Bloomberg Tax

Tax Management Memorandum™

Overlooked? During a Divorce, Don't Forget About Tax Issues Related to Business Entities

By Habeeb"Hobbs" Gnaim, Esq.[*]

INTRODUCTION

When a high-net worth couple is going through a divorce there are many important tax issues that need to be examined and sorted through. Many divorce agreements typically contain language providing for how the divorcing couple will handle the reporting and payment of taxes for years prior to, and including in the year of, the divorce.

Further, with the passage of the Tax Cuts and Jobs Act, many articles and press releases have focused on the elimination of the alimony deduction for divorces after 2018. While these are important tax items, in many instances, the tax issues associated with a divorcing couple's business entities and the assets contained within such business entities are overlooked or not properly examined when the marital estate is divided up. It's important that an attorney experienced in tax law, as well as business entity transactions, is consulted. This is a complex topic that can go in many different directions, depending on the details of each divorce, but consider the following as sampling of important issues.

TAX INDEMNIFICATION

A person getting divorced should consider whether there needs to be more comprehensive tax indemnification provisions related to business entities within their marital estate. Although the intent may be to partition ownership interests in business entities in a manner that provides for a clean separation between the spouses, this can be diminished by tax issues that may arise post-divorce. Well-written indemnity language in the divorce agreement may be the most viable means of addressing these concerns.

For example, if ownership interests in any particular business entity are being transferred to one spouse in the divorce, the other spouse that will no longer have an ownership interest in the business entity needs to be protected. If the business entity is audited post-divorce for a prior year in which the divorced couple was still married, the spouse that now owns the business entity, while the audit is going on post-divorce, will be in control. Does that mean the spouse in control of the business entity makes all the decisions regarding the tax audit, despite that fact that the other spouse (which no longer has an ownership interest) may still be on the hook for pre-divorce tax years? These are complicated, sticky issues that should be addressed.

With the passage of new tax audit rules for entities taxed as partnerships for federal tax income purposes, which can shift the tax liability of an audit to other partners in the entity, this issue has become more complicated. The spouse that is giving up ownership in a business entity should consider having more comprehensive tax indemnity protections providing that the spouse keeping the business entity is responsible for all taxes, penalties, and interest that may arise in a post-divorce audit of a prior year in which the couple was still married. If the spouse that no longer has ownership in the business entities is still hit with any tax liabilities from the audit, these comprehensive tax indemnity provisions can provide that such spouse shall be indemnified by the other spouse for the tax liabilities (including all reasonable legal and CPA fees in connection with the matter), plus any gross-up amount required to cover any taxes due on any such tax indemnification payments (as the party receiving an indemnification payment may owe taxes on such indemnification payments).

---

[*]Habeeb "Hobbs" Gnaim is shareholder and head of the Tax Planning & Business Transactions group with Chamberlain, Hrdlicka, White, Williams & Aughtry, P.C. in the firm's Houston office.

DIVISION OR REDEMPTION ISSUES

Tax code §1041 generally provides for tax-free transfers of property between spouses incident to divorce. While it's common in divorces to rely on §1041 to get assets from one spouse to the other spouse in a tax-free manner, §1041 is not a cure-all provision and may not be applicable if there's a need to get assets out of a business entity to one of the spouses. Depending on the type of business entity (partnership vs. corporation vs. LLC) and how such business entity is taxed for federal income tax purposes (C corporation vs. S corporation vs. partnership vs. disregarded entity), this can be a complex situation packed full of potential tax landmines. Accordingly, where a divorcing couple owns significant assets in an entity, and wants to transfer some of those assets to one or both spouses in connection with a divorce, tax considerations take on an increased importance.

In many states, a popular estate planning and asset protection vehicle commonly utilized by high-net worth couples is the family limited partnership (FLP), which typically holds various marital assets, including ownership interests in business entities, real estate, or investments in other companies. In many cases, winding down an FLP is too complicated or a non-starter. Selling assets from the FLP to a spouse is typically not tax efficient. Some divorcing couples decide to simply transfer certain FLP assets out of the FLP to one spouse in exchange for that spouse's ownership interest (a redemption transaction), so that the other spouse can continue owning the FLP post-divorce. While that sounds fairly simple on the surface, such a transaction can be loaded with complex tax implications. It's possible, if structured correctly, that a redemption can work, but such a determination can only be made after reviewing the FLP's partnership agreement and analyzing the relevant figures, such as the partners' outside basis in their respective partnership interests. If a redemption transaction is not tax-efficient, a partnership division, in which an FLP is divided into two separate FLPs under the state's business statutes, may be a solution to achieve a tax-free separation.

A corporation (whether a C corporation or S corporation for federal income tax purposes) may also hold assets that a divorcing couple wishes to extract out of the entity. Consequently, the rules governing the tax consequences of transferring property out of a corporation are also relevant in the context of high-net-worth divorces. There are various ways a divorcing couple can remove assets from a corporation. The more simple method allows the parties to use corporate distributions to extract assets, but distributions from a C corporation can have various tax implications depending on a number of factors such as the corporation's earnings and profits and a shareholder's adjusted tax basis in his or her stock. S corporations are pass-through entities, similar to partnerships, that generally pass items of income and loss through to their shareholders, without imposition of a corporate-level tax. The biggest difference between partnerships and S corporations in the context of extracting assets during divorce is the treatment of distributions of appreciated property. In contrast to a partnership, which can generally distribute appreciated property without triggering taxable gain recognition, an S corporation's distribution of appreciated property typically triggers gain recognition. Such gain is passed through to the shareholders, which is the main reason why S corporations can be troublesome in divorces.

If there's a corporation involved in a divorce that contains an active trade or business, a tax-free reorganization under §355 may be an option. Such a tax-free division of assets typically takes one of three forms (a spinoff, a split-off, or a split-up), each of which comes with complex rules and requirements, but the gist of them is that they allow the division of assets in a tax-free manner, and are an exception to the general rules briefly discussed above, that the transfer of assets out of a corporation triggers taxes.

TRUSTS INVOLVED WITH BUSINESS ENTITIES

Many high-net-worth married couples, as part of their estate planning, transfer ownership interests in business entities to trusts for the benefit of family members (typically, their children). These trusts may be established as Intentionally Defective Grantor Trusts (IDGTs), which are complicated, but basically hold ownership interests in a business entity and benefit from the cash flow and appreciation of such ownership interest. However, as an estate planning tool, the grantors of the IDGT (typically, the parents that set up the IDGT) pay the IDGT's taxes on its income from the business (despite the fact that the IDGT owns the business interest). If a divorcing spouse transfers their ownership interests in a business entity to the other spouse, they both will continue to owe the taxes on the income of the IDGT. If a divorcing spouse will no longer have anything to do with that business entity post-divorce, the divorcing couple should consider whether they want to turn off the grantor status of the trust. This is just an example of the many tax issues that can arise in a divorce when trusts are involved with family entities.

CONCLUSION

The takeaway here should be that there can be many tax issues involved when a marital estate includes business entities. This article is just a sampling

ISSN 0148-8295

of the potential tax issues. To avoid surprises, misunderstandings, and potential disputes, it's important to stay ahead of these issues and consult with, or have your divorce counsel consult with, an attorney experienced in taxation and business entities.

ISSN 0148-8295