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Divorce and the Family Business—What Are the Options?

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Any successful family-owned business should employ protective strategies to minimize the impact of a shareholder's divorce. In a mature family-owned business, one that has been in existence long before the marriage of one of its young shareholders, the founders should have engaged in business-succession planning that contemplates the possibility of a shareholder's divorce. This can be accomplished with contractual agreements or by using trusts or other entities, such as family limited partnerships, to hold the business interests and protect against an involuntary transfer due to a shareholder's divorce. At a minimum, such strategies will track the ownership of the business and/or confirm the interest was non-marital or separate property when the marriage began. Sometimes a business enterprise is started early in a marriage and then only after the business becomes successful does the owner's marriage fail. This article examines the issues and options available to a divorcing couple who own and manage a family business, the ownership of which is not subject to any preexisting contracts as to distribution on divorce. The article is written in the context of a corporation for the family business but the concepts would apply generally to any form of business entity.

General Tax Implications of a Divorce

There are numerous tax considerations that must be addressed in the event of a divorce. The divorcing parties should try to agree on the division of a family business in whatever form that takes, and in doing so, utilize a mutually tax efficient method the benefits of which can then be further divided between the parties.

The most tax efficient method to divide a family business depends on the circumstances surrounding the business and the respective goals of the divorcing parties. In the context of a family business the advisor must consider: (i) is there a premarital agreement; (ii) is there a buy/sell agreement; (iii) what are the ownership interests of the divorcing parties; (iv) how much alimony is to be paid, if any; (v) were both parties active in the business; (vi) what value, if any, does each spouse contribute to the success of the business; and (vii) were both parties sufficiently compensated in the years prior to the divorce. General tax considerations for divorcing spouses include the non-recognition of property transfers, the tax-free division of retirement plans, and the tax shifting result of alimony payments.

Tax-Free Transfers Between Divorcing Spouses

In general, intra-spousal transfers prior to a divorce will typically qualify for the unlimited marital deduction and will not have any negative transfer tax implications. [1] Additionally, transfers prior or incident to a divorce are generally not recognized for income tax purposes, including the transfer of qualified retirement plans. [2] Any transfers made under the non-recognition rules are neither deductible by the payor spouse nor includable as income of the recipient spouse. The recipient spouse is treated as having received a gift for income tax purposes and therefore receives the same basis, as well as the same holding period, as what the transferring spouse had prior to the transfer. [3]

Tax-Free Division of Retirement Plans

In order to divide retirement plans free of taxation, the divorcing spouses must utilize a qualified do-

mestic relations order (QDRO). A QDRO is defined as an order "which creates or recognizes the existence of an alternate payee's (the receiving spouse's) right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan." [4] An additional requirement of a QDRO is that it cannot alter the form or timing of payments from the retirement plan. Assuming all of these requirements are met, divorcing spouses are generally able to divide their retirement plans as they see fit without incurring any tax.

Income Tax Includable/Deductible Alimony

The divorce settlement may require the division or transfer of property between spouses, or the payment of support and maintenance (alimony), or both. If one of the spouses to the divorce is likely to have a large amount of taxable income in the future, and thus is in the highest marginal tax bracket, and the other spouse is not likely to have a substantial amount of taxable income, it would usually be better for the parties, in the aggregate, to utilize the benefits and lower rates of the low-income spouse by including the benefits in the taxable income of the low-income spouse and deducting such benefits by the high-income spouse. In such cases, the couple may increase the amount of alimony or lengthen the payment period for alimony, and correspondingly decrease the amount of any property settlement between the spouses. This can be accomplished by treating and qualifying the annual payments as alimony. Alimony, as defined by the Code, requires: (i) the divorced spouses to be living in separate households; (ii) cash payments from one spouse to the other; (iii) payments made in accordance with a separation instrument or incident to a divorce decree; and (iv) the termination of all payments on the death of the spouse receiving the payments. [5] If all of these requirements are met, the spouses will generally be able to effectively shift all payments made from the gross income of the high marginal rate spouse to the low marginal rate spouse.

Divorcing couples who are faced with an alimony arrangement may place stipulations on the alimony payments within their divorce decree or separation instrument, such as providing for the termination of alimony payments on the remarriage or cohabitation of the recipient spouse. One commonly requested modification is the elimination of the requirement to terminate payments on the receiving spouse's death so that the payments continue for the benefit of the receiving spouse's children. This can be accomplished with what has been referred to as an alimony trust. [6]

Regardless of whether a general divorce decree, separation agreement, or a more complicated alimony trust is used, the intended tax consequences to both of the parties should be outlined in detail in a written instrument and fully understood by both spouses and their counsel.

Options Available to Divorcing Spouses

Problems in the operation of a family-owned business tend to multiply with the introduction of a shareholder's divorce. Issues such as the direction of the business, the compensation and benefits paid to shareholders, the resolution of day-to-day managerial problems, etc. can destroy the business over time, leaving both parties in worse shape than they would have been had they initially come to terms on how to divide, sell, or otherwise dispose of their similarly owned and controlled business interests.

Sell Business to Third Party

Selling the family business is typically the least desirable outcome, at least to one of the spouses, but will be ordered by the court where there is no other viable alternative. Selling a family business to a third party will have the same general tax consequences whether the sale was driven by a divorce or not. Additionally, a forced sale is likely to result in a depressed sales price.

Buy Out of a Spouse's Interest or Share

The obvious solution in a divorce where one or both of the spouses own a business is for one of the spouses (or the company) to buy the other spouse's interest or for the owner spouse to compensate the non-owner spouse for his or her share of the business interest. This option is particularly suitable where one of the parties is actively engaged in the business and the other is not. The major challenges with this option include getting the spouses to agree on the method of determining the valuation/sales price of the company, the method and timing of paying the sales price, and determining how the transaction will be characterized for tax purposes. Fair market value

is the price at which an independent buyer and independent seller would willingly agree to enter into a purchase transaction; however, as the buyer and seller in this situation are not independent third parties, and are in essence forced to transact with one another as co-owners, it is often difficult to arrive at an agreed upon fair market value for the transaction. In such situations, a specialized appraiser, CPA, or CVA is generally hired for purposes of trying to determine the fair market value. Separate appraisers are also sometimes engaged by both of the spouses for negotiation purposes or even to give testimony before a court when the divorcing spouses cannot reach a satisfactory valuation. After the price and payment terms have been agreed on, the spouses must address the tax consequences.

Transfer/Redemption of Stock. If a spouse owns or, as part of the divorce settlement, receives an interest in the family company as part of his or her share of the marital assets, the spouses may wish to consider how the receiving spouse could sell or exchange the interest for cash. As previously discussed, Section 1041 allows spouses to transfer assets in a tax-free manner; however, when the family company will be used to redeem stock, there will be a recognition event if there is either (i) a redemption under Section 301 or Section 302; or (ii) a constructive dividend. [7]

A redemption is a transfer made by a shareholder of some or all of his or her stock to the issuing company in return for cash or other assets. [8] Shareholders generally prefer transactions to be considered redemptions rather than dividends because of the relatively low long-term capital gains rate of 15%. On the other hand, qualifying dividends can also receive favorable tax treatment and would reduce or eliminate any accumulative earnings and profits locked up in the company. Removing E&P may be attractive to the remaining shareholder if the company is currently an S corporation, or it is considering an election to convert to an S corporation. The parties will also need to consider the basis of the stock, and whether either spouse will have other capital losses that could offset any gain in determining the most tax efficient overall tax approach.

The final regulations under Section 1041 generally respect the form of redemption, and treat a redeeming spouse as the transferor of his or her stock to the company, unless the redemption relieves the other spouse of a primary and unconditional obligation to acquire the shares from the transferring spouse. [9] If such an obligation exists, the non-redeeming spouse will be deemed to have received a constructive dividend under the rules of Section 301 and Section 302. If there is no such obligation, the transferring spouse is treated as entering into a redemption with the company and taxed accordingly. The regulations provide that the spouses can agree between themselves as to how the transaction will be taxed. Counsel for both spouses should take advantage of this provision and be sure to articulate in writing the understanding of the spouses. [10] For the agreement to be effective, it must be filed with the applicable tax return for the year that includes the stock redemption. [11]

Employee Stock Ownership Plans and Tax-Free Exchanges

Employee stock ownership plans (ESOPs) provide an additional option for the company to obtain the stock of a departing spouse. In general, if the ESOP owns at least 30% of the stock of the company immediately after the sale of the transferring spouse's stock to the company and the transferring spouse purchases “qualified replacement property” within the “replacement period,” the transferring spouse would recognize long-term capital gain only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of such qualified replacement property. [12] In other words, the departing shareholder can generally exchange his or her shares in the family business for shares in another corporation without incurring tax so long as the rules are followed and the entire amount received from the sale is at least equal to the amount of the replacement stock purchased. [13] This option also provides benefits to the remaining spouse because the transaction should not be treated as either a redemption or a constructive dividend and, depending on the percentage exchanged, the remaining spouse is likely to control the company after the ESOP transaction.

Co-Existence—Continue Ownership and Operation of the Business

Often the only thing divorcing spouses can agree on is that the family business should not be sold at the time of the divorce. This may be the case if the business would not currently generate an ac-

ceptable purchase price, where the spouses would not retain their positions with the company after sale, where opening a competing business is not practical, or where the spouses' children rely on their current employment with the family business.

Split up the Company

It may be possible to split a family-owned business between the divorcing couple. The alternatives available to a divorcing couple include dividing the business assets and beginning or continuing separate business lines with separate ownership or dividing the business into different segments and continuing to own and operate separate divisions of the business enterprise. For example, if the business owns land and the buildings that house the operating business, the real estate ownership can be severed from the operating business with one spouse taking the real estate and the other taking the business operations. A long-term lease can address the financial relationship and risk allocation between the parties and their respective separate businesses.

Divorcing parties can generally split-up a corporation free of tax. [14] This type of situation usually calls for a Type D reorganization. [15] The general procedure for a Type D reorganization is for the corporation to transfer a portion of its assets to a new subsidiary corporation that it controls. The departing shareholder then distributes all of his or her shares of the original corporation in exchange for all of the shares of the new corporation. This results in both of the divorcing parties owning legally separate corporations without the incurrence of any tax.

To obtain this result, the following requirements must be met: (i) the original corporation can only distribute stock or securities to the departing shareholder in exchange for his or her ownership interest in the original corporation; (ii) the stock or securities distributed by the original corporation must have been “controlled” by the distributing corporation immediately before the distribution; (iii) there must have been a business purpose for the transaction; (iv) the transaction could not be used principally for the purposes of distributing earnings and profits of either of the corporations; and (v) both corporations must be engaged in the active conduct of a trade or business after the transaction. [16] Although most of these requirements can be accomplished by the tax professional engaged to complete the transaction, the divorcing parties should make certain that they are both willing and able to engage in the active conduct of a trade or business after the transaction has been completed. Additionally, the parties should document the business purposes for the transaction, one of which will most likely be that the divorcing parties disagree on the current administration of the family business.

Recapitalization into Different Ownership Classes

Both spouses may wish, or have no other viable option but, to continue owning an interest in the family business. An alternative in this situation is for one of the shareholders to exchange his or her stock for a different class of stock, such as non-voting and/or preferred stock. By making such an exchange, the parties could extend benefits, such as preference on dividends, voting rights, and call or put options, in a manner that is designed to separate, yet equalize, the current value of the family enterprise. For example, the spouse managing the business could retain common voting stock, representing 49% of the total stock, and the other non-working spouse could exchange or receive preferred non-voting stock equaling the remaining 51% of stock. The spouse holding the preferred stock would not have the ability to control the business but would be entitled to receive an agreed upon annual dividend. A protection mechanism could be added to this arrangement whereby if the preferred dividend were to go into arrears for a specific length of time, such as two years, the preferred stock would automatically convert to voting stock, giving this spouse control of the company. An additional feature could be added to allow the company or managing shareholder the option to redeem/purchase the preferred stock at an agreed upon formulaic price. The overall objective of this agreement is to provide the spouse holding the common stock with enough time to accumulate capital to purchase the preferred stock while providing an ongoing incentive to make the company profitable enough to timely pay the preferred dividends and not risk losing control of the company.

Retention of Full Ownership Interests

The option of continuing the family business, with powers and duties divided between the divorcing

couple, usually should be considered as a long-term solution only where special circumstances are present. Such circumstances may include: (i) a profitable business that can sustain the monetary desires of both of the divorcing spouses; (ii) a desire or need by both spouses to continue their ownership; (iii) where neither spouse is able or willing to buy the interests of the other; (iv) children of the divorcing spouses are active in the business; and (v) where both spouses are emotionally and mentally capable of co-existing as shareholders, officers, and directors of the company. To enforce the ongoing business relationship of the spouses, they would enter into management agreements to delineate specific duties of each spouse in the operation of the business and identify those issues requiring the vote or approval of both spouses, such as the sale of the company, salary increases, personnel decisions, borrowing, etc. The spouses may want to prepare employment agreements to address benefits, termination, resignation, covenants not to compete, etc. Additionally, all shareholders should enter into buy-sell agreements to specifically address the future transferability of stock, and the purchase rights on death, among other issues. Lastly, the spouses should consider the means to address any shareholder disputes such as resolution by arbitration.

Estate Planning Opportunities

A divorcing couple who own all or the majority of a closely held business may have a unique estate planning opportunity, particularly where the couples' children are active in the business. The divorcing couple can provide for a succession plan for the benefit of their children or other permissible beneficiaries, reduce or eliminate the uncertainty of how a spouse's interest in the company will be distributed upon the spouse's death, and take advantage of valuation discounts by placing each of the spouses in a minority position. This can all be accomplished by the divorcing spouses while still maintaining joint control over the operations of the business, or utilizing many of the options discussed herein. This will also ensure that the company and/or the divorcing couples' children will at least have an opportunity to acquire the interest of a spouse upon his or her death.

Joint Control and Valuation Discount

Assume Scott and Anne Smith each own 50% of Smith Company. After 30 years of marriage and building an extremely successful business, the Smiths are divorcing. All four of their children are active in the business, which has been valued at $30 million. The Smiths agree that on their deaths the stock in the company should pass to their children; however, each is concerned that the other may change his or her mind. Mrs. Smith is particularly concerned that Mr. Smith may start a new family and dilute the inheritance of their then living children. To address this concern, the Smiths agree to transfer $2 million of stock ($1 million each) to their children, equaling approximately 6%-10% of the company with valuation discounts, and agree to enter into a buy/sell agreement among all shareholders. By doing so, each spouse guarantees that their existing children would inherit at least 55% of the company stock directly, and have the right to purchase the remaining 45% of the non-compliant spouse's stock. Neither spouse maintains a controlling position and therefore their interests should be eligible for minority and marketability discounts on death.

Non-Conventional Methods of Providing Value and Consideration

In some situations, other methods of compensating the spouses may be considered.

Wage Continuation/Consulting Agreement

In a situation where both spouses worked for the family business in its formative years, it is possible that one or both of them did not receive full compensation for the services they provided. In such a situation, it is possible to compensate an exiting spouse by continuing, and possibly increasing, the compensation he or she receives in the form of a consulting or management fee, or deferred compensation arrangement. To do so, great effort should be taken to document the facts as well as the analysis taken to determine the amount of compensation the departing spouse should receive.

Covenant Not to Compete

If the company believes the departing spouse could threaten its business by competing against

it, the company could offer the departing spouse compensation in exchange for agreeing not to compete against it. In most cases, a covenant not to compete will be upheld by a court if it is reasonable as to the length of time the departing spouse cannot compete and the distance within which competition cannot occur. [17] In order for the compensation to be deductible by the company, it must be able to show that the former spouse did indeed pose a threat to the company. It must also show that there was an economic reality in its compensation to the departing spouse.

Conclusion

There are no easy solutions when owners of a family business divorce. The best way to avoid many of the complications outlined in this article is to use prenuptial agreements, buy-sell agreements, or other forms of business succession planning. In the absence of such pre-existing agreements, there are unique and tax efficient methods to divide and exchange the spouses' interests in a family business. This article outlined some of the more common methods available to business owners. The advisors for both spouses will need to coordinate the goals of each spouse, the options available in light of the form, profitability, and nature of the family business, and the risks and costs of having the spouses resolve their differences in the divorce court.

ENDNOTES

[1] Sections 2056(a) and 2523(a).

[2] Section 1041.

[3] Sections 1041(b) and 1223(2).

[4] Section 414(p)(1)(A)(i).

[5] Section 71.

[6] See Ltr. Rul. 9235032 allowing an alimony trusts designation to include amounts distributed as taxable income to the recipient spouse and as deductible by the payor spouse while allowing payments to continue from the trust after the death of the payor spouse. The alimony trust will be included in the estate of the payor spouse under Section 2036(a)(1) but the value of all future payments will be deductible as claims against the payor spouse's estate under Section 2053(a)(3).

[7] See Mulberry Motor Parts, Inc., 273 F3d 1120 (CA-11, 2001), *aff'g without op. sub nom*. Read, 114 TC 14 (2000) for a thorough discussion of the tax issues relating to Section 1041 and the redemption of stock. See also Reg. 1.1041-2.

[8] Section 302.

[9] Reg. 1.1041-2(d)(3).

[10] The regulations apply to stock redemptions after 1/13/03, but see Reg. 1.1041-2(e) for specific application rules.

[11] Reg. 1.1041-2(c)(3).

[12] Section 1041.

[13] Section 1042

[14] Section 355.

[15] Section 368(a)(1)(D).

[16] *Id*.

[17] See In re Marriage of Fisher, 834 P.2d 270 (Colo. App., 1992).