SALE OF THE FAMILY RESIDENCE IN A DISSOLUTION PROCEEDING - THE MOST FREQUENTLY ENCOUNTERED TAX ISSUES

By Alexandra M. Kwoka

In many divorce cases, spouses disagree about whether or when to sell the family home, and how to divide the proceeds. Counsel and the parties, or the Court, resolves this issue, and the home is sold. However, the parties could later face contentious proceedings with the IRS, or the State Board of Equalization, if they do not agree on how the transaction will be reported to taxing authorities, and fail to file either a correct joint return or consistent separate returns.[1]

This article will help divorce counsel identify reporting and tax concerns so these problems can be foreseen and avoided whenever possible. By understanding the tax consequences, counsel will also be able to help the divorcing couple determine the true dollars they will receive upon the sale of the house, and thus prevent unexpected disappointments.

INITIAL QUESTIONS: What was the purchase price of your home? Did you refinance it before or during marriage? Were capital improvements made? What will be the costs of sale?

Principle: The monies the parties will receive when escrow closes are frequently not the "taxable gain"; net proceeds do *not* determine what taxes must be paid when the marital residence is sold.

[1] See Demirjian v. Commissioner of Internal Revenue, (2004) T.C. Memo 2004-22, 87 T.C. M. (CCH) 841 which illustrates what happens when the parties file an erroneous federal tax return, and then one party amends the return attempting to correct the error.

Alexandra M. Kwoka - Sale of the Family Residence

A divorce client understands that, when his/her residence is sold, the escrow company will deduct and pay specific items, including the mortgage loan, and issue the seller a check, the "net proceeds". However, the client is often surprised to discover that capital gains taxes are *not* computed based on the "equity" or the "net proceeds". Rather, the parties must virtually ignore these real estate concepts, and determine what taxes are due and must be paid based on the tax concept of "gain".[2]

First, the client must determine his/her "tax basis" in the residence. This is known as the "adjusted basis" in the IRS Code.[3] The adjusted basis is computed based on the purchase price, i.e., the original cost of the home - any refinancing is irrelevant.

A more sophisticated client will know that his "tax basis" is computed by adding to his purchase price what was spent on improvements during ownership. But again, the attorney must inquire and focus the client's attention on the nature of the improvements. Only improvements which are "capital improvements" (such as a new roof or bathroom, or a room addition) are added to the original purchase price to determine the "adjusted basis".[4] Painting, repairs and other costs incurred to maintain the property, or to improve its appearance immediately before sale, are not "capital improvements".

Second, in order to ascertain taxable "gain", the client must determine the "amount realized". The "amount realized" is the sales price less what the IRS rules permit to be deducted as the "costs of sale". "Costs of sale" include the real estate commissions paid. However, many other payments typically made through escrow, are *not* "costs of sale". Commons deductions not considered as "costs of sale" include real estate taxes, mortgage loan payments, homeowner's association assessments or tax lien.

---

[2] IRS Code Section 1001(a) states that "gain" from the sale of property "shall be the excess of the amount realized... over the adjusted basis."

[3] IRS Code sections 1011(a), 1012, 1016(a)(1) and Regs. section 1.1016-2(a).

[4] IRS Code 1011(a), 1012, 1016(a)(1) and Regs. 1.1016-2(a)

Alexandra M. Kwoka - **Sale of the Family Residence**

QUESTIONS: When did you buy your home? Did you "roll-over" into your present home gain not recognized in an earlier home sale? How long have you lived in the home? Have you deducted depreciation? Is the depreciation for something not part of the "same dwelling unit"?

Principles: All "gain" from the sale of a residence is not "recognized" and taxable. A taxpayer who meets the requirements of Section 121 may exclude up to $250,000 of gain on a qualified sale of his/her "principal residence".

IRS Code Section 121, enacted in 1997, sets forth the rules for when gain from the sale of the family home will not be recognized. A taxpayer who meets the requirements of Section 121, may exclude from gross income up to $250,000 of gain. Married taxpayers who file a joint return in the year of sale, are able to exclude $500,000 of gain. There are several requirements set forth in IRS Code Section 121(a):

(1) If the taxpayer rolled-over gain from the sale of a prior home, his/her "adjusted basis" must reflect the gain not recognized previously. Simply put, if the client's home was purchased before 1997 counsel must inquire whether a roll-over transaction occurred whereby gain was not recognized under former IRS Code Sections 121 and 1034. If so, the basis in the residence will be its purchase price less the amount of gain that was not previously recognized.

(2) The taxpayer cannot have excluded gain under Section 121 within two years immediately preceding the current sale. This applies to both spouses.

(3) The taxpayer must have owned *and* used the home as his/her "principal residence"[5] for periods aggregating two of the five years immediately prior to the sale. Surprisingly, the periods counted for meeting the 24 month *ownership* requirement do not have to be the same as the periods counted for meeting the 24 month *use* requirement. It is the ownership and use requirements of Section 121(a) which often cause divorce counsel the most concern.

The use requirement is particularly tricky because many people in troubled marriages often move in and out of their family residence. As discussed below in more detail, any absence that is not under a "divorce instrument" is not counted toward the 24 month use requirement. Reg. 1.121-1(c)(2). The ownership requirement is tricky because often the parties decide to

---

[5] Regulations adopted in December 2002, Regs. 1.121-1(b), T.D. 9030, 67 Fed. Reg. 78358 (12/24/2002) offer guidance as to what constitutes a taxpayer's "principal residence". Property which qualifies to be designated a "principal residence" includes a house trailer/mobile home, and a houseboat. Vacant land, if adjacent to land containing the principal residence may also qualify for the exclusion, if sold within two years before or two years after the date of the sale or exchange of the principal residence.

divorce before living together in the residence for two years. IRS Code Section 121(d) provides two rules which permit the client to exclude gain in these situations - one modifies the ownership requirement, and one modifies the use requirements:

(1) Ownership: If the home, at the time of sale, is owned by one spouse as the result of a Section 1041 transfer, that party's ownership requirement can be met by including any period the other spouse owned the home.

For example: H and W marry in 2003 and live in H's home (which he bought in 2001) for only one year before divorcing in year 2004, and W receives the home from H in the division of marital assets. Although W did not own the home for two years, if H owned and lived in the home as his "principal residence", his period of ownership is attributed to W to permit her to meet the two year "ownership" requirement. However, wife must also meet the use requirement so the escrow closing date in 2005 will be important.

(2) Use: If one spouse is granted use of the home under a "divorce instrument" - that is, a written separation agreement, a stipulated order, a MSA, or a judgment - and the other spouse is

later awarded the residence which is then sold, the "in-spouse's" occupancy is imputed to the "out-spouse". The written "divorce instrument" requirement is vital. Imputation of ownership and use begins only *after* signature to an agreement, or entry of the Court order or judgment. Thus, if both parties have not lived in the home for two years, counsel must be certain that an appropriate "divorce instrument" exists *before* one spouse moves out.

(3) Mixed-use residence: If the primary residence is on property also used for business purposes computation of "gain" must account for depreciation, *and, may* have to be allocated to the non-business use (which is then of course not subject to the exclusion).

The key to look for in determining whether "gain" must be allocated is whether the two uses are within the same "dwelling unit." A tax payer does not have to allocate gain if both the residential and non-residential portions of the building are within the same "dwelling unit". Therefore, in the common situation of a home office, only depreciation needs to be accounted for. On the other hand, if a separate portion of the real property is used as the "primary residence", the gain must be allocated to the two purposes. Of course, only the gain allocable to the residential portion of the real property is excludable from taxation under Section 121. For example, if the real property sold includes both the residence and a stable used for a horse-training business only the gain attributable to the residence portion is excludable.

QUESTION? Are you able to document and prove that the reason you are selling your home is because of the divorce?

Principle: Partial exclusion of "gain" is allowed if the sale of a home within two years of its acquisition if the sale results from an "unforeseen circumstance."

IRS Code Section 121(c)(2)(B), and Regs. 1.121-3T(e) provide that if the sale of a principal residence "is by reason of ...unforeseen circumstances", a partial exclusion of capital gain is allowed. "Unforeseen circumstances" includes a "divorce or legal separation under a decree of divorce or separate maintenance". The taxpayer has the burden to show he/she qualifies for the exclusion because the property was sold because of the divorce. Since the regulation employs a definition which differs slightly from the language used in Section 71 (which uses the term "divorce instrument") it is preferable for the court to order (or for the MSA to state) that the home is to be sole in the divorce proceeding to effect the division of the community property.

The exclusion allowed by this Section is not a $250,000 exemption, but a less generous exemption. This exemption is computed by use of a fraction (representing that portion of two years during which the taxpayer owned and used the property) multiplied by the maximum exclusion available pursuant to Section 121.[6]

QUESTION: When will the home be sold? Who is selling the residence?

Principle: The obligation to pay capital gain taxes upon the sale of the marital residence is imposed on the party who is the title owner at time of sale, even if the sale was by agreement set forth in the MSA.

If the marital residence is to be sold during or after entry of Judgment but as part of the divorce proceeding, and both spouses are expected to pay any capital gains taxes which may be owing, title should remain in both parties' names. Two Tax Court cases, Wells v Commissioner T.C. Memo 1995-537, and Walker v Commissioner T.C. Memo 2003-325, remind us that gain is taxable to the *owner* of the property at time of its sale. In both of these cases, real property was sold as part of the divorce proceeding - the parties' home in Wells, and the parties' ranch land in Walker. As quit claim deeds were signed and recorded in each case, the IRS sought collection of all of the taxes due from the respective spouse who was the sole record owner at time of sale. The Tax Court affirmed the IRS' position.

SUMMARY

---

[6] The method of computation, and an explanation of how to calculate the fraction to be used, is set forth in Reg.1.121-3(g).

Alexandra M. Kwoka - Sale of the Family Residence

The Section 121 provision for a $250,000 exclusion from capital gains taxes is relatively new. Because it takes several years for the Commissioner's decisions to be challenged and Tax Court opinions to be written, there is little guidance regarding Section 121's construction where the IRS challenges the exclusion of gain, or inconsistent tax returns related to the sale of the marital residence. The basic rules appear reasonably easy to interpret for the client. However, counsel should consult with the client's tax preparer as to the tax basis and/or for an opinion on what "gain" will be recognized in any of the following instances; the client's residence was

purchased before 1997; both parties did not own and live in the residence continually for 24 months before the divorce proceeding was initiated: or the residence was a "mixed-use" property.

Finally, if the parties intend to file separate tax returns reporting the sale, either the parties should be counseled to coordinate with tax advisors, or the Stipulations, MSA, or Judgment should be drafted to include provisions stating how the tax issues will be resolved to avoid inconsistent tax returns. By being attentive to details as to the marital home's acquisition, use, and sale, during divorce proceedings, counsel can recognize and address complicated tax issues.