**Tax Consequences of Dividing Assets in a Pennsylvania Divorce**

The tax consequences of dividing marital property in a divorce can be complicated. Internal Revenue Code (IRC) Section 1041 provides that no gain or loss is recognized on the transfer of property between spouses. Transfers that qualify under Section 1041 do not have to recognize gain or loss for income tax purposes, and the transferee spouse receives carryover basis like a gift. Section 1041’s nonrecognition rule applies to transfers between married partners who are not contemplating divorce and, in addition, extends to transfers that are incident to divorce. “Incident to divorce” is defined in Section 1041(c) as a transfer that occurs within one year after the date on which the marriage ceases or that is related to the cessation of the marriage. Temp. Regs. Section 1.1041-1T further defines the term “related to cessation of the marriage” to be a transfer pursuant to a divorce or separation instrument, if the transfer occurs within six years after the date on which the marriage ceases. However keep in mind Section 1041’s nonrecognition rule does not apply to transfers made to nonresident alien spouses or to transfers in trust where liability exceeds basis.

Considering Section 1041’s nonrecognition rule as well as the unlimited marital deduction for federal estate and gift tax purposes allowed under Section 2523 for gifts of cash and property to a spouse, most property transfers in divorce will likely be nontaxable transfers.

With the presumption that any transfer within six years from the date of divorce, assuming it is under a divorce or separation agreement is treated as nontaxable under Section 1041. In IRS Letter Ruling 8833018, this became evident when the husband was awarded a right of first refusal to acquire the family home that was awarded to the wife. This right of first refusal was exercised within the six-year time frame, and the husband “purchased” the home from his former spouse. The IRS indicated that it was not a purchase and sale but a nontaxable transfer under Section 1041. This resulted in the wife’s receiving nontaxable cash from the “sale” of the home and the husband’s receiving the home with the wife’s cost basis which was lower the purchase price, likely not the result he was hoping for.

Being able to qualify for nonrecognition of income under Section 1041 at the time of a divorce makes the division of assets much easier but leads to certain longer-term tax consequences. Since the assets have carryover basis, the potential tax liability has only been deferred. Looking at the potential tax liability of all the assets that are being divided from the marital estate can help to make the asset division more equitable as well as eliminate potential surprises for the parties later.

Since any asset received will have carryover basis, it is important to obtain the basis information as soon as possible. Temp. Regs. Section 1.1041-1T indicates that the transferor of property under Section 1041 must provide the transferee with sufficient records to determine the cost basis, holding period, and other tax information relating to the property at the time of the transfer. An adviser should recommend that a transferee spouse try to obtain this before the divorce is finalized or require it be provided in the future in the final settlement agreement to ensure compliance.

By having the cost basis prior to the final dissolution, your tax advisers will be able to estimate any potential tax liability of the asset clients are receiving as well as have the information for reporting any future sale.

The principal residence is a typical asset that is discussed and awarded during a divorce. IRC Section 121 allows joint filers to exclude up to $500,000 of gain on the sale of a residence, and individual filers can exclude up to $250,000 of gain. This can provide a tax planning opportunity for some divorcing couples. For joint filers to qualify for the exclusion, one party needs to have owned the residence, and both parties need to have used the residence as their principal residence for a total of any two out of the last five consecutive years.

Section 121 provides very favorable treatment for parties in divorce to assist them in meeting the ownership and use tests. First, to help meet the ownership test, Section 121(d)(3)(A) allows the residence transfer from one spouse to the other spouse to include the holding period. This would allow the receiving spouse to count any ownership time of the transferor spouse as the receiving spouse’s own. Section 121(d) (3)(B) helps the parties meet the use test by allowing an individual to be treated as using property during any period of ownership while their spouse or former spouse is granted use of the property under a divorce or separation instrument. So, if one party is given temporary use of the home in a divorce instrument, the other party can count that use time as their own. Note that voluntarily moving out will not count, as it needs to be part of the agreement.

Retirement plans come in many forms and are also a common asset to be divided in a divorce. “Qualified” plans include pension and profit-sharing plans, such as defined benefit plans, Section 401(k) plans, and Section 403(b) plans. These employer-provided plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA), which provides that these types of plans cannot be assigned from one spouse to the other without a qualified domestic relations order (QDRO). The requirements of a QDRO are listed in Section 414(p), and failure to follow them can have adverse tax consequences. Once the divorce court produces the order to assign some or all of the retirement account to the spouse (alternate payee), and the qualified plan administrator has determined it meets the conditions of Section 414(p) and signs the document, you have a QDRO. The retirement account will now be divided between the parties as provided in the QDRO.

An individual retirement account (IRA) is not covered under ERISA and does not need a QDRO to divide. This is also true for Roth IRAs, rollover IRAs, and nonqualified retirement and deferred compensation plans, as well as a few others. These accounts can be divided by including the instruction in the settlement agreement. These instructions constitute a domestic relations order, not a “qualified” domestic relations order in the same way that property divisions, alimony, and other instructions are recorded in an agreement.

One planning note is that a retirement account being divided via a QDRO has an opportunity to distribute funds out of the plan without having to pay the 10% early-distribution penalty. The 10% penalty normally applies if the spouse receiving the retirement distribution is under 59½ years old. Therefore, the QDRO distribution will be taxable as ordinary income but without the 10% penalty regardless of the spouse’s age. This can be a good way to generate some liquidity in a divorce with limited other assets. This distribution must be part of the QDRO instructions and is not available for IRAs, as they are not divided with a QDRO.

If you have any questions call Shintia Z. Riva, Esquire at 610-521-0604. Shintia specializes in family law at the Law Offices of Spadea & Associates, LLC.