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

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CURRICULUM VITAE OF RICHARD R. ORSINGER

Education: Washington & Lee University, Lexington, Virginia (1968-70)
University of Texas (B.A., with Honors, 1972)
University of Texas School of Law (J.D., 1975)

Licensed: Texas Supreme Court (1975); U.S. District Court, Western District of Texas (1977-1992; 2000-present); U.S. District Court, Southern District of Texas (1979); U.S. Court of Appeals, Fifth Circuit (1979); U.S. Supreme Court (1981)

Certified: Board Certified by the Texas Board of Legal Specialization Family Law (1980), Civil Appellate Law (1987)

Organizations and Committees:

Chair, Family Law Section, State Bar of Texas (1999-2000)
Chair, Appellate Practice & Advocacy Section, State Bar of Texas (1996-97)
Chair, Continuing Legal Education Committee, State Bar of Texas (2000-02)
Vice-Chair, Continuing Legal Education Committee, State Bar of Texas (2002-03)
Member, Supreme Court Advisory Committee on Rules of Civil Procedure (1994-2015 and appointed through 2018); Chair, Subcommittee on Rules 16-165a
Member, Pattern Jury Charge Committee (Family Law), State Bar of Texas (1987-2000)
Supreme Court Liaison, Texas Judicial Committee on Information Technology (2001-2004)
Tx. Bd. of Legal Specialization, Civil Appellate Law Advisory Commission (Member and Civil Appellate Law Exam Committee (1990-2006; Chair 1991-1995); Family Law Advisory Commission (1987-1993)
Member, Supreme Court Task Force on Jury Charges (1992-93)
Member, Supreme Court Advisory Committee on Child Support and Visitation Guidelines (1989, 1991; Co-Chair 1992-93; Chair 1994-98)
Member, Board of Directors, Texas Legal Resource Center on Child Abuse & Neglect, Inc. (1991-93)
President, Texas Academy of Family Law Specialists (1990-91)
President, San Antonio Family Lawyers Association (1989-90)
Associate, American Board of Trial Advocates
Fellow, American Academy of Matrimonial Lawyers
Director, San Antonio Bar Association (1997-1998)
Member, San Antonio, Dallas and Houston Bar Associations

Honors Received:

Texas Center for the Judiciary, Exemplary Non-Judicial Faculty Award (2014)
Texas Bar Foundation *Dan Rugeley Price Award* for "an unreserved commitment to clients and to the practice of our profession" (2014)
Recipient of the Franklin Jones, Jr. CLE Article Award for Outstanding Achievement in CLE (2013)
State Bar of Texas Family Law Section Best Family Law CLE Article (2009)
Recipient of the Franklin Jones, Jr. CLE Article Award for Outstanding Achievement in CLE (2009)
State Bar of Texas *Certificate of Merit*, June 2004
Texas Academy of Family Law Specialists' *Sam Emison Award* (2003)
Association for Continuing Legal Education's Award for Best Program (*Enron, The Legal Issues*) (Co-director, March, 2002)
State Bar of Texas *Presidential Citation* "for innovative leadership and relentless pursuit of excellence for continuing legal education" (June, 2001)
State Bar of Texas Family Law Section's *Dan R. Price Award* for outstanding contributions to family law (2001)
State Bar of Texas *Certificate of Merit*, June 1997
State Bar of Texas *Gene Cavin Award for Excellence in Continuing Legal Education* (1996)
State Bar of Texas *Certificate of Merit*, June 1996
State Bar of Texas *Certificate of Merit*, June 1995

Professional Recognition:

Listed as San Antonio Scene's Best Lawyers in San Antonio (2004-2015)
Listed in Martindale-Hubbell/ALM - Top Rated Lawyers in Texas (2010-2015)
Listed as one of Texas' Top Ten Lawyers in all fields, *Texas Monthly* Super Lawyers Survey (2014)
Listed as one of Texas' Top Ten Lawyers in all fields, *Texas Monthly* Super Lawyers Survey (2013)
Listed as one of Texas' Top Ten Lawyers in all fields, *Texas Monthly* Super Lawyers Survey (2012)
Listed as one of Texas' Top Ten Lawyers in all fields, *Texas Monthly* Super Lawyers Survey (2010 - 3rd Top Point Getter)
Listed as one of Texas' Top Ten Lawyers in all fields, *Texas Monthly* Super Lawyers Survey (2009)
Listed as Family Lawyer of the Year by BEST LAWYERS (2012)
Listed as Family Lawyer of the Year by BEST LAWYERS (2011)
Listed as Texas' Top Family Lawyer, Texas Lawyer's *Go-To-Guide* (2007)
Listed as one of Texas' Top 100 Lawyers, and Top 50 Lawyers in South Texas, *Texas Monthly* Super Lawyers Survey(2003-2015)
Listed in the BEST LAWYERS IN AMERICA: Family Law (1987-2015); Appellate Law (2007-2015)

Books, Journal and Magazine Articles:

—Editor-in-Chief of the State Bar of Texas' TEXAS SUPREME COURT PRACTICE MANUAL (2005)
—Chief Editor of the State Bar of Texas Family Law Section's EXPERT WITNESS MANUAL (Vols. II & III) (1999)
— Author of Vol. 6 of McDonald Texas Civil Practice, on Texas Civil Appellate Practice, published by Bancroft-Whitney Co. (1992) (900 + pages)
—*A Guide to Proceedings Under the Texas Parent Notification Statute and Rules,* SOUTH TEXAS LAW REVIEW (2000) (co-authored)
—*Obligations of the Trial Lawyer Under Texas Law Toward the Client Relating to an Appeal,* 41 SOUTH TEXAS LAW REVIEW 111 (1999)
—*Asserting Claims for Intentionally or Recklessly Causing Severe Emotional Distress, in Connection With a Divorce*, 25 ST. MARY'S L.J. 1253 (1994), republished in the AMERICAN JOURNAL OF FAMILY LAW (Fall 1994) and Texas Family Law Service *NewsAlert* (Oct. & Dec., 1994 and Feb., 1995)
—Chapter 21 on *Business Interests* in Bancroft-Whitney's TEXAS FAMILY LAW SERVICE (Speer's 6th ed.)
—*Characterization of Marital Property*, 39 BAY. L. REV. 909 (1988) (co-authored)
—*Fitting a Round Peg Into A Square Hole: Section 3.63, Texas Family Code, and the Marriage That Crosses States Lines*, 13 ST. MARY'S L.J. 477 (1982)
—*A New Day: Same Sex Marriages: Emerging Gender Identity Issues*; IN CHAMBERS FALL 2015; Texas Center for the Judiciary, p 10.

Continuing Legal Education Administration:

Course Director, State Bar of Texas:
- Practice Before the Supreme Court of Texas Course (2002 - 2005, 2007, 2009, 2011, 2013, and 2015)
- *Enron, The Legal Issues* (Co-director, March, 2002) [Won national ACLEA Award]
- Advanced Expert Witness Course (2001, 2002, 2003, 2004)
- 1999 Impact of the New Rules of Discovery
- 1998 Advanced Civil Appellate Practice Course
- 1991 Advanced Evidence and Discovery
- Computer Workshop at Advanced Family Law (1990-94) and Advanced Civil Trial (1990-91) courses
- 1987 Advanced Family Law Course. Course Director, Texas Academy of Family Law Specialists First Annual Trial Institute, Las Vegas, Nevada (1987)

SELECTED CLE SPEECHES AND ARTICLES

State Bar of Texas' [SBOT] **Advanced Family Law Course**: Intra and Inter Family Transactions (1983); Handling the Appeal: Procedures and Pitfalls (1984); Methods and Tools of Discovery (1985); Characterization and Reimbursement (1986); Trusts and Family Law (1986); The Family Law Case in the Appellate Court (1987); Post-Divorce Division of Property (1988); Marital Agreements: Enforcement and Defense (1989); Marital Liabilities (1990); Rules of Procedure (1991); Valuation Overview (1992); Deposition Use in Trial: Cassette Tapes, Video, Audio, Reading and Editing (1993); The Great Debate: Dividing Goodwill on Divorce (1994); Characterization (1995); Ordinary Reimbursement and Creative Theories of Reimbursement (1996); Qualifying and Rejecting Expert Witnesses (1997); New Developments in Civil Procedure and Evidence (1998); The Expert Witness Manual (1999); Reimbursement in the 21st Century (2000); Personal Goodwill vs. Commercial Goodwill: A Case Study (2000); What Representing the Judge or Contributing to Her Campaign Can Mean to Your Client: Proposed New Disqualification and Recusal Rules (2001); Tax Workshop: The Fundamentals (2001); Blue Sky or Book Value? Complex Issues in Business Valuation (2001); Private Justice: Arbitration as an Alternative to the Courthouse (2002); International & Cross Border Issues (2002); Discovery Issues Facing Associate Judges and Title IV-D Masters (2002); Premarital and Marital Agreements: Representing the Non-Monied Spouse (2003); Those Other Texas Codes: Things the Family Lawyer Needs to Know About Codifications

Outside the Family Code (2004); Pearls of Wisdom From Thirty Years of Practicing Family Law (2005); The Road Ahead: Long-Term Financial Planning in Connection With Divorce (2006); A New Approach to Distinguishing Enterprise Goodwill From Personal Goodwill (2007); The Law of Interpreting Contracts: How to Draft Contracts to Avoid or Win Litigation (2008); Effect of Choice of Entities: How Organizational Law, Accounting, and Tax Law for Entities Affect Marital Property Law (2008); Practicing Family Law in a Depressed Economy, Parts I & II (2009); Troubling Issues of Characterization, Reimbursement, Valuation, and Division Upon Divorce (2010); Separate & Community Property: 30 Rules With Explanations & Examples (2010); The Role of Reasoning in Constructing a Persuasive Argument (2011); Negotiating a Family Law Case (2012) New Appellate Rules for CPS Cases (2012); Court-Ordered Sanctions (2013); Different Ways to Trace Separate Property (2014); Probate & Family Law - What a Family Lawyer Can Learn from the Texas Estates Code (2015)

UT School of Law: Trusts in Texas Law: What Are the Community Rights in Separately Created Trusts? (1985); Partnerships and Family Law (1986); Proving Up Separate and Community Property Claims Through Tracing (1987); Appealing Non-Jury Cases in State Court (1991); The New (Proposed) Texas Rules of Appellate Procedure (1995); The Effective Motion for Rehearing (1996); Intellectual Property (1997); Preservation of Error Update (1997); TRAPs Under the New T.R.A.P. (1998); Judicial Perspectives on Appellate Practice (2000)

SBOT's **Advanced Evidence & Discovery Course**: Successful Mandamus Approaches in Discovery (1988); Mandamus (1989); Preservation of Privileges, Exemptions and Objections (1990); Business and Public Records (1993); Grab Bag: Evidence & Discovery (1993); Common Evidence Problems (1994); Managing Documents--The Technology (1996); Evidence Grab Bag (1997); Evidence Grab Bag (1998); Making and Meeting Objections (1998-99); Evidentiary Issues Surrounding Expert Witnesses (1999); Predicates and Objections (2000); Predicates and Objections (2001); Building Blocks of Evidence (2002); Strategies in Making a Daubert Attack (2002); Predicates and Objections (2002); Building Blocks of Evidence (2003); Predicates & Objections (High Tech Emphasis) (2003); Court-Imposed Sanctions in Texas (2012)

SBOT's **Advanced Civil Appellate Practice Course**: Handling the Appeal from a Bench Trial in a Civil Case (1989); Appeal of Non-Jury Trials (1990); Successful Challenges to Legal/Factual Sufficiency (1991); In the Sup. Ct.: Reversing the Court of Appeals (1992); Brief Writing: Creatively Crafting for the Reader (1993); Interlocutory and Accelerated Appeals (1994); Non-Jury Appeals (1995); Technology and the Courtroom of the Future (1996); Are Non-Jury Trials Ever "Appealing"? (1998); Enforcing the Judgment, Including While on Appeal (1998); Judges vs. Juries: A Debate (2000); Appellate Squares (2000); Texas Supreme Court Trends (2002); New Appellate Rules and New Trial Rules (2003); *Supreme Court Trends* (2004); Recent Developments in the *Daubert* Swamp (2005); Hot Topics in Litigation: Restitution/Unjust Enrichment (2006); The Law of Interpreting Contracts (2007); Judicial Review of Arbitration Rulings: Problems and Possible Alternatives (2008); The Role of Reasoning and Persuasion in the Legal Process (2010); Sanctions on Review (Appeal and Mandamus) (2012)

Other CLE: SBOT Advanced Civil Trial Course: Judgment Enforcement, Turnover and Contempt (1990-1991), Offering and Excluding Evidence (1995), New Appellate Rules (1997), The Communications Revolution: Portability, The Internet and the Practice of Law (1998), Daubert With Emphasis on Commercial Litigation, Damages, and the NonScientific Expert (2000), Rules/Legislation Preview (State Perspective) (2002); College of Advanced Judicial Studies: Evidentiary Issues (2001); El Paso Family Law Bar Ass'n: Foreign Law and Foreign Evidence (2001); American Institute of Certified Public Accounts: Admissibility of Lay and Expert Testimony; General Acceptance Versus Daubert (2002); Texas and Louisiana Associations of Defense Counsel: Use of Fact Witnesses, Lay Opinion, and Expert Testimony; When and How to Raise a Daubert Challenge (2002); SBOT In-House Counsel Course: Marital Property Rights in Corporate Benefits for High-Level Employees (2002); SBOT 19th Annual Litigation Update Institute: Distinguishing Fact Testimony, Lay Opinion & Expert Testimony; Raising a Daubert Challenge (2003); State Bar College Spring Training: Current Events in Family Law (2003); SBOT Practice Before the Supreme Court: Texas Supreme Court Trends (2003); SBOT 26th Annual Advanced Civil Trial: Distinguishing Fact Testimony, Lay Opinion & Expert Testimony; Challenging Qualifications, Reliability, and Underlying Data (2003); SBOT New Frontiers in Marital Property: Busting Trusts Upon Divorce (2003); American Academy of Psychiatry and the Law: Daubert, Kumho Tire and the Forensic Child Expert (2003); AICPA-AAML National Conference on Divorce: Cutting Edge Issues–New Alimony Theories; Measuring Personal Goodwill (2006); New Frontiers` - Distinguishing Enterprise Goodwill from Personal Goodwill; Judicial Conference (2006); SBOT New Frontiers in Marital Property Law: Tracing, Reimbursement and Economic Contribution Claims In Brokerage Accounts (2007); SBOT In-House Counsel Course: When an Officer Divorces: How a Company can be Affected by an Officer's Divorce (2009); Fiduciary Litigation Trial Notebook Course: Family Law and Fiduciary Duty (2010); SBOT Handling Your First Civil Appeal The Role of Reasoning and Persuasion in Appeals (2011-2012); New Frontiers in Marital Property Law: A New Approach to Determining Enterprise and Personal Goodwill Upon Divorce (2011); AICPA-AAML National Conference on Divorce: Business Valuation Upon Divorce: How Theory and Practice Can Lead to Problems In Court & Goodwill Upon Divorce: Distinguishing Between Intangible Assets, Enterprise Goodwill, and Personal Goodwill (2012); SBOT Anatomy of Fiduciary Litigation: Voir Dire and Jury Questionnaires; History of Texas Supreme Court Jurisprudence, 170 Years of Texas Contract Law (2013); SBOT Exceptional Legal Writing: The Role of Reasoning and Persuasion in Legal Argumentation (2013); Family Law Update - 2013, Judicial Conference (2013); Family Law and Fiduciary Duty, Fiduciary Litigation Course (2013); Two Hot Topics in Family Law: Same-Sex Marriage; Mediated Settlement Agreements, 2014 Judicial Conference, Texas Center for the Judiciary (2014); SBOT Advanced Personal Injury Course, Court-Ordered Sanctions (2014); Texas Center for the Judiciary, Same-Sex Marriage and Gender Identity Issues (2015); History of Texas Supreme Court Jurisprudence, The Rise of Modern American Contract Law (2015); New Frontiers In Marital Property Law, Distributions from Business Entities: Six Possible Approaches to Characterization (2015); Texas Center for the Judiciary - Same-Sex Marriage & Gender Identity Issues (2016)

Continuing Legal Education Webinars: *Troubling Issues of Characterization, Reimbursement, Valuation, and Division Upon Divorce*; Texas Bar CLE, Live Webcast, April 20, 2012, MCLE No. 901244559 (2012); *Family Law Update - 2013*, Texas Center for the Judiciary Video

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Education:	BBA - Accounting, University of Texas at Austin - 1973 JD, University of Houston Law Center - 1989
Licenses:	Certified Public Accountant (CPA), Texas - 1975 Licensed, State Bar of Texas - 1991 Accredited in Business Valuation (ABV): American Institute of Certified Public Accountants - 1998
Associations: & Activities	Texas Society of Certified Public Accountants (TSCPA) Houston Chapter, Texas Society of Certified Public Accountants American Institute of Certified Public Accountants (AICPA) Houston Bar Association (HBA) University of Texas at Austin Accounting Advisory Council University of Texas College of Business Distinguished Alumnus (1987-88) University of Houston Law Alumni Association Former Board Member and Past President University of Houston Law Foundation, Director Houston Bar Foundation - Fellow University of Houston Law Center Alumna of the Year - 2003 Texas Family Law Foundation - Member State Bar of Texas 2009 New Frontiers in Marital Properties Course Director

Professional Experience:

Founder and President, Ferguson Camp Poll, P.C., Certified Public Accountants, Analysts & Consultants - 1977 to Present. Perform determinations of economic damages, valuations, tracing of assets and liabilities, and forensic analysis to litigants, attorneys and Courts on matters including breach of contract and fiduciary duties, marital property, and property settlement issues. Engagements have involved various industries, and include business consulting and tax planning services.

Accountant, Ernst & Ernst - Four years on the tax staff.

Speaking and Writing Credits, including:

State Bar of Texas, *21st Annual Advanced Family Law Course*, August 1995, "Business Valuations in Divorce"

American Institute of Certified Public Accountants, *The 1995 Business Valuation Conference*, December 1995, "Managing and Growing Your Practice"

State Bar of Texas, *New Frontiers in Marital Property Law*, October 1996, “Attacking, Defending and Using Trusts, Estates, Family Partnerships and Other Estate Planning Devices”

State Bar of Texas, *Family Law Art & Advocacy Law Course*, December 1997, “Financial Valuation Expert Examination Demonstration”

State Bar of Texas, *24th Annual Advanced Family Law Course*, August 1998, “Tax Impact of Property Division: Seeing the Landmines Before You Step On Them” (presented with Edwin W. Davis and Roy W. Moore), and “Basic Reading and Understanding a Tax Return: Personal, Corporate, Etc.” (presented with Edwin W. Davis)

American Bar Association, *National Institute of Trial Advocacy*, May 1999, Presenter

State Bar of Texas, *Expert Witness Telephone Seminar*, September 1999, “Business Valuation: Assets & Liabilities Approach Compared to Capitalization of Income, ...”

State Bar of Texas, *26th Annual Advanced Family Law Course*, August 2000, “Tracing - How to Actually Do It,” “Personal Goodwill vs. Commercial Goodwill,” and “Ask the Expert” breakout session (presented with Michael P. Geary)

State Bar of Texas, *Advanced Expert Witness Course*, February 2001, “Lost Profits in Business Litigation” (co-authored with Cynthia Phuong Nguyen) and “Lost Profits Close Questioning and Case Study” (presented with Philip B. Philbin and Honorable Tracy K. Christopher)

State Bar of Texas, *27th Annual Advanced Family Law Course*, August 2001, “Valuation of Business Interests - Addressing Common Errors” (co-authored with John E. Camp) and “Valuation of Business Interests in Divorce” panel discussion (presented with J. Kenneth Huff and Milton N. Frankfort; moderated by Richard R. Orsinger)

American Bar Association *Family Law Quarterly*, Volume 5, Number 2, Summer 2001, “Valuation Basics and Beyond: Tackling Areas of Controversy” (co-authored with John E. Camp)

American Academy of Matrimonial Lawyers, *Mid-Year Meeting*, March 2002, “Valuation Issues Related to ‘Hard to Value’ Entities”

State Bar of Texas, “*Marriage Dissolution Institute*, May 2002, “Slam Dunk the Mediation (Preparing for Effective Mediation of Property and Custody Issues in Divorce)” (co-authored and presented with Jan DeLipsey and Randall B. Wilhite)

State Bar of Texas, *Marriage Dissolution Institute*, May 2003, "Demystifying Tax Returns (Using Tax Returns as a Discovery Tool)"

State Bar of Texas, *Advanced Family Law Course*, August 2003, "Tax Issues - Significant Income Tax Developments" (presented with Edwin W. Davis and Randall B. Wilhite)

Practicing Law Institute, *Basics of Accounting & Finance Summer 2003: What Every Practicing Lawyer Needs to Know*, "How Lawyers Use Financial Information—Mergers, Acquisitions, Valuations and Other Transactions and Their Impact on Reported Financial Results"

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2003, "Has the Golden Gate Rusted?" (presented with Mike Gregory, J. Kenneth Huff, Jr., and Randall B. Wilhite)

State Bar of Texas, *Advanced Family Law Drafting and Advocacy: Art and Form 2003*, December 2003, "Drafting for Tax Issues" (co-authored with Cynthia Phuong Nguyen)

State Bar of Texas, *Advanced Expert Witness Course*, February 2004, "Difficult Issues Relating to Lost Profits (Including Start-Up Businesses): Discussion and Demonstration" (co-authored with Cynthia Phuong Nguyen; presented with Robert S. Harrell)

State Bar of Texas, *Advanced Family Law Course*, August 2004, "Property Trial Demonstration" (presented with Gary L. Nickelson, Melissa Nickelson, Hon. Mary Ellen W. Hicks, Brian L. Webb, and G. Thomas Vick, Jr.)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2004, "Sophisticated Corporate Structures" (co-authored with Cynthia Phuong Nguyen; presented with Randall B. Wilhite, Robert J. Piro, and William W. Rucker)

State Bar of Texas, *Advanced Family Law Course*, August 2005, "Employment Compensation & Benefits" (co-authored with Cynthia Phuong Nguyen and Geoffrey S. Poll; presented with Jeffrey Owen Anderson, Jack W. Marr, Jimmy Stewart, and Thomas P. Goranson)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2005, "Help Us, Frank Lloyd!! The Heck with the Division–Is the Valuation Just and *Wright*?" (presented with Randall B. Wilhite, Joan F. Jenkins, and Stewart W. Gagnon)

State Bar of Texas, *Advanced Family Law Drafting Course*, December 2005, "Tax Considerations and Drafting" (co-authored with Cynthia Phuong Nguyen)

State Bar of Texas, *Advanced Family Law Course*, August 2006, "Business Valuation–Concepts, Issues, and Trends" (co-authored with John E. Camp and Cynthia Phuong Nguyen)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2006, "Selected Valuation Topics: Limitations on Use of RMA Data and Understanding the Build-up Method for Deriving Discount Rates" (author) and "Ghiradelli of a Lawyer If You Understand Goodwill" (presenter, with Joan F. Jenkins, Stewart W. Gagnon, Cheryl L. Wilson, and Richard R. Orsinger)

Association of Women Attorneys, November 2006, "Business Valuation–Concepts, Issues, and Trends" (co-authored with John E. Camp and Cynthia Phuong Nguyen)

Houston Bar Association Family Law Section, March 2007, "Qualified Business Appraisers – Different Conclusions" (co-presented with Haran Levy)

State Bar of Texas, *Advanced Family Law Course*, August 2007, "Mi Casa Es Su Casa–Unless I Prove Otherwise" (co-authored Cynthia Phuong Nguyen and co-presented with Michelle May O'Neil) and panelist on "Looking Ahead: Long-Term Financial Planning In Connection with Divorce" (moderated by Jim Penn; with Mark McLeland; Paul A. Premack, and Wesley E. Wright)

State Bar of Texas, *New Frontiers in Marital Property Law Course*, October 2007, "Tracing, Economic Contribution, and Reimbursement Claims in Brokerage Accounts," (moderated by Donn Fullenweider; co-presented with Richard Orsinger and Stewart Gagnon)

State Bar of Texas, *Representing Small Businesses*, March 2008, "Select Valuation Topics" (co-authored with John E. Camp) as part of "Valuation of Small Business" presentation (moderated by John Palter; co-presented with David Fuller)

State Bar of Texas, *Advanced Family Law Course*, August 2008, "Effect of Choice of Entities: How Organizational Law, Accounting, and Tax Law for Entities Affect Marital Property Law" (co-authored and co-presented with Richard Orsinger)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2008, "Dealing with Complex Business Entities on Divorce" (moderated by Warren Cole; co-authored and presented with Joan F. Jenkins, Stewart Gagnon, and Jim Loveless)

State Bar of Texas, *Marital Dissolution Institute*, April 2009, "Avoiding Financial Pitfalls"

State Bar of Texas, *Advanced Family Law Course*, August 2009, "Dealing with Complex Business Entities in a Divorce (Supplement)" (moderated by J. Lindsey Short; co-authored and presented with Mike Gregory and Jim Loveless)

State Bar of Texas, *Marital Dissolution Institute*, May 2010, "Selected Issues Regarding Tracing and Characterization" (co-authored and co-presented with Cynthia Phuong Nguyen)

State Bar of Texas, *Advanced Family Law Course*, August 2010, "Separate and Community Property and Reimbursement" (moderated by Jim Loveless; co-presented with Mike Gregory, Richard Orsinger, and Hon. Vivian Torres) and "Tax Attributes and Divorce" (co-authored with Geoffrey Poll)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2010, "Tax Planning for Divorces" (co-authored with Geoffrey S. Poll, moderator Stewart Gagnon, and co-presenters Warren Cole, Scott Downing, and Jim Penn)

State Bar of Texas, *Advanced Family Law Course*, August 2011, "Characterization and Tracing" (moderated by Kelly Ausley-Flores; co-presented with Richard Flowers, Joan Jenkins, William Love, and Mary Jo McCurley)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2011, "Complex Deals are the Best Deals ... Really?" (co-presented with Warren Cole, Kelly Kubasta, Wendy Burgower, and Tom Goranson)

State Bar of Texas, *Advanced Family Law Drafting Course*, December 2011, "Tax Considerations in Drafting" (written by Geoffrey Poll, co-presented with Susan McLerran)

Texas Academy of Family Law Specialists, *2012 Trial Institute*, February 2012, "Proving Up Elvis' Separate Property" (written with Cynthia Nguyen)

State Bar of Texas, *Advanced Family Law Course*, August 2012, "10 Rules to Remember to Make your Expert Witness More Effective"

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2012, "Compensation, Non-Competes, Return on Capital, and Return of Capital" (moderated by Jim Loveless, co-presented with Richard R. Orsinger and Randall B. Wilhite)

State Bar of Texas, *Advanced Family Law Course*, August 2013, "Business Valuation," (moderated by R. Scott Downing; co-presented with Warren Cole, Michael Geary, and Richard Orsinger)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2014, " Challenging Allegations of Mutation" (moderated by Charla Bradshaw, co-presented with Frederick Adams, Jr., Kyle Sanders, and Randall B. Wilhite)

Houston Bar Association, *Family Law Section Monthly Meeting*, January 2015, "Complex Property Issues," (co-presented with Cynthia Nguyen and Susan McLerran)

State Bar of Texas, *Marriage Dissolution Course*, April 2015, "Divorce Can Be a Taxing Event" (co-authored with Geoffrey S. Poll)

State Bar of Texas, *New Frontiers in Marital Property Law*, October 2015, "Characterizing Distributions from Business Entities" (moderated by Cheryl L. Wilson, co-presented with Richard Orsinger and Randall B. Wilhite)

Table of Contents

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

Richard R. Orsinger
Board Certified in Family Law & Civil Appellate Law by the Texas Board of Legal Specialization

Patrice L. Ferguson
Certified Public Accountant–ABV and Attorney-at-Law

Bryan H. Polk
Certified Public Accountant Master Tax

I. INTRODUCTION. After characterization and valuation issues relating to a business are resolved, it is then necessary to award the business as part of the property division in the divorce. Dividing a closely-held business in a divorce can be a complicated process. Not much has been written in continuing legal education literature on this subject, or about the short-term and long-term considerations that are involved. This Article discusses the legal characteristics of different types of business entities, how they are treated for income tax purposes, and problems and opportunities that can present themselves when dividing a business in a divorce. In this Article, the tax law considered is the Internal Revenue Code ("IRC"), and the business law considered is the Texas Business Organization Code ("TBOC"). Many divorces involve entities formed under Delaware law or the law of other states or even other nations. These other laws are not covered in this Article.

II. SOLE PROPRIETORSHIPS. A sole proprietorship is not a legally-recognized entity. A sole proprietorship is just an aggregation of people and assets associated with a business. The employees work for the person who "owns" the business, and their claims for compensation are against the "owner." The assets of the business that are not leased or rented belong to the business "owner," and if s/he is married they are presumptively community property. The liabilities of the business are liabilities of the "owner," and if s/he is married they constitute community property liabilities. The "owner" may have filed an Assumed Name Certificate with the local county clerk. That Assumed Name Certificate gives the registrant an argument that s/he should have the exclusive right to use that assumed name in that county, but no more. Tex. Bus. Com. Code § 71.157.

A. OWNERSHIP INTEREST. There is no ownership interest in a sole proprietorship as such, because there is no entity to own.

B. ASSETS. A sole-proprietorship has tangible and intangible assets. It can also have business goodwill, distinct from the personal goodwill of the owner-spouse, that relates to trade name, customer relations, supplier relations, advertising, location, and workforce-in-place, etc. The assets are owned by the proprietor or perhaps third parties.

C. LIABILITIES. The liabilities of a sole-proprietorship are liabilities of the business proprietor, and for a married proprietor they are debts of the community estate. The proprietor-spouse's non-exempt separate property, and his/her non-exempt sole management community property, and non-exempt joint management community property, are subject to collection for contractual debts. If the non-proprietor spouse is closely associated with the business, s/he could become personally liable for the businesses debts. This was an issue in *Cockerham v. Cockerham*, 527 S.W.2d 162 (Tex. 1975), where the husband advanced capital for the wife's business, and let the wife sign his name to checks used to pay debts of the business, and once referred to the business's debts as "my debts," resulting in his being held personally liable for the wife's debts.

D. DISTRIBUTIONS. Since the cash and other assets are owned by the proprietor-spouse or third parties, the sole-proprietorship cannot make distributions to owners.

III. CORPORATIONS.

A. OWNERSHIP INTEREST. A corporation has a legal identity distinct from its owners. If a spouse owns shares of stock in a corporation, those shares may be community property and if they are, they are part of the estate of the parties to be divided in a divorce.

Except for certain licensed professions, there is no Texas law prohibiting the award of corporate shares to the non-owning spouse. The corporation's organizational paperwork or agreements between shareholders may impose restrictions on the transfer of shares, or may provide for the option or obligation to purchase or sell the stock upon the happening of certain events, including death and divorce of a shareholder. See Section IX of this Article.

B. ASSETS. Because a corporation has a separate legal identity from the shareholders, all assets of a corporation belong to the corporation and not the shareholders. *Legrand-Brock v. Brock*, 246 S.W.3d 318, 322 (Tex. App.–Beaumont 2008, pet. denied), citing *Bryan v. Sturgis Nat'l Bank*, 40 Tex. Civ. App. 307, 90 S.W. 704, 705 (Tex. Civ. App. 1905, writ ref'd) ("The accumulated earnings or surplus funds of a corporation constitute a part of its assets, and belong to the corporation, and not to the stockholders, until they have been declared and set apart as dividends."). A divorce court cannot award corporate assets to either spouse, absent piercing the corporate veil. See Section VIII.G of this Article for a discussion of piercing the corporate veil.

TBOC § 10.251 provides that a domestic entity "may transfer and convey by sale, lease, assignment, or other method an interest in property of the entity, including real property." The transfer may include goodwill, and may be "on any terms and conditions and for any consideration, which may consist wholly or partly of money or other property . . . ." TBOC § 10.251(a)(2). Unless provided by other Texas statute, a person acquiring property from an entity "may not be held responsible or liable for a liability or obligation of the transferring domestic entity that is not expressly assumed by the person." TBOC § 10.254(b). A corporation may pledge or mortgage any of its assets. TBOC § 10.251(b).

Practice Tip: One corporate asset that often appears in closely-held businesses is a "loans to shareholders" account reflected in the company's general ledger. Particularly when the corporation is separate property, sometimes money is transferred to a married shareholder through loans, not compensation for labor or distributions of profits in the form of dividends.

Tax Tip: The IRS is aware of the trick of lending money to the owner in lieu of paying compensation or distributing profits, and the loans will be taxed as dividends if interest is not paid (or accrued and reported as income) and some plan of repayment exists. In some divorces, the other spouse will contest the legitimacy of these "loans" and will ask that the community liability for such loans be ignored. If that happens, an income tax will be owed on the amount of the loans that are treated as income to the shareholder. That leads to a secondary tax issue, which is whether the loans should be recast as dividends or compensation, which have different tax rates.

C. LIABILITIES. One of the signature features of a corporation is that shareholders are not liable for corporate debts. However, shareholders can be held liable for corporate debts under the equitable (now partially statutory) doctrine of "piercing the corporate veil." See Section VIII.G of this Article. Shareholders are personally liable for any corporate debts that they personally guarantee, and for any wrongs they personally commit or are held individually responsible for.

One of the liabilities that can exist for a corporation is a "loans from shareholders" account reflected in the business's general ledger. Shareholders can put money into a corporation by making contributions of capital or by loaning money to the corporation. In closely-held business, often times the parties dispense with the formalities of a promissory note and instead maintain a running balance in the general ledger of advancements to the company and repayments made by the company. Although informally documented, these loans are nonetheless real.

D. PAYMENT OF CLAIMS. Like any other "person," a corporation can be held liable in contract, or tort, and is subject to claims in equity (unjust enrichment, constructive trust, etc.). A spouse can assert such claims in a divorce. However, claims of fraud on the community are not tort claims, and the spouse cannot recover actual or exemplary damages against a corporation for participating in fraud on the community. *Schlueter v. Schlueter*, 975 S.W.2d 584, 588-89 (Tex. 1998). A spouse can sue a third party for conversion to recover community property held by the third party, for "if a third party steals community property, surely either spouse or both can seek recovery in tort for it." *Chu v. Hong*, 249 S.W.3d 441, 445 (Tex. 2008). A close study of *Chu v. Hong* indicates that, if a spouse fraudulently appropriates community property but retains it, the spouse is not liable except through the power of the divorce court to make a just and right division of the community estate, and third parties cannot be held liable for the action. However, where the third party wrongfully received community property, *Schlueter* and *Chu v. Hong* do not prohibit the wronged spouse from recovering damages or recovering the property from the third party. While *Chu v. Hong* discussed the remedy in tort, the equitable remedy of constructive trust is also available to recover community property in the hands of a third party. *See Barnett v. Barnett*, 67 S.W.3d 107, 112 (Tex. 2001) (wife has a remedy to impose a constructive trust on one half of the proceeds of the community property life insurance policy that passed to husband's mother upon husband's death).

E. DISTRIBUTIONS TO OWNERS. Corporations can pay debt owed to shareholders, and reimburse expenses of shareholders. Corporations can also make distributions to owners in the form of dividends, return of capital, and partial or total liquidation. The decision to do such things normally rests with the corporation's board of directors, and should be reflected in board resolutions. There are also accounting entries that should reflect the nature of such transactions. The tax treatment of these transfers varies, depending on the category. See Section XI.D of this Article. With closely-held corporations, sometimes the proper corporate paperwork that would differentiate a past distribution between repayments of debt, dividend, return of capital, or liquidation, is insufficient or even non-existent. Sometimes, under the scrutiny of forensic CPAs in the divorce, it will appear that the corporation's accountants incorrectly "booked" the transaction in the accounting records, which can create fact issues to be resolved in the divorce. In resolving a divorce, the forensic CPAs and the corporate lawyer and CPA must be attuned to the different types of distributions that have been made, and can be made, and they must choose wisely, paper properly, and report correctly to the IRS. Because some of these categories are affected by the corporation's historical profits and losses, and distributions, past events can affect the tax treatment given to distributions from the corporation in settlement of a divorce.

F. TRANSFERS OF SHARES. The TBOC does not prohibit the transfer of shares to third parties, except for certain licensed professions (like law, medicine, dentistry, veterinary, etc.). See Section IX.C of this Article. However, the corporation's organizational paperwork, or agreements between shareholders, can restrict the transfer of shares, or can provide the optional right to buy shares before or when they would otherwise be transferred to non-shareholders. See Section IX of this Article.

Shares are normally transferred by executing an assignment and delivering the shares to the transferee, and the transfer is supposed to be reflected in the corporate records, especially the stock transfer ledger. The common practice is to retire the old shares and to reissue the same shares under a new certificate number in the name of the new shareholder. If shares are redeemed by the corporation, they are transferred from the shareholder to the corporation, which either retains the shares as unissued shares, or cancels them, in which event the shares cease to exist.

The tax treatment of different kinds of corporate distributions to shareholders is discussed in Section XI.D of this Article.

IV. PARTNERSHIPS. Texas partnerships are governed by Chapter 151, 152 and 154 of the TBOC. These chapters are largely default provisions that apply if the partnership agreement does not provide otherwise. See TBOC § 152.002.[1] Partners have tremendous flexibility in designing their rights and responsibilities, compared to the more rigid corporate form, which is hemmed in by mandatory statutory requirements. Because the partnership agreement controls most issues, and since partnership agreements vary from case to case, determining rights, powers, and duties under a partnership agreement is frequently a matter of contract interpretation. *See Driveway Austin GP, LLC v. Turbo Partners*, 409 S.W.3d 197, 202-03 (Tex. App–Amarillo 2013, judgm't vacated w.r.m.) (extent to which partnership agreement allowed amendment by majority vote was a question of determining the intent of the parties).

Under the TBOC, a partnership is "an association of two or more persons to carry on a business for profit as owners." TBOC §152.051. A general partnership can be formed by the oral or written agreement of two or more individuals. See TBOC §151.001(5). There is no required formality for creating a partnership. See TBOC § 1.002(22) (general partnership is not a filing entity). Partnerships can be formed between human beings or between entities or a mix, including a partnership between partnerships. The decision as to the ownership interest each partner will own will affect distributions of profits, distributions of capital, and preferential entitlement to distributions, during the life of the partnership and on dissolution ("winding up").

Practice Tip: Since there is no registration or other required formality for establishing a general partnership, two or more persons (including spouses) who have associated with each other to carry on a business for profit as owners have created a partnership, whether they realize it or not. See TBOC § 152.051. Every "sole" proprietorship has the potential to be a partnership if there is more than one "owner" of the business. The consequences of finding that a sole proprietorship is really a partnership can be significant, and should be evaluated in every divorce involving a sole proprietorship.

A. OWNERSHIP INTEREST. "A partnership is an entity distinct from its partners." TBOC §152.101. A partnership is owned by its partners. Each partner owns a "partnership interest" which "is personal property for all purposes." TBOC §154.001(a). The partnership interest "may be community property under applicable law." TBOC §154.001(b). However, the right to participate in management cannot be community property. TBOC § 152.203(a). There are normally two types of ownership interests in a partnership: a "capital interest" and a "profits interest." A "capital interest" entitles the partner to receive both a share of future profits and losses, and payments upon withdrawal from the partnership or distributions upon partial or total liquidation ("winding up") of the partnership. *See Central State, Southeast and Southwest Areas Pension Fund, v. Creative Development Co.*, 232 F.3d 406, 425 (Dennis, J., dissenting); Alan J. Tarr, *Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances*, Tax Law and Estate Planning Course Handbook Series p. 19 (Practicing Law Institute, 2007) [available on

Westlaw at 747 PLI/Tax 9]. A "profits interest" entitles the partner to receive a share of earnings and profits, but no right to payment upon withdrawal or winding up. Mark Winfield Brennan, *The Receipt of a Profits Interest in a Partnership as a Taxable Event After Campbell and Mark IV*, 57 MO. L. REV. 273, 276 (1992). TBOC §154.101 permits a written partnership agreement to "establish or provide for the future creation of additional classes or groups of one or more partners that have certain express relative rights, powers, and duties, including voting rights." Classes or groups can be established either at start up or when the class is later created. *Id.* at §154.101(a). Classes established later can have rights, powers, or duties that are senior to previously-existing classes. *Id.* at § 154.101(b).

An essential feature of being a general partner is the right to withdraw from the partnership, TBOC 152.501(b)(1), and receive fair value for the partnership interest. TBOC § 152.602. Shareholders in corporations ordinarily have no such right.

TBOC §154.104 provides that a partnership agreement "may provide rights to any person, including a person who is not a party to the partnership agreement, to the extent provided by the partnership agreement." This power might be useful in settling some divorce cases.

If a spouse's partnership interest is community property, it is subject to being awarded to the other spouse upon divorce (except for certain licensed professions). However, under TBOC Section 152.406, the non-partner spouse can receive only a "transferee's interest" in the partnership. A transferee's interest entitles the transferee to receive distributions from the partnership, and to receive the transferee's share upon winding up of the partnership. TBOC § 152.404. The transferee does not have a right to participate in the management or conduct of the partnership business. TBOC § 152.402(3). The transferee is not obligated to make capital contributions to the partnership, so that obligation remains with the transferor. See TBOC § 152.404.

B. ASSETS. Under TBOC §154.001, "[a] partner is not a co-owner of partnership property." Under TBOC §154.002, "[a] partner does not have an interest that can be transferred, voluntarily or involuntarily, in partnership property." These provisions are the essence of a partnership being an entity distinct from its owners. Thus, partnership assets cannot be awarded by a divorce court to the non-partner spouse. This has long been the law of Texas. *See McKnight v. McKnight*, 5423 S.W.2d 863 (Tex. 1976). A partnership may convey its assets, subject to any restrictions contained in the partnership agreement, and may pledge or mortgage any of its assets. TBOC § 10.251(a) & (b).

C. LIABILITIES. For general partnerships, "all partners are jointly and severally liable for all obligations of the partnership unless otherwise: (1) agreed by the claimant; or (2) provided by law." TBOC §152.303. A partner admitted to a partnership after its inception does not have personal liability for a partnership obligation that arose before his admission to the partnership, or that relates to an event occurring before admission, or that arises after admission under a contract or commitment made before admission. TBOC §152.304(b). If a general partner is married, the partner-spouse's non-exempt separate property, non-exempt sole management community property, and all non-exempt joint management community property, can be taken by contract creditors. If the liability is tortious, the other spouse's non-exempt sole management community property can also be taken. See Tex. Fam. Code § 3.202.

D. PAYMENT OF CLAIMS. Like any other "person," a partnership can be liable in contract, in tort, and is subject to claims in equity (unjust enrichment, constructive trust, etc.). See the discussion in Section III.D above.

E. CAPITAL ACCOUNT. To discuss the division of partnerships it is necessary to become familiar with the concept of a partner's "capital account." The capital accounts of partners in a Texas general partnership are maintained in accordance with Section 152.202 of the TBOC, which provides:

> Sec. 152.202. Credits of and Charges to Partner.
>
> (a) Each partner is credited with an amount equal to:
>
> > (1) the cash and the value of property the partner contributes to a partnership; and
> > (2) the partner's share of the partnership's profits.
>
> (b) Each partner is charged with an amount equal to:
>
> > (1) the cash and the value of other property distributed by the partnership to the partner; and
> > (2) the partner's share of the partnership's losses.
>
> (c) Each partner is entitled to be credited with an equal share of the partnership's profits and is chargeable with a share of the partnership's capital or operating losses in proportion to the partner's share of the profits.

Stated in simpler terms, a partner's capital account reflects the cumulative total of four things:

> (i) capital contributed by the partner, plus
> (ii) the partner's share of profits; less
> (iii) distributions to the partner; less
> (iv) the partner's share of losses.

This rule on capital accounts is one of the many that apply to both general partnerships and limited partnerships. TBOC § 153.003.

The important thing to know about capital accounts is that, upon winding up a partnership, any capital accounts that are out-of-balance must be brought into balance before liquidating distributions are made in proportion to capital percentages. That is, if one partner's capital account is higher than his percentage capital interest and another partner's capital account is lower than his percentage capital interest, the partner whose capital account is lower must forego distributions or even put money back into the partnership until his capital account is brought into parity with his capital interest, and the partner whose capital is higher than his percentage capital interest will disproportionately receive distributions that reduce his capital account until his capital account is brought into parity with his capital interest.

This feature of partnership accounting means that a partner's claim on partnership assets in liquidation is not just a function of his capital interest; it is a function of his capital interest as adjusted by his capital account.

In a sense, a capital account lower than the partner's capital interest is a "loan" from the partnership that must repaid no later than winding up, and a capital account that is proportionately higher than the partner's capital interest is a loan to the partnership that must be repaid no later than winding up. While each partnership agreement is different, many partnership agreements do not provide that a capital account must be brought into balance with the capital interest at any time prior to winding up. Thus, if the partnership agreement allows it, a partner can take more than his share of money out of a partnership simply by taking distributions that reduce his capital account below his proportionate capital interest.

F. DISTRIBUTIONS TO PARTNERS. Partnerships can pay debts owed to partners, or reimburse partners' expenses, make distributions of profits, make distribution of capital, and have a partial or total liquidation. TBOC §154.203(a) says that a partner cannot require a distribution from the partnership in any form other than cash, unless the partnership agreement so provides. Nor can the partnership force a partner to take, as a distribution in kind, a greater portion than his percentage share of a non-cash asset. TBOC §154.203(b).

Tax Tip: Partnership income flows through to the partners' tax returns. So income tax liability on partnership income can arise for a partner even if profits are not distributed.

Different types of distributions to partners can create tax liability. This topic is discussed in Sections VII.B and VIII.D.4 of this Article.

G. TRANSFER OF A PARTNERSHIP INTEREST. "A partner may transfer all or part of the partner's partnership interest." TBOC §152.401. "After the transfer, the transferor continues to have the rights and duties of a partner other than the interest transferred." TBOC §152.403. "A transferee of a partner's partnership interest is entitled to receive, to the extent transferred, distributions to which the transferor otherwise would be entitled." TBOC §152.404(a). The transferee is also entitled to receive "the net amount otherwise distributable to the transferor" upon winding up of the partnership, to the extent transferred. TBOC §152.404(b). The transferee has no liability as a result of the transfer, unless the transferee becomes a partner. TBOC §152.404(c). The transferee can, "for a proper purpose," require "reasonable information or an account of a partnership transaction and make reasonable inspection of the partnership books." TBOC §152.404(d). If the partnership is winding up, the transferee can require an accounting. TBOC §152.404(d). The partnership does not have to give effect to a transferee's rights until is receives notice of the transfer. TBOC §152.404(e). TBOC §152.406 provides that, "on the divorce of a partner, the partner's spouse, to the extent of the spouse's partnership interest, if any, is a transferee of the partnership interest."

TBOC Section 152.405 very importantly says:

> A partnership is not required to give effect to a transfer prohibited by a partnership agreement.

TBOC §152.406(c) says that "[t]his chapter does not impair an agreement for the purchase or sale of a partnership interest at any time, including the death or divorce of an owner of the partnership interest."

These two provisions authorize transfer restrictions and buy-sell agreements for partnership interests, including mechanisms that are triggered by divorce. See the discussion of transfer restrictions and buy-sell agreements in Section IX of this Article.

A transferee is not liable for capital calls. If the transferor does not make the capital contribution required of the transferee's interest, the transferee's interest is subject to the penalties contained in the partnership agreement, including dilution of the transferee's ownership percentage. See TBOC § 153.202. See also Cliff Ernst, *Planning, Drafting and Implementing Capital Call Provisions*, Univ. of Texas School of Law Partnerships, Limited Partnerships and LLC pp. 23-37 (July 2009).[2]

V. LIMITED PARTNERSHIPS. In Texas, limited partnerships have the essential features of general partnerships, except that: registration with the state is necessary to bring the limited partnership into existence; limited partners have ownership with limited management rights; and the liability of limited partners is restricted to their ownership interest in the business. Limited partnerships are governed by Chapter 153 of the TBOC, and provisions governing both general partnerships and limited partnerships are contained in Chapter 154 of the TBOC. A limited partnership must have a general partner and at least one limited partner. If there are at least three partners, the same persons or entities can own both a general partner interest and a limited partnership interest. A limited partnership is a "filing entity" under TBOC § 1.002(22), meaning that it is created by filing a certificate of formation under TBOC § 3.001.

A. OWNERSHIP INTEREST. TBOC §152.101 says that "[a] partnership is an entity distinct from its partners." A partnership is owned by its partners. Each partner owns a "partnership interest" which "is personal property for all purposes." TBOC §154.001(a). A partnership interest give the partner rights and liabilities. In a limited partnership, the partnership interests are divided between a general partner interest and a limited partner interest. The general partner interest may or may not have an ownership interest and always has managerial rights, subject to restrictions in the partnership agreement and a few restrictions in the TBOC. The limited partner interests have ownership with limited management rights, including veto power over certain major decisions. See TBOC § 153.103. The partnership interest "may be community property under applicable law." TBOC §154.001(b).

A limited partner may withdraw as limited partner "only at the time or on the occurrence of an event specified in the written partnership agreement. The withdrawal of the partner must be made in accordance with that agreement." TBOC § 153.110. Limitations on the right of limited partners to withdraw are a significant restriction on the right of limited partners as compared to general partners. Upon withdrawal, the limited partner is entitled to receive "fair value" within a reasonable time. TBOC § 153.111.

B. ASSETS. As with all partnerships, the assets of a limited partnership are owned by the partnership, not the partners. TBOC §§ 154.001 & 154.002.

C. LIABILITIES. The general partner of a limited partnership is liable for all partnership debts and liabilities. *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 (Tex. App.–Dallas 2008, pet. denied). However, a limited partner is not liable for the limited partnership's debts. TBOC § 153.102. Even if a certificate of limited partnership was not filed under pre-TBOC law, or a certificate of formation was not filed under TBOC § 3.001, the limitation of liability of limited partners is effective as against parties with actual notice that the partnership was a limited partnership. *See Apcar Inv. Partners VI, Ltd. v. Gaus*, 161 S.W.3d 137, 141 (Tex. App.–Eastland 2005, no pet.).[3]

If a limited partner participates in the control of the business, he will subject himself to liability like a general partner. TBOC § 153.102(a). That rule applies even if the limited partners manage the partnership through a general partner that is an entity. *Delaney v. Fid. Lease Ltd.*, 526 S.W.2d 543, 545 (Tex. 1975) ("the personal liability, which attaches to a limited partner when 'he takes part in the control and management of the business,'cannot be evaded merely by acting through a corporation").

Using the doctrine of piercing the "corporate" veil to make limited partners liable for partnership debts has been rejected by both Texas and Federal courts. See Section VIII.G.

D. PAYMENT OF CLAIMS. Like a general partnership, a limited partnership can be held liable in contract and in tort, and is subject to claims in equity (unjust enrichment, constructive trust, etc.). See the discussion in Section III.D above.

E. DISTRIBUTIONS TO PARTNERS. Limited partnerships can pay debts owed to partners, and reimburse partners' expenses, and make distributions of profits, distribution of capital, and liquidate distributions. TBOC §154.203(a) says that a partner cannot require a distribution from the partnership in any form other than cash, unless the partnership agreement so provides. Nor can the partnership force a partner to take, as a distribution in kind, a greater portion than his percentage share of a non-cash asset.

TBOC §154.203(b).

The tax treatment of different kinds of limited partnership distributions are discussed in Sections VII.B.6 and VIII.D.4c of this Article.

VI. LIMITED LIABILITY COMPANIES.

A. MEMBERSHIP INTEREST. An LLC is an entity, like a corporation. The owners of an LLC are called "members," and they own membership interests. The company agreement can label membership interests as "shares," "units" or some other name. The rules governing the ownership and operation of the LLC are contained in a "company agreement." TBOC §§ 101.001(1) & 101.052.

Texas has joined a dozen other states in allowing one LLC to have members of different "series." See TBOC § 101.601, subch. M. A series is a sort of subpart of the LLC, but each series is completely distinct from other series. Each series has its own membership interests, assets, liabilities, and management rights. See TBOC § 101.502 (assets); § 101.606 (liabilities); § 101.608 (management); § 101.613 (distributions). See Philip D. Weller, *Transactions in Series LLCs*, State Bar of Texas Advanced Real Estate Law Course ch. 4 (2014). To date, the IRS has recognized the series (pl.) as distinct from one another for tax purposes.

Under TBOC § 101.106, a member's interest in an LLC may be community property, but a member's right to participate in management and conduct of the business is not community property. Under TBOC § 101.115, on divorce of a member, the member's spouse is, "to the extent of the spouse's membership interest, if any, . . . an assignee of the membership interest." Under TBOC § 101.108, an assignee is "entitled, the extent assigned, to the same rights and powers granted or provided to a member of the company by the company agreement or" the TBOC. The assignee is similarly bound to the same restrictions and obligations imposed on members, and is similarly liable for obligations to make contributions to the company, except for obligations which cannot be ascertained from the company agreement and which the assignee had no knowledge when s/he became a member. TBOC § 101.110(b). This differs from transferees of a partnership interest, who are not liable for any obligation to contribute capital to the partnership. See TBOC § 152.404. The assignor of the interest is entitled to continue to exercise all rights and powers not assigned. TBOC § 101.111(a). The assignor is not released by the assignment from liability to the company. TBOC § 101.111(b).

B. ASSETS. The assets of an LLC belong to the LLC, or to the particular series of the LLC, and not to the members. TBOC § 101.106(b). See TBOC § 101.112(f) (a creditor of a member has no right to exercise legal or equitable remedies against the assets of the LLC).

C. LIABILITIES. Under TBOC § 101.113, a member of an LLC can be named a party to a lawsuit by or against the LLC only as to the member's right against or obligation owed to the LLC. The liabilities of an LLC are liabilities of the LLC itself, and not its members; members and managers cannot be held liable unless the company agreement specifically provides otherwise. TBOC § 101.114; *Sanchez v. Mulvaney*, 274 S.W.3d 708, 712 (Tex. App.–San Antonio 2008, no pet.) (members are not liable for LLC debts). In a series LLC, the liabilities of one series are distinct from the liabilities of other series, unless the credit arrangements provide otherwise. The liabilities of a series are not liabilities of the LLC itself, unless the credit arrangements provide otherwise. The series LLC concept is too new to have generated much case law, but corporate lawyers are hoping that the bankruptcy of one series of an LLC will not involve other series or the LLC itself.

As for personal liabilities of a member, the member's interest in the LLC is subject to a charging order to pay a judgment creditor. TBOC § 101.112. This gives the judgment creditor a right to "receive any distribution to which the judgment debtor would otherwise be entitled in respect of the membership interest." A charging order is the sole method of collecting a liability from a member's LLC interest. TBOC § 101.112(d).

D. PAYMENT OF CLAIMS. Like any other "person," an LLC can be liable in contract, in tort, and is subject to claims in equity (unjust enrichment, constructive trust, etc.). See the discussion in Section III.D above. The same can be said of each series of a series LLC.

E. DISTRIBUTIONS TO MEMBERS. Profits and losses of an LLC must be allocated on the basis of contributions made by each member, using agreed values. TBOC § 101.201. The member is entitled only to cash distributions, regardless of the form of contribution to the company. TBOC § 101.202. Distributions from the LLC must be made according to the agreed value of each member's contribution to the company. A member cannot demand interim distributions. TBOC § 101.204. A member "who validly exercises the member's right to withdraw from the company granted under the company agreement,' is entitled to receive, within a reasonable time after the date of withdrawal, the "fair value of the member's interest in the company as determined as of the date of withdrawal." TBOC § 101.205. Distributions cannot be made if the LLC would have a negative net worth, as measured by the terms of TBOC § 101.206.

F. TRANSFERS OF MEMBERSHIP INTERESTS. Membership interests in an LLC (or series) can be freely transferred, subject to any transfer restrictions or buy-sell agreements that apply. If a spouse's membership interest is community property, it can be divided and awarded in a divorce as the parties or the court sees fit, subject to any transfer restrictions and buy-sell provisions.

VII. BASIC ENTITY TAX PRINCIPLES.

Tax-related issues can be as important as legal issues when it comes to dividing business entities upon divorce. This very important section of the Article discusses basic principles of taxation of entities, and complications that can be encountered in dividing entities in a divorce.

A. SOLE PROPRIETORSHIP. Because a sole proprietorship is not a legal entity, all the income and expenses from a sole proprietorship are reported on Schedule C of a Taxpayer's Form 1040 U.S. Individual Income Tax Return. Generally, there is no tax impact related to contributions from or distributions to a sole proprietorship from or to its owners. If a sole proprietorship has been operated by a spouse during marriage, and the business will continue in operation after divorce, the ownership of the business, and related assets and liabilities, will need to be divided between the spouses.

Tax Tip: If both spouses operate an unincorporated business together and share in the profits and losses, they may have a partnership under Texas law and if so, they should report income or losses on Form 1065 and not Schedule C. However, a business jointly-owned and operated by a husband and wife is a partnership (and should file Form 1065 U.S. Return of Partnership Income) unless the spouses qualify and elect to have the business be treated as a qualified joint venture, or they operate their business in one of the nine community property states.

Husband-and-wife businesses in community property states may sometimes qualify to be treated similarly to a sole proprietorship. For Special Rules for Spouses in Community States, see Revenue Procedure 2002-69 and the Instructions for Schedule C.

B. PARTNERSHIP, AND LLC CLASSIFIED AS A PARTNERSHIP FOR TAX PURPOSES. A partnership is a "pass-through entity" for tax purposes. Income or loss is passed through to partners on a Form K-1, and the partners report the income on their individual tax returns. The partners and not the partnership pay the income tax on partnership income.

Computing income or loss for a partnership is similar to a sole proprietorship. Net income or loss is allocated among the partners according to the partnership agreement, generally but not always in proportion to profits interests. Income or loss that is passed through to a partner is referred to as the partner's distributive share. Each partner pays the tax on his/her distributive share of income in the year earned or received. When a partnership distributes cash or property to a partner, the transaction is generally not taxable, subject to exceptions.

A partnership's business income, deductions, credits, gains, and losses resulting from partnership operations are reported on Form 1065, U.S. Return of Partnership Income. The partnership tax return Form 1065 includes a separate Schedule K-1 for each partner, which reports the partner's distributive share of income and other separately stated items. The partnership is required to furnish a copy of Schedule K-1 to each partner by the due date (including extensions) of the partnership return.

An individual partner reports ordinary income from the Schedule K-1 on Schedule E of his/her Form 1040 U.S. Individual Income Tax Return. Other items of income or loss are reported on the appropriate forms or schedules.

Practice Tip: Always obtain the pass-through entity tax returns and the owner-spouse's Schedules K-1. This information will help not only in identifying and valuing ownership interests, but also can provide important information that can affect the decision of whether to continue co-ownership after the divorce.

1. Distributions from a Partnership. Partners generally are taxed when the income is received by the partnership (if the partnership utilizes the cash method of accounting) or earned by the partnership (if the partnership utilizes the accrual method of accounting). A distribution of cash or property from a partnership to its partners generally does not result in taxable income to the partner, though taxation can occur if the distribution is a guaranteed payment, a distribution made in exchange for a partner's capital interest, or the distribution is in excess of the partner's tax basis in the partnership interest.

A partner's tax basis in non-cash property distributed by the partnership to the partners is the partnership's adjusted tax basis in the property immediately before the distribution, limited to the partner's adjusted tax basis in the partnership. IRC § 732(a). If money and property are distributed together, the money reduces the partner's adjusted tax basis before the property is received. The partner's holding period for the property includes the partnership's holding period plus any holding period of the partner who contributed the property to the partnership.

2. Exceptions for Distributions. A partner must recognize a gain on distribution from a partnership when the partnership distributes non-cash property with:

a. a disproportionate distribution of Section 751 ("hot") assets,
b. a distribution of contributed property to which Section 704(c)(1)(B) applies (Section 704(c)(1)(B) applies when property is contributed by a partner and the property is subsequently distributed by the partnership to another partner within seven years of the original contribution),
c. a distribution subsequent to a contribution of appreciated property to which Section 737 applies,
d. a distribution of marketable securities under Section 731(c), or
e. a distribution that is part of a disguised sale transaction under Section 707(a).

A partner's gain on distribution is considered to be a gain from the sale or exchange of a partnership interest, which is generally a capital gain, except to the extent the partnership has "hot assets," like unrealized receivables or inventory. IRC § 731(a). See Section XI.B of this Article. If the holding period for the partnership interest is one year or less, the gain is a short-term capital gain; if held longer than one year, the gain is a long-term capital gain.

3. Losses from a Partnership. A partner's distributive share of losses can be deducted by a partner up to the partner's adjusted tax basis in the partnership. The adjusted tax basis in the partnership generally includes the partner's pro rata share of partnership liabilities. A partner's adjusted tax basis can never be less than zero. Deducting losses in excess of adjusted tax basis is not allowed. Other rules limiting a partner's losses include the at-risk and passive activity loss rules.

4. Tax Basis. A partner's initial tax basis in a partnership is generally the cash contributed, plus the adjusted tax basis of property contributed, plus any taxable income to the partner from the contributed property, plus any liabilities the partner assumes when becoming a partner, and less any liabilities the partnership assumes from the partner. Any liabilities assumed by the partnership are treated as a distribution of money to the contributing partner. IRC § 752(b). Each of the other partners' tax basis is increased by his/her proportionate share of the liability assumed.

5. Contributed Property. Generally, no gain or loss is recognized by the partner or partnership when a partner contributes property to the partnership in exchange for an interest in the partnership. IRC § 721(a).

6. Tax Upon Sale or Liquidation of a Partnership Interest.[4] The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. However, see Section VII.B.6.a below, for certain exceptions. Gain or loss is the difference between the amount realized and the adjusted tax basis of the partner's interest in the partnership. If the selling partner is relieved of any partnership liabilities, that partner must include the liability relief as part of the amount realized for his or her interest.

a. Payments for Unrealized Receivables and Inventory Items–"Hot" Assets Defined. If a partner receives money or property in exchange for any part of a partnership interest, the amount attributable to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss. This amount is treated as if it were received for the sale or exchange of property that is not a capital asset.

This treatment applies to the unrealized receivables part of payments to a retiring partner or successor-in-interest of a deceased partner only if that part is not treated as paid in exchange for partnership property. See Section VII.B.6.b below.

b. Unrealized Receivables. Unrealized receivables include any rights to payment not already included in income for the following items:

- Goods delivered or to be delivered to the extent the payment would be treated as received for property other than a capital asset.

- Services rendered or to be rendered.

These rights must have arisen under a contract or agreement that existed at the time of sale or distribution, even though the partnership may not be able to enforce payment until a later date. For example, unrealized receivables include accounts receivable of a cash method partnership and rights to payment for work or goods begun but incomplete at the time of the sale or distribution of the partner's share.

The tax basis for any unrealized receivables includes all costs or expenses for the receivables that were paid or accrued but not previously taken into account under the partnership's method of accounting.

(1) Other Items Treated as Unrealized Receivables. Unrealized receivables include potential gain that would be ordinary income if the following partnership property were sold at its fair market value on the date of the payment.

- Mining property for which exploration expenses were deducted.
- Stock in a Domestic International Sales Corporation ("DISC").
- Certain farm land for which expenses for soil and water conservation or land clearing were deducted.
- Franchises, trademarks, or trade names.
- Oil, gas, or geothermal property for which intangible drilling and development costs were deducted.
- Stock of certain controlled foreign corporations.
- Market discount bonds and short-term obligations.
- Property subject to recapture of depreciation under Sections 1245 and 1250 of the Internal Revenue Code.

(2) Determining Gain or Loss. The income or loss realized by a partner upon the sale or exchange of her interest in unrealized receivables and inventory items, discussed below, is the amount that would have been allocated to the partner if the partnership had sold all of its property for cash at fair market value, in a fully taxable transaction, immediately prior to the partner's transfer of interest in the partnership. Any gain or loss recognized that is attributable to the unrealized receivables and inventory items will be ordinary gain or loss.

c. Liquidation at Partner's Retirement or Death. Payments made by the partnership to a retiring partner or successor-in-interest of a deceased partner in return for the partner's entire interest in the partnership may have to be allocated between payments in liquidation of the partner's interest in partnership property and other payments. The partnership's payments include an assumption of the partner's share of partnership liabilities treated as a distribution of money.

For income tax purposes, a retiring partner or successor-in-interest of a deceased partner is treated as a partner until his or her interest in the partnership has been completely liquidated.

d. Liquidating Payments. Payments made in liquidation of the interest of a retiring or deceased partner in exchange for his or her interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction (or its equivalent) for the partnership.

(1) Unrealized Receivables and Goodwill. Payments made for the retiring or deceased partner's share of the partnership's unrealized receivables or goodwill are not treated as made in exchange for partnership property if both of the following tests are met:

- Capital is not a material income-producing factor for the partnership.
- The retiring or deceased partner was a general partner in the partnership.

However, this rule doesn't apply to payments for goodwill to the extent that the partnership agreement provides for a reasonable payment to a retiring partner for goodwill.

Unrealized receivables includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered.

(2) Partners' Valuation. Generally, the partners' valuation of a partner's interest in partnership property in an arm's-length agreement will be treated as correct. If the valuation reflects only the partner's net interest in the property (total assets less liabilities), it must be adjusted so that both the value of, and the tax basis for, the partner's interest include the partner's share of partnership liabilities.

(3) Gain or Loss on Distribution. Upon the receipt of the distribution, the retiring partner or successor in interest of a deceased partner will recognize gain only to the extent that any money (and marketable securities treated as money) distributed is more than the partner's adjusted tax basis in the partnership. The partner will recognize a loss only if the distribution is in money, unrealized receivables, and inventory items. No loss is recognized if any other property is received.

e. Other Payments. Payments made by the partnership to a retiring partner or successor-in-interest of a deceased partner that are not made in exchange for an interest in partnership property are treated as distributive shares of partnership income or guaranteed payments. This rule applies regardless of the time over which the payments are to be made. It applies to payments made for the partner's share of unrealized receivables and goodwill not treated as a distribution.

If the amount is based on partnership income, the payment is taxable as a distributive share of partnership income. The payment retains the same character when reported by the recipient that it would have had if reported by the partnership.

If the amount is not based on partnership income, it is treated as a guaranteed payment. The recipient reports guaranteed payments as ordinary income.

These payments are included in income by the recipient for his or her tax year that includes the end of the partnership tax year for which the payments are a distributive share or in which the partnership is entitled to deduct them as guaranteed payments.

Former partners who continue to make guaranteed periodic payments to satisfy the partnership's liability to a retired partner after the partnership is terminated can deduct the payments as a business expense in the year paid.

C. CORPORATIONS AND ENTITIES ELECTING TO BE TAXED AS A CORPORATION. A C Corporation is a taxable entity for Federal income tax purposes. It is subject to double taxation: once at the corporate level at corporate tax rates, then again on the shareholder's tax returns upon distribution of dividends. Dividend income is taxable to recipients beginning at a 15% rate, or for taxable income exceeding $415,050 (for single taxpayers) at a 20% rate. An eligible C Corporation may make an S Corporation election to avoid tax at the corporate level and tax income to the shareholders as a pass-through entity have the corporation's income reported on the shareholders personal tax returns.

Every corporation must file an annual tax return, which is generally a Form 1120 U.S. Corporation Income Tax Return. The tax return due date is the 15th day of the third month following the close of its tax year. For tax years beginning after 2015, the Highway Act makes C Corporation returns due by the 15th day of the <u>fourth</u> month following the close of a fiscal year (e.g., April 15 for FYE 12/31). The revised deadline applies to 2016 tax returns due in 2017. For corporations with a 6/30 year-end, the changes will be effective for tax years beginning after 12/31/2025. Sole proprietorships and partnerships may elect to be taxed as corporations. The election is made by filing Form 8832, Entity Classification Election. Corporations cannot elect out of corporate tax treatment. If an entity is classified as a corporation under the Treasury Regulations, the entity must file as a corporation.

Unlike partnerships, a C Corporation is taxed on its income. A C Corporation carries on a trade or business, realizes net income or loss, pays income taxes, and distributes profits to shareholders. C Corporation income has double taxation: the income of the corporation is taxed to the corporation when it is earned, and it is taxed again to shareholders when the profits are distributed to them in the form of dividends. No deduction is allowed to the corporation for dividends paid to shareholders.

1. Electing to be Taxed as a Corporation. An LLC or other entity that files a Form 8832 Entity Classification Election to be taxed as a corporation, is able to make an S election. All members must be an eligible shareholder to own S Corporation stock. An LLC that is eligible to elect S status and timely files a Form 2553 electing S status is considered to have made the election to be taxed as a corporation. A Form 8832 does not have to be filed if an S election is properly filed.

2. Estimated Tax Payment Requirements. A C Corporation's estimated income tax must be deposited quarterly or an underpayment penalty will apply. Exception: no underpayment penalty is assessed if the tax owed is less than $500. Different estimated tax payment rules may apply based on the level of taxable income generated by the corporation.

3. Capital Contributions. There is no gain or loss to the corporation when it issues stock in exchange for cash or property. IRC § 1032. There is no recognition of gain or loss by shareholders when contributing *cash* in exchange for stock. Recognition of gain or loss may occur when a shareholder contributes *property* in exchange for stock. When property is transferred to a corporation in exchange for stock, the property is deemed to have been sold to the corporation at fair market value. If services are performed in exchange for stock, the fair market value of the service is taxable compensation. Any amount included in income is the shareholder's tax basis. The tax basis of property contributed by a non-shareholder is zero. Any cash contributed by a non-shareholder reduces the corporation's tax basis in assets held inside the corporation. Capital contributions made to a corporation after start-up are called "additional paid-in capital."

4. Section 351 Transfers. Ordinarily, when a person transfers property to a corporation in exchange for shares in the corporation, the contributing person recognizes a capital gain (or loss) on the property transferred. However, an IRC § 351 transfer is generally not taxable. In a Section 351 transfer, no gain or loss is recognized if one or more persons transfer cash or property to a corporation solely in exchange for stock if the person or persons control the corporation immediately after the exchange. Control is owning at least 80% of the voting stock and 80% of all other classes stock. Under Section 351, the corporation receives the transferor's tax basis in the property received.

Section 351 does not apply to: 1) property transferred to an investment company, 2) a transfer of property in a bankruptcy in exchange for stock used to pay creditors, or 3) stock received in exchange for the corporation's debt or for accrued interest on the corporation's debt that occurred while the transferor held the debt.

The holding period for an asset received in a Section 351 transfer includes the time the asset was held by the transferor. The shareholder's holding period for the stock received in a Section 351 transaction includes the period the shareholder held the property before the exchange. IRC § 1223.

If a shareholder contributes property subject to liabilities in a Section 351 exchange, the shareholder's basis in the stock received is reduced by the amount of liability relief. IRC § 358. If liabilities exceed the shareholder's adjusted tax basis in the property transferred, gain is recognized on the excess and the shareholder's tax basis in the stock is zero. However, liability relief is not included in the computation if payment of the liability gives rise to a deduction. IRC § 357(c)(3).

5. Distributions. When a C Corporation distributes cash or property to a shareholder, the type of distribution determines the tax treatment. Distributions from a corporation to a shareholder are generally transferred in one of the following forms: wages, salary, bonuses, deferred compensation, fringe benefits, dividends, distributions of capital, loans, rent payments, or royalties. In certain situations, the IRS may attempt to reclassify the distribution as a dividend to the shareholder.

Distributions paid to shareholders from earnings and profits (E&P) are generally considered taxable dividends. If non-cash property is distributed, the shareholder is taxed on the fair market value of the property less any liabilities assumed by the shareholder in connection with the distribution. Distributions in excess of E&P are considered to be a nontaxable return of capital. However, any return of capital in excess of the shareholder's adjusted tax basis in his/her stock is treated as a gain from the sale or exchange of property. IRC § 301(c)(3)(A).

6. Tax Effects of Distributions.

a. No gain or loss is recognized by corporation when cash is distributed to shareholder.

b. If a C Corporation distributes appreciated property to a shareholder (other than the corporation's stock or securities), the corporation must recognize a gain as if the corporation sold the property at fair market value. IRC § 311(b). For purposes of distributions, fair market value is the greater of the actual fair market value or the amount of liabilities assumed by the shareholder in connection with the transaction. The rule also applies to a distribution of property in satisfaction of a declared dollar dividend.

c. There is no loss recognition by the corporation on the distribution of property to a shareholder unless the corporation is undergoing a complete liquidation. See discussion in Section VIII.D.2 on C Corporation liquidations.

d. Distributions of cash or property will reduce the corporation's E&P. Distributions of cash or property do not affect the corporation's taxable income. Distributions of appreciated property increase E&P by the amount of appreciation and decrease E&P by the fair market value of the distribution.

7. Nondividend Distributions.

a. Form 5452, Corporate Report of Nondividend Distributions, must be filed when nondividend distributions are made to shareholders, which includes distributions that are fully or partially nontaxable because the distribution exceeds the corporation's E&P. Form 5452 does not need to be filed for distributions of tax-free stock dividends or distributions exchanged for stock in corporate liquidations or redemptions of corporate stock.

b. A distribution of stock or right to acquire stock in a corporation is not a taxable distribution to the stockholder unless it is one of the following IRC § 305(b) conditions apply:

1) distribution in lieu of money or other property,
2) disproportionate distribution,
3) distribution with respect to preferred stock,
4) distribution of certain convertible preferred stock (there are exceptions), or
5) distribution of common and preferred stock resulting in the receipt of preferred stock by

some common shareholders and receipt of common stock by other common shareholders.

The above-listed distributions will be a taxable dividend only to the extent that the corporation has E&P.

8. Constructive Dividends.

a. If a C Corporation with E&P makes a distribution to a shareholder and classifies the distribution as something other than a taxable dividend, and the IRS reviews it, the IRS will likely reclassify the distribution as a constructive dividend. The reclassification of payments as a constructive dividend is often raised by the IRS in connection with closely-held corporations. Inadequate records and lack of substantiation by the closely-held corporation may lead to a tax controversy with the IRS.

b. Constructive dividends may result from the following types of transactions:

1) Unreasonable compensation paid to a shareholder.
2) Payment of rent to a shareholder in excess of fair market value.
3) Personal use of corporate property (auto, airplane, other property depreciated by the corporation [such as home furnishings or artwork], and entertainment facilities).
4) Interest on loans owed by the corporation to shareholders if the loans are not bona fide or the debts are excessive in relation to equity.
5) A loan owed by the shareholder to the corporation, which may be shown as a receivable due from shareholder on the books and records of the corporation.
6) Sale of property to a corporation if the sales price is greater than the fair market value of the property.
7) Expenses classified as personal expenses (auto, travel, and entertainment).
8) Shareholder purchase of property from the corporation at a price lower than its fair market value.

9. Earnings and Profits. Corporate E&P is not equivalent to taxable income. E&P determines taxation of corporate distributions to shareholders. Taxable distributions of a corporation are deemed to come first from current E&P and then from accumulated prior-year E&P, and then from paid-in capital. IRC § 316(a).

Distributions in excess of E&P are nontaxable to the shareholder to the extent of the shareholder's tax basis in the stock. Distributions in excess of E&P that exceed the shareholder's stock basis are taxable as a capital gain. IRC § 301(c).

D. S CORPORATIONS. So-called "S Corporations" get their name from Subchapter S of Chapter 1 of the Internal Revenue Code. To be an S Corporation, the entity must meet the following requirements (among others): (i) it must be a domestic corporation (or entity taxable as a corporation); (ii) with not more than 75 shareholders who are individuals (excluding nonresident aliens or their spouse), estates or certain trusts; and (iii) have not more than one class of stock.[5] All shareholders must sign the election for Subchapter S treatment (IRS Form 2553). *Id*. at 610.

The election of S Corporation status is usually based on the desire to pass through earnings to shareholders but retain the protection afforded under state law for the corporate form of business. The election is made under IRC §1362 by filing a Form 2553 with the IRS.

Distributions from a C Corporation are usually in the form of dividends that are taxable as income to the shareholders. Tax treatment of S Corporation distributions depends on whether the S Corporation has accumulated earnings and profits ("E&P"). See IRC §§1368 and 301. An S Corporation typically will not have accumulated E&P unless it was previously a C Corporation or it acquired another corporation with accumulated earnings and profits. BNA Tax Management Portfolios, Dividends-Cash and Property A-8, Volume 764 (2nd ed. 2001). See IRC §1368 for taxation scheme. If the S Corporation has accumulated E&P–or if the S Corporation has no E&P–see ordering rules for distributions discussed in Section VII.D.9.c.

1. S Corporation Requirements Summarized.

a. All shareholders must consent to the S election.
b. Maximum number of shareholders is 100.
c. Only one class of stock allowed.
d. Must be a domestic corporation.
e. Individual shareholders must be U.S. Citizens or residents.
f. Entity must use a Required Tax Year, or elect to use a tax year other than a Required Tax Year.
g. Qualifying shareholders: individuals, estates, certain trusts and certain charities. IRC § 1361. Certain single member LLCs can qualify.

Ineligible shareholders: Corporations, partnerships, LLCs, LLPs, nonresident aliens, IRAs.

2. IRS Form 2553 Election by a Small Business Corporation.

a. Form 2553 is filed to elect S Corporation status.
b. All shareholders must consent to the S election.
c. S Corporation tax year is selected.
d. Form 2553 can be filed any time during a tax year prior to the year the S election will begin. The Form 2553 can also be filed on or before the 15th day of the third month of the tax year to which the election is to apply.
e. In community property states, the shareholder's spouse must sign the Form 2553. (A Form 2553 signed by both spouses sometimes gives rise to a spurious argument that separate property stock has become community by making an S election.)

4. Terminations and Revocations of the S Status.

a. Terminations of S status can occur if 1) shareholders agree to terminate the S election, 2) the corporation ceases to qualify as a small business corporation, or 3) the corporation fails the passive income restrictions.
b. An S election can be revoked if more than 50% of the number of shares issued and outstanding stock consent to terminate the S election. Treas. Reg. § 1.1362-2. To revoke the S election the IRS requires 1) a statement from the corporation, and 2) a statement from the shareholders that consent to the revocation.

5. Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc. Income and deductions of an S Corporation are "passed through" to shareholders on Schedule K-1 (Form 1120S). S Corporation items are generally allocated to shareholders on a per-share, per-day basis. IRC §1377(a)(1). Certain income and deductions are separately stated on Schedule K and K-1, as the taxation and limitations for the separately stated items may be different than ordinary income and deductions.

6. Filing Requirements. An S Corporation must file a Form 1120S U.S. Income Tax Return for an S Corporation by the 15th day of the third month following the close of its tax year or date of dissolution (March 15 for calendar year S Corporations).

7. Comparison of C Corporation and S Corporation. Qualifying corporations can elect to be taxed as an S Corporation. Generally, an S Corporation will not pay a corporate level tax on net income passed through to shareholders. S Corporations avoid the double taxation problem associated with C Corporations.

a. S Corporations. S Corporations are a pass-through entity similar to a partnership. Rules for S Corporation shareholders are often similar to the rules affecting partners in a partnership.

(1) Taxation. Income and losses are passed through to shareholders. No corporate level tax.

(2) Dividends. Dividends are ignored for tax purposes. Earnings are passed through to the shareholder and taxed as ordinary income, regardless of whether dividends are paid.

(3) Ordinary Losses. Losses are passed through to shareholders. Losses are deductible up to the shareholder's tax basis in S Corporation stock and loans to the S Corporation.

(4) Capital Gains. Passed through to shareholder and eligible for capital gain tax rates for individuals.

(5) Capital Losses. Passed through to shareholder. Capital losses can reduce capital gains and are deductible but limited on the shareholder's individual return.

b. C Corporations.

(1) Taxation. Double taxation: income is taxed at the corporate level and distributions to shareholders treated as dividends are taxed at the shareholder level.

(2) Dividends. Generally taxed to the individual shareholder at the same rate as long-term capital gains (0%, 15%, or 20%).

(3) Ordinary Losses. Losses are deducted only at the corporate level, including net operating loss carrybacks and carryforwards.

(4) Capital Gains. Taxed at the same rates as ordinary income.

(5) Capital Losses. Deductible only to the extent of capital gains. Net capital losses are carried back three years and forward five years.

c. C Corporation Carryovers. No carryforward, and no carryback arising for a taxable year for which a corporation is a C Corporation, may be carried to a taxable year for which such corporation is an S Corporation. IRC § 1371(b)(1). However, capital losses and net operating losses may carry over from a C Corporation to an S Corporation for purposes of calculating the built-in gains tax.

8. Shareholder Tax Basis in S Corporation Stock.

a. Shareholder's tax basis in stock in an S Corporation includes the purchase price paid for the stock and capital contributions, plus or minus the adjustments under IRC § 1367, which include:

Increases
+ Separately stated income, including tax-exempt income.
+ Non-separately stated income.
+ Depletion in excess of the basis in the property.

Decreases
– Distributions of cash or property to shareholders.
– Separately stated losses and deductions.
– Non-separately stated losses.
– Nondeductible corporation expenses.
– Depletion to the extent it does not exceed the basis in the property.

b. Shareholder's tax basis may not go below zero. Any reduction to basis below zero will be suspended until the basis is reinstated. Losses from the S Corporation are allowed to the shareholder only to the extent of the shareholder's basis in the stock. Losses may be further limited under the "at risk" rules and passive activity loss rules.

c. Unlike partnerships, the liabilities inside an S Corporation do not increase a shareholder's basis. However, direct bona fide loans a shareholder makes to an S Corporation create additional basis for purposes of determining the shareholder's limit on losses. IRC § 1366(d)(1).

d. If a C Corporation makes an S election, the shareholder's stock basis in the C Corporation stock becomes the beginning stock basis in the S Corporation stock.

9. Distributions from an S Corporation.

a. S Corporations with Accumulated Earnings and Profits. If an S Corporation has accumulated earnings and profits, the S Corporation must maintain a retained earnings account consisting of three sub-accounts:

Accumulated Adjustments Account,
Accumulated Earnings and Profits, and
Other Adjustments Account.

b. Accumulated Adjustments Account ("AAA"). Distributions to a shareholder from AAA are not taxable, unless AAA exceeds the shareholder's tax basis in the stock. Distributions exceeding basis—up to the amount of AAA—are capital gains to the shareholder.

AAA is a cumulative balance of undistributed net income generated by the S Corporation. The AAA account is adjusted in a manner similar to a shareholder's basis in his/her S Corporation stock. The AAA account, unlike stock basis, can have a negative balance resulting from losses in S Corporation years (but not from distributions to shareholders). Treas. Reg. 1.1368-2(a)(3)(iii). Income in subsequent years can make the accumulated adjustments account positive only after the negative account balance has been restored. Any distributions or other decreases will not reduce AAA when the AAA balance is negative.

An accumulated adjustments account is increased and decreased as follows,

Increases:
(a) ordinary income,
(b) separately stated income (other than tax exempt income),
(c) gains – capital and Section 1231, and
(d) other income.

Decreases:
(a) ordinary losses,
(b) separately stated losses, capital losses, Section 1231 losses,
(c) other expenses (except for expenses related to tax exempt income), and
(d) distributions (distributions will not reduce AAA below zero).

Tax Tip: It is desirable to have an interest in an S Corporation with high AAA because the high AAA balance represents future distributions that are non-taxable or at worst taxable at a capital gain rate.

c. Ordering Rules for Distributions. The following priority of distributions is dictated by IRC § 1368.

(1) Accumulated Adjustments Account ("AAA"). Distributions come from AAA first and are not taxable to the extent the distributions do not exceed tax basis. Distributions from AAA reduce the shareholder's basis.

(2) Accumulated Earnings and Profits ("AEP"). After AAA is depleted, distributions come from accumulated E&P. To the extent distributions are from AEP, the distributions are taxable to the shareholders as dividends. Distributions from AEP do not reduce a shareholder's basis in stock. An election is available to make distributions from AEP before distributions from AAA. The election is made on an annual basis. Treas. Reg. 1.1368-1(f).

(3) Other Adjustments Account ("OAA"). After AAA and AEP are depleted, distributions come from OAA. Distributions from OAA are a return of capital up to the shareholder's tax basis in the S Corporation stock. Distributions in excess of tax basis are capital gains to the shareholder (short-term capital gain if the holding period is one year or less).

d. Deemed Dividends. An S Corporation may elect to make a deemed dividend, without actually distributing money or property. A deemed dividend is considered made on the last day of the tax year. The deemed dividend is treated as dividend income to the shareholder followed by a capital contribution which increases the tax basis of the shareholder's stock. The election may be made annually. *See* Treas. Reg. Sec. 1.1368-1(f).

e. Property Distributions. The fair market value of the property determines the tax impact and tax basis adjustment to the shareholder's stock. When appreciated property is distributed, the S Corporation is deemed to have sold the property at fair market value, and any gain is recognized. IRC § 311(b).

Any loss from a property distribution that is not in complete liquidation of the shareholder's stock is disallowed under Section 311(a) and treated as a nondeductible expense under Section 1367(a)(2)(D). The disallowed loss will reduce the basis in the shareholder's S Corporation stock and the S Corporation's AAA. Let. Rul. 201421015, June 2, 2014.

In addition to the Internal Revenue Code, the Thomson Reuters *Small Business QuickFinder Handbook* has been used for definitions and explanations.

VIII. DIFFERENT APPROACHES TO DIVIDING A BUSINESS INTEREST. In dividing a business interest in a divorce, the court usually has two choices, the court can: (A) leave the ex-spouses as co-owners; or (B) award the business to one spouse and offsetting assets or a money judgment or promissory note to the other spouse. When the business is wholly-owned as community property of the spouses, courts sometimes expand the remedies to include: (C) ordering the redemption of one spouse's ownership interest; (D) ordering the entity to be sold or dissolved; (E) ordering a split-off; (F) imposing a constructive trust; and (G) ordering a change in the type of entity. When the entity identity is disregarded (for alter ego, fraud, etc.), the court has the additional option of (H) treating individual assets (that are not separate property) as part of the community estate. These additional remedies can be implemented by ordering the spouse who controls the entity to take the steps necessary to achieve the desired outcome.

Divorcing spouses who can agree on the division of a community property business interest have the foregoing options plus others. For example, spouses working together might be able to trigger or avoid triggering a buy-sell clause, or make part of the property division into an estate plan for the benefit of children and grandchildren. If there are other owners besides the spouses, their interests cannot be impaired without their consent, which could limit options. If the business has outstanding loans, the possible choices can be restricted by loan covenants that trigger default on a change of ownership or diminished minimum cash reserves, etc.

Practice Tip: Spouses can also agree to future alimony payments in lieu of transferring offsetting cash or other assets specifically attributable to the value of the business. See Section VIII.I of this Article.

A. CONTINUING CO-OWNERSHIP AFTER A DIVORCE. Leaving spouses as co-owners of a business may avoid hard decisions at the time of divorce (including having to value the business), but it may force the ex-spouses to make harder decisions down the road, when they do not have the flexibility that exists at the time of divorce.

Practice Tip: If the community estate owns a controlling interest in the business, and in the property division the interest is split into two non-controlling interests, the ex-spouses individually will lose control of the business. Each spouse's post-divorce interest could suffer a resultant loss of value associated with loss of control.

1. Control; Fiduciary Duties. One problem with leaving ex-spouses as co-owners of a business involves post-divorce control of the business operations. If control between the ex-spouses is equal, an impasse in management can create legal problems that may ultimately require litigation. If one ex-spouse has control while the other does not, this can lead to exploitation of management powers to the detriment of the non-controlling ex-spouse, leading to shareholders derivative actions or suits for breach of fiduciary duty.

Directors and officers of a corporation owe a fiduciary duty to the corporation regarding corporate matters. *International Bankers' Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). However, "[u]nder the 'business judgment' rule, alleged unwise, inexpedient, negligent or imprudent decisions or conduct will not sustain a suit against the management of a corporation. . . ." The case of *Cleaver v. Cleaver*, 935 S.W.2d 491, 495-96 (Tex. App.–Tyler 1996, writ den'd), speaks to the problems of a minority shareholder:

> A claim that corporate dividends have been suppressed implies a breach of duty by the management to the corporation itself, not to the shareholders. . . . It is established that corporate management may invest company earnings in corporate assets rather than distributing those earnings to shareholders. . . .The Texas Business Corporation Act does not empower even stockholders to participate in, or control, the management of the corporations; that is the province of the managing board. . . . Under the "business judgment" rule, alleged unwise, inexpedient, negligent or imprudent decisions or conduct will not sustain a suit against the management of a corporation by the shareholders. [citations omitted]

Id. at 495-96. A shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to co-shareholders. *Pabich v. Kellar*, 71 S.W.3d 500, 504 (Tex. App.–Fort Worth 2002, pet. denied). "Instead, whether such a duty exists depends on the circumstances, e.g., if a confidential relationship exists." *Id*. at 504-05. Generally speaking, an officer of a corporation owes a fiduciary duty to the shareholders collectively (that is, to the corporation itself), but she does not have a fiduciary relationship with individual shareholders, unless there is some contractual or other special relationship apart from the corporate relationship. *Faour v. Faour*, 789 S.W.2d 620, 621-22 (Tex. App.–Texarkana 1990, writ denied). For a shareholder to sue another shareholder directly, she must "prove the existence of a relationship . . . other than the business relation-ship." *Hsu v. U.S. Small Business Admin.*, 2000 WL 31867, *3 (Tex. App.--San Antonio 2000, no pet.) (unpublished). In *Miller v. Miller*, 700 S.W.2d 941, 945-46 (Tex. App.–Dallas 1985, writ ref'd n.r.e.), this other relationship was the spousal relationship. In a post-divorce situation, a fiduciary duty between the ex-spouses can be established by agreement or even by the court in the divorce decree.

Texas case law has a long history of recognizing a fiduciary duty between partners. *See e.g.*, *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976). The TBOC does not define the duty owed by partners to each other as being a fiduciary duty. TBOC § 152.204(d) ("A partner, in the partner's capacity as partner, is not a trustee and is not held to the standards of a trustee"). The duties that partners owe each other are described in more specific terms in TBOC § 152.203 (use partnership property only for partnership purposes), § 152.204 (duty of loyalty and duty of care and to exercise powers in good faith and in a manner the actor believes to be in the best interest of the partnership), § 152.205 (accounting for profits, refraining from acting on behalf of someone with an adverse interest, and refraining from competing), § 152.206 (duty of care is care of an ordinarily prudent person in similar circumstances), § 152.207 (duties apply during winding up). A partner can be sued by the partnership or other partners for breaching the partnership agreement. *Id.* § 152.210. A general partner in a limited partnership owes these same duties to limited partners. *Id.* § 153.152(a)(1)(2).

As for LLCs, the TBOC does not expressly state that members and managers have fiduciary duties, but it does provide that such duties can be expanded or restricted in the company agreement, thus implying that they exist. TBOC § 101.401; *see* Byron F. Egan, *Choice of Entity Decision Tree*, State Bar of Texas Choice & Acquisition of Entities Course ch. 1.1, pp. 359-62 (2015).

What is the remedy for shareholder oppression? In *Patton v. Nicholas*, 154 Tex. 385, 279 S.W.2d 848 (1955), an injunction was issued against the majority shareholder who maliciously suppressed dividends, requiring that dividends be paid. In *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App.–Houston [1st Dist.] 1988, writ denied), the court ordered a buy-out of the minority shareholder to remedy oppression. In *Duncan v. Lichtenberger*, 671 S.W.2d 948 (Tex. App.–Fort Worth 1984, writ ref'd n.r.e.), the minority shareholders were given reimbursement of their monetary contribution to the corporation where they were completely excluded from management of the business.

The law regarding minority oppression was dramatically altered in *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), where the Supreme Court addressed the right under the forerunner statute to TBOC § 11.404 to have a court appoint a rehabilitative receiver for a corporation when the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent. A divided Supreme Court held that, for a receiver to be appointed on this ground, "the complained-of action must create exigent circumstances for the corporation." *Id.* at 867. But the Court went on to hold that no common law cause of action for "shareholder oppression" exists in Texas, and that the remedies of damages and a court-ordered buy-out are not available to minority shareholders who are being oppressed. However, the Court recognized the availability of a derivative action for failure to pay dividends, saying:

> In sum, a remedy exists for dividend decisions made in violation of a director's duties to the corporation and to its shareholders collectively, but no remedy exists for decisions that comply with those duties, even if they result in incidental harm to a minority shareholder's individual interests.

Id. at 884. And the Court recognized the continuing validity of claims by minority shareholders against corporate directors and officers for an accounting, breach of fiduciary duty, breach of contract, fraud and constructive fraud, conversion, fraudulent transfer, conspiracy, unjust enrichment, and quantum meruit. *Id.* at 882. The Court acknow-ledged that rejecting a common law claim for minority oppression leaves a "gap in the protection the law affords to individual minority shareholders." The Court in *Ritchie v. Rupe* specifically did not reject the remedy of a buy-out order for minority shareholders who could prove breach of an informal fiduciary duty owed by the officers or directors to the minority shareholders. *Id.* at 892. The Court drew a distinction between the formal fiduciary duty that officers and directors owe by operation of law to the corporation, and the fiduciary duty-in-fact that they could owe to individual shareholders. *Id.* at 891-92. Perhaps an example would be *Miller v. Miller*, 700 S.W.2d 941, 945-46 (Tex. App.--Dallas 1985, writ ref'd n.r.e.), where the appellate court found that, as to community property shares in a business, the husband had a fiduciary duty to the wife to make full disclosure to her of the circumstances that existed at the time she executed a buy-sell agreement between them. The formal fiduciary duty between spouses ends with divorce. *In re Marriage of Notash*, 118 S.W.3d 868, 872 (Tex. App.--Texarkana 2003, no pet.) ("The fiduciary duty between husband and wife terminates on divorce");*Camacho v. Montes*, 2006 WL 2660744, *3 (Tex. App.--Amarillo 2006, no pet.) (mem. op.) ("The formal fiduciary relationship between Frances and Delfino as husband and wife terminated on their divorce"); *Grossnickle v. Grossnickle*, 935 S.W.2d 830, 846 (Tex. App.--Texarkana 1996, writ denied) (no fiduciary duty after divorce). But an informal fiduciary or confidential relationship may exist between ex-spouses even after divorce, either by agreement, by court order, or arising from the facts.

Byron Egan reads *Ritchie v. Rupe* to leave "as viable remedies for a director or officer's self-dealing and similar malfeasance (i) fiduciary damage claims for breach of the fiduciary duty of loyalty and (ii) a receivership of the corporation. Contrary to some interpretations, the *Ritchie v. Rupe* decision leaves vibrant claims for breach of fiduciary duty of loyalty and viable remedies for such breaches if appropriate facts can be established." Byron F. Egan, *Choice of Entity Decision Tree*, State Bar of Texas Choice & Acquisition of Entities Course ch. 1.1, p. 279 (2015).

Partners owe each other a special duty, and "[a] managing partner . . . owe[s] to his copartners one of the highest fiduciary duties recognized in the law." *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976). Usually a partner can bring a suit against another partner for breach of this duty. However, if an ex-spouse has only a transferee/ assignee's interest in the partnership, which has no management rights, one wonders how to reconcile the normal right of a partner to sue with the language in the partnership statutes indicating that a divorce court can award the non-partner spouse only a transferee's interest, with no management rights. How claims of suppression of distributions in such a situation can translate to partnerships is unclear, considering that a transferee of a partnership interest has no "right to compel distributions by the partnership." Partners have the right to terminate their relationship with a general partnership and receive fair value for their ownership interest. TBOC § 152.501 & 152.602; *Ritchie v. Rupe*, 443 S.W.3d at 879. Although the TBOC doesn't say, a transferee may not have that right. However, the transferee spouse may have a breach of fiduciary duty claim against the transferor spouse.

As noted above, *Ritchie v. Rupe* recognized that a fiduciary-in-fact relationship can exist between owners of an entity. A confidential relationship can arise from the facts and circumstances of a particular situation, even where a fiduciary relationship does not exist by operation of law. *See Izzo v. Izzo*, 2010 WL 1930179, *7 (Tex. App.--Austin 2010, pet. denied) (John became Sharon's attorney, investment advisor, and custodian of her assets prior to marriage, and thus owed her fiduciary duties that existed independently from the fiduciary duty of a spouse). To prove a confidential relationship, the injured party must show a high degree of trust, influence, or confidence was placed in the wrongdoer. *Crim Truck and Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992). Once a confidential relationship is established, then duties akin to fiduciary duties arise, and the principles of fiduciary law come into play.

Practice Tip: *Ritchie v. Rupe* permits a non-controlling shareholder to sue for breach of fiduciary duty if the person in control has a fiduciary-in-fact duty to the non-controlling owner. In a settlement, the spouses can write such a post-divorce duty into the divorce agreement. If the divorce is tried, the court can order such a post-divorce duty in the decree of divorce.

TBOC §§ 101.451 - 463 sets out rules for derivative proceeds relating to LLCs. The derivative plaintiffs must give 91 days' advance notice before filing. TBOC § 101.453. The proceeding can be stayed while the LLC investigates the claim. TBOC § 101.455. The suit must be dismissed if, after investigation, the LLC determines that the derivative proceeding is not in the best interests of the company. TBOC § 101.458(a).

Practice Tip: Tex. Fam. Code § 9.011(b) provides that an ex-spouse's "actual receipt" of property awarded to the other ex-spouse "creates a fiduciary obligation in favor of the owner and imposes a constructive trust on the property for the benefit of the owner." The divorce court can enforce this obligation through a proceeding under Chapter 9 of the Texas Family Code, although the remedies of that chapter are not exclusive. Because a business entity (shareholders, partners, or members) owns the entity's assets, Chapter 9 would not apply to assets acquired after divorce inside a corporation or partnership or LLC, but it would apply to distributions from entities that came into the hands of the ex-spouse, if they were awarded to the other ex-spouse. The remedy of reverse piercing of the entity may be available. See Section VIII.G of this Article.

2. Phantom Income. Co-ownership of a pass-through entity after divorce can lead to a problem with "phantom income." The management of an S Corporation, partnership, or LLC taxed as a partnership, can retain earnings without distributing them, even though the income on those earnings must be reported on the owners' personal tax returns. *See Cleaver v. Cleaver*, 935 S.W.2d 491, 495 (Tex. App.–Tyler 1996, writ denied); *Thomas v. Thomas*, 738 S.W.2d 342 (Tex. App.–Houston [1st Dist.] 1987, writ denied (involving an S Corporation). This can create a tax liability for the partners or owners on income they did not actually receive in the form of distributions.

3. Series LLCs. The ability of an LLC to create different series opens up possibilities in divorce settlements. For example, a new series could be created for a spouse that would have its own membership interests, management, assets, and liabilities. See Section VI.A of this Article. The tax implications of such a resolution would need to be explored.

4. Other Types of Post-Divorce Arrangements. In some situations the spouses can have a post-divorce business relationship that does not involve shared ownership of the business. For example, where important operating real estate, plant and/or equipment is owned by the parties, these assets can be awarded to a spouse in the divorce, and the company that is awarded to the other spouse can sign a 10-or-20-year triple net lease on the property.

B. AWARDING OFFSETTING ASSETS, MONEY JUDGMENT, OR PROMISSORY NOTE.

1. Awarding Offsetting Assets. If the business is awarded to one spouse and there are other assets that can be awarded to the other spouse, so that there will be no payments over time, it eliminates worry about whether delayed payments will in fact be made. This method requires that the business interest be valued, and that the assets awarded to the other spouse be valued, to be sure that the division is just and right. In *Hanson v. Hanson*, 672 S.W.2d 274, 278–79 (Tex. App.--Houston [14th Dist.] 1984, writ dism'd), the court said: "We agree with the principle that if an estate can be divided equitably by partitioning the assets in kind, this method should be used instead of a money judgment." However, "[t]he trial court is given broad discretion to divide the marital estate "in a manner that the court deems just and right . . . [and] [t]he award of a money judgment is one of the methods a trial court may divide property in a divorce proceeding in the exercise of its discretion." *Id*. at 278-79.

Practice Tip: In some instances a spouse may be able to borrow from a third party (lender, other co-owners of the business, family member) the money needed to buy out the spouse's interest in the business. This is better for the exiting spouse than having to seller-finance the buy-out, and the exiting spouse should consider accepting a discount on the sales price in return for full payment in cash at the time of divorce.

2. Awarding Money Judgment. As part of a divorce property division, "[a] trial court may order a party to pay a cash sum to the other party, even when there is no cash in the community estate." *Finch v. Finch*, 825 S.W.2d 218, 224 (Tex. App.--Houston [1st Dist.] 1992, no writ). However, immediate payment of a large amount of cash may not be possible. As noted in *Magallanez v. Magallanez*, 911 S.W.2d 91, 94 (Tex. App. 1995, no writ), "[a] trial court has the ability to award the community homestead to the appellant and to require the appellee to execute a general warranty deed conveying to the appellant any interest in the community property. . . . The court also has the ability to require that the appellant compensate the appellee for any community interest in the property and to provide that this be accomplished by means of a deferred payment." The same principle applies when a court awards a business interest to one spouse and orders that spouse to make payments to the other spouse after the divorce. The court can also require a spouse to execute a promissory note payable to the other spouse, as part of the property division. *Kimsey v. Kimsey*, 965 S.W.2d 690, 698 (Tex. App.–El Paso 1998, pet. denied) (the El Paso Court of Appeals reversed a trial court for imposing only an equitable lien and failing to require the husband to sign a promissory note and deed of trust).

The divorce court does not have the power to put an ex-spouse in jail for failing to make post-divorce payments pursuant to a property division, as that would violate the Tex. Const. Art. I, § 18 which says that "[n]o person shall ever be imprisoned for debt." However, a money judgment is subject to collection remedies like execution and garnishment, as well as enforcement proceedings under Chapter 9 of the Family Code, and turnover proceedings under Sections 31.002, §31.0025 and §31.010 of the Texas Civil Practice and Remedies Code. The court can make the judgment payable in installments, suspending enforcement of the judgment unless a payment is missed.

Practice Tip: A judgment becomes dormant and uncollectible if a writ of execution is not issued within ten years, and every ten years thereafter. Tex. Civ. Prac. & Rem. Code §34.001. Consider requesting the issuance of a writ of execution at the time of divorce even though you do not intend to have it served on the judgment debtor. If the judgment will be paid out over more than ten years, the client should be instructed on the need to reissue a writ of execution after the passage of 9 or so years.

Practice Tip: If enforcement of a judgment is to be suspended unless default occurs, you should discuss whether an abstract of judgment can be issued and filed, and a writ of execution issued–even if not served, and those terms should be included in the judgment. The abstracting of the judgment can adversely affect the judgment debtor's credit rating and make borrowing new money more difficult.

3. Contract to Make Payments After Divorce. In settling a case, spouses can agree for property to be awarded to one spouse in exchange for future payments to the other spouse. "Such an agreement, though incorporated into a final divorce decree, is treated as a contract, and its legal force and its meaning are governed by the law of contracts, not by the law of judgments." *McGoodwin v. McGoodwin*, 671 S.W.2d 880, 882 (Tex. 1984). A divorce court does not have the power to hold an ex-spouse in contempt for failing to comply with contractual provisions of a divorce settlement incorporated into a decree of divorce. *Ex parte Jones*, 358 S.W.2d 370, 376 (1962). So the remedies for enforcing such payments are remedies for the collection of a debt or breach of contract. *See Colquette v. Forbes*, 680 S.W.2d 536, 539 (Tex. App.–Austin 1984, no writ) (appellate court affirmed foreclosure of ex-wife's implied lien in ex-husband's property in order to pay a promissory note given to ex-wife in the divorce property division).

Practice Tip. If the obligation to make payments over time is made part of the decree of divorce, either expressly or by incorporation of an agreement incident to divorce or a promissory note, post-divorce enforcement under Texas Family Code ch. 9 is also available.

A contractual promise to pay the other spouse after divorce can be embodied in an agreed judgment, or in a contract (including an agreement incident to divorce or a promissory note), or both. However, it is typical to use a promissory note in preference to an agreement incident to divorce because a promissory note focuses just on the debt to be paid in contrast to an agreement incident to divorce, which is a multi-faceted and sometimes complicated agreement with obligations running to both parties.

Practice Tip: A spouse can be bought out of a business in exchange for a stream of alimony payments. The payments would be deductible to the paying spouse and taxable as ordinary income to the receiving spouse. Alimony payments might be attractive in a situation where collateral is not good, because an alimony obligation is not dischargeable in bankruptcy, and because the spouses can agree that the alimony payments will be enforceable by contempt up to the maximum duration and amount of spousal maintenance under Family Code Sections 8.054 and 8.055. See Tex. Fam. Code § 8.059(a-1) ("The court may not enforce by contempt any provision of an agreed order for maintenance that exceeds the amount of periodic support the court could have ordered under this chapter or for any period of maintenance beyond the period of maintenance the court could have ordered under this chapter").

Practice Tip: If payments are to extend for some period of time, the interest rate on unpaid sums can become an important factor. For the past few years, price inflation has been "under control" and interest rates have been intentionally depressed by the Federal Reserve Board of Directors. This cannot last forever. History shows that interest rates will adjust to market forces eventually. A forensic CPA can tell you the current yield on 1-year, 5-year, 7-year, 10-year, 20-year and 30-year Treasury notes and bonds, but that is not an appropriate rate for a risky loan such as we find in most divorces. Commercial loan rates are a better parameter of an appropriate rate of interest, but it may be that a commercial bank would not be willing to make this loan to the spouse, so a higher interest rate may be appropriate. Another possibility for loans of long duration is a variable interest rate, such at 1 or 2 or 3 percentage points above the prime rate, adjusting every six months or year. Remember that the minimum interest rate on judgments in Texas is 5%.

Practice Tip: There are situations where the value of a business can vary due to changing circumstances. A recent example is the unexpected and sudden collapse of crude oil prices in 2015 and 2016, that brought the headlong drilling in the Eagle Ford region of south Texas to a screeching halt. Many Eagle Ford-related businesses that once had astounding cash flows are now "on the ropes," and oil field service companies are laying off work force or shutting down, the value of their drilling rigs and fracking equipment has plummeted, and the survival of the companies is in grave doubt. Where such fluctuations in value are possible, the parties may consider agreeing that the amount to be paid to the "selling spouse" will be adjusted based on subsequent events. This spreads the risk/reward of the business between the spouses.

Practice Tip. Old timers will remember the Saudi-induced oil downturn in the 1980s, and the collapse in Texas land values that also occurred in the 1980s, and the demise of savings and loans nationwide and commercial banks in Texas in the

1980s. We have now suffered another Saudi-influenced oil downturn in 2015-16. Few persons predicted the recent crash in the price of crude oil, and no one can predict when and how far the world price of crude oil will rise again. If a divorce involves a business whose value could change significantly over time, a settlement can be fashioned that would adjust the amount to be paid to reflect changes in economic conditions. Using a benchmark that is external to the business (like the price of a barrel of West Texas Intermediate crude oil) is better than using net profits or even gross revenues, because an independent benchmark is not subject to manipulation by the other spouse. If no such benchmark exists, gross revenues are a better metric than net profit, since net profit can be depressed by artificially increasing operating expenses. However, even gross revenues can be manipulated downward by deferring sales or deferring customers' payments, or diverting business opportunities to a newly-created entity.

Practice Tip: A variable buyout price can be applied to a plaintiff lawyer's personal injury cases, or to real estate development projects, or any speculative business whose future is difficult to predict. Variable payment terms can be drafted into the agreement incident to divorce. In many instances, this kind of sophisticated transactional lawyering should be guided by a specialist brought in to handle this phase of the divorce settlement.

4. Collateral for the Obligation to Pay. Promises to make payments in the future are subject to the risk of non-payment. This is why lenders normally insist on collateral or security for a promise to pay in the future. An obligation of one spouse to make payments to the other spouse after the divorce is subject to similar risk of non-performance.

a. Court-Ordered Collateral. A divorce court can secure a judgment ordering one spouse to make payments to the other spouse after the divorce with an equitable lien in community property awarded to the obligor-spouse. An equitable lien is different from a judgment lien which arises upon the filing of an abstract of judgment. An equitable lien is created by virtue of a declaration contained in the decree of divorce. In *Hanson v. Hanson*, 672 S.W.2d 274 (Tex. App.--Houston [14th Dist.] 1984, writ dism'd), the court of appeals said that a trial court should provide security for money judgments granted to achieve an equitable division of the community estate, so as to protect the receiving party "from uncertainties such as bankruptcy, concealment, and use of assets, which could work to deprive the party of his share of the community estate." *Id.* at 279. Several courts have declined to reverse for the failure to impose an equitable lien in a divorce. *See Wren v. Wren*,702 S.W.2d 250 (Tex. App.--Houston [1st Dist.] 1985 writ dism'd); *Wisdom v. Wisdom*, 575 S.W.2d 24 (Tex. Civ. App.--Fort Worth 1978, writ dism'd); *Goldberg v. Goldberg*, 392 S.W.2d 168 (Tex. Civ. App.--Fort Worth 1965, no writ). However, the court in *Kimsey v. Kimsey*, 965 S.W.2d 690, 698 (Tex. App.–El Paso 1998, pet denied), reversed for the failure of the divorce court to require the husband to sign a promissory note and deed of trust.

The rule is different with equitable liens in separate property. "Although courts may impress equitable liens on separate real property to secure reimbursement rights, they may not impress such liens, absent any compensable reimbursement interest, simply to ensure a just and right division." *Heggen v. Pemelton*, 836 S.W.2d 145, 146 (Tex. 1992); *Wilkerson v. Wilkerson*, 992 S.W.2d 719 (Tex. App.—Austin 1999, no pet.)."[T]rial courts may impose equitable liens on one spouse's separate real property to secure the other spouse's right of reimbursement for community improvements to that property." *Heggen v. Pemelton*, 836 S.W.2d at 145. Tex. Fam. Code § 3.406 provides: "On dissolution of a marriage, the court may impose an equitable lien on the property of a benefitted marital estate to secure a claim for reimbursement against that property by a contributing marital estate." *See Hinton v. Burns*, 433 S.W.3d 189, 201 (Tex. App.–Dallas 2014, no pet.) (discussing the evolution of the language of Family Code Section 3.406).

In *McGoodwin v. McGoodwin*, 671 S.W.2d 880, 881 (Tex. 1984), the Supreme Court held that, in connection with a divorce decree approving a property settlement agreement in which the husband agreed to pay a sum of money as consideration for the wife's interest in a particular piece of community property real estate, an implied vendor's lien arose in favor of the wife. However, the lien extended only to one-half of the property. This lien could be enforced despite a claim of homestead asserted by the ex-husband after the divorce. Tex. Const. art. XVI, § 50 allows a lien against the entire property to be imposed by court order or agreement to secure an owelty of partition. Such a lien would be enforceable against a claim of homestead.

b. Collateralization by Agreement. In *Taylor v. Banks*, 392 S.W.2d 856, 858 (Tex. 1965), the Supreme Court wrote:

> It has been recognized since the case of *King & Co. v. Texas Banking & Insurance Co.*, 58 Tex. 669 (1883), "[t]hat parties by contract may regulate in advance the remedy which the creditor must pursue in subjecting property pledged to the payment of the debt which it is hypothecated to secure, cannot be questioned. The time, mode and place of sale may be so fixed; and it has been held that the parties may agree that the property may be sold without notice and at a private sale upon default of pledgor to pay the debt."

Practice Tip: Taking and perfecting liens in land and security interests in personal property is a field of law unto itself. It is affected by Texas land law and by the nearly 200 pages of statutory provisions contained in Texas Business and Commerce Code, art. 9, Secured Transactions. If there are significant sums involved in your case, it behooves you to have the client engage a transactional lawyer who practices in this area, to prepare or review the paperwork and perfect the liens and security interests.

Practice Tip: Securitizing future payment obligations is a specialized area of the law. Beyond the routine retaining of a vendor's lien in a deed between spouses and preparing and filing a deed of trust or deed of trust to secure assumption in order to create and perfect a lien in land, it is better for the family lawyer to require the client to hire a transactional lawyer to be sure that the proper liens and security interests are created *and perfected*.

Caveat: The following thumbnail sketch of secured transactions is *offered for descriptive purposes only* and *should not be relied upon* in making *actual* decisions affecting *real* people.

Speaking in very rudimentary terms, a lien to establish the priority of a judgment claim can be created by filing an abstract of judgment in counties where the judgment debtor owns or might come to own land. Doing so affixes a lien in the non-exempt real property in that county, Tex. Prop. Code § 52.001, which is good for 10 years, *Id.* at § 52.006. *See* Donna Brown, *Post Judgment Remedies, Judgment Liens, Garnishment, Execution, Turnover Proceedings, Receiverships under the DTPA, and "Other Stuff"*, State Bar of Texas 14th Annual Collections & Creditors' Rights Course, ch. 7, pp. 1 & 6, (May 5-6, 2016).

Practice Tip: If the abstract of judgment is not properly filled out, and properly filed and indexed, it will not create the judgment lien, so extreme caution is advised.

Filing a certified copy of the divorce judgment, reciting an equitable lien, gives the public notice of the equitable lien, but whether it "perfects" the lien for priority against other creditors and a trustee in bankruptcy is not clear. A vendor's lien in real estate (enforceable against a claim of homestead) must be retained in the deed whereby the prior owner conveys the property to the new owner. A lien in land can also be created by a deed of trust filed in the county where the land is located. A lien in personal property is called a "security interest," and this is created in a security agreement. The security interest is not protected against other creditors or a trustee in bankruptcy unless it is "perfected." For some kinds of personal property, to perfect a security interest a UCC-1 financing statement is filed in the right government office. This Article does not undertake to describe which office that would be in various instances. A security interest in a deposit account can be perfected only by taking control. A security interest in shares of stock and other "investment property" must be perfected by taking possession, often done by having the debtor execute a pledge agreement and deliver the investment property to an escrow agent. A partnership interest and a member interest in an LLC both are "general intangibles," not investment property, and a security interest in a general intangible must be perfected by filing a UCC-1. However, if a partnership has "opted into Article 8," the UCC-1 will not perfect the security interest against a creditor who perfects by taking possession. The need to bring in a specialist to deal with these complexities is evident.

Practice Tip: If the payments to buy out an interest in the business take the form of alimony, and the paperwork indicates that, for enforcement purposes, the agreement is for periodic payments of spousal maintenance under Chapter 8 of the Family Code, the payments will be enforceable by contempt and incarceration up to the statutory maximum duration and amount. Tex. Fam. Code § 8.059(a-1). Best for the paperwork to provide expressly for enforcement by contempt, and better still if that agreement is recited in or incorporated by reference into the decree of divorce. However, the agreement or decree should specify that the contractual obligation is not altered by a subsequent court-ordered modification of Chapter 8 spousal maintenance. See Section VIII.I of this Article.

c. Charging Order. A charging order is an order of a court directed to a partnership, or LLC, directing the entity to pay all distributions that would ordinarily go to a partner or member to a judgment creditor of that partner or member instead. TBOC § 152.308. The creditor is entitled to receive only what the judgment debtor becomes entitled to receive. *Id.* at 152.308(b). That means that a judgment creditor cannot force a distribution. Under TBOC § 153.308, the charging order is a lien on the judgment debtor's partnership interest, but a lien that cannot be foreclosed. A charging order is the exclusive remedy a judgment debtor has against a partner's interest in a partnership. The judgment creditor has no claim against the assets of the partnership. TBOC § 152.308(f). Identical provisions apply to a charging order against a member's interest in an LLC. TBOC § 101.112.

A divorce decree could award a partnership interest or member interest to one spouse and a money judgment to the other spouse, while at the same time imposing a charging order on that ownership interest to assist in collection of the judgment. The charging order could be for 100% of the distributions, or 50% of the distributions, or all distributions up to a point and pro rata thereafter. The charging order should be delivered to and acknowledged by the entity.

C. REDEMPTION OF AN OWNERSHIP INTEREST. One way to extinguish a spouse's interest in a company is for the company to redeem that spouse's ownership interest by distributions of cash or other assets. For corporations, the redemption would be a stock redemption. A good definition of a stock redemption could not be found in Texas case law. American Jurisprudence succinctly describes what constitutes a corporate stock redemption for tax purposes:

> A stock redemption is the acquisition by a corporation of its own stock from a shareholder in exchange for cash or property . . . , whether or not the stock so acquired is

> cancelled, retired or held as treasury stock. . . . If the distribution isn't made in connection with a complete liquidation of a corporation, it is a nonliquidating redemption distribution.

33A Am. Jur.2d ¶ 4952, Stock redemption defined. For partnerships and LLCs, the term "redemption" does not have the formality that it does for corporations. It is nothing more than a transfer of an ownership interest to the entity.

1. Legal Considerations. For a corporation, in a redemption the shares of the shareholder are transferred to the corporation. In a partnership, there may be the formality of an assignment or there may just be an entry in the accounting records or an adjustment in the ownership percentages on the partnership's tax return and Schedules K-1. For an LLC, there may be an assignment of membership units to the LLC, or the change in ownership may just be reflected in accounting records or tax returns and Schedules K-1.

2. Tax Considerations. If one spouse buys the other spouse's stock, Section 1041 will apply and there will be no tax at the time of divorce. However, if the spouses use money from inside the corporation to cash out the departing spouse's shares, a tax must be paid by someone. A redemption of an ownership interest in a business entity is ordinarily treated for accounting and tax purposes as the sale or exchange of the interest. However, because of Section 1041, in a divorce whether the sale is treated for tax purposes as a sale of a capital asset (imposing capital gain recognition on the departing spouse), or as a constructive dividend (creating a tax on dividend income to the spouse who remains with the company), depends on tax factors which should be considered in working out the divorce property division.

This issue was examined in the famous *Arnes* cases. In *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992), affg. 91-1 USTC ¶50,207 (W.D Wash. 1991) (*Arnes I*), the spouses' wholly-owned corporation operated a McDonald's franchise. McDonald's Corporation informed the husband that its rules precluded joint ownership of the corporation after divorce. The spouses agreed that the corporation would redeem Mrs. Arnes' shares. This agreement was incorporated into the divorce decree and Mr. Arnes guaranteed the corporation's obligation to pay Mrs. Arnes. Mrs. Arnes paid tax on the capital gains arising out of the redemption, but later sued for a refund arguing that IRC § 1041 protected her from taxation on the distribution. The crux of Mrs. Arnes' argument was that her transfer of shares to the corporation, which was required by the divorce instrument, was a transfer "on behalf of" Mr. Arnes. The District Court agreed, finding the transfer "benefitted" him and the Court of Appeals affirmed. The story did not end there. Perhaps because *Arnes I* was decided in favor of Mrs. Arnes, the government pursued Mr. Arnes on the theory that he had received a constructive dividend when the corporation redeemed Mrs. Arnes' shares. Mr. Arnes liability was decided in *Arnes v. Commissioner*, 102 TC 522 (1994) (*Arnes II*), a case that was appealed to the Ninth Circuit. The majority held that Mr. Arnes did not have a primary and unconditional obligation to buy his ex-wife's stock since he had merely guaranteed the corporation's payment and, therefore, he was not taxable on the transaction. The majority opinion also distinguished *Arnes I* based on its different facts. Because the test for taxability in *Arnes II* varied from the test for taxability in *Arnes I*, both Mr. and Mrs. Arnes escaped tax on the redemption of her shares, even though cash was distributed from the corporation. The government was clearly whipsawed in the two decisions. The U.S. Tax Court disagreed with *Arnes I* in *Blatt v. Commissioner*, 102 T.C. 77 (1994), saying that a divorce-related redemption is not on behalf of the spouse or former spouse. The Tax Court also noted that, in *Arnes I*, the wife was required by a third party to relinquish her shares and the husband personally guaranteed the corporation's obligation to redeem wife's shares, neither of which was true in *Blatt*. Eventually the Treasury Department issued Regulations under Section 1041 which, in effect, say that in these transactions someone must pay tax, but allow the parties to determine who.[6] So, in cashing out a spouse using a divorce-related redemption the parties lose the possibility of deferring a tax entirely under Section 1041, and instead they must choose between: (i) the selling spouse recognizing a capital gain (or loss); or (ii) the remaining spouse being taxed on a constructive dividend.

Practice Tip: The disagreement between the Ninth Circuit in *Arnes I* and the Tax Court in *Blatt* was based partly the fact that a business arrangement with a third party required Ms. Arnes to redeem her stock upon divorce and that Mr. Arnes personally guaranteed the corporation's duty to redeem Ms. Arnes' shares. Neither was true in *Blatt*, and the Tax Court held that the redemption was not "on behalf of" the husband, a necessary condition for Section 1041 to apply. The Temporary Regs seems to have resolved the uncertainty by permitting the parties to agree where the tax will fall. The focus now is on tax planning and not technical rules. If the divorce settlement will involve a redemption of stock, the family lawyer should engage and rely on the advice of a tax advisor, be that a tax lawyer or a CPA, in thinking through the tax consequences of a redemption.

Tax Tip: While the tax rate is presently the same for capital gains and dividends, there are circumstances where the parties might prefer capital gain recognition to the departing spouse, rather than a constructive dividend to the remaining spouse. This would be true if there is a capital loss on the transaction, or where there are capital loss carryovers to be offset, or where a high tax basis in the stock will significantly reduce the capital gain to be taxed. Or the redeeming spouse might want to elect installment reporting of the capital gain over a period of years.

D. TOTAL OR PARTIAL LIQUIDATION. A business can be divided in a divorce by distributing cash or other property to a spouse or by selling assets and distributing the sales proceeds to one or both of the spouses. If the business is an entity, these proceeds can be treated as a dividend (i.e., a distribution of earnings and profits) or as a liquidating distribution (a capital asset sale), with differing tax consequences, which are discussed in Section VII.B.6 as well as this Section of the Article.

The winding up of a domestic entity is governed by Chapter 11 of the TBOC. Once the winding up is triggered, the entity must cease carrying on business, except as needed for winding up. TBOC § 11.052(a)(1). However, the entity may continue its business wholly or partly "for the limited period necessary to avoid unreasonable loss of the entity's property or business." TBOC § 11.053(d). In liquidating, the entity must apply it assets first to discharge, or make adequate provision for the discharge of, its liabilities and obligations. TBOC § 11.053(a). Thereafter the entity "shall distribute the remainder of its property, in cash and in kind, to the domestic entity's owners according to their respective rights and interests." TBOC § 11.053(c).

1. Sole Proprietorships. Ordinarily, the best way to preserve the value of a business after the divorce is to keep the business-related assets together and award them to the spouse who ran the business before the divorce. To split the business-related tangible assets between the spouses is ~~to~~ a step toward liquidating some or all of the business, and the value generated through splitting assets would in most instances be less than the value obtained by selling the assets as part of a going concern.

Most businesses have intangible assets. Intangible assets include identifiable intangibles like accounts receivable, notes receivable, leases, intellectual property rights, and the like. The intangible value of a business can also include "goodwill," which is intangible value that cannot be assigned to identifiable intangible assets. While many descriptions have been given for "goodwill," in the context of a sole proprietorship goodwill is the extra value that the assemblage of people and assets has when they are combined to make a profitable business. Stated differently, the goodwill of a sole proprietorship is the amount by which "the whole is greater than the sum of its parts." The value of goodwill can be realized in only two ways: by (i) keeping the business intact and receiving future profits; or (ii) selling the business for more than the individual values of tangible and identifiable intangible assets. In a property division, the goodwill inherently goes to the spouse who receives the going business, and other community assets, or payments to be made out of future income (including contractual alimony), would have to be awarded to the other spouse. If the business is ordered sold, the proceeds would be divided as directed by the court.

2. C Corporations. Distributions from C Corporations are treated as dividends to the extent that the corporation has a positive earnings and profits ("E&P") account. Distributions in excess of E&P are not taxed as dividends. However, even when the C Corporation has a positive E&P account, distributions to shareholders will be taxed as capital gains (or losses) if they qualify as distributions in complete or partial liquidation of the corporation's shares. This is because the shareholders are treated as selling their shares back to the corporation in exchange for the liquidating distribution. The practical effect of a complete liquidation is that double taxation of E&P is avoided.

a. Distributions in Excess of E&P. When a corporation pays dividends to its shareholders, the dividends must be reported by the shareholders as ordinary income and the corporation gets no deduction. However, not all distributions from a corporation to its shareholders are taxed as dividends. One federal court wrote of corporate distributions:

> The Code generally treats corporate distributions (or dividends) out of earnings and profits as ordinary income to the shareholder taxpayer. But if a corporation pays a dividend which exceeds its earnings and profits (as measured by § 316(a)), the Code treats that portion of the dividend as a nontaxable return of capital to the shareholder taxpayer to the extent of the taxpayer's basis in the securities, and as a capital gain to the taxpayer once the taxpayer's basis is exhausted.

Mazzocchi Bus Co., Inc. v. C.I.R., 14 F.3d 923, 927 (3rd Cir. 1994).

b. Complete Liquidation. Dividend treatment for C Corporation distributions to shareholders does not apply to payments that are part of a complete liquidation of the corporation. In the complete liquidation of a corporation, the shareholders might receive cash, property, or both from the corporation. Generally a complete corporate liquidation is taxable as a capital gain. The basic income tax rule in this context is that a shareholder is treated as having exchanged all of her stock for the net amount received in the corporate liquidation. If property is received in kind, the value received by the shareholder in that liquidating transaction includes the fair market value of that property distributed, net of debt. The amount of the gain or loss is measured by the difference between the amount realized and the shareholder's adjusted tax basis in the stock canceled in the liquidation. In a complete liquidation, the earning and profits account, which would otherwise be taxed as a dividend, will be part of the capital gain or loss.

c. Partial Liquidating Distributions. Distributions in redemption of stock that qualify as a "partial liquidation" of the corporation will result in capital gain tax treatment to the selling shareholder. A stock redemption is treated as a partial liquidation if it is in redemption of stock held by a noncorporate shareholder and is (i) is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a complete plan of liquidation, or (ii) is a redemption of part of the stock of the corporation and is made pursuant to a plan and occurs within the tax year in which the plan is adopted or within the succeeding tax year, and is not essentially equivalent to a dividend at the corporate level. 26 CFR1.346-1. Noncorporate shareholders include individuals, partnerships, estates, and trusts. If the requirements are met, the distribution can be made to a sole shareholder, pro rata to all shareholders, or non-pro rata to one or more shareholders.

To be a partial liquidation for tax purposes, the distribution must relate to the termination of a distinct part of the corporation's business. An example given is a distribution of insurance proceeds from the destruction by fire of a building used in the company's business, where that business activity has been abandoned by the company.

3. S Corporations. Many of the provisions which deal with liquidation of a C Corporation and the tax consequences to its shareholders also apply to S Corporations. Subchapter C (governing C Corporations) applies to an S Corporation and its shareholders except as otherwise provided in Subchapter S and except to the extent inconsistent with Subchapter S. IRC § 1371(A)(1).

Generally, IRC § 331 will apply to the complete liquidation of an S Corporation. The electing corporation will recognize gain on its liquidating distribution of the appreciated property. IRC § 336(a). The effect of the gain recognition will vary depending upon whether IRC § 1374 is applicable. If IRC § 1374 is applicable, a corporate level tax will be imposed and the liquidation will therefore operate in a manner similar to that applicable upon liquidation of a C Corporation. IRC § 1374.

If IRC § 1374 is not applicable to the dissolution, although the S Corporation will recognize gain on the distribution or sale of appreciated assets, it will generally have no tax liability as a result of the recognition. IRC § 1363(a). This assumes, of course, that no tax is applicable on excess passive income. IRC § 1375. Where no corporate level tax is imposed, the corporation's gain will be taxed to the shareholders and will increase their tax basis in stock or debt. This higher tax basis will generally eliminate gain that the shareholders would otherwise have recognized on distribution of the appreciated assets. As a result, a single level tax will be imposed on the gain inherent in the corporation's assets.

When an S Corporation is liquidated, each shareholder will have gain to the extent that the fair market value of the assets distributed in liquidation exceeds the adjusted tax basis of the stock. Such gain will be capital gain (long-term if the stock has been held for more than the requisite holding period). If the fair market value of the assets distributed in liquidation is less than the adjusted tax basis of the shareholder's stock, the shareholder will incur a loss on liquidation.

Where an S Corporation has an accumulated adjustments account ("AAA"), at least to the extent of the accumulated adjustments account it will normally make no difference to a shareholder, when a distribution is made, whether it is characterized as a liquidating distribution or a distribution under IRC § 1368. When accumulated earnings and profits exist, however, characterization of the liquidating distribution as a distribution under IRC § 1368 or as a liquidating distribution will be determinative of whether it is accorded capital gain or dividend treatment. As is the case with C Corporations, where accumulated earnings and profits exist, care must be exercised to ensure that a distribution is treated as a liquidating distribution rather than a normal dividend subject to the rules of IRC § 301.

4. Partnerships.

a. The Legal Mechanics of Winding Up. The winding up of a partnership is governed by TBOC ch. 11, which contains provisions relating to all types of Texas entities. The winding up of a limited partnership is additionally governed by TBOC ch. 153, subchapter K. Unless provided otherwise by the limited partnership agreement, the assets of a limited partnership that is winding up must first be paid to creditors, then to partners and former partners entitled to distributions, then to partners to return capital, and last to partners in proportion to their capital interests. TBOC § 153.504. Limited partnerships frequently specify who receives what on winding up. For example, real estate development partnership agreements often provide that the partner who provided the capital is entitled to a return of all of its capital, together with a preferential return on that capital, then other partners receive a return of their capital, then the assets are distributed in the proportion provided in the limited partnership agreement.

b. Non-Liquidating Distributions of Capital. General partnerships have no special statutory rule regarding distributions of income versus distributions of capital. Limited partnerships do. TBOC § 153.208 provides:

> § 153.208. Sharing of Distributions
>
> (a) A distribution of cash or another asset of a limited partnership shall be made to a partner in the manner provided by a written partnership agreement.
>
> (b) If a written partnership agreement does not provide otherwise, a distribution that is a return of capital shall be made on the basis of the agreed value, as stated in the partnership records required to be maintained under Section 153.551(a), of the contribution made by each partner to the extent that the contribution has not been returned. A distribution that is not a return of capital shall be made in proportion to the allocation of profits as determined under Section 153.206.
>
> (c) Unless otherwise defined by a written partnership agreement, in this section, "return of capital" means a distribution to a partner to the extent that the partner's capital account, immediately after the distribution, is less than the amount of that partner's contribution to the partnership as reduced by a prior distribution that was a return of capital.

This statutory description of "return of capital" excludes distributions from the portion of a capital account attributable to profits or surplus. If the written partnership provides something different, the agreement prevails over Section 153.208.

c. Tax Aspects of Liquidating Distributions from a Partnership–General Recognition Rules. From a tax perspective, a *liquidating distribution* is a distribution or a series of distributions that terminates a partner's interest in the partnership. The liquidating distribution may be in the form of a payment as part of the liquidation of the whole partnership, or the distribution may be to a retiring partner or deceased partner's estate. In the latter case, special rules will apply.

(1) Payments as Part of the Liquidation of an Entire Partnership

   (a) Generally, **gain** is recognized only if *money* (cash and marketable securities) is distributed that exceeds the tax basis in the partnership interest before the distribution. The partner's tax basis of his or her interest is determined at the time of the distribution.

   (b) Also, **loss** is recognized only if 1) the adjusted tax basis of the partner's interest exceeds the distribution, 2) the partner's *entire* interest is liquidated (e.g., a liquidating distribution), and 3) the distribution is only in money, unrealized receivables, or inventory items.

   (c) Once again, these results ignore the implications of Sec. 751 assets. See discussion of Sec. 751 assets under *Tax*

Upon Sale or Liquidation of a Partnership Interest at Section VII.B.6.

(2) Payments to a Retiring Partner or a Deceased Partner's Estate

Payments made in liquidation of the interest of a retired or the successor-in-interest of a deceased partner may have to be allocated between payments 1) in liquidation of the partner's interest in partnership property and 2) "other payments." The retiring partner is treated as a partner until the interest is completely liquidated.

(a) **Payments made in liquidation of the partner's interest in partnership property** are treated as a distribution under the rules for complete liquidations discussed above; these are *not* distributive shares of income or guaranteed payments. In most cases, any gain or loss on the liquidation of the partnership interest is reported as capital gain or loss, as a partnership interest is generally treated as a capital asset. Special tax treatments may apply for unrealized receivables and goodwill to cause the recognition of some ordinary income. This is discussed in Section VII.B.2.

(b) **Other payments** are payments in excess of payments made in liquidation of the partnership interest. These payments are treated either as *distributive shares of income* (if based on partnership income) or *guaranteed payments* (payment is not dependent on income), and as such, are usually subject to self-employment tax. Payments treated as distributive shares of income retain the same character to the partner as in the hands of the partnership. Any guaranteed payments are treated as ordinary income by the partner and are deductible by the partnership. Guaranteed payments are unpaid income taxable to the person who earned the income under the assignment of income doctrine, and generally not deferred under IRC § 1041.

E. A SPLIT-OFF OR ASSET TRANSFER. One possible division of a corporation upon divorce is to award the company to one spouse while "splitting off" some of the assets into another company which is then awarded to the other spouse. A variation on the split off is an asset transfer of specific assets of the business to another entity which is then awarded to the other spouse.

1. Definitions. In a 'spin-off,' a parent company distributes shares of a subsidiary to the parent company's shareholders, usually on a pro rata basis, and the subsidiary becomes a separate company. In a "split-off," the stock of the subsidiary corporation is distributed to only some of the shareholders of the distributing corporation, and those shareholders in turn relinquish their stock in the distributing corporation. In the "split-up," the distributing corporation contributes all of its assets into two or more controlled corporations, makes a distribution of the stock of the controlled corporations to its shareholders, and then liquidates itself in the distribution.

2. Tax Aspects. Corporate spin-offs, split-offs, and split-ups are examples of corporate divisions under IRC § 355. In these corporate divisions there is a corporation, known as the distributing corporation, that distributes the stock of a controlled corporation to its shareholders. The distributing corporation can contribute assets to the controlled corporation before the stock is distributed to shareholders. Five specific requirements apply to divisive reorganizations. These are:

1. The distribution requirement -- the distributing corporation must only distribute stock of the controlled corporation to its shareholders;

2. The control requirement -- the distributing corporation must distribute enough stock of the controlled corporation to constitute control of the controlled corporation;

3. The active trade or business requirement -- the distributing corporation and the controlled corporation must both be engaged in an active trade or business immediately after the division;

4. The anti device requirement -- the distribution must not be a device for distributing earnings and profits;

5. The business purpose requirement -- there must be a valid corporate business purpose for the division.

A corporate division or divisive reorganization is the only way for a corporation to distribute appreciated property without triggering a corporate–level tax on gains recognized inside the corporation. The character of gains as either ordinary, capital, or § 1231, will depend on the type of asset distributed. Congress was concerned about the use of these corporate divisions to avoid gain on transactions that were essentially asset sales to unrelated parties. Therefore, anti-abuse rules exist that are specific to corporate divisions. These include the disqualified distribution rule (IRC § 355) and the prohibited acquisition rule (IRC § 355(e)).

In a divorce, requirements 1 and 2 may be met, but requirements 3, 4, and 5 may not be met. The consequence of failing the divisive reorganization test is a taxable distribution. For further study, see Morton A. Harris & Carl A. Rhodes, *Splitting Corporations under Section 355*, ABA Section of Taxation/Section of Real Property, Trust & Estate Law Joint Program (2011).[7]

3. Asset Transfer to New Entity. In a contested divorce, a court cannot award corporate assets to either spouse, absent piercing the corporate veil. *Siefkas v. Siefkas*, 902 S.W.2d 72, 79 (Tex. App.–El Paso 1995, no writ) ("unless the corporation is a spouse's alter ego, a court may only award a spouse's interest in the corporation, not specific corporate property"). The same rule applies to partnerships, *McKnight v. McKnight*, 5423 S.W.2d 863 (Tex. 1976), and LLCs. However, if the divorce does not involve non-consenting third parties, the parties can transfer corporate assets into a new entity that is awarded to the other spouse. If appreciated property is transferred, the transferring corporation will recognize a capital gain and the receiving corporation will receive the property with a tax basis of fair market value. In a Montana case, the divorce court ordered the husband to conduct a divisive reorganization of a corporation, splitting off into a new corporation the parties' ranch. Husband was then ordered to transfer the stock in the new corporation to wife. Wife's experts said this was not a taxable event; husband's experts said it was. *In re Marriage of Edwards*, 340 P.3d 1237 (2015). *See* Leon Gabinet, TAX ASPECTS OF MARITAL DISSOLUTION § 9:19:50, Court-ordered transaction with uncertain tax consequences (2d ed. 2005).

A variation on this theme is a series LLC. A series LLC can create a new series in settling a divorce, and making the departing spouse the member of the new series and placing selected assets in the series. See VI.A of this Article for a discussion of series LLCs.

F. CHANGING THE TYPE OF ENTITY. TBOC§ 10.101 provides that "[a] domestic entity may convert into a different type of domestic entity or non-code organization by adopting a plan of conversion." Ownership in the changed entity continues uninterrupted. TBOC § 10.101(e). There must be a written plan of conversion. TBOC § 10.103(a). The conversion becomes effective as provided in the plan. TBOC § 10.105. The entity continues to own all of its assets without the necessity of transfer documents. TBOC § 10.106(2). The rights of existing creditors are not affected. TBOC § 10.106(4). Owners who oppose the conversion have a right of dissent and appraisal, and to request that their interests be liquidated for "fair value." TBOC § 10.357. Fair value is described in TBOC § 10.362, and essentially is fair market value based on a going concern, disregarding the effect of the proposed entity action and ignoring a control premium, minority ownership discount, or discount for lack of marketability. TBOC § 10.362 (a) & (b).

Practice Tip: Conversion may be a tool to use in settling a divorce, for example when the parties are contemplating continued ownership by both spouses and a different form of entity is more suitable to that arrangement. For example, converting a partnership to an LLC might provide more protection to the other spouse from new creditors' claims (the rights of existing creditors are not altered by a conversion). If the departing spouse is a dissenter from the conversion, s/he is entitled to be cashed out in a transaction that may avoid capital gain recognition under IRC § 1041. Advice on this type of solution would need to come from a lawyer experienced in entity law and taxation.

Tax Tip: In general terms, when a partnership or entity taxed as a partnership is converted into a different kind of entity that is taxed as a partnership, there will be no adverse tax consequences. However, converting a partnership, or entity taxed as a partnership, into a corporation, or entity taxed as a corporation, will probably be treated for tax purposes as a liquidation of the partnership and start-up of the new entity. Converting a corporation or entity taxed as a corporation to a partnership or entity taxed as a partnership will be treated as a liquidation of the corporation or entity taxed as a corporation and start-up of the partnership or entity taxed as a partnership.[8] The family lawyer should take no steps toward converting entities without solid tax advice.

G. PIERCING THE CORPORATE VEIL. "The corporate form normally insulates shareholders, officers, and directors from liability for corporate obligations; but when these individuals abuse the corporate privilege, courts will disregard the corporate fiction and hold them individually liable." *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986). One basis for disregarding the corporate entity is the equitable doctrine of "alter ego." "Alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice." *Id.* at 272. Alter ego is just one of several grounds to pierce the corporate veil. As noted in *Castleberry*: "[m]any Texas cases have blurred the distinction between alter ego and the other bases for disregarding the corporate fiction and treated alter ego as a synonym for the entire doctrine of disregarding the corporate fiction. . . . However, . . . alter ego is only one of the bases for disregarding the corporate fiction . . . ." *Id.* at 272. To quote *Castleberry* further: "We disregard the corporate fiction, even though corporate formalities have been observed and corporate and individual property have been kept separately, when the corporate form has been used as part of a basically unfair device to achieve an inequitable result." *Id.* at 271. Continuing from *Castleberry*:

> Specifically, we disregard the corporate fiction:
>
> (1) when the fiction is used as a means of perpetrating fraud;
> (2) where a corporation is organized and operated as a mere tool or business conduit of another corporation;
> (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation;
> (4) where the corporate fiction is employed to achieve or perpetrate monopoly;
> (5) where the corporate fiction is used to circumvent a statute; and
> (6) where the corporate fiction is relied upon as a protection of crime or to justify wrong.

Id. at 272. [Footnotes omitted.]

Texas law also recognizes the remedy of "reverse piercing." As explained in *Chao v. Occupational Safety & Health Review Comm'n*, 401 F.3d 355, 364 (5th Cir. 2005):

> In the typical corporate veil piercing scenario, the corporate veil is pierced such that individual shareholders can be held liable for corporate acts. . . . Here, the purpose of piercing the corporate veils . . . would be to hold the corporations liable for the acts of their individual shareholder . . . Therefore, this case presents a "reverse corporate veil piercing" situation. . . . This slight variation is of no consequence, however, because the end result under both views is the same--"two separate entities merge into one for liability purposes." . . . If alter ego is shown, courts reverse pierce the corporate veil to treat the individual and the corporation as "one and the same."

However, a post- *Castleberry v. Branscum* statute, TBOC § 21.233, Limitation for Liability for Obligations, provides in part that corporate shareholders "may not be held liable to the corporation or its obligees with respect to: . . ." (2) any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder, beneficial owner, subscriber, or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud, or other similar theory; or (3) any obligation of the corporation on the basis of the failure of the corporation to observe any corporate formality, including the failure to: (A) comply with this code or the certificate of formation or bylaws of the corporation; or (B) observe any requirement prescribed by this code or the certificate of formation or bylaws of the corporation for acts to be taken by the corporation or its directors or shareholders." The statute recognizes an exception "if the obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, beneficial owner, subscriber, or affiliate." The effect of this statute was two-fold. First, shareholders cannot be held liable for a corporation's contractual liabilities based on piercing the corporate veil, absent actual fraud. Second, the failure to observe corporate formalities is not a ground for making shareholders liable to corporate creditors. However, the statute recognizes an exception to the bar against piercing for contact claims where "the obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, beneficial owner, subscriber, or affiliate." In effect, contract claimants can still pierce if they can prove *actual* fraud. Thus, *Castleberry*'s reliance on constructive fraud for piercing was undone as to contract claims, but contract claimants can still pierce for claims based on *actual fraud*.

Because Section 21.233 is a limitation on holding shareholders liable for corporate obligations, it has no effect on the typical piercing claim brought in a divorce case, which is based on a shareholder-spouse's duties arising from the marriage relationship and community property rights, and a fiduciary-in-fact or confidential relationship between spouses, if one is found to exist. Piercing the corporate veil is a divorce case was discussed in *Vallone v. Vallone*, 644 S.W.2d 455, 458 (Tex. 1982), where the Supreme Court said:

> Consideration of whether a corporation is an alter ego for purposes of determining whether assets held in the corporation's name should be treated as community property is an issue of fact from which the status of the property is determined.

The trial court's finding of alter ego was reversed in *Robbins v. Robbins*, 727 S.W.2d 743, 746–47 (Tex.App.--Eastland 1987, writ ref'd n.r.e.), due to insufficient proof. An example of a successful claim of disregarding the corporate form in a divorce is *Dillingham v. Dillingham*, 434 S.W.2d 459, 462 (Tex. Civ. App. 1968, writ dismissed):

> In the case presently before us the proof was such as to entitle the trial court, for purposes of the litigation, to conclude that the appellant's wholly owned corporation was indeed his Alter ego, and that the increase thereof was and became a part of the parties' community estate. Further, the court held that there had been such a commingling of the community property with that purportedly corporate, and as such claimed as the separate property of the appellant, that any segregation of that portion which he claimed as his separate estate was impractical or impossible. We also hold that the evidence fully warranted the trial court's conclusion.

Thus, in *Dillingham*, the corporate entity was disregarded, and the corporate assets fell into the community and became commingled, so that the husband's separate property claim to the corporation and its assets was totally defeated. The court in *Zisblatt v. Zisblatt*, 693 S.W.2d 944, 952 (Tex. App.–Fort Worth 1985, writ dism'd), said: "The theory of alter ego is applied in order to achieve an equitable result. In an action for divorce, it is applied to properly characterize corporate assets as part of the community estate."

The State Bar of Texas' PATTERN JURY CHARGES -- FAMILY AND PROBATE (2016) contains instructions and questions about disregarding the separate existence of an entity. PJC 205.1 sets out the claim that a corporation has been a mere tool or business conduit, or alter ego. The instruction states: "the distinct corporate identity of the corporation made be disregarded if there is such unity between the corporation and a shareholder that the separateness of the corporation has ceased and the shareholder's improper use of the corporation has damaged the community estate." PJC 205.2 is an instruction for a claim to disregard the separate identity of a corporation because the corporate form "has been used as a sham to perpetrate a fraud," or "has been resorted to as a means of evading an existing legal obligation," or "has been employed to achieve or perpetrate a monopoly," or "has been used to circumvent a statute," or "has been relied on as a protection of crime or to justify a wrong." The jury questions in PJC 205.3 asks (i) whether "the distinct corporate identity of CORPORATION should be disregarded" and "What percentage, if any, of each of the following assets of CORPORATION is the separate property of SPOUSE A?" The practical effect of the second question is to include the listed corporate assets in the marital estate and put the burden of proving that the assets are separate property on the spouse who claimed the business as his or her separate property.

Disregarding the separate identity of a corporation in a divorce makes the corporation like a proprietorship for purposes of the divorce. The assets become assets of the shareholder(s). To actually award specific corporate assets to the non-shareholder spouse, the corporation and perhaps even other shareholders would need to be made parties to the divorce proceeding. But if the assets of the "pierced" corporation are not awarded to the other spouse, but instead are just treated as if they are community property assets awarded to the owner-spouse, and other assets or a money judgment are awarded to the non-shareholder spouse, then it can be argued that the corporation and other shareholders would not need to be made parties to the divorce.

Practice Tip: If the corporation and other shareholders have not been joined as a party, the defending shareholder-spouse may wish to join the corporation under TRCP 39 as a party whose joinder is needed for just adjudication.

Practice Tip: If a piercing claim is part of a divorce that is settled, it is possible that transferring specific corporate assets to the non-shareholder spouse could be justified on the basis of the corporation's settling a claim against the corporation. From a tax standpoint, the transfer of assets by the corporation to the non-shareholder spouse to settle such a claim would probably be treated as a distribution, to the shareholder-spouse subject to tax rules.

Practice Tip: Courts have said that limited partners cannot be held liable for partnership debts using the piercing of the veil principle. *Peterson Grp. V. PLTQ Lotus Grp.*, 417 S.W.3d 46, 56-67 (Tex. App.–Houston [1st Sit.] 2013, pet. denied); *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 (Tex. App.–Dallas 2008, pet. denied); *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n*, 77 S.W.3d 487, 499 (Tex. App.--Texarkana 2002, pet. denied); *Skidmore Energy, Inc. v. KPMG*, 2004 WL 3019097, at *5 (N.D. Tex. 2004). Whether this view applies to reverse-piercing was not discussed, and its application to a PJC-style, reverse-piercing divorce claim was not discussed in these cases.

Practice Tip: Several Federal cases have held that members of an LLC can be held liable for LLC debts using the same standard for piercing that is applied to corporations. *See Spring Street Partners-IV, L.P. v. Lam*, 730 F.3d 427, 443 (5th Cir. 2013) (applying Texas law); *Rimade Ltd. v. Hubbard Enters.*, 388 F.3d 138, 143 (5th Cir. 2004) (applying corporate piercing standards to LLC); *Copeland v. D & J Constr. LLC*, No. 3:13-CV-4432-N-BH, 2015 WL 512590, at *3 (N.D. Tex. Feb. 6, 2015) (evaluation piercing claim against LLC based on both contract and actual fraud claims); *In re Williams*, No. 09-52514, 2011 WL 240466, at *3 (Bankr. W.D. Tex. Jan. 24, 2011) (LLC member may only be held liable for the LLC's breach of contract under traditional veil piercing laws). There was no discussion of reverse-piercing or application of the doctrine to a divorce situation. The case of *Sanchez v. Mulvaney*, 274 S.W.3d 708, 712 (Tex. App.–San Antonio 2008, no pet.), said that the normal rules for piercing the veil apply to LLCs.

1. Tax Implications. The Internal Revenue Service published guidance to taxpayers in a Field Service Advice Memorandum ("FSA") for dealing with tax implications of piercing the corporate veil.[9] The advice in the FSA has been adapted from discussions involving recovery of assets by the trustee of a bankruptcy estates to apply to facts related to individual taxpayers who are shareholders in a generic corporation. The FSA identified several applications of the alter ego theory doctrine to Shareholder and Corporation: 1) merely imposes a collection device to extract assets out of the Corporation to satisfy Shareholder's tax liability; 2) constitutes a complete nonrecognition of the corporation (or nonrecognition of the separateness of Shareholder from the Corporation) so that all of Corporation's assets are considered as owned by Shareholder; or 3) effectively treats the property (P1) as having been owned by Shareholder ab initio while otherwise respecting the Corporation as a separate legal and taxable entity. Applying these factors to marital property, it appears that the *complete nonrecognition* of the corporation follows the language of the Pattern Jury Charge described above. The IRS has said it has several arguments regarding the tax treatment of nonrecognition of the corporation: the shareholder receives a constructive distribution treatment on the use of the Corporation's property to satisfy his personal tax liability; the Corporation recognizes Section 311 gain on its deemed distribution of appreciated property to the shareholder (a corporation is required to recognize gain if it directly exchanges appreciated property for its own stock). Alternatively, the IRS indicates if the use of Corporation's property to satisfy shareholder's liability is not considered to be a distribution with respect to shareholder's stock interest in the Corporation, the argument should be that the shareholder recognizes ordinary income under Section 61(a) on the use of Corporation's property to satisfy his tax liability. Effectively, the deemed distribution is treated as a redemption of the Shareholder's interest for the property held by the Corporation–in the case of stripping away the corporate veil–a complete redemption of the interest held and therefore a "sale or exchange" of the interest. If the treatment is a liquidation, the Corporation will recognize gain under Section 336(a).

The FSA concludes: "The amount of the constructive distribution will be the fair market value of the property at the time of the constructive distribution. Sections 301(b)(1) and 301(b)(3); Treas. Reg. §1.301-1(b). To the extent of Corporation's earnings and profits, Shareholder will have dividend income under section 301(c)(1). If the amount of the distribution exceeds Corporation's earnings and profits, Shareholder will have a return of basis and capital gain thereafter. Sections 301(c)(2) and 301(c)(3)." In layman's terms, the constructive dividend is taxed to the shareholder at dividend rates. The impact to the corporation depends on whether the distribution consists of cash or appreciated property. See also the discussion of Basic Entity Tax Principles related to Corporations in Section VII.C of this Article.

H. CLAIMS AGAINST THE ENTITY; RESULTING OR CONSTRUCTIVE TRUST. In certain situations, it is possible for the non-owner spouse to bring claims against the family business. It is perfectly legitimate for the business to settle such claims, before or after liability has been determined in a trial. Such claims are a potential vehicle for getting assets out of an entity to the non-owner spouse in a manner other than by redemption or by making a distribution to the owner under the TBOC. A corporation is an entity apart from its owner, if even it is wholly-owned by one person. *See In re Marriage of Morris*, 12 S.W.3d 877, 885 (Tex. App.–Texarkana 2000, no pet.) (error to require husband to pay wife $5,000 owed to him by his corporation, absent alter ego and absent joining the company as a part to the divorce). A divorce court can adjudicate a claim against a business entity only if it is made a party to the divorce. However, the unadjudicated claim itself can be awarded to either spouse as part of the property division, if it is a claim of the community estate.

1. Suing the Company for Money Damages. An entity can be sued for damages in contract or tort, or under a statute imposing penalties. The recovery would be community property to the extent that the injury was suffered by the community estate; the recovery would be separate property if the injury was to the separate estate. Possible contract claims would be a suit on a note or a suit on a payable-to-owner account. Possible tort claims would include conversion, fraud, and conspiracy. Fraud on the community is not a tort. *Schlueter v. Schlueter*, 975 S.W.2d 584, 588-89 (Tex. 1998). A possible statutory claim would be for unlawful interception of a communication or email. Tex. Civ. Prac. & Rem. Code § 123.001-ff.

Tax Tip: The payment to a spouse may be tax deductible to the company as a business expense, if the payment is business-related and not based on a personal obligation of the owner-spouse.

2. Establishing a Resulting Trust. A resulting trust arises by operation of law when title is conveyed to one party while consideration is provided by another. *Cohrs v. Scott*, 338 S.W.2d 127, 130 (Tex. 1960). Generally, a resulting trust can arise only when title passes, not at a later time. *Id*. at 130. Ordinarily, the proponent of a resulting trust has the burden of overcoming the presumption of ownership arising from title by "clear, satisfactory and convincing" proof of the facts giving rise to the resulting trust, *Stone v. Parker*, 446 S.W.2d 734, 736 (Tex. Civ. App.--Houston [14th Dist.] 1969, writ ref'd n.r.e.).

If community funds are used to buy an asset, but title or ownership of the asset is taken in a business entity, a spouse can assert a claim against the entity to impose a resulting trust on the asset. A resulting trust is also available if community credit is used to pay for the asset taken in the name of the business. What if the business borrowed the purchase money, but one or both spouses personally guaranteed the loan? Does that raise an issue of whether a resulting trust should be imposed on some or all of the asset? Does it depend on the credit worthiness of the business?

These questions raise a more fundamental challenge that may require forensic accounting analysis to determine how the transaction was recorded on the books and records of the company. Only if the transaction is analyzed will an understanding be gained to determine the effect of the transaction and how it needs to be unwound and/or its tax implication. If community funds were used to acquire an asset in the name of the business, how was the contribution of funds recorded on the books? Was it a loan from shareholder? Or was it recorded as "additional paid-in capital"? If the asset is "taken" from the corporation and treated as an asset of the community, would the reversal of the entry as a loan (plus interest) or paid-in capital be sufficient to correct the transaction? Or could the repayment be treated as a sale of the property to the community? If the value of the asset has decreased or increased since the date when first acquired, would any gain or loss be realized by the entity? Depending on the alternative treatments, the tax ramifications will also vary. For example:

- Is the loan a valid debt, repaid with cash plus interest? If so, the interest would be included in income of the shareholder. If the debt is repaid with assets, what basis does the shareholder take? Any gain or loss on transfer? If the asset were depreciated, would there be possible depreciation recapture? See Section VII.B.6 of this Article.

- If the repayment is treated as a return of paid-in capital, is the distribution taxed? Would there be recognition of gain or loss in excess of tax basis? Would IRS related-party rules affect the transaction's taxability? Do the answers to these questions change based on the type of entity (C Corporation, S Corporation, partnership or LLC)?

How will the correct treatment be determined? Will alternatives be presented at trial for the court's determination? Will the shareholder's spouse be eligible for innocent spouse relief for the transaction? See Appendix I for information from *IRS Publication 971 Innocent Spouse Relief*.

3. Imposing a Constructive Trust. A "constructive trust" is not really a trust–it is an equitable remedy. The court imposes a constructive trust when equitable title or an ownership interest ought to be, as a matter of equity, recognized in someone other than the holder of legal title. The Supreme Court described the doctrine as follows:

> A constructive trust does not, like an express trust, arise because of a manifestation of intention to create it. It is imposed by law because the person holding the title to property would profit by a wrong or would be unjustly enriched if he were permitted to keep the property.

Omohundro v. Matthews, 341 S.W.2d 401, 405 (Tex. 1960). *See Mills v. Gray*, 147 Tex. 33, 210 S.W.2d 985, 988-99 (1948).

Constructive trust is a broad equitable concept, and it has many potential uses in divorce proceedings. If a breach of some duty can be proved, and the result is that money or assets are owned by an entity when they should belong to the community estate or to the other spouse's separate estate, then constructive trust may be an available remedy. If a constructive trust were to be imposed upon cash or assets of a business, it must be accounted for and reported for tax purposes.

Unlike the examples in the Resulting Trust section above, the constructive trust is imposed when the actual transaction may not have been recorded on the company books at all but, in equity, the property should be returned to the community estate or to the other spouse's separate estate. If property is on the books of the company, but not by way of a debt transaction or paid-in-capital, the means of removing it may be through a dividend transaction or as a bonus to the shareholder who receives the property. From an entity standpoint, a bonus would be deductible by the company, but would create tax issues for the failure to properly withhold income taxes (Federal and state) and income inclusion for the shareholder. In a C Corporation, and depending on the tax bracket of the particular entity, a worse result might be that no deduction is allowed at the corporate level and the transaction is treated as a dividend to the shareholder. In an S Corporation the distribution may or may not be taxable depending upon the corporations's tax basis, the AAA account, earnings and profits, and the shareholder's tax basis in the stock. The S Corporation income is a pass-through to the shareholder as is income from a partnership and an LLC reporting as a partnership.

Tax Tip: Will the shareholder's spouse be eligible for innocent spouse relief for the transaction? See IRC § 6015(b), (c) & (f).

I. USING CONTRACTUAL ALIMONY. Instead of a promissory note, money judgment, redemption, etc., the parties could agree for the spouse keeping the business to pay alimony to the departing spouse. The alimony will be deductible to the payor under IRC § 215 and taxable to the payee, under IRC § 71, and the amount of the alimony may need to be "grossed up" so that the after tax payments to the payee will match the value of the departing spouse's ownership interest. Under IRC § 71(b)(1)(D), the alimony must end on death of the payee. So the heirs of the spouse receiving alimony would lose their inheritance rights in the wealth.

Practice Tip: To deal with the death contingency, in the property division, extra wealth could be allocated to wife to permit her to buy a life insurance policy, payable on her death to her heirs.

Practice Tip: Alimony has the added advantage /disadvantage of being non-dischargeable if husband later takes bankruptcy. 11 U.S.C. § 523(a)(5).

Practice Tip: The court can modify spousal maintenance under Family Code Section 8.057, and Section 8.059(c) recognizes inability to pay as an affirmative defense to a contempt claim. It is unclear whether these provisions can be waived prospectively in a divorce settlement. Wife may want to specify in the divorce settlement that husband's contractual obligation to pay alimony will not be affected by these Family Code provisions.

IX. TRANSFER RESTRICTIONS AND BUY-SELL AGREEMENTS. Except for the requirement that business in licensed professions can be owned only by licensed professionals, Texas corporate law imposes no restrictions on the transfer of shares from a shareholder to his/her spouse in a divorce. The transfer of a partnership interest to a partner's spouse in a divorce is restricted by TBOC § 152.406 to a transferee's interest. The subject is not mentioned in the LLC provisions of the TBOC. The TBOC prohibits unlicensed individuals from being an owner of an entity that is engaged in a licensed profession (medical, legal), which effectively bars an assignment of an ownership interest in the entity to an unlicensed spouse. TBOC ch. 301. Apart from these statutory transfer restrictions, business entities are free, in organizational documents, to restrict the transfer of ownership interests as a condition to ownership, or it can be done by agreement of the owners. *Ritchie v. Ritchie*, 443 S.W.2d 856, 871 (Tex. 2014) ("Shareholders of closely-held corporations may address such problems by entering into shareholder agreements that contain a buy-sell, first refusal, or redemption provisions that reflect their mutual expectations and agreements").

Buy-sell agreements are terms in an entity's organizational paperwork, or in agreements between owners, that give the other owners or the company itself the right to purchase an owner's ownership interest under certain circumstances. The triggering events are usually leaving employment, death, disability, or divorce.

In this discussion, we differentiate transfer restrictions from buy-sell provisions.

A. THE LEGAL PERSPECTIVE. Many business entities have restrictions on the ability of owners to transfer their ownership interest in the business. Some transfer restrictions prohibit the transfer of an owner's interest to anyone who is not already an owner, while others limit transfers to a described class of transferees, and others condition transfer upon the consent of other owners, or the general partner, etc. Buy-sell agreements are usually some form of option to buy or sell an ownership interest in the business. Such agreements often give the business's other owners or the business itself the right to buy a departing owner's ownership interest in preference to a transfer to a third party.

TBOC §21.211, Valid Restrictions on Transfer, authorizes restrictions on the ability to transfer shares of a corporation. In the statute, the term "security" is used, rather than "shares." Under Section 21.211, the restriction must *reasonably*:

(1) give the other owners or the company a right-of-first-refusal to buy the "restricted security" before it is transferred to someone else;

(2) obligate the corporation or "another person" to purchase the security;

(3) require the consent of the corporation or other shareholds to consent to a proposed transfer of the security;

(4) prohibit transfer of the security to a designated person or persons, provided the designation "is not manifestly unreasonable";

(5) maintain the status of the corporation as an S Corporation;

(6) maintain a tax advantage to the corporation;

(7) maintain the status of the corporation as a close corporation;

(8) obligate the shareholder to transfer an amount of restricted security to a person, persons, or the corporation; or

(9) trigger the automatic sale or transfer of the security to a person or persons or the corporation.

TBOC § 21.212 says that the restriction can be noted in a filing with the Secretary of State. TBOC § 21.213 says that the restriction is enforceable if (i) it is noted on the certificate or (ii) if the security is uncertificated, the restriction is reasonable and "a notation of the restriction is contained in the notice sent with respect to the security under Section 3.205." Absent such notice, the restriction is not binding on a bona fide purchaser for value without actual notice. TBOC § 21.212(b).

1. Examples of Buy-Sell Provisions. In buy-sell agreement no. 1, shares can be sold, but the other owners have a right of first refusal on the same terms. In buy-sell agreement no. 2, shares cannot be transferred, and upon the shareholder's death, disability, or termination of employment the corporation must buy the shares for $1.00 per share. In buy-sell agreement no. 3, upon exit the departing owner's interest can be purchased by other owners at book value, excluding all intangibles. In buy-sell agreement no. 4, the exit price is fair market value. In buy-sell agreement no. 5, the exit price is fair value. In buy-sell agreement no. 6, the exit price is set by an appraiser whose opinion of value is binding. In buy-sell agreement no. 7, the company must designate an appraiser and the selling owner designates a different appraiser and the two appraisals are averaged to determine the exit price. Buy-sell agreements often provide for the purchase price to be paid over time, on terms favorable to the business.

Often a buy-sell agreement will contain a divorce clause saying that, if some or all of the owner-spouse's interest is awarded to the other spouse, then the owner-spouse has an option or obligation to buy the other spouse's interest at a set price, and if the option is not exercised then other owners and ultimately the entity have the option to purchase on those terms.

In *Miller v. Miller*, 700 S.W.2d 941, 945–46 (Tex.App.—Dallas 1985, writ ref'd n.r.e.), the appellate court held that a buy-sell agreement between spouses respecting corporate stock was not enforceable because it was a constructive fraud on the wife, who was not a manager of the company.

B. THE PRACTICAL PERSPECTIVE. Transfer restrictions are designed to give existing owners the right to control who will become new owners of interests in the business. Buy-sell agreements are designed to say to whom and on what terms and conditions an owner can sell or transfer his/her ownership interest in the business.

A buy-sell agreement can contain a "right of first refusal," requiring departing owners to first offer the ownership interest to current owners, and alternatively to the business itself, before transferring it to third parties. Only if there are no takers can the departing owner sell or transfer his/her interest to an outsider. Outright bans on the transfer of an interest in the business are not very common, perhaps because of the risk that a court might declare the unqualified ban an unlawful restraint on alienation. In some family businesses, only direct descendants of owners are allowed to own interests.

Sometimes the price to exercise the "right of first refusal" is nothing more than the right to match any offer the departing owner may have received for his interest. This would by definition set the exercise price at fair market value.

A feature of some buy-sell agreements is a price-setting mechanism to determine how much another current owner, or the business itself, must pay to buy the departing owner's share of the business. Some agreements set a formula to calculate the exercise price, such as book value or a multiple of earnings, or some other formula. This exercise price would usually not be fair market value, and it could be higher or lower than fair market value. A third approach to setting an exercise price is selecting one, two, or three appraisers to value the departing owner's share of the business.

Like any contract, the language describing a valuation mechanism may be susceptible to different interpretations, which could require litigation to resolve. Where the buy-sell agreement details what must be considered in arriving at a calculation, there may be litigation to determine the underlying information or over whether the designated accountant or appraiser followed the instructions set out in the agreement. And there is an argument that contractual valuation mechanisms may be inherently subject to judicial review.

The typical divorce-related provision provides for the entity to buy the interest in the business if that interest ends up in the hands of the non-owner spouse as a result of divorce. The way most of these clauses are written, the divorce-related trigger will not apply unless the non-owner-spouse actually ends up with an ownership interest in the entity after the divorce. Depending on the facts of the case, an award of an ownership interest to the non-owner-spouse, so as to trigger a buy-sell provision may be a useful step on the way to getting cash from the business to the non-owning spouse.

Practice Tip: Occasionally you might find a divorce-buy-out provision where both spouses are owners, and each spouse has a right or obligation to buy out the other spouse's interest after a divorce. This creates a recursive loop where a spouse deprived of his/her ownership interest in the divorce has the right or obligation to buy-back that very interest after divorce.

C. ENTITIES OF LICENSED PROFESSIONALS. Certain professional entities are governed by Chapters 301-303 of the TBOC. Professional entities include a professional association, a professional corporation, or professional limited liability company. TBOC § 301.003. However, these provisions do not apply to partnerships. TBOC § 301.001(c). Under TBOC § 301.006, a professional association may provide professional services in Texas only if all owners are individuals who are licensed to provide professional services in Texas. TBOC § 301.006(a). Only "authorized persons" may be an owner, officer, or governing person of a professional entity. TBOC § 301.007. If someone who is not an authorized person "succeeds to the ownership interests of an owner," that person must promptly relinquish that ownership interest. TBOC § 301.008(c). The professional entity must purchase the ownership interest held by the non-authorized person. TBOC § 301.008(d). "The price and terms of a purchase of an ownership interest required under this section may be provided by the governing documents of the entity or an applicable agreement." TBOC § 301.008(d). No statutory provisions set the price and terms where they are not in the governing documents or applicable agreement. Ownership interests in a professional entity can be transferred only to (i) an owner of the entity, (ii) the entity itself, or (iii) an authorized person. TBOC § 301.009.

Under TBOC § 303.003, "[a]ny restriction on the transfer of shares in a professional corporation that is imposed by the governing documents of the corporation or an applicable agreement must be: (1) noted on each certificate representing the shares; or (2) incorporated by reference in the manner provide by Chapter 21."

X. THE IMPACT OF CONTROL OF THE BUSINESS. Control of a business involves the right to determine operations, the amount and frequency of distributions from the business, and when and how to sell or liquidate the business. Owning a non-controlling interest in a business is considered to be undesirable and often a non-controlling interest in a business is worth less than that interest's proportional share of the overall value of the business.

This control issue can affect the value of ownership interests after a property division. For example, if a community property ownership interest in a business is divided 50-50, but with one ex-spouse being awarded control of the business, the value of the controlling interest is worth more than the value of the non-controlling interest. For this reason, the typical valuation question addressed in the divorce trial, which is the value of the entire community property ownership interest in the business, will not apply to the post-divorce values of the partial interests. Considering the after-divorce value, a control premium should be considered in the value of the controlling ex-spouses's interest. In many instances the value of the non-controlling ex-spouse's interest should be reduced by a lack of control or minority discount.

Practice Tip: If the community property interest in the business is a controlling interest, and the court divides the interest in kind in such a way that one or both spouses have a non-controlling interest, a spouse who plans to appeal should request a TRCP 296 finding of fact on the value of each spouse's post-divorce interest. That assumes that evidence was presented at trial about a minority discount.

Practice Tip: The judge or jury is normally asked to value the entire community property interest in the business. If a community property controlling interest in a business is divided in such a way that it becomes a non-controlling interest, there will be no valuation finding for the value of the non-controlling interest.

XI. IMPORTANT TAX CONSIDERATIONS.

Past, present, and future income tax issues need to be considered in dividing a business upon divorce.

With regard to tax treatment of a property division on divorce, the principal issue is IRC § 1041, under which a transfer of property between spouses incident to a divorce is not recognized for capital gain tax purposes.

As to business taxation, there are three basic constructs: (i) a sole proprietorship, (ii) a C Corporation, and (iii) a partnership. Business entities make the following types of payments: (i) business-related expenditures, (ii) dividends and distributions of profits, and (iii) distributions of capital, including liquidating distributions (which can be in complete or partial liquidation). It is important to note that the income of partnerships and other pass-through entities is taxed to the owners regardless of whether that income is distributed to the owners.

A. INTERNAL REVENUE CODE § 1041. The Internal Revenue Code imposes a tax on the gain upon sale of a capital asset. The tax is triggered when the capital gain is "recognized." Historically, when a capital asset (including a business) was awarded to one spouse in the divorce, there was a risk that the transaction might be "recognized" as a capital gain and therefore taxed at the time of divorce. *See U.S. v. Davis*, 370 U.S. 65 (1962). This problem disappeared in 1984 when Congress amended the Internal Revenue Code to add Section 1041, which eliminates capital gain recognition on interspousal transfers that are incident to divorce. Under Section 1041, "[n]o gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)– (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce." IRC § 1041.

The transfer is "incident to divorce" if the transfer occurs within one year after the date on which the marriage ceases, or is related to the cessation of marriage. IRC § 1041(c).Where a transfer of property occurs more than six years after divorce, a presumption arises that it is not incident to divorce. However, the transfer will still qualify for Section 1041 treatment if it is shown that the transfer is referable to a division of property owned at the time of divorce. A transfer subject to IRC § 1041(a) is treated like a gift for income tax purposes – the receiving party takes the existing tax basis in the property received and the gain, if any, is recognized when the recipient ultimately disposes of the asset. If a transaction falls within the scope of IRC § 1041, then the non-recognition rule's application is mandatory, even if the parties desire to engage in a bona fide sale in a desire to create a current income tax consequence.

Section 1041 does not apply to assignments of income.[10] See Section XI.F of this Article.

B. APPLICATION OF SECTION 751 "HOT" ASSETS. Any transaction involving a distribution of partnership assets or the liquidation of an ownership interest must take into consideration the tax implications of "hot" assets. This is because disposition of a partner's interest in an entity that holds hot assets may convert long-term capital gain to ordinary income or in certain cases may force the partner to recognize ordinary income offset by a nonutilizable capital loss upon the disposition.

<u>Example</u>: Partner A owns a 50% interest in ABC Partnership. ABC holds hot assets, otherwise referred to as Sec. 751 property or ordinary income property. A's outside tax basis of his interest in ABC is $100,000. He sells his interest for $200,000, resulting in an overall gain of $100,000. The partnership assets consist of a Sec. 751 asset with a value of $400,000 and a tax basis of zero and a non–Sec. 751 asset with a value of zero and a tax basis of $200,000. Since the partnership holds a hot asset, A is treated as having separately sold his 50% share of the Sec. 751 asset for its value of $200,000 ($400,000 × 50%) and will realize $200,000 in ordinary income. The remaining proceeds (zero) are then applied to the remaining basis of $100,000 ($200,000 × 50%), producing a

$100,000 capital loss. In this case, rather than recognizing $20,000 in tax on $100,000 of long-term capital gain ($100,000 × 20%), A will incur an immediate tax liability of $79,200 ($200,000 ordinary income × 39.6%) and a tax benefit of $20,000 ($100,000 × 20%) at the time the capital loss is utilized. The net tax cost of the disposition of A's partnership interest is $59,200 rather than $20,000. In this example, the application of Sec. 751 is important, given the 19.6% difference in tax rates between ordinary income and long-term capital gain.

In the case of a sale or exchange, Regs. Sec. 1.751-1(a)(1) provides that:

> To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or . . . inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741.

In the case of a redemption, Regs. Sec. 1.751-1(b)(1) provides that:

> Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. . . . Section 751(b) applies whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

There are two categories of hot assets that trigger ordinary income upon the disposition of a partner's interest: unrealized receivables and inventory items. Sec. 751(c) provides the definition of unrealized receivables, while Sec. 751(d) defines inventory items.

There are three categories of unrealized receivables: goods, services, and recapture items. Sec. 751(c) defines the term "unrealized receivables," which include, "to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered." For example, accounts receivables of a cash-basis partnership would be classified as an unrealized receivable.

The third category of unrealized receivables includes the following list of partnership assets, which, if sold by the partnership, may result in ordinary income recapture:

Sec. 1245 property; Sec. 1250 property; Understated rent—Sec. 467(c); Farmland and land clearance deductions—Sec. 1252; Oil, gas, and geothermal property—Sec. 1254; Mining property—Secs. 617(d) and (f); Franchises, trademarks, and trade names—Sec. 1253(a); Market discount bonds—Secs. 1276(a) and 1278; Short-term obligations—Secs. 1271(a) and 1283; DISC stock—Sec. 995(c); and Stock of a controlled foreign corporation—Sec. 1248(a).

Because Treasury Reg. § 1.751-1(c)(5) provides that the tax basis of any potential gain recapture is zero, the recapture must be computed separately for each asset, assuming the asset has a zero tax basis. This may result in a partner's recognizing ordinary income on the disposition of his or her partnership interest, although the aggregate fair market value (FMV) of all recapture properties would produce an overall loss if grouped in aggregate. The most common unrealized receivable recapture item that partners often overlook is partnership property subject to depreciation recapture under IRC Sec. 1245.

Depreciated Property.

> Example: Husband and Wife, H and W, each own 50% of HW partnership. HW owns a machine that it purchased for $400,000. HW has claimed depreciation of $100,000, and the machine's FMV is $410,000 at the time HW redeems W's 50% interest pursuant to divorce. The partnership is treated as holding a hot asset with a basis of zero and a FMV of $100,000 and a non-Sec. 751 asset with a basis of $300,000 and a FMV of $310,000. Assuming, HW redeems W's interest in the partnership for $205,000 and her outside basis is $150,000, she would realize a $55,000 gain, of which $50,000 ($100,000 recapture x 50%) will be classified as ordinary income and $5,000 ($10,000 gain on non-Sec. 751 asset x 50%) will be classified as capital gain. Note, in this example, because HW partnership has only two partners, the partnership would terminate with only one partner after redemption of W's interest.

Inventory. The Regulations do not limit the definition of inventory items to items held primarily for sale to customers in the ordinary course of a trade or business; but instead they provide for a very broad definition to include realized and unrealized accounts receivables. IRC Sec. 751(d) defines "inventory items" to mean:

> (1) property of the partnership of the kind described in Sec. 1221(a)(1), (2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in Sec. 1231, and (3) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in (1) or (2).

Although the above definition makes no distinction in the term "inventory item" between a sale or redemption, Sec. 751(b)(3) states that in the case of a redemption only substantially appreciated inventory is considered a hot asset. In accordance with Treasury Reg. § 1.751-1(d), inventory items are substantially appreciated if "the total fair market value of all inventory items of the partnership exceeds 120% of the aggregate adjusted basis for such property in the hands of the partnership." Prior to June 8, 1997, the substantially appreciated test also applied to a sale or exchange. However, the 1997 Taxpayer Relief Act, P.L. 105-34, eliminated the requirement that inventory must be substantially appreciated to be classified as a hot asset in a transaction structured as a sale or exchange. Therefore, all items of inventory are considered hot assets in a disposition structured as a sale or exchange. In this regard a planning opportunity exists, as the application of Sec. 751 may ultimately generate an ordinary loss if the partnership holds inventory that has declined in value below its aggregate basis and the transaction is structured as a sale rather than a redemption.

> <u>Example</u>: Husband and wife own a general partnership. They divorce and agree to have the partnership redeem husband's 50% interest in the partnership. Husband's proceeds on the disposition are $300,000 while his outside basis in the partnership interest is $90,000, resulting in an overall gain of $210,000. At the time of husband's redemption, the partnership has: (1) cash with a basis equal to fair market value ("FMV") of $30,000; (2) inventory or property held for sale to customers with a basis of $50,000 and an FMV of $60,000; (3) realized accounts receivable with a basis of $100,000 and an FMV of $70,000; and (4)

goodwill with a basis of zero and an FMV of $440,000.

As noted above, in accordance with Treasury Reg. § 1.751-1(d)(2)(ii), the partnership's inventory items include realized accounts receivable. Therefore, the partnership's accounts receivables must be aggregated with property held for sale to customers for the purpose of determining if the partnership's inventory items are substantially appreciated. In this regard, inventory items are not substantially appreciated ($130,000 ÷ $150,000 = 86.67% < 120%) and are therefore not considered a hot asset. In the case of a redemption, the partnership is deemed not to have any unrealized receivables or substantially appreciated inventory, so husband's gain of $210,000 is classified as capital gain. However, if the disposition was structured as a sale of a partnership interest, husband must account for all inventory items as a hot asset and will therefore recognize an ordinary loss of $10,000 [($150,000 – $130,000) × 50%] and a capital gain of $220,000.

Congress enacted Sec. 751 to prevent the conversion of potential ordinary income into capital gain upon the sale or redemption of a partnership interest. Given the federal rate differential between ordinary income rates (39.6%) and long-term capital gain rates (15-20%), a spouse should consider the tax cost and purchase price allocation prior to finalizing an agreement to dispose of the partnership interest. As noted in the previous Example, it is also important to consider the tax differences that may result between structuring a disposition as a sale or a redemption.

C. REPORTING INCOME FOR CORPORATIONS AND PASS-THROUGH ENTITIES. The key tax feature of corporations derives from the corporation's separate existence as an entity: double-taxation of income, where corporate profits are taxed when earned by the corporation, and corporate profits are taxed again when they are distributed as dividends to the shareholders. This feature is avoided with S Corporations, partnerships, and LLCs that elect to be taxed as a partnership. See Comparison of C Corporation and S Corporation in Section VII.D.7. Also see Basic Entity Tax Implications for Partnerships at Section VII.B.

D. DIVIDENDS, REDEMPTIONS, AND LIQUIDATIONS – C CORPORATIONS. When considering a divorce settlement between spouses who own an interest in a closely-held C Corporation, it is important to consider the tax implications associated with different types of divisions. If a spouse's interest in the C Corporation is awarded to the other spouse, no taxable event is recognized because of IRC § 1041. However, a redemption of a spouse's shares will be treated as a "sale or exchange" for capital gain tax purposes, or a constructive dividend to the spouse who remains with the corporation.

1. Capital Gains and Dividend Rates. A dividend received from a corporation will be taxable to the transferee spouse to the extent that the corporation has earnings and profits ("E&P"). The tax rate on a dividend will generally range from 0% to 39.6%, depending on transferee-spouse's level of income and whether the dividend is an ordinary dividend or qualified dividend. Dividends are generally taxed as ordinary income. However, qualified dividend income received by an individual is taxed at long-term capital gains rates. Qualified dividend income is defined as dividends received during the tax year from a domestic corporation or a qualified foreign corporation (IRC § 1(h)(11)). For tax years beginning after December 31, 2012, the capital gains rates for non-corporate taxpayers are 20% for individuals, estates, and trusts in the 39.6% income tax bracket; 15% for most individuals, estates, and trusts; 0% for individuals in the 10% or 15% income tax brackets; and 0% for estates and trusts in the 15% income tax bracket.

0%, 15%, and 20% Capital Gain Rates	
Tax rate if gain were taxed as ordinary income:	**Applicable long-term capital gain rate:**
10% or 15%	0%
25%, 28%, 33%, or 35%	15%
39.6%	20%

Individuals, estates and trusts subject to the 20% capital gains rate may also be subject to the net investment income tax of 3.8%, which brings the capital gains rate (as well as the qualified dividend rate) for higher-income taxpayers to 23.8%.

2. Redemption. If the distribution of funds from the C Corporation to the spouse is treated as a redemption of shares instead of a dividend, there are options/strategies a practitioner must consider.

a. Gain from Redemption of Shares to the C Corporation. The gain to the spouse redeeming his/her shares to the corporation is measured by the amount received less the tax basis in shares redeemed. If a dividend is paid instead of a redemption of shares, there is no tax basis in the shares that could be deducted in calculating the gain, and the full amount of the distribution will be taxable to the spouse redeeming his/her shares. This tax treatment can be avoided by one of the spouses if IRC § 1041 applies.

b. Treas. Reg. §1.1041-2 – Special Rules Permit Parties to Allocate Tax Consequences of Transfers Incident to Divorce. Treas. Reg. §1.1041-2(c) was enacted to prevent uncertainty regarding tax consequences associated with stock redemptions in divorce. The special rules under the regulations suggest that the Internal Revenue Service will respect the parties' assignment of tax liabilities in a divorce or separation instrument, or a valid written agreement which expressly provides:

a. the parties intend to treat the redemption, for federal income tax purposes, as a redemption distribution to the transferor spouse or a constructive distribution to the non-transferor spouse; and

b. that the instrument or agreement specifying the tax treatment supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of redemption.

The divorce or separation instrument must be effective, or the written agreement must be executed by both parties, prior to the date on which the transferor spouse (treated as receiving a redemption distribution under Treas. Reg. §1.1041-2(c)(1)) or the non-transferor spouse (treated as receiving a constructive distribution under Treas. Reg. §1.1041-2(c)(2)) timely files his/her federal income tax return for the year that includes the date of the redemption, but no later than the date the return is due, including extensions. See Section VIII.C.2 of this Article.

3. Complete or Partial Liquidation of the C Corporation. In a complete liquidation of a C Corporation, the corporation ceases to exist. In a partial liquidation, the corporation is not terminated and some assets remain inside the entity. A complete liquidation can occur, though the corporation may retain a nominal amount of assets in order for it to wind up its affairs, pay debts, and distribute the remaining balances to the shareholders. In a complete liquidation, the corporation will generally recognize gain or loss on the distribution of assets as if the property were sold to the distributee shareholder at fair market value. (There are exceptions to gain recognition in a parent-subsidiary liquidation or a corporate reorganization. Corporate reorganizations fall outside the general rules for corporate liquidations.)

The economics of liquidation may also affect the C Corporation entity by requiring the entity to recognize a gain or loss on distributions of property. See discussion regarding tax effects of Distributions in a C Corporation at Section VII.C.5.

a. Liquidating a Corporation When Property is Subject to Liabilities. If property subject to liability is distributed to a shareholder in liquidation, and the liability is greater than the fair market value of the property, the amount of the liability is considered the fair market value when computing gain under IRC § 336.

b. Limitation on Losses. Losses on distribution (where tax basis exceeds fair market value) of property in complete liquidation are in general allowed, with two exceptions under IRC§ 336(d):

1) Distributions to Related Parties. If a liquidating distribution is made to a related party, a loss is disallowed if the distribution is not pro rata, or the property is disqualified property under §336(d)(1)(B) – property acquired by the corporation in a §351 transaction or as a contribution to capital during a five-year period ending on the date of the distribution. Related parties are determined under IRC § 267.

2) Distributions of Property with Built-In Losses that was Contributed Prior to the Adoption of the Plan of Liquidation. If a liquidating distribution is made to an unrelated party, a loss is disallowed when the property distributed was acquired in a IRC §351 transaction or as a contribution to capital shortly prior to the adoption of a plan liquidation. Note, the rule for unrelated parties is different than losses disallowed under the related party rules in that the loss disallowed applies only to built-in loss at the time of the §351 transaction.

c. Section 351 Exchange Defined. A IRC § 351 exchange is generally a nontaxable exchange. The corporation receives the transferor's tax basis in the property received. No gain or loss is recognized if one or more persons transfer cash or property to a corporation solely in exchange for stock if the person or persons control the corporation immediately after the exchange. Control is owning at least 80% of the voting stock and 80% of all other classes stock. See additional discussion regarding IRC § 351 Transfers at Section VII.C.3 of this Article.

d. Effect on Shareholders. Amounts realized by a shareholder in complete liquidation of a corporation are treated as full payment for stock. Gain or loss is generally recognized as if the shareholder sold the stock back to the corporation. There are exceptions to this general rule for a parent-subsidiary liquidation or a corporate reorganization.

4. Dividing Ownership Interests in a Closely-Held C Corporations – Recap.

a. Dividend. A dividend from a C Corporation is taxed to the shareholder to the extent the corporation has earnings and profits. Generally, there is no reduction in the shareholder's tax basis in shares. A dividend is not deductible to the corporation and is taxable to the shareholder.

b. Redemption. In a redemption connected to a divorce, it is possible to allocate tax consequences among the spouses based on Treasury Regulation 1.1041-2. It is possible to avoid additional tax at the corporate level if the redemption is funded with cash and not funded with property with unrealized (built-in) gain. If unrealized gain property inside the corporation is utilized to fund the redemption, it will trigger capital gain recognition for the corporation and is taxable to the shareholder.

c. Liquidation or Partial Liquidation. If a corporation has assets with unrealized gain inside the corporation, there could be a double tax: first level tax inside the corporation upon liquidation and a second tax at the shareholder level to the extent the fair market value of the property received exceeds the shareholder's basis in the stock.

E. DISTRIBUTIONS, REDEMPTIONS AND LIQUIDATIONS – S CORPORATION. In determining the tax consequences of a stock redemption in an S Corporation, there are two considerations: 1) whether the transaction qualifies for sale or exchange treatment, and 2) whether the corporation has accumulated earnings and profits ("AE&P"). If the S Corporation does not have accumulated earnings and profits (the corporation has always been an S Corporation and has never acquired a C Corporation with E&P through a merger), then no dividend treatment occurs from a redemption. With no AEP, the redemption distribution is treated as a nontaxable return of capital to the shareholders to the extent of their adjusted basis of stock. Any proceeds received in excess of the shareholder's tax basis in the stock is a capital gain from the deemed disposition of stock.[11]

Tax Tip. A noncapital gain redemption of an S Corporation shareholder can be more advantageous than capital gain treatment because the shareholder may be able to recover the tax basis in the stock without any capital gain recognition.

> Example: Assume W is the senior shareholder in a law firm that has always been an S Corporation. W owns 60% of the stock, and her husband H, also an attorney, owns the other 40%. W is getting a divorce from H and would like the corporation to redeem his stock. P's stock basis equals $100,000 and the fair market value of her stock is $200,000.
>
> Because W can potentially recover the first $100,000 tax-free against her basis, the redemption can be structured in two steps. First, the corporation redeems half of her stock for $100,000 prior to divorce. The redemption does not qualify for sale or exchange treatment, as it is not a complete redemption, nor is it substantially disproportionate (dropping W below 50% ownership) because of the family attribution rules. As a consequence, the $100,000 partial redemption in the first year is treated as a distribution and, under the S distribution rules, is a return of stock basis that is tax-free.
>
> The following year, W can sell her remaining shares post-divorce. The sale is structured as an installment sale over a 10-year term. W recovers her basis tax-free against the initial payment of $100,000, and her capital gain on the transaction is deferred, to be recognized as the installment payments are received.

1. Net Investment Income Tax. The Health Care and Education Reconciliation Act of 2010, P.L. 111-152, authorized a new tax on net investment income for higher-income individuals starting in 2013. This net investment income tax applies to singles with modified adjusted gross income (MAGI, which is AGI for those not claiming the foreign earned income exclusion) above $200,000, married couples filing a joint return with MAGI above $250,000, and married individuals filing separate returns with MAGI above $125,000. (IRC § 1411(b)). Net investment income includes dividends, capital gains, and income from passive activities (among other types of qualifying income), less any expenses properly allocable to the income.[12]

According to IRC § 1411(c)(4), gain or loss from the disposition of an interest in an S Corporation that conducts a trade or business in which the shareholder materially participates is subject to the net investment income tax only to the extent of the net gain that the shareholder would report if all of the S Corporation's nonbusiness property had been sold for its fair market value immediately before the disposition. (This "deemed sale" rule adjusts the amount of gain or loss taken into account for net investment income tax purposes.) However, the deemed sale rule does not apply if the S-corporation does not conduct a trade or business, or the trade or business is a passive activity or a trade or business of trading in financial instruments or commodities for the redeemed shareholder, because there would be no change in the net gain included in the shareholder's net investment income under Sec. 1411(c)(1)(A)(iii) (Prop. Regs. Sec. 1.1411-7(a)(2)); preamble to REG-130507-11.

IRC § 1411(c)(4), Prop. Regs. Sec. 1.1411-7(a) and the preamble to the proposed regulations are silent on whether an S Corporation redemption is a "disposition of an interest in . . . [an] S corporation" under Sec. 1411(c)(4). Most practitioners would consider a redemption, no matter how effected, to be a disposition of the stock. On the other hand, it is possible that the deemed sale rule applies only to a redemption that qualifies for sale or exchange treatment under IRC §§ 302(b) or 303. Otherwise, the redemption is taxed as a distribution under IRC § 1368. In any event, Prop. Regs. Sec. 1.1411-1(a) states that: "Except as otherwise provided, all Internal Revenue Code provisions that apply . . . in determining taxable income . . . of a taxpayer also apply in determining the tax imposed by section 1411."

Assuming the net investment income tax deemed sale rule can apply to an S Corporation redemption that qualifies for sale or exchange treatment, the deemed sale rule will apply when the property is held in a trade or business not described in IRC § 1411(c)(2). This means that the deemed sale rule does not apply when 1) there is no trade or business, 2) the trade or business is a passive activity for the transferor (the redeemed shareholder), or 3) the S Corporation is in the trade or business of trading in financial instruments or commodities. In these three circumstances, there would be no change in the amount of net gain included in the shareholder's net investment income under the deemed sale rules. Furthermore, the net investment income tax does not apply if the redeemed shareholder's MAGI in the year of the redemption does not exceed the thresholds previously listed (e.g., $200,000 for single filers).

2. Calculating Gain or Loss. When an S Corporation redeems its stock in a transaction that qualifies as a sale or exchange, the shareholder's realized and recognized gain or loss is governed by IRC § 1001. The shareholder's adjusted tax basis in the stock is subtracted from the amount of cash and the fair market value of other property received from the corporation. While the general rule is that stock basis is determined as of the end of the S Corporation's tax year, the basis of stock disposed of during the year is determined immediately before the disposition occurs. (Regs. Sec. 1.1367-1(d)(1)). Therefore, stock basis is adjusted for current-year items of S Corporation income, loss, etc., before determining gain or loss from the redemption.

3. Choosing the Method for Allocating Passthrough. The specific accounting method can be elected if the redeemed shareholder completely terminates his/her interest in the S Corporation, or there is a "qualifying disposition" of the stock as defined in Regs. Sec. 1.1368-1(g)(2). The method of allocation is important because it affects the amount of passthrough income, loss, etc., allocated to each person who owned stock during the year.

In many cases, use of either allocation method will result in the redeemed shareholder's recognizing the same amount of income, since passthrough income increases the amount of the shareholder's tax basis, which reduces the amount of gain recognized because of the redemption. However, the character of the recognized income (ordinary income vs. capital gain) may differ. Furthermore, if the redeemed shareholder recognizes capital losses in the year of redemption, or has a capital loss carryover, he or she will normally want to maximize the capital gain reported from the redemption. Because all affected shareholders must consent to the election in the case of a complete termination of a shareholder's interest, and because all shareholders must consent to the election in the case of a qualifying disposition, the shareholders should consider addressing this issue in the shareholder or redemption agreement.

4. Characterizing the Gain or Loss. The character of gain or loss recognized by the redeemed S Corporation shareholder depends on whether the stock is a capital asset in the redeemed shareholder's hands and whether the redemption is treated as a sale or exchange. Capital gain status can be beneficial because of the maximum tax rate of 20% imposed on long-term capital gains. However, with dividends also taxed at a maximum 20% rate, structuring a redemption to qualify for capital gain status has diminished in importance. Nevertheless, there are still important reasons for qualifying the redemption for sale or exchange status. For example:

– Capital gains can be offset with capital losses, while dividends cannot be offset.

– Capital gain recognition can be deferred when an installment note is issued to the shareholder in a redemption that qualifies for sale or exchange treatment.

5. The Effect of Redemption on the Corporation's S Election. If the redemption occurs by the 15th day of the third month of the S Corporation's tax year and the remaining shareholders own more than half of the outstanding stock, they can terminate the S election retroactive to the first day of the tax year. (Sec. 1362(d)(1)). In addition, the remaining shareholders can change the corporation's accounting method, resulting, for example, in passthrough income rather than an expected passthrough loss.

6. Using Suspended Passthrough Losses. In a complete redemption of S Corporation stock, suspended passthrough losses (losses not previously deducted because of basis limitations) remaining after the basis of the redeemed stock have been reduced to zero, and do not reduce gain or increase loss resulting from the redemption (the result is the same whether the redemption qualifies as an exchange or is treated as a distribution). When all of the shareholder's stock is redeemed, the shareholder loses the ability to deduct any carryover losses. If less than all of the shareholder's stock is redeemed, suspended passthrough losses are carried forward in full. Suspended losses are personal to the shareholder, not the shares owned, so a partial redemption would not result in a pro rata reduction of these losses. Regs. Sec. 1.1366-2(a)(5).

Losses limited by the IRC § 465 at-risk rules are eligible for indefinite carryover (the same as losses suspended under the basis limitation rules). However, unlike the basis limitation rules, at-risk basis is increased for gain recognized on disposition of stock. Apparently, suspended losses arising from application of the at-risk rules can be claimed by the redeemed shareholder to the extent of gain recognized, if there is no basis limitation problem.

Losses limited by the IRC §469 passive activity rules are also suspended at the shareholder level and carried forward indefinitely to offset future passive income. When a taxpayer disposes of an entire interest in a passive activity to an unrelated party in a fully taxable transaction, suspended passive losses (and any loss from disposition of the activity) can be deducted first against current net passive income and then against nonpassive income.

While a complete redemption seems to fall within this rule (since it is a taxable transaction), it is unclear when a redeemed shareholder would be prevented by the related-party rules from deducting suspended passive losses. In the authors' opinion, any future regulations (Regs. Sec. 1.469-6 is reserved for this topic) will focus on who controls the corporation after the redemption, rather than whether the corporation is treated as a related party to the redeemed shareholder before the redemption.[13]

F. THE ASSIGNMENT OF INCOME PROBLEM.[14] Under IRC Section 1041, transfers between spouses in a divorce are generally tax-free. But the Internal Revenue Code is silent on what happens if the transfer includes uncollected income, encouraging the IRS to apply a court-developed assignment of income doctrine to tax the person making the transfer.

The assignment of income doctrine holds that income from services is taxed to the party who performed the services. *Lucas v. Earl*, 281 U.S. 211 (1930). Thus, if the right to receive income for past services is assigned to another person, the assignor is taxed on the income assigned. The rule was applied to assignments of future income in *Helvering v. Eubank*, 311 U.S. 122 (1940) (insurance agent taxed when assigning present right to future renewal commissions). The rule was applied to income producing property, where the owner assigned the right to such income to a third party (without also assigning the income-producing assets itself). *Helvering v. Horst*, 311 U.S. 112 (1940).

In Revenue Ruling 87-112, the IRS took the position that Section 1041 does not exempt divorce settlements from the assignment of income doctrine. This argument was rejected in *Balding v. Commissioner*, 98 T.C 368 (1992), where the tax court held that wife's relinquishing her community property interest in husband's future retirement benefits in exchange for a cash settlement to be paid over three years was protected from taxation by Section 1041. Commentators disagree whether *Balding v. Commissioner* states a complete exemption from taxation. *See* Richard I. Zuber, *Who Pays the Tax?: The Assignment of Income Doctrine, Code § 1041, and Dividing Non-Qualified Pensions*, 29 THE COLORADO LAWYER 59 (2000).

Tax Tip: If husband transfers his right to receive accounts receivable, yet to be collected, to wife in a divorce property division, is husband taxed on that income when wife receives it? In *Kochansky v. Commissioner*, T.C. Memo 1994-160, where wife was awarded in a divorce part of husband' contingent fee in a malpractice case, husband was taxed on 100% of the income when the fee was collected. The Ninth Circuit Court of Appeals affirmed. *Kochansky v. Commissioner*, 92 F.3d 957 (9^{th} Cir. 1996). So the answer there was "yes," the assignment of income doctrine applies to divorce property divisions. The rule does not apply to qualified retirement plans because of the Retirement Equity Act of 1984, relating to QDROs. IRC § 402(e)(1)(A). *See* Leon Gabinet, TAX ASPECTS OF MARITAL DISSOLUTION § 9:9, Taxation of distributions made pursuant to QDROs (2d ed. 2005).

Tax Tip: The Internal Revenue Service does not apply the assignment of income doctrine to a divorce-related transfer of *vested* non-statutory stock options. Rev. Rul. 2002-22. The Service applies IRC §1041. The receiving spouse will be taxed at the time the options are exercised. *Id*. It appears that *non-vested* non-statutory stock options continue to be covered by *Kochansky*.

G. "INSIDE" AND "OUTSIDE" BASIS IN PARTNERSHIPS.[15] The term "inside" basis refers to the partnership's adjusted tax basis for its property (either for all properties or for a particular property). The term "outside" basis refers to the partners' tax basis (either individually or collectively) in the partnership interest(s). In the great majority of cases, there is no distinction between the two. However, differences can arise between "inside" and "outside" basis, depending upon various transactions which may have occurred over the life of the partnership.

The most common differences between "inside" and "outside" basis arise from (1) failure to file a timely §754 election in connection with the transfer of a partnership interest by sale or exchange or upon the death of a partner, or (2) when an adjustment cannot be made to basis under §734(b) in connection with a distribution of partnership property because of the partnership's failure to make a timely §754 election. The unavailability of the §734(b) adjustment to the tax basis of the partnership property can create the same kind of imbalance between inside basis and outside basis with respect to a transfer of a partner's interest.

H. DEPRECIATION RECAPTURE. Depreciation recapture is discussed with regard to partnership "hot assets" in Sections VII.B.2 and XI.B. The following discussion is more generalized.

1. General Rule. In a complete liquidation of a corporation (C Corporation or S Corporation), a corporation recognizes gain or loss on the distribution of property as if the property were sold to the distributee at FMV. Exceptions to this rule include Parent-Subsidiary Liquidations and Corporate Reorganizations. When an asset is disposed through liquidation of the corporate entity, the entity is subject to the depreciation recapture rules. To the extent that property is distributed and gain is recognized by a S Corporation, the recapture rules will affect the shareholder versus the entity itself. When depreciation is recaptured, some or all of the gain may treated as ordinary income. Depreciation recapture rules can convert what would otherwise have been a Section 1231 gain (potentially taxed as a long-term capital gain) to ordinary income. Any ordinary income due to Section 1245 or 1250 recapture cannot be reported on the installment method. The entire recapture income is recognized in the year of sale, regardless of the amount of payments received that year.

2. Section 1245 Depreciation Recapture. Section 1245 property is personal property (either tangible or intangible) that is subject to depreciation or amortization. Section 1245 property includes machinery, furniture, vehicles, livestock, franchises, covenants not to compete and Section 197 goodwill. When Section 1245 property is disposed of (whether by sale, exchange or involuntary conversion) at a gain, the gain is treated as ordinary income up to the lesser of (i) the sum of all depreciation or amortization deductions allowed or allowable, or (ii) gain realized on disposition. §1245(a). Any gain recognized that is more than the ordinary income from depreciation recapture is a Section 1231 gain.

3. Section 1250 Depreciation Recapture. Section 1250 property is any depreciable real property that is not and never has been Section 1245 property. Reg. §1.1250-1(e). Gain on disposition of Section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. Additional depreciation on Section 1250 property held one year or less is all depreciation allowed or allowable. Additional depreciation on Section 1250 property held longer than one year is the excess of the depreciation allowed or allowable over the amount that would have been allowed using the straight-line method of depreciation.

4. Unrecaptured Section 1250 Gain. Unrecaptured Section 1250 gain is gain attributable to straight-line depreciation on real property. For non-corporate taxpayers, this gain is treated as a capital gain subject to the maximum 25% rate. §1(h)(1)(D).

5. Depreciation recapture for C Corporations. Section 1245 recapture is calculated the same way for all entities and individuals. However, Section 1250 recapture is different for C corporations and S Corporations that were C Corporations in the last three years. IRC §1363(b)(4). For the sale of depreciable real estate that is Section 1250 property, 20% of the excess of the amount that would be treated as ordinary income if the property were Section 1245 property, over the amount treated as ordinary income under Section 1250, is additional ordinary income.[16]

I. TAX LOSS CARRYOVERS. "Tax attributes" generally refer to deductions or credits under the Internal Revenue Code that were not fully used up in a specific tax year, but which can be carried forward or backward to another tax year, and used in such years to reduce income and/or taxes (in the case of a tax credit). Tax attributes may be described as assets with a potential economic benefit that raise issues related to valuation, allocation, and timing. Some more common tax attributes that relate to businesses include:

1. net operating loss carryover
2. capital loss carryover
3. passive and suspended loss carryover
4. investment interest expense carryover
5. Subchapter S corporation losses

1. Net Operating Losses. The Internal Revenue Code provides rules for computing and applying a net operating loss ("NOL") carryback and carryover in circumstances where individuals have not had the same marital or filing status for all the years involved in the NOL computation.[17] Where joint returns have been filed for all the years involved in the NOL computation, no real complications arise. In that instance, the carryback or carryover is computed as though all the income and deductions reported on the return were attributable to a single taxpayer.[18] However, what if the NOL was generated prior to marriage and is being carried forward to a year in which a joint return is filed? In this case, the spouse's premarital separate NOL may not be used to offset the other spouse's income on the joint return.[19] This is based on Treasury Reg. §1.172-7(f) which provides that a married person who sustains an NOL in a year in which a separate return is filed may not use the separate NOL to offset their spouse's income in a later joint return year. Conversely, when an NOL occurs in a year where husband and wife file a joint return and the NOL is subsequently carried to a year where separate returns are filed, then each spouse's share of the joint NOL must be computed. This is done by figuring each spouse's NOL as if he/she had filed a separate return for the year of the loss. The deductions attributable to each spouse are compared to the gross income attributed to them and the excess of the deductions over income is that spouse's share of the loss to be carried to the separate return. Where separate income and deductions attributable to either spouse are reported on the joint return, then this is the manner in which each spouse's share of the loss would be computed. However, in the situation where there is solely community income and deductions reported on joint return where the NOL arises, then the loss would be allocated one-half to each spouse.

2. Capital Loss Carryover. A deduction is allowed for the aggregate of all capital losses to the extent of the aggregate of all capital gains plus $3,000 ($1,500 in the case of married filing separately).[20] To the extent that capital losses exceed the capital gains plus $3,000, the excess may be carried forward indefinitely to offset capital gains in subsequent years.[21]

When spouses have capital losses from years in which they filed separate returns, they may carry the losses over and use them on a joint return.[22] If capital losses are carried over from a joint return to a separate return year, the short-term and long-term capital losses must be allocated separately to each spouse based on the short-term and long-term losses attributable to each.[23]

Only the capital losses that were not offset by short-term or long-term capital gains (attributable to either spouse) and reported on the joint return may be carried forward from a joint return year to a separate return year.[24] The carryover is either short-term (from assets held for less than a year) or long-term (from assets held for more than a year), and retains its character.[25]

When capital losses are incurred on a jointly-filed return in a community property jurisdiction and they arise from community assets, then they are divided equally between the spouses based on the directives found under the Treasury Reg § 1.1212-1(c)(1)(iii). Several courts have held that a capital loss carryforward is a form of marital property that can be allocated by the divorcing spouses as they wish. See *Baker v. Baker*, 109 A.3d 167, 172 (Md. App. 2015), and cases cited therein. In *Haley v. Haley* 936, So.2d 1136 (Fla. App. 2006), the court determined that a capital loss carryforward from a married couple's joint returns was not subject to equitable allocation between the individuals upon their divorce, because the capital loss carryforward was generated by an entity that was a non-marital asset belonging to the wife, to which the husband had made no special contribution.

3. Passive and Suspended Loss Carryover. Passive activities are activities that involve the conduct of a trade or business in which the taxpayer does not materially participate. Generally, losses from passive activities may not be deducted from non-passive income (e.g., wages, interest, or dividends).[26] The disallowed loss is suspended and carried forward as a deduction from the passive activity in the next succeeding year.[27] Unused suspended losses are allowed as a deduction in full when the taxpayer disposes of the entire interest in the activity in a fully taxable transaction.[28] The loss carryovers "follow" the asset that can give rise to the carryover and are awarded on that basis.

The transfer of a passive activity incident to a divorce is not considered a fully taxable transaction and any suspended losses would not be freed-up and allowed as deductions under IRC §469(g). However, IRC §1014(b) states that any transfer incident to divorce is treated as a gift and, therefore, the losses of the donor spouse are added to the basis of the passive activity. Therefore, if preserving a suspended passive loss carryover is a goal on the division of assets pursuant to divorce, care and consideration must be paid to how those assets are awarded.

4. Investment Interest Expense Carryover. Individuals are allowed to deduct investment interest in any tax year only to the extent that it does not exceed their net investment income for the year.[29] Investment interest that is disallowed as a deduction because it exceeds net investment income may be carried forward and treated as investment interest in the succeeding tax year to the extent there is investment income (such as dividends and interest).[30] This is yet another carryover that must be considered in the property settlement—usually divided equally if the funds were community property.

5. S Corporation Losses. In an S Corporation, the taxable income or loss is passed through to the shareholders. IRC §1366. Losses which exceed the shareholder's basis in stock and debt in the corporation are suspended and carried forward to the succeeding tax years. IRC §1366(d)(1) (aggregate amount of losses and deductions taken into account by a shareholder for any taxable year shall not exceed the sum of the adjusted basis of the shareholder's stock in the S Corporation and the shareholder's adjusted basis of any indebtedness of the S Corporation to the shareholder).

When the stock in such a corporation is owned as community property and transferred or divided incident to divorce, the suspended loss carryforwards associated with the stock are transferred along with the stock on a pro rata basis based on the number of shares owned by each spouse during the tax year. IRC §1367. In an in-kind division of the stock which was equally owned by the parties during marriage, each spouse will receive one-half of the suspended loss carryforward.

However, if the stock is awarded entirely to one spouse, the other spouse's share of the suspended loss carryforward is *not* transferred to the other spouse. The carryforward is personal (having already passed-through to that spouse's tax return when the loss was realized). IRC §1366(d)(2). The party receiving the stock will only have the benefit of his or her one-half share of the carryforward; the other half will be lost. It is not added to the basis in the stock, as the loss was disallowed in the year in which it occurred and carried forward. Pvt. Ltr. Ruling, Tech. Adv. Mem. 9552001. The spouse receives the transferor's basis in the stock per IRC §1041, which does not include the loss carryforward associated with the transferee's stock.

XII. WHAT ABOUT DELAWARE ENTITIES? TBOC § 1.101 says that the law of Texas governs the formation and internal affairs of an entity formed under Texas law. TBOC §§ 1.102 and 1.103 say that, if the entity was not formed in Texas, the law of the state where it was formed governs the formation and internal affairs of that entity. TBOC § 1.104 says that the law of the state of formation governs the liability of an owner, member, or managerial officer for obligations of the entity, unless that liability is established by contract or non-corporate law. TBOC § 1.105 defines "internal affairs" to include "the rights, powers, and duties of its governing authority, governing persons, officers, owners, and members" and matter relating to its ownership interest.

Many business entities you encounter in family law practice will be Delaware entities, or entities that were formed in other states. Non-Texas law is not covered by this article. In business litigation, in determining which state's law to apply, under the "internal affairs doctrine, the law of the jurisdiction of organization applies to rights and responsibilities of directors, officers and shareholders." See Thomas E. Rutledge, *To Boldly Go Where You Have Not Been Told You May Go: LLCS, LLPS, and LLLPS in Interstate Transactions*, 58 BAY. L. REV. 105, 213 (2006) ("Rutledge"); the former Texas Limited Liability Company Act art. 7.02 (applying the internal affairs doctrine to foreign companies). The RESTATEMENT (SECOND) OF CONFLICT OF LAWS says that shareholder liability is governed by the laws of the jurisdiction of organization. See Rutledge, at 231. Nonetheless, a married shareholder domiciled in Texas would be subject to the marital property rules of this State. Tex. Fam. Code § 1.103; *Legrand-Brock v. Brock*, 246 S.W.3d 318, *1 (Tex. App.--Beaumont 2008, pet. denied) (applying Texas marital property law to Texas shareholder of Delaware corporation in a Texas divorce). The susceptibility of an entity to "piercing," or the powers the divorce court may have in awarding an interest in an entity chartered in another state, do not fall into neat categories. Depending on the issue, the question of which state's law to apply to a particular issue in a divorce can be problematic.

XIII. EXAMPLES. The following examples apply the principles discussed in this Article to fact scenarios that arise in divorces.

A. LEAVING SPOUSES AS CO-OWNERS.

Example 1: Orderly Liquidation. When the spouses wholly-own a number of investments, the parties or the court can place ownership and control of the assets in the hands of a trustee to liquidate in an orderly fashion and then to distribute the sales proceeds to the former spouses. This solution works best when the investments to be liquidated do not require active management for an extended period.

There is no inherent reason to prefer a liquidating trust over a liquidating corporation, partnership, or LLC, as long as the managing entity is a pass-through entity for tax purposes. However, a corporation, an LLC, and a limited partnership must file a certificate of formation and must be officially terminated. Also, from a tax standpoint, it is easier to distribute and liquidate assets out of a partnership (including an LLC taxed as a partnership) without any gain or loss than it is from a corporation or S Corporation.

Example 2: Control. Husband owns a 1% general partner interest in a family limited partnership as his separate property. The spouses each own a 49½% community property limited partner interest. A jury finds the community estate's 99% limited partner interests to be worth $1 million. The court awards each spouse a 49½% limited partner interest, and sets aside the 1% general partner interest to husband as his separate property. Wife wants to appeal the property division as an abuse of discretion. How does she show the value of each spouse's limited partner interest after divorce? Answer: Wife should request a TRCP 296 finding of fact as to the value of her 49 ½% limited partner interest. If the court will not give one, she should argue error in the refusal to make the finding. If there was no evidence presented as to the post-divorce value of a 49 ½ % interest awarded to wife, then wife has a problem.

Example 3: Impasse. The parties own 100% of an LLC. They decide to avoid a valuation fight by splitting the membership units 50-50. After the divorce, ex-wife remarries and her new husband becomes her "voice" in the management of the LLC. Management disagreements degrade into a complete impasse. What can the ex-husband do? Answer: file suit for the appointment of a receiver under TBOC § 11.404(a)(1)(B), where "the governing persons of the entity are deadlocked in the management of the entities affairs . . . , and irreparable injury is being suffered or threatened because of the deadlock."

Example 4: Loss of Control. The community estate owns a 60% interest in a corporation; the other 40% is held by a third party. The divorce court awards a 30% interest in the corporation to each spouse. After the divorce neither spouse has a controlling interest. What is the practical effect of this division? Answer: Where a controlling interest belonging to the community estate is broken into two non-controlling interests, control adjustments are eliminated, unless the two ex-spouses vote as a block.

Example 5: Factions. A corporation is owned half by the husband, as community property, and half by the husband's brother. All management decisions are by majority vote, and each brother's vote is equal. Wife is considering asking for half of husband's shares in the corporation, with associated voting rights. What are the possibilities or problems when either ex-spouse can form a voting block with the ex-husband's brother and exercise control?

Example 6: Phantom Income. Husband owns a 2/3 limited partner interest in a partnership that earns lots of profits. The 1/3 general partner is husband's good buddy. In the past the partnership has distributed enough cash for the partners to pay the tax liability on their share of partnership income. In settling the divorce, the husband proposes to split his limited partner interest 50-50, where husband remains as a named limited partner and wife would have a transferee's interest. What concerns does the wife have about phantom income? Answer: If wife owns an interest in the partnership after divorce, she will have to report her share of partnership income on her personal tax return, and pay the tax on that income even if the partnership does not distribute enough money to pay the tax. See Section VIII.A.2 above. The divorce settlement agreement can require distributions sufficient to pay the tax on phantom income, but the partnership itself would have to agree to such an obligation, which would require the consent of the general partner.

Example 7: Interrupted Cash Flow. Prior to divorce, a family-owned C Corporation had paid dividends of $200,000 per year for years. Under the divorce decree, the ex-husband received 50.1% and the ex-wife 49.9% of the company's shares. The trial court said from the bench that she expected the wife's 49.9% of the dividend income to pay for her living expenses after the divorce. Under the by-laws, each share is entitled to one vote on shareholder decisions, and all votes are by simple majority. The net profits of the business continued as before, but after the divorce the ex-husband has refused to declare a dividend, even though the ex-wife needs the cash to pay her living expenses. What can the ex-wife do? Answer: ex-wife can sue ex-husband for breach of fiduciary duty, especially if the divorce decree provides that ex-husband will have a continuing fiduciary duty to wife to distribute earnings and profit. See Section VIII.A.1 of this Article.

Example 8: Mature Tax Shelters. For 15 years, husband has owned a 1/3 limited partner interest in a partnership that buys run-down apartment complexes at a low price, fixes them up, and rents them out. The apartments generate lots of rental income, much of which is sheltered by depreciation deductions from the apartment buildings and equipment. The business plan is to liquidate all apartment complexes in five years. Husband wants wife to take a 45% limited partner interest in the partnership in the divorce. Does wife have a tax-related concern? Answer: Yes, the partnership is likely to contain hot assets that would trigger depreciation recapture when the apartment complexes are sold. Certain depreciation on the buildings and equipment may be recognized as ordinary income when the assets are sold. Wife may have to pay a tax on post-divorce income at ordinary rates. See Section IX.B above.

Example 9: Future Cash Calls. Husband owns a limited partner interest in a partnership that builds and rents strip shopping centers. The partnership issues a cash call each time they start construction of a new shopping center. The failure to meet a cash call permits other partners to cover the cash call and dilute the non-contributing partner's ownership interest. In settling the divorce, husband proposes to split ownership, 50-50, except that wife would have a transferee's interest. Who is taking the risk of future cash calls? Answer: husband. Under Texas partnership law, a transferee has no responsibility to make capital contributions. If husband wishes to receive credit for paying wife's share of the capital calls, something should be written into the divorce settlement to provide for eventual repayment to the husband. Wife must also contemplate the risk that husband may not make the capital calls on her ownership interest, in which event her ownership interest could be diluted. See Section IV.G above.

Example 10: Carried Interests or "Promotes." If a spouse in the divorce is a real estate developer or promoter, there may be carried interests or "promotes" that need to be divided. Consider the following two examples.

Example 10a: Carried Interests in Existing Deals. Husband owns a development company that plans, builds, rents and sells high rise office buildings. At the time of divorce, there are three projects under construction. Each construction project is owned by a different "single purpose entity," and the husband has varying indirect ownership interests in each such entity. The business model provides for each project to be constructed, leased up to 85% occupancy, and then sold for cash. Under the controlling documents, the sales proceeds will be applied first to outstanding bank loans and accounts payable, then to the "capital partner" until all invested capital has been returned and the capital partner has received an additional 8% annual rate of return on the invested capital. Any remaining proceeds from sale are split 2/3 to the capital partner and 1/3 to the husband's development company. This "back end" claim on one-third of remaining funds is called a "carried interest" or a "promote." In this instance, the value of the promote is speculative. What do you do with the promotes in the property division? Answer: husband can buy the promotes from wife at an agreed-upon figure or the promotes can be divided in kind. A 50-50 split of the promotes is not necessarily fair, if husband will have to invest post-divorce labor to get the projects to the liquidation stage. Also to be considered is the fact that the husband may remain liable after divorce on sizeable personal guarantees of credit or performance that serve to make ultimate liquidation possible. Perhaps wife needs to carry part of the credit risk by indemnifying husband on part of his continuing liability. Alternatively, the husband can be given credit in the percent allocation of the promotes commensurate with his continuing risk on the guarantees.

Example 10b: Carried Interests in Planned Deals. Apart from the projects under construction, husband's development company has twelve projects being investigated, including some that are ideas only, others where a single purpose entity has been formed but no capital partner has signed on, others where land is under option and engineering reports have been ordered, etc. These projects are not assets on the books of husband's development company; they are reflected only as past operating expenses. What do you do with these projects in the property division? Answer: If there are pro forma projections of the profitability of the project upon completion, some percentage of that value could be allocated. Alternatively, a smaller percent of the carried interest could be awarded to the other spouse, to be paid if, as and when received. Or the expenses already advanced could be credited to the community estate, to "reimburse" the community estate's investment in these projects.

Example 11: Landlord-Tenant on Land Owned Personally. The parties own a C Corporation manufacturing company that operates on a large commercial tract of land that is subject to a mortgage. The reasonable rental rate on a triple net lease (all costs are passed through to the tenant) is $35,000 per month. What settlement opportunity is presented? Answer: In the divorce, the land can be awarded to wife, and the company can sign a triple net lease for $35,000 per month for 20 years. The rent obligation could be secured by husband's ownership interest in the company, the company's equipment, and the company's accounts receivable. Wife will have the carryover tax basis in the property that the parties have before the divorce. The rental income to wife will be taxed as ordinary income, offset by depreciation deduction. Over a period of years, the rental income will pay down the mortgage, and hopefully the land will appreciate, increasing wife's equity in the property, as the mortgage is paid down and land value rises. When wife ultimately sells the property, she will have to pay a tax on depreciation recapture and capital gain tax.

Example 12: Landlord-Tenant on Land Distributed From a C Corp. Same as previous Example, except that the real estate is an asset of the C Corporation, not the spouses. The corporation could redeem wife's community property ownership interest in the company in the divorce, by conveying the land to wife. What are the tax effects? Answer: The company will recognize a gain (the character of the gain may include depreciation recapture, ordinary income, and Section 1231 gain, which may become a capital gain) to the extent that the value of the real estate exceeds its tax basis. Wife will recognize a capital gain, assuming the redemption qualifies under IRC § 302, on the transaction to the extent the fair market value of the land exceeds her tax basis in the shares redeemed.

Example 13: Tenant on Land Distributed From a Pass-Through Entity. Same as the previous Example, except that the manufacturing company is an S Corporation. From a legal perspective, C Corporation vs. S Corporation makes no difference. But from a tax perspective, the redemption by transfer of the land to the wife will cause the S Corporation to recognize a gain (the character of the gain may include depreciation recapture/ordinary income and Section 1231 gain, which may become a capital gain). If the land is encumbered with debt that wife assumes in the transaction, wife will have a tax basis in the land equal to the land's fair market value.

B. OFFSETTING ASSETS, PROMISSORY NOTE, OR MONEY JUDGMENT. In many cases the preferred approach is to award 100% of the business to one spouse and award other community assets to the other spouse. If the other community property assets are not sufficient for this purpose, the alternative is to give the other spouse a promissory note or money judgment for her share of the interest in the company. The note or judgment should be secured by the ownership interest at a minimum, but better also by a lien in real property and a security interest in personal property owned by spouse or by the business. The principal payments will be protected from capital gain recognition by IRC § 1041 for six years after the divorce, but after six years each payment is presumed to be a reportable gain and, if the IRS challenges it, the ex-wife must prove that the payments are incident to a divorce property division. The interest wife earns on the promissory note or judgment is taxable income. The interest paid will not be deductible to husband.

Tax Tip: While the parties can agree that interest will accrue on deferred payments incident to a property division, if they do not agree for interest to accrue, the IRS will not impute interest into such an agreement. Treas. Reg. l.1274-l(b)(3)(iii); Code Sec. 1041. It may be better to provide for no interest and instead increase the amount to be paid to wife.

Example 14: Note vs. Judgment. Two sisters are getting divorced at the same time. In each case, the husband will receive the family business and payments will be made over time to the wife. Sister 1 gets a promissory note that is payable monthly for five years at 4% interest per annum, with a security interest in husband's stock in the company. Sister 2 gets a money judgment payable monthly over 5 years, secured by an equitable lien in husband's stock in the company, but enforcement is suspended so long as husband timely makes the monthly payments, Who is in better shape in the event of default? Answer: Sister 1 has the advantage of being able to conduct a non-judicial foreclosure on the stock if default occurs. But if the proceeds from foreclosure are less that the debt, wife will have to sue on her promissory note to get a judgment for the unpaid balance of the debt. Sister 2 already has a judgment she can collect on, but she will have to seek judicial foreclosure to sell the stock to pay her judgment.

Example 15: Note vs. Judgment. Same as the previous Example, except that Sister 1's promissory note is secured by a security interest in husband's ownership interest in the business, while Sister 2 has an equitable lien in the equipment of the business. Which sister is better off and why? Answer: Sister 2, because the equipment can be sold to pay her judgment, while Sister 1 will have difficulty finding someone to buy husband's ownership interest in a foreclosure sale. For both sisters, the real pressure on their ex-husbands to pay the judgment is that, one way or the other, the ex-wife can put ex-husband out of business.

Example 16: Ownership Interest as Collateral. Husband gets the family business, a corporation; wife gets a promissory note. Wife takes a pledge of husband's stock as collateral. In 18 months ex-husband defaults under the note, and when ex-wife goes to foreclose, she learns that ex-husband has given a lender first lien positions in all corporate land, equipment, and receivables. What can ex-wife do? Answer: she can foreclose on ex-husband's stock, but she will have difficulty finding a buyer, because the bank has a superior claim on the business's assets.

Example 17: Business Assets as Collateral. In settling their divorce, husband and wife agree that husband will give wife a promissory note paid over five years to buy out her interest in the family corporation. The corporation owns land worth $1.5 million (subject to a $1 million mortgage), $500,000 of equipment, and $500,000 in receivables. The equipment is free and clear of liens, but the receivables are pledged to a bank to secure a variable line-of-credit on which $250,000 is now owed. What collateral can husband give wife? Answer: husband can cause the business to give wife a second lien on the land, a first priority security interest in the equipment, and a subordinate security interest in the accounts receivable.

Example 18: Perfecting Security Interest. Wife has a promissory note secured by a security interest in the company's equipment, but her divorce lawyer fails to file a UCC-1 to perfect the security interest in the equipment. The company goes into bankruptcy and wife is an unsecured creditor. What can wife do? Answer: wife is an unsecured creditor in bankruptcy. She needs to fight the discharge based on 11 U.S.C. § 523(a)(5) (domestic support obligation) or § 523(a)(15) (a debt to a former spouse pursuant to divorce).

Example 19: Personal Injury Lawyer. Husband is a personal injury lawyer, who owns 100% of a professional corporation that employs 3 associate attorneys, 9 paralegals, and other support staff. The P.C. had 350 pending cases representing injured claimants. Husband has an unknown number of possible referral fees coming from high damage cases he has referred to other lawyers. The parties disagree on the value of the P.C. What settlement options do they have? What is the effect of Tex. Disc. R. of Prof. Conduct 1.04(f), that requires a referral fee to be in proportion to services performed or responsibilities assumed by the referring lawyer? Answer: the spouses can provide for wife to receive payment from husband set at a percentage of the fees collected. The percentage to allocate to wife depends on factors like (i) how much money has been invested in the cases, (ii) how much money needs to be invested after divorce, (iii) how far the cases have progressed to conclusion, (iv) what happens in the event of an appeal, etc. What are the tax ramifications? Answer: husband will probably be taxed on the entirety of the fee income, when it is received, under the assignment of income doctrine, so the payment to the wife should be calculated on an after-tax basis. See Section XI.F of this Article.

Example 20: Perfecting a Security Interest in "Investment Property." Husband will buy wife out of her interest in the family business with a promissory note secured by a security interest in investments awarded to husband in the divorce. The securities are "investment property" under Tex. Bus. & Com. Code § 9.101(49). How does wife perfect her security interest? Answer: by taking control of the account, per Tex. Bus. & Com. Code § 9.314(a), or by filing, per Tex. Bus. & Com. Code § 9.312(a); however, perfection by filing is subordinate to perfection by possession. See Tex. Bus. Com. Code § 9.328(1).

C. REDEMPTION OF OWNERSHIP INTEREST. When a spouse's interest in a C Corporation will be cashed out using corporate moneys through a redemption, the distribution will either be taxed to wife as a dividend or capital gain (or loss), if the rules of IRC §302 are met, or taxed to husband as a constructive dividend. The spouses can allocate the tax liability in accordance with Treasury Reg. 1.1041-2(c). If they fail to do so, the distribution is generally taxed to the spouse who has the obligation to purchase the other spouse's shares. If neither spouse has an obligation to purchase the other spouse's shares, the redeeming (transferor) spouse will generally bear the tax. See Section VIII.G of this Article.

Example 21: Triggering Constructive Dividend Tax. The parties decide that wife's interest in a C Corporation will be liquidated by redemption of wife's community property interest in the business, and the parties want the transaction to be taxed to husband as a dividend. How is this done? Answer: the drafting lawyer provides in the divorce paperwork that (i) both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and (ii) such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption. With this important language in the divorce agreement, Treasury Reg. 1.1041-2(c) provides that the husband will be taxed on a constructive dividend. See Section VIII.C. of this Article.

Example 22: Triggering Capital Gain Recognition. Same as the previous Example, only the parties wish to report the transaction as a capital gain to wife, so she can apply her high tax basis in the stock to the redemption and pay a small capital gain tax. The drafting lawyer fails to make the statement prescribed by Treasure Reg. 1.1041-2(c)(1) in the divorce paperwork. From a tax standpoint, what happens? Answer: Absent using the language prescribed in Reg. 1.1041-2(c), you are thrown back onto the *Arnes 1* vs. *Blatt* controversy, and the question is presented of whether IRC § 1041 shields the wife from any tax and, if so, whether husband is taxed on a constructive dividend. Without the statements prescribed by Treas. Reg. §1.1041-2(c)(1), the distribution is generally taxed to the spouse who has the obligation to purchase the other spouse's shares. If neither spouse has an obligation to purchase the other spouse's shares, the redeeming (transferor) spouse will generally bear the tax. See Section VIII.C.2.

D. PARTIAL AND TOTAL LIQUIDATION.

Example 23: Partial Liquidation. The spouses own 100% of an LLC that has elected to be taxed as a corporation. The LLC has E&P of $500,000. In settlement, the LLC will acquire wife's membership units for a payment of $750,000 cash. What is the tax effect? Answer: If distribution falls outside of IRC § 302, Wife will be taxed on a dividend to the extent of the $500,000 in E&P. The remaining $250,000 will be treated as a non-taxable return of capital to the extent wife has basis in the LLC units, and as a capital gain once the Wife's basis is exhausted. If Section 302 applies, then Wife will have capital gain or loss equal to the difference between proceeds received and Wife's basis in LLC units. See rules discussed in Section XI.D of this Article.

Example 24: Total Liquidation. Same as the previous Example, but in this scenario the spouses decide to liquidate the LLC and split the proceed 50-50. What is the tax effect? Answer: in a total liquidation, the E&P will be ignored, and each spouse will recognize a capital gain to the extent the funds they receive in liquidation exceed their tax basis in the LLC units. See Section VIII.D.2.

E. SPLIT-OFF OR ASSET TRANSFER.

Example 25: Asset Transfer of Plant Facility. The manufacturing business is a wholly-owned community property C Corporation owned by husband. The corporation owns real estate on which the manufacturing plant is housed. Awarding the plant to the wife subject to a long-term lease would provide cash flow income to her while awarding the business to the husband for continued operations. Can the real estate be transferred from the corporation and placed in a new entity, tax-free, so that husband owns 100% of the old corporation and the wife owns 100% of the new company? Answer: The transaction would be tax-free if it is a "divisive reorganization" under IRC § 355 or IRC § 368, but that calls for the guidance of a tax advisor.

F. CHANGING THE FORM OF THE ENTITY. If there is going to be continued ownership by both spouses, it may be advisable to consider changing the form of the entity on a going-forward basis. The driving factors could be control, fiduciary duties, ability to withdraw from ownership, and tax effects.

Example 26: Converting C Corporation to Series LLC. The parties' C Corporation has cash, equipment, inventory, land and investments. The C Corporation can be converted to a series LLC, and selected assets can be placed in a series owned entirely by wife. If the LLC series elects to be taxed as a corporation, there would likely be no tax effect from the conversion. However, if the LLC series elects to be taxed as a partnership, the conversion would likely be seen as a liquidation of the C Corporation and initial capitalization of the LLC series. See Section VIII.D.2 & XI.D of this Article.

G. PIERCING THE CORPORATE VEIL.

Example 27: Joinder of the Corporation. Husband owns a 100% separate property ownership interest in a C Corporation. Wife obtained a jury finding that the separate identity of the corporation should be disregarded. Husband failed to obtain findings as to what assets held by the corporation are his separate property. If the corporation was a party to the divorce, what can the court do? Answer: the Court can award corporate cash and other assets to wife. If the corporation was *not* a party, what can the court do?

Answer: the court can award the corporate assets to husband and give wife other community property in offset, or can award wife a promissory note or money judgment.

Example 28: Tax Effects of Piercing. During the parties' ten-year marriage, the company's retained earnings have increased from $1 million to $5 million. What would be the tax effect if the corporation pays $2 million to wife to satisfy her piercing claim? Answer: the corporation has E&P in excess of $2 million, so husband will be taxed on the $2 million payment as a constructive dividend, with no deduction to the company for the payment. Wife will probably receive the money tax-free under IRC § 1041. If the retained earnings built up because husband was under-compensated, husband may have a problem with the IRS about whether the $2 million payment is really compensation that should be taxed at the ordinary income rate.

H. CLAIMS AGAINST THE COMPANY.

Example 29: Tort Claims. Wife sues husband's separate property corporation for $1,000,000 for invasion of privacy, intentional infliction of severe emotional distress, and illegally wire tapping her phone calls. The corporation agrees to settle the claim for $500,000. What is the tax treatment of the payment to the corporation and to the wife? Answer: the payment is deductible to the corporation only if it arises from business activity and not personal activity. The IRS would probably argue that the claim arose from husband's non-business-related tortious acts, and that the payment is not deductible. The IRS would also argue that the payment is a constructive dividend taxable to husband. Wife would have no tax except on the portion of the recovery allocated to lost income or exemplary damages. Wife's attorney may wish to omit those two claims from her pleadings.

Example 30: Fraud on the Community. Wife sues husband and his separate property LLC for actual and exemplary damages for fraud for contributing $500,000 in community property cash to the company without issuing new membership units or recognizing a loan from husband. The company agrees to settle the claim for a payment of $550,000 to wife. What is the tax treatment of the payment? Husband would argue that $500,000 was a return of capital, or else it was repayment of a loan. If the LLC had elected to be taxed as a corporation, the $550,000 could be characterized as a loan repayment, and / or a taxable or non-taxable non-liquidating distribution (dividend or return of basis), or some combination thereof. If the LLC had elected to be taxed as a partnership, the tax on the $50,000, if earnings, would have already been reported on his personal return, and no additional tax would be owed on the $50,000 payment. Since the $550,000 is not tort damages, it would not be taxable to wife under rules applying to tort recoveries. See Section VIII.H1 of this Article. The full amount of the recovery would be community property.

Example 31: Loans to Shareholder. During marriage, husband borrowed repeatedly from his separate property C Corporation and used that money to pay family living expenses, buy the family's automobiles, and to buy furniture and works of art for the family home. On divorce, Husband claims the loans to be a community liability. Wife contends that the loans are a sham, and asks the court to declare the debts void. What are the remedies if wife joins the corporation, and what are the remedies if wife does *not* join the corporation? Answer: If the corporation is not a party, wife can ask the court to ignore this liability in the property division and to order husband to hold wife and her property harmless from the liability. If the corporation is joined as a party, the court can declare the loans to be fraudulent or illusory, and declare them uncollectible against the wife or the community estate. Caution: invalidating the loans creates a significant risk that the loans were compensation that should have been taxed as ordinary income to husband. Husband should argue that the tax liability, penalties, and interest should be an offset against wife's claim, if she is successful.

Example 32: Resulting Trust. Husband used community property funds to purchase an automobile, but took title in the name of his separate property C Corporation. What can wife do in the divorce? Answer: wife can join the corporation as a party and ask the court to declare that the automobile is community property. Under the resulting trust doctrine, if the court declares the automobile to be community property, the husband may want to treat the event as repayment of a loan, in which event interest may be due on the loan. The interest would be deductible to the corporation as taxable to the husband.

Practice Tip: A resulting trust claim could also be asserted against a community property entity that held an asset purchased with community property funds. But if the value of the vehicle increased value of the entity by like amount, there may be no gain in asserting the claim.

Example 33: Constructive Trust. Husband is a doctor who practices medicine through a wholly-owned professional association, which is a partner in a medical partnership with 19 other doctors. The P.A. was created prior to marriage and is a pass-through entity for tax purposes. During marriage the husband retained earnings in the P.A. of $1.5 million. The PA has no employees other than him, no equipment, and no expenses other than his salary and benefits. Wife, who is not a licensed physician, has sued husband for fraud and breach of fiduciary duty, alleging that husband left his earnings inside the P.A. in order to keep them from her, and further alleging that this retaining of earnings is a breach of fiduciary duty and is not fair. If the P.A. settles wife's claim by paying her $750,000, who will be taxed for what in that transaction? Does wife have to join the P.A. as a party to the divorce? Answer: if the P.A. elected to be taxed as a corporation, and the entity is a pass-through corporate entity, the entity is classified as an S-Corporation for Federal income tax purposes. The IRS could argue that the $750,000 is compensation to the husband that is deductible to the P.A. but taxable as ordinary income to husband. If the IRS were successful, the flow through ordinary income to the husband would be reduced by the $750,000 compensation deduction, but the S-Corporation would be subject to employment taxes. Husband would argue that the $750,000 is a non-taxable shareholder distribution, to the extent of the PA's accumulated adjustments account and Husband's basis. If the PA was previously a C Corporation, before it elected S corporation status, some or all of the distribution could be taxable as a dividend, to the extent of accumulated earnings and profits, if the accumulated adjustments account is exhausted. After the accumulated adjustments account and accumulated earnings and profits are depleted, the distribution would be a return of stock basis. Distributions in excess of tax basis are capital gains to the shareholder (short term capital gain if the holding period is one year or less). See VII.D.9.c Ordering Rules for S Corporation Distributions.

I. USING ALIMONY INSTEAD OF PROPERTY DIVISION.

Example 34: The Alimony Alternative. Husband owns a limited partner interest in a partnership with transfer restrictions, hot assets, and a risk of future capital calls. To avoid these complications, husband agrees to pay alimony to wife in exchange for her community property interest in the partnership. What are the advantages and disadvantages:? Answer: Alimony is tax deductible to husband and taxable as income to wife. Once it is determined what wife is entitled to receive for her community property interest in the partnership, the alimony should be "grossed up" so that wife's after tax payments are the appropriate amount. If payments will extend over a period of time, present value discounting would be warranted. The parties can agree to contempt enforcement of the obligation for the maximum duration permitted under Texas Family Code

Section 8.054, and up to the maximum amount that could be awarded under Texas Family Code Section 8.055. Wife would want to ensure that any provision involving spousal maintenance under Chapter 8 of the Family Code clearly indicates that the contractual alimony obligation cannot be altered by the court.

Under Federal tax law, alimony must end upon the death of the receiving party, so the alimony stream has no value that wife can leave to her heirs. The parties may want to consider funding a decreasing term life insurance policy to pay wife's heirs upon her death. The alimony obligation is non-dischargeable in bankruptcy, so if husband's finances decline, he must still pay wife even if he can't pay all of his debts.

J. RESTRICTIONS ON TRANSFER; BUY-SELL AGREEMENTS. The variations in transfer restrictions and buy-sell agreements are endless, but they tend to fall into broad categories: absolute bars, a limited class of transferees, and options to buy or sell an ownership interest. See Section IX.

Example 35: Outright Prohibition of Transfers. The entity paperwork prohibits transfers of an ownership interest without the unanimous consent of the other owners. Husband and wife would like to divide the ownership interest 50-50. What can they do? Answer: Because of the transfer restrictions an outright transfer of an ownership interest to wife is not possible. However, the parties could set up husband as trustee to hold half of the ownership interest for the benefit of wife.

Example 36: Transfers Allowed Only to Family Members. The husband's LLC has a company agreement that prohibits transfers without the consent of other members, except that a member may transfer any part of his membership interest to spouses, children and grandchildren, or to trusts for those persons. If the case is settled in mediation, *before* divorce, while the wife is still a spouse, can a membership interest in the LLC be transferred to wife without the consent of other members? Answer: probably. What if the case is tried and the court awards an interest to wife in the property division? Answer: the transfer to wife would be prohibited.

Example 37: Option/Obligation to Purchase From Spouse. The buy-sell agreement provides that, if the spouse of a shareholder receives shares in a divorce, the shareholder spouse may purchase these shares within 90 days. If he doesn't exercise the option, other shareholders can and, if they don't, the company can. Can this provision be invalidated in court? Answer: Probably not, if the buy-sell agreement had a valid business purpose and was not intended to defraud the wife. What happens if all of the community property shares are awarded to the shareholder spouse? Answer: nothing. What happens if the non-owner spouse receives an ownership interest in the divorce? Answer: the buy-sell agreement will be triggered. What if husband exercised his option to buy wife's shares? IRC § 1041 may apply, allowing the spouses to allocate the sale to husband (as a constructive dividend) or to wife (as a capital gain or loss). See Section VIII.C.2 of this Article. If husband does not exercise his option and instead the company pays wife cash to exercise the option 180 days after the divorce, what is the tax effect on the company? Answer: probably no tax effect. On the husband? Answer: probably no tax effect. On the wife? Answer: the transaction is a redemption, with tax ramifications for wife. See Section VIII.G of this Article.

Example 38: Low Value From Jury. The buy-sell agreement says if corporate shares are awarded to wife in a divorce, then the company must buy the shares within 90 days for $1.00 per share. The jury found the spouses' ownership interest to be worth 50¢ per share. What should wife do? Answer: ask the court to award the shares to her. That will trigger the corporation's obligation to buy her shares at $1.00 per share. If wife receives shares in the divorce, and the corporation buys them in 90 days, who pays what tax? Answer: the corporation pays no tax, assuming the corporation does not distribute any appreciated assets. Wife is taxed on a stock redemption. See Section VIII.G of this Article.

K. OTHER TAX CONSIDERATIONS.

Example 39: S Corporation AAA Accounts. The spouses own two S Corporations of equal value, one with high AAA and low AEP, the other with low AAA and high AEP. Considering future taxes, which one is more desirable? Answer: The S Corporation with higher AAA will generally be more desirable, as the shareholder stock will generally have a higher stock basis. Shareholder distributions are generally non-taxable to the extent of AAA and shareholder basis. However, if the corporation was previously a C Corporation with accumulated earnings and profits, shareholder distributions will be taxable as dividends after the accumulated adjustments account is exhausted. If a client has an S Corporation with accumulated earnings and profits, consult a tax advisor regarding the ordering rules for shareholder distributions discussed in VII.D.9.c.

Example 40: Capital Loss Carryovers. Husband owns a community property partnership that has generated capital loss carryovers. The partnership is awarded to husband in the divorce. What happens to the capital loss carryovers? Answer: under Treasury Reg. § 1.1212(1(c)(i)(iii), each spouse gets half of the carryovers to use on their post-divorce tax returns. See Section XI.I.2 of this Article.

Example 41: S Corporation Loss Carryovers. Husband and wife wholly-own an S Corporation as community property. The Corporation has loss a carryover from prior years. What happens if the S Corporation is awarded half to each spouse? Answer: all of the loss carryovers remain to be applied against future income. What happens if the S Corporation is awarded 100% to wife? Answer: wife can use only her half of the loss carryforward. Husband's half of the loss carryforward is not available to either former spouse. See Section XI.I.5 of this Article.

Example 42: Redemption Involving Hot Assets. Wife will cash out her community property interest in a partnership by a liquidating distribution from the partnership. The partnership has both inventory and receivables. What tax issues could be raised by the liquidation? Answer: ordinarily the liquidating distribution would be taxed to wife as the sale of a capital asset. However, both inventory and receivables are "hot assets" that can trigger ordinary income taxation of what otherwise would be capital gain upon liquidation of a capital asset. The distribution received by wife will be allocated to the hot assets in the same proportion as the hot assets bear to total partnership assets. The portion allocated to hot assets will be taxed to wife at ordinary income rates. The balance will be treated as a capital gain. See Section XI.B of this Article.

ENDNOTES

1. TBOC § 152.002(a) provides: "Except as provided in Subsection (b), a partnership agreement governs the relations of the partners and between the partners and the partnership. To the extent that the partnership agreement does not otherwise provide, this chapter and the other partnership provisions govern the relationship of the partners and between the partners and the partnership."

2. http://www.gdhm.com/images/pdf/ce-planning-drafting-implementing-capital-call-provisions.pdf.

3. However, if a limited liability partnership fails to comply with the TBOC provisions governing creating and maintaining LLP status, the limited liability protection is lost. *Apcar Inv. Partners VI, Ltd. v. Gaus*, 161 S.W.3d 137, 141 (Tex. App.–Eastland 2005, no pet.).

4.IRS Publication 541.

5.Leslie H. Loffman & Sanford C. Presant, *Choice of Entity–Business and Tax Considerations*, Tax Law and Estate Planning Course Handbook Series (2007) [available on Westlaw at 743 PLI/Tax 575], p. 609 ("Loffman & Presant")

6. The applicable IRS Regulation is on-line at:
<http://edocket.access.gpo.gov/cfr_2005/aprqtr/26cfr1.1041-2.htm>[last checked 6/29/2016].

7. The article on Splitting Corporations Under Section 355 is at
<http://www.americanbar.org/content/dam/aba/events/taxation/taxiq-fall11-harris-section355.authcheckdam.pdf>.

8. Byron F. Egan, *Choice of Entity Decision Tree*, State Bar of Texas Choice & Acquisition of Entities Course ch. 1.1, pp. 47-48 (2015).

9.Field Service Advice Memorandum, FSA 001436, October 18, 1994: Constructive dividend: Corporate assets: Satisfaction of personal liabilities: Alter ego theory: Bankruptcy: Transfer to trust: Avoidance of transfer., FSA 001436, Internal Revenue Service, (Oct. 18, 1994).

10.For an additional article, see Zuber, R.I. (February 2000). Who Pays the Tax?: The Assignment of Income Doctrine, Code §1041, and Dividing Non-Qualified Pensions. 2000 Colorado Bar Association, 29 The Colorado Lawyer 59.

11.*Tax Advisor*, Understanding the Tax Consequences of S Corporation Redemptions to a Shareholder (August 1, 2013).

12. For more on the net investment income tax, see Williamson, D.T. (August 2013). "Planning for the 'Parallel Universe' of the Net Investment Income Tax," *The Tax Adviser*.

13.This case study has been adapted from *PPC's Tax Planning Guide—S Corporations*, 27th Edition, by Andrew R. Biebl, Gregory B. McKeen, George M. Carefoot, James A. Keller, and Kimberly Drechsel, published by Practitioners Publishing Co., Fort Worth, Texas, 2012.

14.Maples, L and Earles, M.J. (January 31, 2002). Employment Benefits and Divorce. *Journal of Accountancy*.

15.Willis, A.B., Pennell, J.S., Postlewaite, P.F. (December 1999). Partnership Taxation, Sixth Edition. p. 5-18 through 5-20.

16. Internal Revenue Code, Treasury Regulations, and Thomson Reuters, Small Business Quickfinder Handbook. 2015.

17. See IRC §1.172-7.

18. See IRC Reg. §1.172-7(c).

19. See A.E. Calvin, 66-1 USTC ¶9108.

20. See IRC §1211(b)(1).

21. See IRC §1211-1(b)(2).

22. See Treas. Reg. §1.1212-1(c)(1)(i).

23. See Treas. Reg. §1.1212-1(c)(1)(iii).

24. See Treas. Reg. §1.1212-1(c)(2), Ex (2).

25. See Treas. Reg. §1.1212-1(c)(1)(i).

26. See IRC §469.

27. See Treas. Reg. §1.469-1(f)(4).

28. See IRC §469(g).

29. See IRC §163(d)(1).

30. See IRC §163(d)(2).