

Divorce: the most tax-free part of marriage

By Robert W. Wood

The gay marriage debate raises enormous political and even religious issues. In what has become at times a rancorous national debate, taxes are probably low on the list of priorities. But as a tax lawyer for over 30 years, I see taxes front and center in this and many other issues. Taxes may not be driving the debate, but the tax consequences of being married — or not married — are huge.

That's especially true at the end of marriage. You might think the main tax issue would be whether same-sex couples can file joint income tax returns. That issue does merit discussion. Yet it's nothing compared to the tax aspects of dissolving a relationship. They are very different inside and outside marriage.

If you're married, there's no limit on the money or property you can transfer between spouses. That is true during the marriage and throughout the process of unwinding the marriage. There's no gift tax at any point (unless the spouse receiving assets isn't a U.S. citizen). If you're not married, you are limited to \$13,000 per year tax free. Gifts beyond that trigger an immediate gift tax or eat into your lifetime gift-tax exemption.

If you are married and then divorce, you can divvy up property tax-free. Again, there's no limit. So if you jointly bought a house, you can transfer your interest to your ex without tax. That means if you keep the house but your ex keeps the stock portfolio, neither one of you pays tax until you sell it.

That means in addition to the market value of assets you divide, you should also compare the tax basis of the assets. For example, suppose you keep the house which has a basis and a market value of \$1 million. Your ex gets the stock portfolio which has a market value of \$1 million but a basis of \$500,000. Who got the better deal? You did, since your ex-spouse will have to pay tax on the \$500,000 gain when he or she sells the stock.

Not married? Same sex or not, if you're [not] married unwinding a relationship can be very pricey, including income taxes, gift taxes or both. Suppose you give your half of the house to your ex-partner and receive nothing in exchange? Outside of marriage, you've made a taxable gift.

Suppose you're not feeling that generous and instead deed your half of the house to your ex in exchange for some of your ex-partner's stock holdings. This might sound better from a tax perspective, but actually it's worse. Here, you [both] could be hit with income taxes. As the departing partner, you'll be treated as selling your half of the house to your former partner.

Suppose you bought the house together decades ago for \$400,000 and it is now worth \$1,000,000? Your half has a \$200,000 basis and a value of \$500,000. That means you, the departing partner, will have a \$300,000 gain. If you qualify for the exclusion on sale of a principal residence (up to \$250,000 per person), only \$50,000 of it is taxable.

What about your ex-partner who is keeping the house and handing over \$500,000 in securities? If the staying-put partner's basis in the stock is \$300,000, he or she will have a \$200,000 gain. But

here's the kicker: If the same couple had been married, there would be no taxes paid on any of these asset transfers.

Note that these are simple examples. If you look at a many-year relationship with varied and significant assets, the taxes at stake can be enormous. The tax bill can be so big that in some cases, unmarried couples trying to untangle joint assets might consider getting married just so they can then qualify for the benefits of a tax-free divorce!

Here's a real life example. Mary and Bob were divorcing and dividing a whopping \$100 million of highly appreciated stock from the sale of a company he founded. Then a background check revealed that Mary had still been married to someone else when she and Bob had tied the knot 10 years earlier.

That "void" marriage meant if they divvied up the stock, one or both would be liable for a whopping tax. As tax lawyers, we had all sorts of elaborate ideas for how to get around this. But sometimes simplest is best: the couple had a quickie marriage so they could immediately get a quickie divorce and divide the stock tax free! (Not surprisingly, the divorce lawyers insisted on an ironclad prenuptial agreement that preserved the terms of the already agreed divorce settlement.)

Despite my focus on tax law, I realize the non-tax aspects of marriage are considerably more important than taxes. Still, taxes matter, especially if you have to unwind a relationship. Divorce isn't pleasant for anyone, but at least the tax laws don't contribute to the difficulty. In contrast, unwinding cohabitation can be a tough job for a tax adviser and expensive for the couple.



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