



Divorce Taxation: Community Property Laws and Property Settlements

Course #3122B

Taxes

2 Credit Hours

Support@PacificCPE.com | (800) 787-5313

PacificCPE.com

DIVORCE TAXATION: COMMUNITY PROPERTY LAWS AND PROPERTY SETTLEMENTS

This course covers how community property laws affect how assets will be divided and the tax issues associated with property settlements due to divorce.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Community Property Tax Issues in Property Settlements

Study the course materials from pages 1 to 54

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recognize how community property laws affect how assets will be divided in community property states when a couple divorces
- Recall the tax issues associated with property settlements due to divorce.

NOTICE

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties or merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

The End User shall be permitted to use the Licensed Content for internal purposes only and not for resale or distribution. The Licensed Content is provided on an “as is” basis and without any warranties of any kind, express or implied. CCH INCORPORATED AND ITS LICENSORS AND AFFILIATES DISCLAIM ALL WARRANTIES WITH RESPECT TO THE LICENSED CONTENT, EXPRESS OR IMPLIED, INCLUDING BUT NOT LIMITED TO, WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, NON-INFRINGEMENT, TITLE, QUIET ENJOYMENT AND INFORMATION COMPLETENESS, CURRENCY OR ACCURACY.

End User assumes all responsibilities and obligations with respect to the selection of the Licensed Content to achieve End User’s intended results. End User assumes all responsibilities and obligations with respect to any decision or advice made or given as a result of the use or application of the Licensed Content. CCH and its licensors and affiliates are not engaged in the rendering of legal, accounting, tax or other professional advice or services. If legal, accounting, tax or other expert assistance is required, the services of a competent professional should be sought.

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

© **Pacific CPE, LP 2021**

Program publication date **09/15/2021**

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

TABLE OF CONTENTS

Chapter 1: Community Property	1
I. Distinguishing Community and Separate Property	1
A. "COMMUNITY PROPERTY" DEFINED	1
B. SEPARATE PROPERTY	3
C. DOMICILE AND COMMUNITY PROPERTY STATES	6
D. PRENUPTIAL AGREEMENTS	7
E. MISCELLANEOUS ISSUES	7
II. Federal Taxation: Community or Separate Property Income	8
A. DETERMINING THE CHARACTER OF ASSETS	8
B. COMMUNITY PROPERTY LAWS DISREGARDED	9
C. SPOUSES LIVING APART ALL YEAR	11
III. End of the Marital Community	12
A. DEATH OF SPOUSE	12
B. DIVORCE OR SEPARATION	13
IV. Federal Income Tax Return Preparation	13
A. JOINT RETURN VERSUS SEPARATE RETURNS	13
B. IDENTIFYING INCOME, DEDUCTIONS, AND CREDITS	14
Chapter 1: Test Your Knowledge	21
Chapter 1: Solutions and Suggested Responses	23
Chapter 2: Tax Issues in Property Settlements	25
I. Introduction	25
II. Transfer of Assets Between Spouses	26
A. GENERAL RULE	26
B. OTHER TRANSFERS COVERED	27
C. RULES WHERE TRANSFER IS RESULT OF DIVORCE	28
D. REPORTING INCOME FROM PROPERTY	34
E. NOTE ON CERTAIN ACCOUNTS	34
F. SUBSEQUENT TRANSFER NOT EXEMPT	34
III. Tax Treatment of Property Received	35
A. GENERAL RULE	35
B. BASIS OF PROPERTY RECEIVED	35
C. PROPERTY TRANSFERRED IN TRUST	36
IV. Gift Tax on Property Settlements	37
A. EXCEPTIONS	37
B. GIFT TAX RETURN	38

V. Note on the Sale of a Principal Residence	38
A. EXCLUSION RULE	38
B. MARRIED TAXPAYERS	40
C. OCCUPANCY PERIOD IN EVENT OF DIVORCE	40
VI. Note on Qualified Residence Interest Payments	40
Chapter 2: Test Your Knowledge	47
Chapter 2: Solutions and Suggested Responses	49
Glossary	51
Index	55
Final Exam Copy	56

CHAPTER 1: COMMUNITY PROPERTY

Chapter Objective

After completing this chapter, you should be able to:

- Recognize how community property laws affect how assets will be divided in community property states when a couple divorces.

Note



Alaska, Tennessee, and South Dakota. The states of Alaska, Tennessee, and South Dakota have passed elective Community Property Laws. This course does not address the federal tax treatment of income or property subject to the “community property” election.

Same sex marriages. For federal tax purposes, marriages of couples of the same sex are treated the same as marriages of couples of the opposite sex. For federal tax purposes, the term “spouse” means an individual lawfully married to another individual and includes an individual married to a person of the same sex. However, individuals who have entered into a registered domestic partnership, civil union, or other similar relationship that is not considered a marriage under state law are not considered married for federal tax purposes.

Divorce or separation instruments after 2018. Amounts paid as alimony or separate maintenance payments under a divorce or separation instrument executed after 2018 will not be deductible by the payer. Such amounts also will not be includible in the income of the recipient. The same is true of alimony paid under a divorce or separation instrument executed before 2019 and modified after 2018, if the modification expressly states that the alimony is not deductible to the payer or includible in the income of the recipient.

I. DISTINGUISHING COMMUNITY AND SEPARATE PROPERTY

A. “COMMUNITY PROPERTY” DEFINED

Community property is a classification-based system that divides all marital assets into one of two categories: (1) community property; and (2) separate property. The general rule is that all property, real or personal, acquired by a married person during the marriage while domiciled in a community property state is community property. The term “property” refers to both real and personal property of all types, including stocks, bonds, jewelry and cash.

Example



John and Mary were married in 2019. They live in Washington, a community property state. In 2020, the couple purchased a home in Washington. Both John and Mary work outside the home. John is a sales manager with an annual salary of \$100,000. Mary is a nurse with an annual salary of \$70,000. The home and the salaries of each spouse are community property.

1. Importance of Distinction

The distinction between community and separate property is very important! If a couple domiciled in a community property state gets divorced, community property law determines how their assets will be divided. In general, each spouse is entitled to all of his or her separate property and one-half of the community property. Since divorcing couples typically do not get along very well, they often argue over the correct characterization of the couple's assets.

In addition, community property laws are important because they affect how taxpayers figure their income on their federal income tax return if they are married, live in a community property state or country, and file separate returns. Married persons will usually pay less tax if they file a joint return (an issue discussed in detail in Chapter 2, Filing Status). Sometimes, however, it can be advantageous to file separate returns. In such cases, each spouse must determine his or her community income and his or her separate income. Community property laws also affect an individual's basis in certain property and therefore affect tax liability.

2. Presumption of Community Property

The law in community property states generally creates a presumption that any property acquired during the course of a marriage is community property. This presumption places the burden of proof on the party challenging such a classification to come up with evidence to show that the property in question should be classified as separate property. Such evidence includes:

- Showing that the property was acquired by gift, devise, or bequest;
- Tracing the property to separate property assets; or
- Showing a clear agreement between the parties regarding the nature of the property.

Example



Bill and Angie were married in 2007 and have their domicile in Texas, a community property state. In 2010, Angie's grandmother died and left her \$100,000 worth of stocks and bonds. Angie transferred the stocks and bonds into a brokerage account in her name only. In 2020, Bill and Angie decided to divorce. The value of the brokerage account had grown to be worth \$150,000. Because the portfolio was a bequest and because it was maintained as her separate property, the \$150,000 is Angie's separate property and Bill is not entitled to any of it. As an aside, if Angie elects to sell the assets to pay for her legal fees, her basis in the property will be its fair market value on the date she inherited it, or \$100,000.

B. SEPARATE PROPERTY

Simply put, property that is not community property is separate property. This includes property acquired prior to marriage and not gifted to the community, inheritances received during the marriage (so long as they are not subsequently commingled) and certain insurance proceeds. A married person may, without the consent of the person's spouse, dispose of his or her separate property at will (although legal, it could result in marital discord). Remember that the laws in each community property state may be different. In most cases, separate property will include the following:

- All property owned by the person before marriage;
- All property acquired by the person after marriage by gift, bequest, devise, or descent; and
- The rents, issues, and profits of the property described above.

In addition, the earnings and accumulations of a spouse and the minor children living with, or in the custody of, the spouse while living separate and apart from the other spouse are the separate property of that spouse.

1. Determining Date of Separation

When a married couple in a community property state decides to separate, it is important to determine the exact date of separation. This date is necessary to determine what property is community and what property is separate. Property acquired by a spouse after separation but before a divorce is final is separate property.

The date of separation is typically when either one of the spouses makes a decision that he or she does not intend to resume the marriage, or, based upon his or her actions, such an intention can be presumed. Remember that determining the date of separation is crucial because all income after that date is the separate property of each spouse.