**What are the income tax consequences of property transfers pursuant to a divorce?**

**Prior to 1984 U.S. v  Davis held that a transfer of property from one spouse to another "incident to a divorce" or property settlement was an event for recognition of gain or loss to the transferor. The measure of this gain or loss was held to be the difference between the basis of the transferred property and its fair market value at the time of the transfer. In 1984 the Internal Revenue Code was amended to provide that gain or loss will be recognized on transfers of property between spouses or between former spouses "incident to a divorce," IRC $ 1041(a). The basis of the property at the time of the transfer (the transferor's adjusted basis) will carry over to the transferee and be his or her basis. IRC $ 1041(b). This will apply to all transfers of property for the exchange of marital rights, cash, property or any other consideration. For income tax purposes, the transfer is treated as a gift. IRC $ 1041(b). The rule also applies to transfers of trusts, transfers of life insurance contracts, transfers of annuity contracts, and transfers of installment obligations.**

**IRC $ 1041 creates a conclusive presumption that the transfer is "incident to a divorce" if the transfer occurs within a year after the date on which the marriage ceases. Otherwise, the transfer must be related to the cessation of the marriage.IRC $1041(c).**

**--Application.**

**Section 1041 as amended in 1984 is not limited to transfers of property incident to divorce. Section 1041 applies to any transfer of property between spouses, regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arm's length (including a transfer in exchange for the relinquishment of property or marital rights or an exchange otherwise governed by another nonrecognition provision of the Code). A divorce or legal separation need not be contemplated between the spouses at the time of the transfer nor must a divorce or legal separation ever occur.**

**Example: A and B are married and file a joint return. A is the sole owner of a condominium unit. A sale or gift of the condominium from A to B is a transfer subject to the rules of $ 1041.**

**Example: A and B are married and file separate returns. A is the owner of an independent sole proprietorship, X Company. In the ordinary course of business, X Company makes a sale of property to B. This sale is a transfer of property between spouses and is subject to the rules of $ 1041.**

**Example: Assume the facts as in example (2), except that X Company is a corporation wholly owned by A. This sale is not a sale between spouses subject to the rules of $ 1041. However, in appropriate circumstances, general tax principles, including the step-transaction doctrine, may be applicable in recharacterizing the transaction. Reg. $ 1.1041-IT, Q-1.**

**Only transfers of property (whether real or personal, tangible or intangible) are governed by $ 1041. Transfers of services are not subject to the rules of $ 1041.Reg. $ 1041-IT, Q-4.**

**The property transferred to a former spouse need not have been owned by the transferor spouse during the marriage.Reg. $ 1.1041-IT, Q-5.**

**--Requirement That Transfer Must be Incident to the Divorce or Related to the Cessation of the Marriage.**

**A transfer of property is "incident to the divorce" in either of the following two circumstances:**

**(1) the transfer occurs not more than a year after the date on which the marriage ceases, or**

**(2) the transfer is related to the cessation of the marriage.**

**Thus, a transfer of property occurring not more than a year after the date on which the marriage ceases need not be related to the cessation of the marriage to qualify for $ 1041 treatment. Reg. $ 1.1041-IT, Q-6.**

**A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in $ 71(b)(2), and the transfer occurs not more than 6 years after the date on which the marriage ceases. A divorce or separation instrument includes a modification or amendment to such decree or instrument. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the 1- and 6-year periods described above because of factors that hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed. Reg. $ 1.1041-IT, Q-7.**

**Annulments and the cessations of marriages that are void ab initio due to violations of state law constitute divorces for purposes of $ 1041.Reg. $ 1.1041-IT, Q-8.**

**--Transfers on Behalf of a Spouse.**

**There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under $ 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse), subject to the rules of $ 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse), and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under $ 1041. Reg. $ 1.1041-IT, Q-9.**

**--Tax Consequences.**

**The transferor of property under $ 1041 recognizes no gain or loss on the transfer, even if the transfer was in exchange for the release of marital rights or other consideration. This rule applies regardless of whether the transfer is of property separately owned by the transferor or is a division (equal or unequal) of community property. Reg. $ 1.1031-IT, Q-10.**

**The transferee of property under $ 1041 recognizes no gain or loss upon receipt of the transferred property. In all cases, the basis of the transferred property in the hands of the transferee is the adjusted basis of such property in the hands of the transferor immediately before the transfer. Even if the transfer is a bona fide sale, the transferee does not acquire a basis in the transferred property equal to the transferee's cost (the fair market value). This carry-over basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer (or the value of any consideration provided by the transferee) and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property by the transferee. Thus, this rule is different from the rule applied in $ 1015(a) for determining the basis of property acquired by gift. Reg. $ 1.1041-IT, Q-11.**

**The rules described above apply even if the transferred property is subject to liabilities that exceed the adjusted basis of the property. For example, assume A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows $5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes or takes the property subject to the liability to pay the $5,000 debt. Under $ 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is $1,000. Reg. $ 1.1041-IT, Q-12.**

**A transfer under $ 1041 may result in a recapture of investment tax credits with respect to the property transferred. Property transferred under $ 1041 will not be treated as being disposed of by or ceasing to be $ 38 property with respect to the transferor. However, the transferee will be subject to investment tax credit recapture if, upon or after the transfer, the property is disposed of by or ceases to be $ 38 property with respect to the transferee. For example, as part of a divorce property settlement, B receives a car from A that has been used in A's business for 2 years and for which an investment tax credit was taken by A. No part of A's business is transferred to B and B's use of the car is solely personal. B is subject to recapture of the investment tax credit previously taken by A. Reg. $ 1.1041-IT, Q-13.**

**--Notice and Record keeping Requirement.**

**A transferor of property under $ 1041 must, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer. In addition, in the case of a transfer of property that carries with it a potential liability for investment tax credit recapture, the transferor must, at the time of the transfer, supply the transferee with records sufficient to determine the amount and period of such potential liability. Such records must be preserved and kept accessible by the transferee. Reg. $ 1.041-IT, Q-14.**

**The 1986 Amendment : Transfers Between Spouses.**

**The 1986 Amendments provide that Internal Revenue Code $ 267(a)(1), which disallows losses from the sale or exchange of property between related taxpayers, is not to apply to a transfer that is described in Internal Revenue Code $ 1041(a). Under Internal Revenue Code $ 1041(a), no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or to a former spouse incident to a divorce. Such transfers are treated under Code $ 1041(b) as gifts, with the transferee taking the transferor's adjusted basis in the property. Act $ 1842(a), adding Code $ 267(g).**