

Divorce and Taxes: Community Property and Property Settlements

Property division in divorce raises complex federal tax questions, especially when community property rules are in play. This section helps you distinguish community from separate property, understand how each type of income is taxed under federal law, and address the tax consequences when the marital community ends. You'll also cover asset transfers between spouses, the tax treatment of property received in a settlement, gift tax considerations, and key rules around principal residence sales and qualified residence interest—practical knowledge for any practitioner advising clients on divorce-related property matters.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course 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.

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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

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 payor. 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 payor 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 2025. They live in Washington, a community property state. In 2026, 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 of course 30051K, 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 2010 and have their domicile in Texas, a community property state. In 2013, 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 2026, 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.

Example

Doug and Holly were married in 2012 and remained happily married until 2026, at which time Holly discovered that Doug was having an extra-marital affair. While Doug was at work one day, Holly packed her bags and moved into an apartment across town. She subsequently filed for divorce and the divorce decree was eventually handed down nine months later. For purposes of determining what assets are community and what assets are separate property, the date Holly moved into an apartment will be considered the couple's date of separation. While Holly never said to Doug, "you are a dog and I am leaving you," her actions clearly showed her intent to end the marriage.

2. Presumed Gift

Where one party contributes a separate asset to the community, it is presumed to be a gift to the community and will not be reimbursed unless the person who made the gift can prove there was an agreement to the contrary.

Example

Linda and Greg were a married couple living in California, a community property state. When his grandmother died, Greg inherited a ring that had been in his family for over 100 years. He had the ring appraised and it was valued at \$25,000. Greg gave the ring to Linda as a present for their 10th wedding anniversary. Two years later, Greg filed for divorce. He argued that since he received the ring as a bequest, it was his separate property. Linda argued that when he presented her with the ring, it was deemed to be a gift to the community. Unless Greg can show that he only intended Linda to wear the ring so long as the couple was married, the ring will be classified as community property and Linda will therefore be entitled to one-half of its value.

3. Separate Property Business

A separate property business that is improved and grows in value during the course of marriage is subject to being divided upon divorce. Determining how much of the business belongs to the community and how much is still classified as separate property depends on how much time the owner spouse spent on the business during the course of the marriage. Where the value of the business increased largely due to the efforts of the spouse during the marriage, more of the business will be considered community property at the time of divorce. The reason for that is that in general the wages made by a spouse during the course of a marriage are community property assets. Profits from a separate property business are like wages. In addition, to the extent the labor the spouse increased the value of the business, the community interest in the business is increased.

Example 1

Hal owned a successful investment company at the time he met and married Sarah. After they were married, Hal worked full-time at the company. After 20 years of marriage, Hal filed for divorce. Under these facts, a large portion of the value of the business will be considered community property.

Example 2

Lara was a CPA who also owned a 35 percent share of a local restaurant at the time she met and married Lawrence. Lara was a silent partner in the restaurant and continued her job as a CPA during the entire course of the 10-year marriage. Lawrence filed for divorce. The court is not likely to consider much of the restaurant ownership to be community property since Lara did not spend much of her time during the marriage working on the investment.

4. Management and Control

Each spouse has management and control of the community property to the same degree he or she has control of his or her own separate property. If the parties want to alter their community property rights, such agreement must be executed in writing.

5. Change of Form

The original characterization of the property as community or separate does not change even though the property may change its form. This means that at the time a couple is divorcing it may be necessary to trace the history of certain assets to determine whether their genesis was community or separate property.

Example

Bill and Marci have been married for 10 years. In recognition of his five years of service at his place of employment, Bill receives a \$5,000 bonus. The money is received as compensation for his services rendered during the course of the marriage and therefore is community property. Bill takes the \$5,000 and opens a brokerage account. He uses the funds to purchase shares of Microsoft. The shares are community property, even if the brokerage account is in his name only.

C. DOMICILE AND COMMUNITY PROPERTY STATES

1. Community Property States

The following are community property states:¹

- Arizona
- California
- Idaho
- Louisiana
- Nevada
- New Mexico
- Texas
- Washington
- Wisconsin

2. Domicile

Whether an individual has community property is determined by whether or not he or she is domiciled in one of the above community property states. Each individual has only one domicile, regardless of the number of homes each person owns or occupies.

a. Definition

A person's domicile is defined as the permanent legal home that he or she intends to use for an indefinite or unlimited period, and to which, when absent, he or she intends to return. The question of domicile is therefore largely a matter of intent. A person must be prepared to show with facts that he or she intends a given place or state to be his or her permanent home. If a person moves into or out of a community property state during the year, he or she may or may not have community income.

b. Relevant Factors

Factors considered in determining where an individual is domiciled include, but are not limited to, the following:

- Where the individual pays state income tax;
- Where the individual votes;
- Location of property he or she owns;
- Citizenship;
- Length of residence; and
- Business and social ties to the community.

The amount of time spent in one place does not always explain the difference between home and domicile. A temporary home or residence may continue for months or years while a domicile may be established the first moment a person occupies the property. A person's intent is the determining factor in proving where he or she is domiciled.

Example

Phil and Mary are a married couple. The couple owns a home in Los Angeles and an apartment in New York. Phil spends at least two weeks out of the month in New York where he owns a marketing firm. Mary typically spends one weekend a month there and several months during the summer. The couple's children attend school in Los Angeles and both Mary and Phil have California drivers' licenses. They are also registered to vote in California. Even though they own property in New York and Phil spends more time in New York than in California, both Phil and Mary are domiciled in California.

D. PRENUPTIAL AGREEMENTS

A prenuptial agreement is nothing more than a contract between two persons that governs the distribution of marital assets at the time of dissolution rather than the state's laws. They are generally enforceable so long as they comply with the laws governing enforcement of contracts. However, prenuptial agreements are not generally valid if the party against whom enforcement of the contract is being sought is able to prove:

- That the party did not execute the agreement voluntarily; and
- The agreement was unconscionable and all of the following apply:
 - ☐ He or she was not provided disclosure of the property of the other;
 - ☐ He or she did not voluntarily waive, in writing, any right to the disclosure;
 - ☐ He or she did not have adequate knowledge of the property of the other; and
 - ☐ The agreement is against public policy by encouraging, facilitating or promoting divorce or dissolution.

E. MISCELLANEOUS ISSUES**1. Installment and Credit Acquisitions**

When one spouse executes an installment contract to purchase property before marriage and then uses community funds after marriage to pay some of the installment, the community property is entitled to an interest in such property in the proportion that community funds were used for installments.

If one spouse acquires property on credit during the marriage, it is presumed to be community property. To rebut this presumption, the courts will consider the intent of the lender. If the lender intended to extend the credit based on the separate assets of one spouse, the property will be characterized as separate.

2. Personal Injury Damage Awards