The tax consequences of equitable distribution or community property division of assets are an important factor for divorcing parties and their counsel. Although tax consequences are not immediate, as in the case of alimony, which is taxable upon receipt, capital gains and other taxes associated with equitable distribution can be far more substantial. If a spouse receives assets without recognizing the tax consequences upon sale, he or she may be quite unhappy to discover that the after-tax value of the assets is far less than anticipated. A lawyer’s failure to consider the tax consequences is a potential avenue for a malpractice action by a disgruntled divorce client.

**Basis**

Obtaining full and complete basis records for assets distributed to the client is essential for effective tax planning as part of equitable distribution. This is particularly so for assets that have increased in value over time. The knowledge of an asset’s basis allows counsel and the client to plan for taxes that will arise upon the sale or disposition of the asset. The adjusted basis of the property dictates the amount of taxable gain. The higher the asset’s adjusted basis, the lower the gain and the tax.

Gain is defined in the Internal Revenue Code (I.R.C. § 1011(a)) as the difference between the amount realized (the
amount you receive from the sale of the property) and the adjusted basis. I.R.C. § 1012 defines adjusted basis as the purchase price (the taxpayer’s cost as defined in I.R.C. § 1012) plus any improvements (invested capital and other additions) minus depreciation (cost recoveries). Basis documents that need to be maintained by the parties and scrutinized by counsel during the equitable distribution process include: (1) the deed or agreement of sale for the property, reflecting the original purchase price; (2) records of all improvements to the property; (3) all Form K-1’s for partnerships, S corporations, and LLCs; and (4) brokerage account statements.

**Capital gains taxes**

Traditionally, capital gains have been taxed more leniently than ordinary income, but the ability to deduct capital losses has been subject to limitations. I.R.C. § 1222(3) defines long-term capital gain as the gain from the sale or exchange of a capital asset held for more than one year. I.R.C. § 1222(1) defines short-term capital gains in the same way, except that the asset is held for one year or less.

The Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law No. 108-27 (May 28, 2003) changed the preferential tax rate on net capital gains and reduced it far below the tax rate for ordinary income. The Act reduces the 10-percent rate on adjusted net capital gain to 5 percent, and the 20-percent rate on adjusted net capital gain to 15 percent. These lower rates apply only to long-term capital assets. The 15-percent rate is for taxpayers in most income ranges, and the 5-percent rate is for very low-income taxpayers. The short-term capital gains rate is the same as the taxpayer’s ordinary income tax rate.

**Transfer of property**

Pursuant to I.R.C. § 1041, the transfer of assets or property between spouses or former spouses incident to divorce and made pursuant to a divorce instrument, qualifies for non-recognition tax treatment. According to I.R.C. § 1041, the transferor spouse recognizes no gain or loss incident to the transfer, and the transferee spouse takes the property with a transferred or carryover basis. This means any appreciation or drop in value of the property owned will shift to the transferee upon a transfer pursuant to divorce.

Section 1041 treatment also applies to a transfer of property between former spouses if the postdivorce transfer is incident to the divorce. A transfer is incident to a divorce if it occurs not more than one year after the date the marriage ceases or the transfer is related to the cessation of the marriage. “Related to the cessation of marriage” is not defined in Treas. Reg. § 1.041-1T(b), Q & A 7, as a transfer pursuant to a divorce or separation instrument (described in I.R.C. § 71(b)(2)) that occurs not more than six years after the date on which the marriage ceases. If a transfer takes place more than one year after the marriage ceases but fails the “related to cessation of marriage” test, meaning that either the transfer takes place more than six years after the marriage ends or that the transfer is not pursuant to a divorce or separation instrument, it is presumed to be not related to divorce, falling outside the ambit of I.R.C. § 1041. This presumption is a rebuttable presumption if it can be demonstrated that the transfer is, in fact, related to the cessation of the marriage.

Section 1041 also covers certain transfers of property made by a spouse or former spouse on behalf of the other to a third party as long as: (1) the transfer is required by the qualified divorce agreement; (2) the transfer is pursuant to a written request of the transferee spouse; or (3) the transferor receives from the transferee a written consent or ratification of the third-party transfer.

If and when the transferee spouse sells appreciated property that was transferred pursuant to a divorce and falling within I.R.C. § 1041 nonrecognition, he or she must pay capital gains taxes at that time. However, I.R.C. § 1223(2) permits the transferee to tack on the previous spouse's holding period for the purpose of determining whether the gain on the sale or disposition is long-term or short-term. Tax-savvy divorce planning requires the parties and counsel to review all available basis documents to determine the transferred or carryover basis of the assets and the character of the gain that will result from their sale.

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**Any appreciation or drop in value of the property owned will shift to the transferee upon a transfer pursuant to divorce**

In addition to receiving a fair share of the fair market value of the marital or community assets, each spouse should receive a fair share of the basis associated with each asset. If one spouse receives assets with a substantially lower basis and the other spouse receives assets with a substantially higher basis, then what may initially appear to be an equal or fair division based on the current value of the property may turn out to be unfair or unequal after deducting applicable taxes. A simple example will illustrate the point. Assume the parties own 10 shares of IBM stock worth $1,000 with a $500 basis and 200 shares of Microsoft stock worth $1,000 with a $200 basis. Both stocks have been held for more than a year. The IBM and Microsoft stock have the same current value. However, upon sale, the IBM stock will yield $500 of gain, leaving $925 after federal capital gains taxes, whereas...
the Microsoft stock will yield $800 of gain, leaving $880 after federal capital gains taxes.

Assets that appear to be of equal value before tax can be worth substantially different amounts after reviewing the basis and determining applicable tax. A property distribution that gave one spouse the IBM stock and the other the Microsoft stock does not result in an equal distribution. To alleviate this problem, each party should receive one-half of the shares of Microsoft and IBM. In that case, each party receives one-half of the respective basis. This division results in an equal distribution, taking into account the basis of each and the tax consequences upon the respective sales.

**Adjustments to basis**

1. **Commercial buildings and rental property.** It is possible for the adjusted basis of property to increase incrementally and decrease during the same time period. The usual decrease in basis is the result of depreciation and the usual increase in basis is the result of capital improvements made to the property. I.R.C. § 167(a) authorizes a deduction equal to a reasonable allowance for the exhaustion, wear and tear, of property used in a trade or business or of property held for the production of income. This is called depreciation. Depreciation will reduce the owner’s basis in the building or property at a constant rate over a fixed period of time. However, even though depreciation reduces basis over time, the basis in property can also increase when capital expenditures are made.

   According to I.R.C. § 263 and the accompanying Treasury Regulation under § 162, to increase the adjusted basis of the property, an expenditure must be a capital improvement, not a current expenditure, for maintenance and repairs. The difference between the two is that maintenance and repairs simply maintain the property for its intended use, whereas capital improvements increase the use, function, or utility of the property. Although the distinction may seem clear on its face, in practice borderline cases often cause disputes. Some expenses that have caused disputes include replacing air conditioning and heating units, repaving, new roofs, and new windows.

2. **Partnership interests and “S” corporation stock.** The adjusted basis of a partnership interest or S corporation stock also can decrease and increase over time. When a partnership makes a distribution (not a salary payment), the partner’s adjusted basis in the partnership interest decreases. Likewise, when an S corporation makes a distribution (not a salary payment), the S corporation’s shareholder’s basis decreases. Another basis decrease occurs when the partnership or S corporation passes through to the partners or shareholders their allocable share of partnership or corporate losses. The adjusted bases in their partnership or S corporation stock with an accountant or tax attorney.

Interest on a payout

In some cases, an equitable or community property division may require an adjusting payment by one spouse to the other. This often is the case when one spouse owns a business of substantial value but has only limited liquid or other assets available to transfer to the other spouse to offset the business’s value. When assets are insufficient to effect a transfer, an adjusting payment must be deferred and paid out over time.

Often interest is paid to the recipient spouse on the deferred payment. This is necessary to preserve the present value of the payment stream to the recipient spouse. The interest is taxable income to the recipient spouse and is not a capital gain. Therefore, it would be taxed at the recipient-spouse’s highest marginal tax rate.

However, are interest payments on such a deferred equitable distribution payout tax deductible to the payor spouse? Prior to 1986, all such interest was deductible. However, the Tax Reform Act of 1986, pursuant to I.R.C. § 163(h)(1), stated that “no deduction shall be allowed for personal interest paid or accrued during the taxable year.”

Two solutions to the problem of the nondeductibility of interest on deferred payments are possible. The first is to restructure the interest as a deductible interest payment. The three deductible interest payments that may lend themselves to such restructuring are: (1) interest on debt properly allocable to a trade or business (other than the business of performing services as an employee), pursuant to I.R.C. § 162
and § 163(a); (2) investment interest, pursuant to I.R.C. § 163(d); or (3) interest associated with a passive activity, pursuant to I.R.C. § 163(a).

Although possible, this solution is not particularly viable because most situations do not fall into any one of these categories. The second solution is to restructure these payments in the property settlement agreement as tax-deductible alimony and increase them to include the interest without so stating. Because no interest is imputed upon such payments, this is probably the best solution. Furthermore, the payor spouse can be given the option or ability in the divorce agreement to make “prepayments,” thereby paying off the obligation faster.

If payments are restructured as alimony, they must meet alimony requirements under I.R.C. § 71. Those requirements are not difficult to meet, but the most commonly “forgotten” requirement is that payments must terminate upon the death of the recipient spouse. This requirement is partially contrary to the concept of interest on deferred payments. In theory, interest on a deferred payment should not terminate upon death because the principal payments would not terminate then and because payments are property that is owned by the recipient spouse. They are distributable upon her death to named beneficiaries.

By contrast, alimony is not a property right, nor is it in the nature of property. Rather, alimony is a form of spousal maintenance or support. As such, alimony usually terminates upon the death of the recipient spouse under state divorce laws. For the payment to be tax-deductible, it must terminate upon the recipient’s death and should be stated as such in the divorce settlement agreement.

A potential problem arises when interest payments are restructured as alimony, and the payor spouse pays off some or all of the deferred sum earlier than originally planned, even though the recipient spouse usually is ecstatic to receive payments sooner rather than later. Usually a schedule of the amounts and due dates of the reclassified payments are set forth in the marital settlement agreement, based on a standard amortization schedule without any prepayment option. The amortization schedule is part of the planning technique used in calculating the amount of interest. If the option for prepayment is provided for in the agreement and an accelerated payment is made, the amortization schedule is thrown off. These contingencies must be addressed in the marital settlement agreement.

One suggestion to avoid this dilemma is to include a prepayment provision in the marital settlement agreement that includes a discounting or discount formula for prepayment. Under the discount theory, the entire amount due to the recipient spouse changes because the interest that was previously calculated, based on a set period for payment of the deferred sums owed, is no longer relevant. Payments are no longer deferred, and interest is no longer necessary.

### Stock options

One marital asset that is often the center of controversy for divorcing parties is a stock option. The decision of whether to exercise a stock option can be fought over to the point of litigation. However, both parties and their counsel should be aware that exercising stock options results in tax consequences that must be considered during the division of marital assets as well as during the battle of whether and when to exercise the options.

A variety of tax planning considerations can be used for various types of stock options, such as I.R.C. § 83(b) elections. However, the various plans and tax planning tools go beyond the scope of this article. One of the more problematic types of stock options are those called nonstatutory options. The IRS has specifically ruled on nonstatutory stock options and stated the transfer of nonstatutory stock options from the employee spouse to the nonemployee spouse pursuant to a divorce is not subject to tax according to Rev. Rul. 2002-22, 2002-1 C.B. 849.

Upon the exercise of an option, a transfer of stock to the employee spouse is subject to FICA and FUTA taxes and treated as compensation to the extent that the stock is worth more than the employee-spouse paid. Rev. Rul. 2004-60, 2004-24 IRB. FICA taxes, imposed by I.R.C. §§ 3101 and 3111, consist of Social Security and Medicare taxes and are withheld from wages. FUTA taxes, imposed under I.R.C. §§
3301, 3306(b), and 3306(r)(2) are paid by the employer. The employee spouse can simultaneously exercise the right to purchase stock at the option’s exercise price and immediately sell the stock at current market price. The employee receives profit on the difference in the prices on which he or she must pay taxes.

With this approach, the employee-spouse who sold the stock must report the profit as ordinary income, and the income is subject to federal, state, and local income tax. Alternatively, the employee can exercise the option, purchase the stock at the exercise price, and hold it, but not sell it. This requires a reporting of ordinary income for the difference between the exercise price and the fair market value of the stock at the time of exercise. If the stock appreciates in the hands of the employee spouse, but the stock is held for less than one year and is then sold, the appreciation over the fair market value at the time of exercise is taxed at short-term capital gains rates. If the employee spouse holds the stock for longer than one year and then sells it, the appreciation over the fair market value at the time of exercise is subject to lower long-term capital gains rates.

When options are transferred to a nonemployee spouse as part of a division of marital assets, there is no tax upon the transfer. However, when the nonemployee spouse exercises the option, to the extent the stock is worth more than what the nonemployee spouse paid for it, the nonemployee spouse is treated as the employee spouse, and taxes must be withheld. The nonemployee spouse is not, however, an employee, which makes it impossible to withhold FICA and pay FUTA taxes. Thus, according to the 2004 IRS Revenue Ruling, the options transferred under I.R.C. § 1041 to the nonemployee spouse pursuant to a divorce are taxable for employment tax purposes as if retained by the employee spouse. Therefore, the income recognized by the nonemployee spouse upon exercise are wages for purposes of income tax withholding, pursuant to I.R.C. § 3402 and will be withheld from the employee-spouse’s wages, as long as the employee-spouse is still an employee. If not, the nonemployee spouse will be responsible for FICA taxes.

One important aspect of stock options is the volatility of the stock market itself. The market price of the stock may drop during the holding period, and the anticipated profit may be smaller or lost entirely. Furthermore, disputes between the parties may arise as to when the employee spouse chooses to or must exercise the option.

The employee spouse may be more willing to hold the option longer to gamble that the stock price will go up over time. The nonemployee spouse may be risk-averse and not in a financial position to take such a gamble. The nonemployee spouse may wish to exercise the option sooner than the employee spouse to lock in profits, rather than hold the stock in hopes of a profit at a lower long-term capital gains tax rate.

Ultimately, courts may have to decide when the option will be sold and at what price. Sometimes courts will use a trust as the vehicle to hold and direct the sale of stock options. By using a trust, the nonemployee spouse can direct when the employee spouse must sell the options, thereby avoiding any further options-related issues or problems.

**Redemption of stock**

In some cases, a spouse who is a shareholder in a closely-held C or S corporation can satisfy his or her equitable distribution obligation to the other spouse by having the corporation redeem all or a portion of his or her stock. This approach eliminates the need for a deferred payout. Alternatively, both spouses may be shareholders of the same closely-held corporation, and one spouse may want to divorce himself completely from the business. Also, one spouse may demand that the other buy his or her stock. In any of these situations, a shareholder spouse can sell some or all of the stock back to the corporation at fair market value. This type of transaction creates tax issues— who pays the capital gains tax on the sale of the stock: the owner spouse, the recipient-spouse?

A redemption is defined for purposes of I.R.C. § 302 by I.R.C. § 317(b) as a corporation’s acquisition of its stock from a shareholder in exchange for property. Property includes money, securities, and any other property except the stock or rights to acquire the stock of the redeeming company.

On January 13, 2003, the IRS issued Treas. Reg. § 1.1041-2 to help clarify what was quickly
becoming a serious problem, as evidenced by a split in the federal circuit courts as to the tax treatment of a stock redemption for both “S” and “C” corporations between spouses and former spouses incident to a divorce. The regulation divides stock redemptions into two groups: redemptions of stock that result in a constructive distribution (i.e., a dividend) to the nontransferor spouse, and redemptions that are treated as a sale by the transferor spouse.

The redemption occurs when one spouse is required to purchase the other spouse’s stock but, instead, the corporation “redeems” or purchases the stock. For clarity, we will use the names Jane and Jim. Assume Jim is supposed to purchase Jane’s stock in connection with their divorce. Instead, Jim arranges to have the corporation redeem Jane’s stock. In this scenario, there are two possible ways to analyze the tax consequences. Under one analysis, the stock is deemed transferred by Jane to Jim. Then the stock is deemed transferred by Jim to the corporation for cash, and the cash is deemed paid. Treasury Regulation § 1.1041-2(b)(2) states that the first transfer (Jane’s stock to Jim) and the last are nontaxable under I.R.C. § 1041. However, Jim’s receipt of the redemption proceeds is treated as a taxable distribution to him.

The redemption of Jane’s stock will not result in a constructive distribution to Jim if the obligation to redeem the stock rests with the corporation rather than Jim. The nonrecognition tax treatment afforded by I.R.C. § 1041 does not apply, and Jane, the spouse who sold her stock back to the corporation, will recognize any gain or loss on the redemption.

Regulation § 1.1041-2 provides a tax-planning mechanism that allows the parties to know the tax consequences of the transaction before it occurs. The regulation allows the tax consequences of a redemption to be controlled by a written agreement between the parties. The agreement can be a divorce agreement, a separation agreement, or any other valid written agreement that expressly supersedes all other instruments or agreements related to the purchase, sale, redemption, or other disposition of the stock in question.

The written agreement must state clearly the intention of the parties as to how the redemption is to be treated for federal income tax purposes, i.e., as a redemption distribution of the stockholder spouse who sells his or her stock, or a constructive dividend to the spouse who arranges for the corporation to buy stock from the other spouse.

The written agreement must be executed prior to the date the spouse who is reporting the redemption as a taxable event first timely files an income tax return for the year that includes the date of redemption, but no later than the date such return is due, including extensions.

Conclusion
The tax consequences of property distributions vary depending on the nature of the asset and the applicable tax rules. In all cases, it is essential for divorce counsel to consider the tax issues and communicate them to the client. It may be wise to consult with a tax attorney or accountant in more complex tax situations. FA

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