

Dividing Ownership Interests in Closely-Held Business Entities: Things to Know and to Avoid

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Important Principles in Dividing Business Interests in a Divorce (Legal)

- From legal standpoint, there are 4 types of business entities:
 1. Sole proprietorship
 2. Corporation
 3. Partnership
 4. Limited Liability Company (“LLC”)

Important Principles in Dividing Business Interests in a Divorce (Tax)

- For tax purposes, there are generally 3 types of business entities:
 1. Sole proprietorship
 2. Corporation
 3. Partnership

Types of Business Entities

Sole Proprietorship

- Not an entity for legal purposes or tax purposes.
- The assets belong to the owner.
- The debts are liabilities of the owner.
- The income is taxed to the owner, on Schedule C of his/her personal tax return.

Corporation (Legal)

- A corporation is an entity for legal purposes.
- All corporate assets belong to the entity.
- All corporate debts are debts of the entity.
- The shareholders do not own corporate assets, and they are not liable for corporate debts.
- Unless shareholders become liable for corporate debts by personally guaranteeing them or due to piercing the corporate veil.

Corporation (Tax)

- A corporation is an entity for tax purposes.
- A corporation is taxed either as a C Corporation or an S Corporation.

C Corporation (Tax)

- A C Corporation is treated as an entity for all tax purposes.
- A C Corporation is taxed on its earnings and profits.
- When it distributes its E&P to shareholders, a C Corporation gets no deduction, and the shareholders are taxed at the dividend tax rate—either 0%, 15%, or 20% (if qualified).
- This results in double-taxation of the same profits.
- C Corporation stock is a capital asset subject to capital gain tax when sold or liquidated.

S Corporation (Tax)

- For tax purposes, an S Corporation is treated in some ways as an entity and in some ways not as an entity. For example:
 - An S Corporation's profits and losses are taxed not to the corporation but to the shareholders. So, profits are taxed only once: there is no double taxation.
 - However, an S Corporation is treated as an entity for some purposes. For example:
 - When shares in an S Corporation are sold or redeemed, there can be a capital gain or loss.

Partnership (Legal)

- A partnership is an entity for legal purposes.
- All partnership assets belong to the entity.
- As for liabilities, however, a general partnership is not like an entity. In a general partnership, the partnership and all of the partners are liable for partnership debts.
- In a limited partnership, the partnership and its general partners are liable for partnership debts, but limited partners are not personally liable.

Partnership (Tax)

- For tax purposes, in some ways a partnership is an entity and in some ways it's not. For example:
 - A partnership's profits and losses are reported to the IRS but they are taxed to the partners.
 - The partnership reported its profits, losses, and distributions, on a Schedule K-1 sent to each partner.
 - The partner reports his/her share of the partnership's profits or losses on Schedule E of his/her personal tax return.

Partnership Interest (Tax)

- When a partner's interest is sold or liquidated, the transaction is treated as a capital gain or loss.
- Tax law distinguishes "inside" from "outside" tax basis.
 - Inside tax basis is the partnership's tax basis in partnership assets.
 - Outside tax basis is the partners' tax basis in their partnership interests.
- Capital gains can be recognized both "inside" and "outside" the partnership.

Limited Liability Company (“LLC”)

- An LLC is an entity for legal purposes.
- The LLC owns its assets and the members are not liable for LLC debts, except for personal guarantees and piercing the veil.
- The LLC can elect to be taxed like a C Corporation or like an S Corporation.
- When a membership interest in an LLC is sold, it is recognized as a capital gain or loss.

Types of Property Divisions

Basic Choices

1. Leave the spouses as co-owners of the business.
2. Sell the business and split the proceeds.
3. Award the business to one spouse and award offsetting community property or cash to the other spouse, or a money judgment, promissory note, or contractual alimony.
4. Transfer money or assets held inside the business to the departing spouse in liquidation of his/her interest.

Leaving the Spouses as Co-Owners of the Business

- Avoids the need to value the business, but it can create problems regarding the **post-divorce control** of the business.
- If both ex-spouses have equal control, an **impasse** can develop that may require a court-appointed receiver.
- If one ex-spouse is given control of the business, there can be **abuse of control**, leading to minority oppression and the filing of a derivative action or a suit for breach of fiduciary duty.

Leaving the Spouses as Co-Owners of the Business

- Even the controlling ex-spouse can be dissatisfied with having to deal with an **unhappy minority owner**.
- If there are other owners, splitting the community property interest may cause both ex-spouses to lose control of the business, or one ex-spouse can join other minority owners in a voting block to injure the other spouse.
- The co-owned business can be converted from partnership to LLC, S Corporation to C Corporation, etc.

Selling the Business

- Avoids having to value the business in the divorce, since the price at which the business is sold is by definition Fair Market Value.
- However, dissension between the two spouses can scare off legitimate buyers, leaving only “vultures” who are looking for a bargain.
- If a receiver is appointed, there is that cost.

Selling the Business

- If the terms of sale are determined by a receiver or broker, they may reduce the price to make a quick sale for cash, when a longer period of marketing or more strenuous negotiations might lead to a higher sales price or better terms of sale.
- Neither spouse can be required to sign a covenant not to compete, which depresses the sales price.
- If a covenant will be signed, how much will be allocated to the covenant?

Awarding the Business to One Spouse, and Offsetting Money or Property to the Other

- Requires the business to be valued in the divorce.
- Often there are not enough other assets or money to award to the other spouse, so some part of the "purchase price" will have to be paid over time.
- This turns the marriage relationship into a debtor/creditor relationship, and raises issues involving collateral to secure the promise to pay, perfecting liens, and post-divorce collection and enforcement remedies.

Taxation of the Property Division

Internal Revenue Code § 1041

- Eliminates a capital gain tax where one spouse conveys an interest in the business to the other spouse for money or other property, incident to divorce.
- However, if the spouses want to use **money inside the entity** to redeem a spouse's interest in the business, it will require a distribution from the entity and that distribution is subject to income tax.

Internal Revenue Code § 1041

- Treasury Regs under **IRC § 1041** permit the spouses to agree that a redemption or liquidation will be taxed either to the “departing spouse” as a capital gain or loss, or to the “remaining spouse” as a constructive dividend.
- The tax rates on a dividend or a capital gain are the same, but a capital gain tax is levied on the amount paid after subtracting the departing spouse’s tax basis in the entity, whereas a dividend tax is levied on 100% of the amount paid.
- Moreover, a capital gain can be reported on an installment basis over a period of months or years, which may lower the overall tax paid.

“Hot” Assets

- In a redemption or partial liquidation, a tax at ordinary tax rates (up to 39.6%) can be triggered if the entity owns “hot assets.”
- Hot assets include unrealized receivables, mineral leasehold interests for which intangible drilling and investment costs were deducted, and property subject to depreciation recapture.
- Hot assets can increase the tax that will be triggered upon a redemption or liquidation.

“Assignment of Income” Doctrine

- Income is taxed to the person whose efforts or property earned it, even if the right to receive the income is assigned to someone else.
- A lawyer or doctor spouse who assigns part of her accounts receivable to the other spouse will have to pay the tax on that income when it is received by the other spouse.
- IRC § 1041 does not protect against this.

Transfer Restrictions Buy-Sell Provisions

Statutory Restrictions

- There are no Texas Business Organizations Code (“TBOC”) prohibitions against transferring an ownership interest in a business entity to a spouse in a divorce, except for licensed professions like law and medicine.
- However, the TBOC provides that a spouse of a partner can receive only a transferee’s interest in the partnership, which entitles the transferee to receive part of future distributions, but gives limited access to financial information and no management rights.

Transfer Restrictions & Buy-Sell Agreements

- Entities and their owners can create restrictions on transfer of ownership interests.
- They can also enter into buy-sell agreements that give one or more parties an option to purchase or sell an interest under certain circumstances, including divorce.

Transfer Restrictions & Buy-Sell Agreements

- The buy-sell terms are sometimes no more than a right of first refusal to buy the ownership interest on the same terms offered by a third party.
- In other instances, the buy-sell agreement sets a price, e.g.:
 - \$5/share, or
 - a formula (i.e., book value plus accounts receivable), or
 - fair market value or fair value, or
 - set by a business appraisal by 1, 2, or 3 appraisers).

Tax Aspects of Buy / Sell

- If the option to purchase is exercised by a spouse incident to divorce, IRC § 1041 will keep the transaction from being taxed.
- If other owners exercise the option to purchase, it is not clear whether IRC § 1041 applies.

Tax Aspects of Buy / Sell

- If the entity exercises the option to purchase, it is a redemption, and the Treasury Regs. under IRC § 1041 allow the spouses to choose to treat the event as a capital gain to the departing spouse or a constructive dividend to the remaining spouse.
- If the spouses do not choose, then whether IRC § 1041 applies depends on whether the entity assumed an obligation of the remaining spouse to buy-out the departing spouse.

EXAMPLES

Example 2 – Control

- H owns 1% general partner interest in partnership as separate property.
- 99% limited partner interest is community property.
- The court awards a 49.5% limited partner community property interest to each spouse.

What problems does that create?

Example 6 – Phantom Income

- W receives a transferee's limited partner interest in divorce.
- Post-divorce, the partnership has income that is taxed to the partners, but the GP doesn't make actual distributions to the partners.

What can W do?

Example 8 – Mature Tax Shelter

- H's partnership has heavily-depreciated apartment buildings and equipment.
- Plan is to liquidate everything in 3 years.

What is the risk to W in taking a transferee's interest?

If H takes partnership interest and W gets large 401(k), what are the tax consequences to each?

If the partnership redeems W's interest in divorce, what are the tax consequences to each spouse?

Example 9 – Future Cash Calls

- H and W will each receive 50% of the H's limited partner interest.

Who bears what risk on future cash calls?

Example 12 – Landlord–Tenant

- Spouses own land where the family corporation maintains its distribution facility.

What settlement opportunity is presented?

What if the land is owned by the corporation?

Examples 14 & 15 – Note vs. Judgment

In settling a divorce, is it better to receive a promissory note at 5% interest or a judgment at 5% interest?

What if the note is collateralized and the judgment is not?

Examples 16 & 17

- W1 gets note from H1 collateralized by his ownership interest in LLC.
- W2 gets note from H2 collateralized by security interest in LLC's equipment.

Who is better off?

Example 18 — Perfecting Security Interest

- W gets promissory note from H collateralized with guarantee from LLC and a security interest in the LLC's equipment.
- W's attorney files the UCC-1 in the wrong office.
- LLC later files for bankruptcy.

How is W affected?

If it is H who files for bankruptcy—not the LLC—how is W affected?

Example 19 — Assignment of Accounts Receivable

- H is a solo practitioner plaintiff's lawyer with contingency fee cases.
- H agrees to pay W a percentage of each fee, if, as, and when received.

Who pays tax and when?

What if the fees belong to a partnership?

Example 23 — Partial Liquidation

- H owns Community Property interest in C Corporation.
- W will receive cash from the corporation to buy out her interest in the property division.
- The corporation has undistributed earnings and profits (“E&P”).

What is the tax effect when the corporation pays \$ to W in exchange for half of H's shares?

What if the corporation has no E&P?

Example 24 — Total Liquidation

- H owns a C Corporation as 100% community property.
- The corporation will sell all its assets, liquidate, and distribute half of the proceeds to each spouse, then shut down.
- The corporation has undistributed earnings and profits (“E&P”).

What is the tax effect when the corporation pays \$ to H and to W?

Example 38-1 — The Buy-Sell Can Help the Non-Owner Spouse (1)

- Under the buy-sell agreement, H must buy LLC units awarded to W at "Fair Value" (i.e, no discounts).

What can W do?

Example 38-2 — The Buy-Sell Can Help the Non-Owner Spouse (2)

- Under buy-sell agreement, H must buy stock awarded to W in divorce at \$1/share.
- Jury values Community Property stock at 50¢/share.

What can W do?

Example 40 — Capital Loss Carryovers

- Community Property partnership generated capital loss carry overs.

What happens to them on divorce?

What if partnership interest is H's Separate Property?