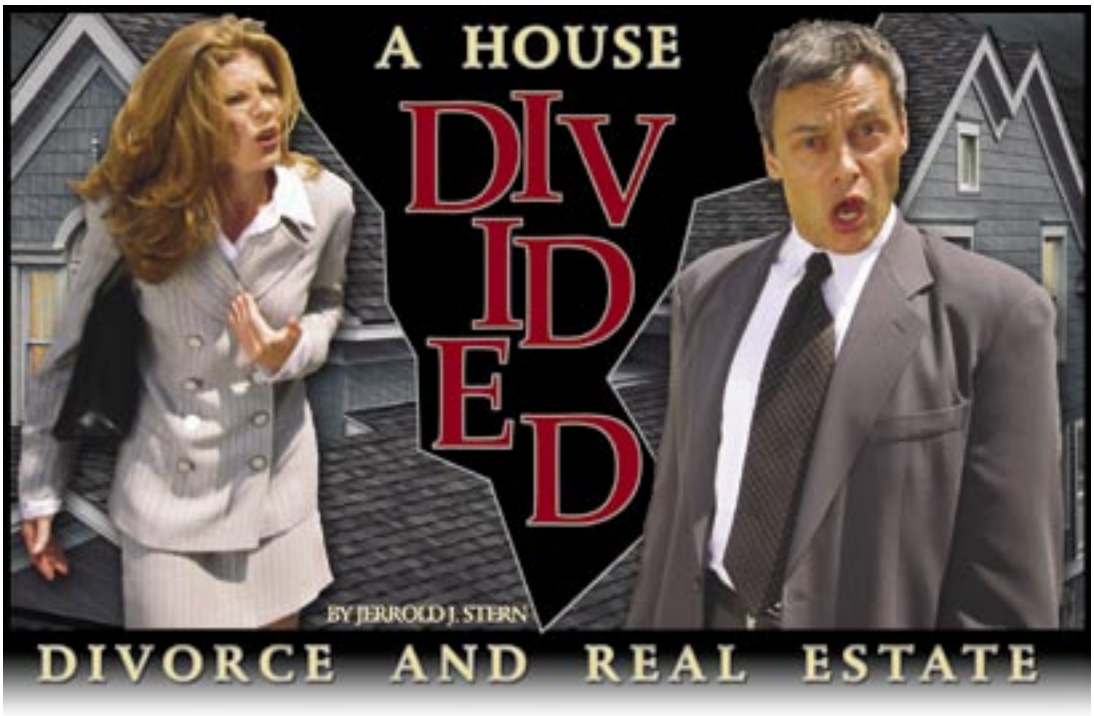
A Reprint from *Tierra Grande*



When a married taxpayer transfers property to his or her spouse, no gain or loss is recognized for tax purposes. This nontaxable result occurs regardless of whether the transfer is made through gift, sale or otherwise — even if the transfer is prompted by a divorce. The transferor's tax basis in the transferred property becomes the tax basis of the transferee spouse (or ex-spouse), and the transferee becomes responsible for paying tax if the property is later sold at a gain.

For example, in year 1, Harry purchases raw land for $700,000. In year 10, Harry marries Wendy, at which time the land is worth $1.2 million. Harry arranges for a new deed to be created for the property, naming himself and Wendy as joint owners. Even though the land has appreciated in value since purchase, no gain is recognized on the "transfer" of one-half of the land to Wendy. Wendy's basis in her one-half interest is $350,000 (one-half of the original $700,000 cost).

The same nonrecognition rule applies when property is transferred between spouses in conjunction with a divorce, as long as the transfer is made within one year after the divorce. The one-year time limit is extended to six years if the transfer is the result of a divorce or separation document.

Continuing the example from above, assume Harry and Wendy divorce in year 12, when the land is worth $1.3 million. In connection with the divorce, Harry transfers his 50 percent interest in the land to Wendy. No gain or loss is recognized. Wendy now owns the entire property, which has a $700,000 tax basis.

The same nontax result for Harry would occur if he and Wendy transfer their interests in the land to a creditor of Wendy's (such as a savings and loan institution) to which Wendy owed $1.3 million. Harry does not recognize gain. Wendy, however, recognizes the entire gain, which is $600,000 ($1.3 million fair market value less $700,000 tax basis).

Beware of bad faith tactics in real estate transactions related to divorce.

A recent U.S. Tax Court case *(Claudia F. Walker v. Commissioner*, TC Memo 2003-335) illustrated these tax rules but with a twist. In this case, Claudia Walker misrepresented the facts to her accountant and misapplied the tax rules in an attempt to make her ex-husband pay tax on 50 percent of the gain.

As part of a divorce agreement, Claudia Walker was to receive $500,000 from Bert Walker. Bert's divorce attorney sent a letter to Claudia's accountant asking what the tax consequences would be if Bert deeded his interest in real property to Claudia to satisfy the $500,000 obligation. The letter specifically asked whether the transfer would be a taxable event to Bert or if the capital gains tax responsibility and the tax basis of the real estate would carry over to Claudia. The accountant correctly replied that Bert's tax basis would become Claudia's tax basis, and she would be responsible for tax on the capital gain.

The property was listed for sale in 1997. In August that year, a prospective purchaser made an offer to buy it, and in September, Claudia agreed to receive her ex-husband's interest in the land in lieu of the $500,000 settlement. Bert filed a quitclaim deed in October transferring the real estate to Claudia. When the property was sold shortly thereafter, the closing statement listed Claudia as the only owner.

The accountant prepared 1997 tax returns for **both** Bert and Claudia. Claudia did not give the settlement statement to the accountant. Rather, she informed the accountant that Bert agreed to be responsible for paying tax on half of the capital gain. The tax returns were filed based on the information Claudia provided.

In January 2000, Bert gave the accountant the quitclaim deed and related documents and fully explained the circumstances. The accountant amended Bert's tax return and requested a refund from the IRS. The IRS disallowed the refund claim and sent Claudia a deficiency notice to avoid being "whipsawed" (neither party paying the tax).

The tax court held that Claudia was the liable party. Moreover, the court assessed a negligence penalty against her, stating that she intentionally disregarded the tax rules and acted in bad faith.

As this case illustrates, real estate transactions related to divorce can be complex. Moreover, taxpayers need to be mindful of bad faith tactics aimed against them. Consultation with a tax accountant or tax attorney who is **your personal advocate** is recommended.

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