How Taxes Relate to California Divorce: Property Division

There are four basic ways taxes have an impact on your California divorce: support, filing status, property division, and dependency exemptions. Here's a brief overview on what you need to know about how taxes impact property division in your divorce.

IRS Code Section 1071 allows for any spouse to spouse transfer of property that is incident to the divorce proceedings to be tax-free. That means that a lump sum payout, transferring titles of vehicles, refinancing and buying out the other person's interest in the house all have the ability to be treated as tax-free transactions.

Different rules apply when third parties are involved, though. A general rule of thumb is to remember that a divorce does not change basic tax treatment of transactions involving other people or entities. For example, if you and your spouse chose to sell the family home to a third party rather than one of you refinancing and buying out the other person's interest in the property, you may be liable for capital gains taxes just like if you were selling the house as a happily married couple. If you sell stock, you will be taxed on your profits just as you would even if you weren't getting a divorce.

When it comes to retirement accounts, it is entirely possible to avoid any tax consequences whatsoever as long as the retirement accounts maintain their character as a retirement account. In other words, if you cashed out your retirement account, you would be liable for taxes and penalties. If, however, you divide the retirement account property with a Qualified Domestic Relations Order (QDRO) or Domestic Relations Order (DRO), the transfer would be tax-free.

One last potential tax consequence to consider is with the division of Restricted Stock Units (RSUs) or another asset that cannot be transferred into the other spouse's name. If for example, Wife owned RSUs that would not vest for another year, and Husband wanted his community property share of them, his share could not be put in his name. This creates an issue because when Wife sells the RSUs, on paper, she alone will be liable for the taxes, even though Husband is entitled to his share of them. In order to make sure that each person receives the correct amount of income and takes on the correct amount of taxes associated with the income, they will need to work together with their tax advisors and attorneys in order to protect both of their interests.

The bottom line is that tax implications can make splitting assets complicated and difficult. If not done correctly, the spouses may end up with significant tax liability that could easily be avoided. In order to avoid complications, both spouses should work with tax professionals and attorneys in order to protect their assets.

For more advice regarding the property division and tax issues in your divorce, please contact us for help.