse would be subject to the recapture.

### **Summary**

You may find that after-tax values are not permitted for consideration in the division of your marital assets and there may be nothing that you can do about that. What you can do, though, is to educate yourself about the tax issues related to your various assets and to consider them as part of your overall decision-making process when you and your attorney are discussing the division of your assets and liabilities. You may find that keeping a particular asset is going to cost you more than just its current value.