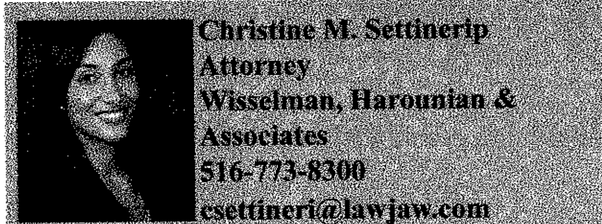
Avoiding the Built In Tax Liability of an Asset Transferred In Divorce



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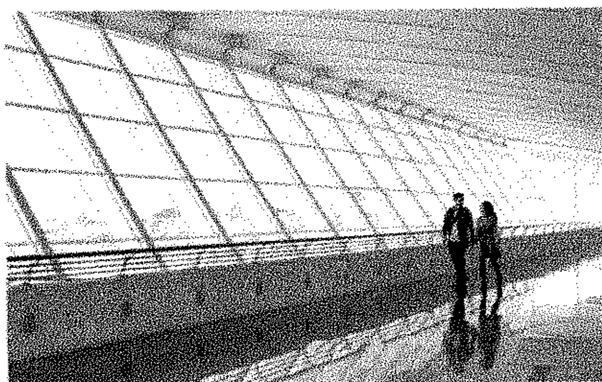
Often times divorcing couples do not consider the tax implications of their property settlements beyond the fact that IRC section 1041 provides that transfers between spouses, or former spouses "incident to divorce" are non taxable in most circumstances.

It is important that all property settlements consider the built in tax liability of the assets being transferred. A built in tax liability occurs because the transfer of an asset to your spouse is not considered a sale and thus, the original cost basis of the asset is assumed by transferor spouse. This rule is called a carryover basis rule. In other words, appreciated assets are worth less than an equal amount of cash.

For example, suppose a married couple purchased a home in the year 1980 for $200,000. At the time of the divorce in 2010, the husband bought out the wife's interest in the home for $325,000, which was one half of the value of the marital residence at that time. The transfer was a non taxable transaction. Years later, in 2016 the husband sells the marital residence for $675,000, and for the first time considers the built in tax liability that he assumed upon the buyout of the marital residence. His taxable gain is the difference between the sale price of $675,000 and the original cost basis of $200,000. The consideration paid to his wife at the time of the divorce in the amount of $325,000 does not adjust the cost basis of the property. The husband is left with a taxable gain in the amount of $475,000.



The husband may be able to qualify to exclude up to $250,000 of that gain from his income, or up to $500,000 if he files jointly and otherwise qualifies for the principal residence exemption. However, in the circumstances in which the principal residence exemption does not cover the taxable gain, there would have been a clear benefit to considering the tax liability of the asset at the time of the divorce and to negotiate a reduction in the buyout price. It is recommended that you seek legal and tax advice to protect your interests, whether you are the transferor or transferee spouse.

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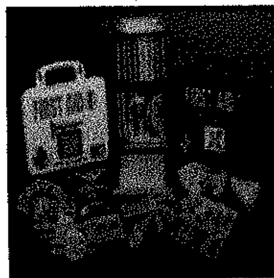

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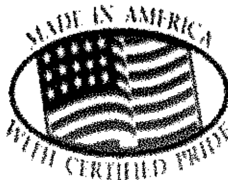

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