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Stock Redemption in Connection With Divorce

Tax Advantageous Methods for Structuring Stock Divisions

When negotiating the division of assets in a divorce, couples should be aware of the complexities involved and the importance of properly structuring the redemption of any corporate stock. Factors to consider include short- and long-term gains, dividend distribution treatment and constructive ownership.

When two individuals decide to divorce, the process typically starts with a legal decree of separate maintenance. Subsequent to the separation decree, the couple will engage in negotiating a property settlement, if applicable, that will eventually become part of the final divorce agreement. The proposed property settlement may involve, among other things, stock in a corporation that the couple owns jointly, as well as cash and accumulated earnings and profits.

During the negotiating phase of the divorce, the focus for many spouses is to eliminate the other spouse's 50% ownership in the family business or in the stock of other business concerns. The goal is typically for one spouse to own all of the stock while providing compensation for the other spouse. There are a number of tax advantageous ways of accomplishing this, with the most common being corporate redemption of all of one spouse's shares in such a way that he or she will be entitled to long-term capital gains treatment on the redemption distribution (to the extent that the distribution exceeds her basis in the stock).

The redemption can be partial for cash and, to the extent that cash held by the corporation is insufficient, for a note on which corporation will be the obligor. The details of the redemption should be spelled out in detail in the divorce agreement. This method allows you to use the corporation's assets, and not have to use your own personal assets, to satisfy a significant part of your property settlement obligations to your spouse, and at a minimum tax cost to him or her.

Ordinarily, no gain or loss has to be recognized on transfers of property between husbands and wives, whether or not incident to divorce or legal separation, and regardless of what consideration may be involved. However, some special rules apply when a corporation redeems stock owned by a spouse or former spouse.

The first thing to consider is a rule under which you could be treated as having, in effect, bought your spouse's stock from him or her and redeemed it yourself. The tax result, if this rule applied, would be that you would be treated as having received a dividend distribution from the corporation, which is taxable as ordinary income up to the amount of the corporation's retained earnings and profits.

However, this won't happen unless there is an agreement between you and your spouse under which you have obligated yourself to buy their stock. And even if such an agreement exists, there is a fairly simple way around this problem, which is to include language in the divorce agreement that the redemption is to be treated as a direct redemption of the shares from W herself, and not from you, and that any earlier agreement is thereby superseded.

A second point has to do with insuring that the redemption of your spouse's shares qualifies for capital gains treatment. Generally speaking, the complete redemption of a shareholder qualifies as a sale or exchange of the stock, with the result that there is no dividend distribution, and the redemption proceeds qualify for capital gain. One problem here comes from the so-called "attribution" or "constructive ownership" rules under which one spouse is treated as owning all the shares that belong to the other. This means that even if a spouse redeems all the shares that he or she directly owns, the constructive ownership rules apply to treat that spouse as continuing to own all the stock possessed by the other spouse, so there can be no complete redemption.

However, still another rule comes to the rescue here. This is the rule under which husband-wife attribution doesn't apply if they are separated under a decree of divorce or separate maintenance. If you are already legally separated, then you are home free on this point.

If for some reason you were not legally separated at the time of the redemption, there would still be a way out under still another special rule. With this rule, your spouse won't be treated as constructively owning the stock actually owned by you if he or she has no interest in the corporation (except that of a creditor) immediately after the distribution, doesn't reacquire any interest in the corporation within 10-years after the distribution, agrees to notify IRS if that changes, and meets certain other requirements.

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If you have any questions, please feel free to contact your Seiler professional at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your particular circumstance.

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