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TRANSFERRING FARM PROPERTY IN A DIVORCE

— by Neil E. Harl

The rising tide of divorces and separations in recent years has not bypassed the farm sector. In many instances, the problems of property division are more severe where a farm business is involved because typically most of the available assets are being used in the business. A loss of the assets can pose significant problems of economic survival for the farming operation; increasing the debt load to avoid loss of productive assets can pose equally serious problems.

**Tax-free transfers**

The problems of property division were eased substantially with enactment of I.R.C. § 1041 in 1984. Prior to that time, a transfer of appreciated property to a spouse or former spouse in exchange for marital claims resulted in recognition of gain to the transferor. The receiving spouse recognized no gain because the transaction was viewed as an exchange for marital rights. It was assumed that marital rights were worth at least as much as a property given in exchange so there was no gain to the spouse receiving the property. The recipient spouse took the property with an income tax basis equal to fair market value. Under the pre-1984 state of the law, losses could not be recognized on such interspousal transfers.

For transfers of property (but not services) after July 18, 1984, no gain or loss is recognized for sales or exchanges (or gifts) between spouses. This is usually the case without regard to type of property. The income tax basis for the spouse receiving the property is the basis in the hands of the transferor spouse immediately prior to the transfer. Even if the transfer is by sale, the carryover basis applies and the purchasing spouse does not receive a new income tax basis in the property. In the event that liabilities assumed exceed the income tax basis in an outright transfer, the transferee still takes the property with a basis the same as the basis of the asset in the hands of the transferor spouse. No gain is recognized where liabilities exceed the basis. That rule does not apply if the transfer is in trust. The same treatment applies to a transfer of property to a former spouse if the transfer is incident to a divorce.

Although the nonrecognition treatment applies generally to all types of property, special attention should be given to items of property involving deferred income such as interest on government bonds. In a 1987 ruling, IRS held that the accrued interest on U.S. savings bonds was includible in the transferor’s gross income in the taxable year the bonds were transferred to the transferor’s spouse even though coming within the nonrecognition rules otherwise. The transferee’s basis in the bonds after the transfer was equal to the transferor’s basis in the bonds increased by the interest amount included in the transferor’s income as a result of the transfer.

Property transfers are incident to a divorce if the transfer occurs within one year after the divorce or are “related to the cessation of the marriage.” A transfer is related to the cessation of a marriage if the property is transferred under a divorce or separation instrument and within six years after the date of the divorce. Any transfer not pursuant to a divorce or separation instrument and any transfer more than six years after the cessation of marriage are presumed not to be related to the cessation of the marriage. The presumption may be rebutted only by showing that the transfer was made for the purpose of dividing the property owned by the former spouses at the time the marriage ceased. Thus, the presumption may be rebutted by showing that — (1) the transfer was not accomplished during the one-year and six-year periods because of legal or business impediments to transfer or disputes concerning valuation and (2) the transfer occurred promptly after the impediment to transfer was removed.

The nonrecognition treatment applies only to real or personal property, tangible or intangible, and does not apply to services. Moreover, the nonrecognition provisions do not apply to transfers to a spouse or former spouse who is a nonresident alien. In that event, gain or loss is recognized at the time of transfer of the property if no other nonrecognition provision applies.

It is important to note that, to be eligible for nonrecognition treatment, it is not necessary for the property to have been owned by the spouses or the transferor spouse during the marriage. Property acquired after the marriage ceases may also be eligible for nonrecognition treatment.

Neither the statute nor the regulations define “cessation of marriage” although the regulations do state that annulments and the cessation of marriages that are void ab initio constitute marriages for this purpose. A transfer of property from a person other than a former spouse may qualify for nonrecognition of gain if it results from the cessation of the marriage. Such transfers may
qualify for the special nonrecognition treatment if — (1) the transfer to the third party is required by a divorce or separation instrument,23 (2) the transfer to the third party is pursuant to a written request of the other spouse or former spouse or (3) the transferee receives from the other spouse or former spouse a written consent or notification of the transfer to the third party.24 In all three situations, the transfer of property is treated as made directly to the nontransferring spouse or former spouse and the nontransferring spouse or former spouse is treated as immediately transferring the property to the third party.25 The deemed transfer from the nontransferring spouse or former spouse to the third party does not qualify for nonrecognition treatment unless covered by another nonrecognition provision.26

As an example of a third party transfer, in one IRS letter ruling a promissory note was transferred from one spouse’s wholly-owned corporation to the other spouse.27 IRS held that the obligation arose from the termination of the marriage, not from dealings with the corporation, and the transfer did not result in recognition of gain or loss.28 The transfer was considered to have been incident to the divorce.

Corporate stock redemptions pose special problems.29 In one case, gain was not recognized on stock redemption when a corporation was required by a divorce instrument to redeem the wife’s half of the stock in the corporation.30 The former husband had an obligation to the wife under the property settlement agreement to purchase the wife’s stock. The wife’s transfer of the stock was treated as a constructive transfer to the former husband who then transferred the stock to the corporation.31

In a later case, a wife was required to recognize gain on redemption of her stock by a corporation owned with the former husband.32 The redemption was incidental to the divorce decree but it failed to qualify for nonrecognition treatment because the wife did not transfer the redeemed stock to the corporation on behalf of her former husband. The transaction was viewed as no more than a transaction between the corporation and the wife and did not satisfy any obligation or liability of the husband.33

**Records and notices**

The transferor of property, at the time of the transfer, is required to provide records sufficient to show the adjusted income tax basis and holding period of the property as of the date of the transfer.34 The records must be preserved and kept accessible by the transferee.35

**FOOTNOTES**

3. Id.
4. Id.
7. Id.
8. I.R.C. § 1041(b).
10. Id., Q&A 12.
12. I.R.C. § 1041(e).
14. Rev. Rul. 87-112, 1987-2 C.B. 207 (Series E and EE bonds). It is not known whether such treatment would extend to all items of income-in-respect-of-decedent property, not just accrued interest on U.S. Government savings bonds but transfers of such property including installment land contracts and stored grain and growing crops produced under a nonmaterial participation lease should be avoided where possible. See 6 Harl, Agricultural Law § 47.03 (1996); Harl, Agricultural Law Manual § 6.02[1] (1996).
15. Id.
17. Temp. Treas. Reg. § 1.1041-1T(b), Q&A 7. A divorce or separation instrument includes a modification or amendment of a decree or instrument. Id.
18. Id.
19. Id.
20. Id.
22. I.R.C. § 1041(d).
25. Id.
28. See Ingham v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 50,131 (W.D. Wash. 1996) (decrees of dissolution ambiguous as to whether sale of property was required by divorce decree; government’s motion to dismiss denied because taxpayer had alleged facts entitling her to relief).
29. Id.
32. Id. IRS declined to rule on whether the note might represent earned or accrued income subject to the assignment of income principle. Rev. Rul. 87-112, 1987-2 C.B. 207.
33. See Ltr. Rul. 9046004, July 20, 1990 (redemption of corporate stock treated as transfer of corporate stock to former spouse followed by redemption of stock by corporation).
34. Arnes v. United States, 981 F.2d 456 (9th Cir. 1992).
35. Id. See Hayes v. Comm’r, 101 T.C. 593 (1993) (wife shielded from recognizing gain on redemption of stock as transfer of property between spouses incident to divorce; corporation’s redemption of wife’s stock constituted constructive dividend to husband where husband obligated to redeem stock pursuant to divorce decree).
37. Id.
39. Id.