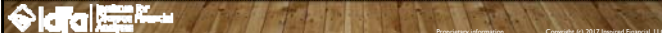


**A SURVEY OF  
IRC SECTION 1041**

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IDFA NATIONAL CONFERENCE  
MAY 5, 2017

BY: MARK L PRENDERGAST CPA CFP® CDFA™



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**SECTION 1041**

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Section 1041(a) - General rule

Section 1041(b) - Transfer treated as gift; transferee gets transferor's basis

Section 1041(c) - Incident to divorce

Section 1041(d) - Special rule where spouse is a nonresident alien

Section 1041(e) - Transfers in trust where liability exceeds basis



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**SECTION 1041(a)**  
**General rule**

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**No gain or loss** shall be recognized on a **transfer of property** from an individual to (or in trust for the benefit of)—

- (1) a spouse, or
- (2) a former spouse, but only if the transfer is **incident to the divorce**.



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**SECTION 1041(a)**  
**“transfer of property”**

- Real property
- Personal property
- Intangibles
- Financial assets
- Tax carryovers? *Baker v. Baker, 2494113 (Md. Ct. Spec. App. 2015)*
  - NOLs, Capital losses, Charitable contributions, Investment interest expense, Gen Business Credits
  - Suspended PALs, S Corp losses in excess of basis



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**SECTION 1041(b)**  
**Transfer treated as gift; transferee has transferor's basis**

In the case of any transfer of property described in **subsection (a)** —

- (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
- (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.



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**SECTION 1041(b)**  
**Paul & Patty & the Rental Property**

- Bought in 2006 for \$250K; thru 2015, depreciation taken of \$80K. Adjusted basis = \$170K
- Suspended PAL thru 2015 is \$120K.
- Divorce in 2016 and Paul takes the rental property. Paul's basis?
  - No gain or loss recognized
  - \$170K adjusted basis + \$60K (Patty's 50% of PAL) = \$230K
  - Paul's suspended PAL is only \$60K

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**SECTION 1041(b)**  
**Transfer treated as gift**

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- Suspended passive activity losses (“PALs”)
  - Recharacterizing future tax benefit from “ordinary loss” to “additional basis” (decreasing a Capital Gain and losing the Ordinary Loss)
  
- If sold before divorce on joint return, deduct that suspended PAL (ordinary loss)

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**SECTION 1041(c)**  
**Incident to divorce**

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For purposes of **subsection (a)(2)**, a transfer of property is incident to the divorce if such transfer—

- (1) occurs within 1 year after the date on which the marriage ceases, or
  
- (2) is related to the cessation of the marriage.

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**SECTION 1041(c)**  
**Incident to divorce**

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1. Within 1 year after date of divorce is presumed “incident to”
  
2. Years 2 thru 6 must be pursuant to divorce decree
  
3. Transfers after year 6 presumed to be unrelated to divorce
  - Rebuttable presumption

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**SECTION 1041(c)**  
**Incident to divorce – Example 1**

Paul owns house, separate property

- Basis \$100,000
- FMV \$500,000

Patty takes property in settlement (carryover basis)



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**SECTION 1041(c)**  
**Incident to divorce – Example 2**

Patty owns Apple stock, separate property


- Basis \$1,000
- FMV \$50,000



In month 11 after divorce, Paul takes Apple stock in lieu of \$50K alimony

- Tax-free disposition for Patty
- Non-taxable to Paul (gets carryover basis)

Not ALIMONY for tax purposes – payment was not in cash



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**SECTION 1041(d)**  
**Special rule where spouse is a nonresident alien**

**Subsection (a)** shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.



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**SECTION 1041(d)**  
**Nonresident Alien**

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- Spouse is not a US citizen, and
- Spouse does not live in the US

- Two types of transfers
  1. Sales & Exchanges
  2. Gifts



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**SECTION 1041(d)**  
**Example 1 – Sale or Exchange**

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Paul & Patty are divorcing. Paul = Taiwanese. Patty = US Citizen.  
Patty (an executive) owned their personal residence in Taipei prior to marriage.

- Basis = \$200,000; FMV = \$1,000,000
- “Subsection (a) shall not apply . . .”



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**SECTION 1041(d)**  
**Example 2 – Gift**

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Paul & Patty are married. Paul = Taiwanese. Patty = US Citizen.  
Patty (an executive) owns their personal residence in Taipei.  
For local law reasons, Patty gifts the property to Paul.

- Basis = \$200,000; FMV = \$1,000,000
- Gift Tax provisions apply (no unlimited marital deduction)

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**SECTION 1041(e)**  
**Transfers in trust where liability exceeds basis**

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**Subsection (a)** shall not apply to the transfer of property in trust to the extent that—

- (1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds
- (2) the total of the adjusted basis of the property transferred.

Proper adjustment shall be made under **subsection (b)** in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.



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**SECTION 1041(e)**  
**Example 1: Debt > Basis**

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- 1976, Grandma gifts Paul (age 21) her NB rental house; basis \$5,000 (fully depr.)
- Paul & Patty marry in 1980 and live there until the 2016 divorce. (Paul still owner)
- Over the years, Paul borrowed against the property: \$500,000 mortgage
- Divorce decree
  - House put in trust with Patty having life estate interest
  - At her death, house goes to their 3 children
- Taxable to? How much?

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**SECTION 1041(e)**  
**Example 2: Installment obligation-transfer in trust**

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- Paul sold a capital asset (his sole/separate prop) on installment basis.
- Remaining balance = \$100,000; basis in the note is \$40,000.
- Divorce decree
  - Paul transfers the Note into trust for Patty's benefit
- Taxable results:
  - Nontaxable to the trust & Patty (except for interest payments)
  - \$60,000 taxable gain to Paul
  - Trust's basis in the Note is \$100,000



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**PLANNING POINTS**  
**Basis Matters !!!!**

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- Require CARRYOVER BASIS to be incorporated in the MSA.
  - Not just some memorandum but **IRS-bullet-proof** documentation
- Transfers in trust: Warning Bells & Whistles:
  - determine Tax Basis and Debt (assumed and subject to)
- Spreadsheet of Draft Property Settlement / Asset Division
  - Insert a column for Tax Basis for each asset listed

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**THANK YOU TO THE ATTENDEES OF THE**  
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