

# Distribution of Corporate Stock at the Time of Divorce: What Are the Options?

By Steven Glaser and Theodore Sternklar

**Y**ou are representing the wife in a divorce action. Other than the marital residence which is heavily mortgaged, and some retirement accounts, the only major marital asset is a closely held corporation owned jointly by the parties. After the divorce, the husband wishes to retain ownership of the corporation; the wife wants to be cashed out of her interest. Without careful planning and research, the method by which these results are achieved can have unintended and adverse tax consequences for your client, the husband and the corporation

Assuming that there are insufficient assets that can be transferred to the wife in equitable distribution in exchange for the relinquishment of her shares in the corporation, the first step is to determine from what source(s) the wife can obtain her buyout. If the corporation has sufficient liquid assets and/or financing capabilities, the parties may consider a redemption of the wife's shares by the corporation, as discussed below. A redemption is distinguishable from a transfer in equitable distribution in a number of ways. In the latter, the parties to the transaction are the husband and wife. There is a direct transfer of the wife's shares to the husband in exchange for other marital assets. The entire transaction is tax-free pursuant to Internal Revenue Code (IRC) § 1041 and Domestic Relations Law (DRL) § 236(B) as a distributive award. The total outstanding shares of the corporation remain the same, with the husband owning both parties' shares after the transfer.

A redemption, on the other hand, involves a transaction between the corporation and the redeeming spouse, the wife in our example. In a redemption transaction, the wife surrenders her shares to the corporation in exchange for assets of the corporation,

usually a cash payout. The wife's redeemed shares become treasury shares or are canceled, and, accordingly, reduce the number of shares outstanding. The husband receives no additional shares, although his ownership percentage increases because he will then own all of the remaining, outstanding shares.

The tax consequences of redemption differ substantially from a basic transfer in equitable distribution. First, a redemption is not a tax-free exchange pursuant to IRC § 1041. Under IRC § 302, the transaction will generally be treated as a capital transaction to the wife, provided that the redemption occurs after entry of the divorce decree. The wife's taxable gain will be the difference between the amount received from the corporation and the "tax basis" in the shares. (Generally speaking, the "tax basis" is the original cost paid for the shares, as adjusted pursuant to the Internal Revenue Code.) The profit element -- computed by comparing the proceeds paid at the time of the redemption with the tax basis -- will then be taxed at the preferential capital gains rate of 20 percent.

Practitioners should be aware that if there is only a partial redemption of the wife's shares (e.g., if she retains an ownership interest in the company), the payment to her from the corporation may be treated as a dividend, and thus be taxed to her as ordinary income. Consultation with a tax professional in this regard is strongly recommended. Moreover, practitioners should obtain a written agreement between both parties to treat the transaction consistently. This will minimize audit risk.

## Traps for the Unwary

### MOSES & SINGER LLP

1301 AVENUE OF THE AMERICAS  
NEW YORK, NY 10019-6076  
212.554.7800 FAX: 212.554.7700  
WWW.MOSESANDSINGER.COM

**Q:** If the husband has a right to treat the transactions as either a tax-free transfer pursuant to IRC § 1041 or a redemption, will this affect the ultimate tax treatment?

**A:** Yes. A recent tax court case indicates that if the husband has this right of election, a subsequent redemption may be recharacterized during audit and result in ordinary income to the husband. *Read v. Commissioner*, 114 T.C. 2 (2000). There, the husband's right to choose the manner in which the transaction occurred caused the court to treat the buyout as a constructive transfer of the stock to the former husband and a constructive redemption of that stock by him, resulting in ordinary income to him. Accordingly, to avoid such adverse consequences, practitioners should ensure that the rights and obligations exist solely between the corporation and the wife. Nevertheless, the husband may act as a guarantor of the corporation's obligation without fear of tax reprisal.

**Q:** Is a tax-free exchange pursuant to IRC § 1041 always preferable for the parties?

**A:** Not always. If tax-free treatment is accorded preference under IRC § 1041, the shares received by the husband from the wife will retain the wife's tax

basis -- which may be substantially less than the fair market value. If he husband thereafter sells these shares, he will incur a greater profit -- and greater taxes.

**Q:** How does the presence of shareholders other than the husband and wife affect a redemption?

**A:** If there are other shareholders, a redemption might not accomplish the intended result. The continuing shareholder (e.g., the husband) would not be left in the same position as he would if a straight transfer of the wife's shares had occurred. For example, if the husband and wife each own a 30 percent interest in a corporation, and a third party owns the remaining 40 percent, a redemption of the wife's shares will leave the husband owning 43 percent of the remaining shares -- a 17 percent decrease from the combined 50 percent formerly owned by both spouses.

**Q:** Can the wife's buyout be structured in whole or in part as a consulting or noncompete agreement?

**A:** Yes. The payments, however, will be taxed to her as ordinary income, and are deductible by the corporation. If the wife can shelter some of this income, this may be a planning opportunity.



Steven Glaser

Steven Glaser is a partner in Moses & Singer, LLP's Tax Department. Theodore Sternklar chairs the firm's Matrimonial Department.



Theodore Sternklar

---