2018 Presents a Window of Opportunity for a Tax Smart Method for a Buyout of a Business Interest

By Joseph W. Cunningham, JD, CPA

A business (or professional practice) owned by a divorcing party may present tax problems in structuring a property settlement. The business is often the parties' largest marital asset and will usually be retained by the owner spouse. If other marital property is insufficient to balance the settlement, some form of installment payments is generally used to buy out the nonowner spouse's marital interest in the practice.

It is sometimes appealing to a divorcing business owner to have the company make payments buying out the other spouse's marital interest in the business on a tax deductible basis. Attempts to do this include labeling such payments for the ex-spouse's consulting services or administrative assistance.

If examined by the Internal Revenue Service (IRS), however, the deduction is likely to be disallowed if the other spouse did not in fact provide services commensurate with payments received. Rather, the IRS would treat the payments as step transactions (1) constructive dividend distributions to the business owner spouse followed by (2) nondeductible property settlement payments to the other.

For such arrangements to withstand IRS scrutiny, the spouse receiving payments must in fact perform services. If the wife did *not* work for the practice during the marriage, such arrangements would generally be viewed as sham transactions. And, even if the wife had previously worked at the practice, she must actually perform duties commensurate with the amount of payments. This is often unlikely in view of the strained relationship generally prevailing between the husband and the wife as a result of the dissolution of their marriage.

The Tax Court has upheld IRS disallowance of practice deductions for payments to the owner's ex-spouse that in fact represented part of the divorce related buy-out of his or her interest in the company. [1]

For this article, it is assumed that H is the business owner.

For divorces completed before December 31, 2018, there is a better way to achieve the same result (i.e., the use of deductible payments by the company to buy out the W's marital interest in the business). As indicated, however, this method is available only for divorces and separations finalized in 2018.

"Section 71 payments," as they are sometimes referred to, resulted from the Tax Reform Act of 1984's elimination of the requirement that payments must in fact discharge the payor's obligation to support the payee. The subjective "support" requirement (which had given rise to an ever-increasing number of tax disputes) was essentially replaced by more objective strictures. First, payments must terminate on the payee's death and, second, payments must not be excessively front-loaded (i.e., disproportionately bunched in the years immediately succeeding the divorce).

These changes opened a vista of planning opportunities for divorce practitioners. Payments in settlement of property rights or for legal fees of the other spouse may be made on a taxable/deductible basis provided the alimony requirements of Section 71 are satisfied. They are used as a means of dividing non-qualified retirement benefits to which QDROS do not apply. Such flexible uses of Section 71 payments are especially beneficial where the payer is in a considerably higher tax bracket than the payee.

But, the alimony deduction under Section 71 has been eliminated by the 2017 Tax Cuts and Jobs Act (Tax Act) effective for divorces and separations finalized after December 31, 2018. The Tax Act also provides, however, that the prevailing deductible treatment of alimony will be grandfathered for divorces finalized before December 31, 2018. Thus, 2018 is a "window" for using Section 71 payments to advantage, including one spouse buying out the other spouse's marital interest in a business (or professional practice) on a taxable/deductible basis.

Example

Assume that H and W agree that he will pay her $25,000 annually for ten years in consideration of her marital property interest in his business and, further assume that H's marginal tax bracket averages thirty percent, the W's fifteen percent. In view of bracket disparity, H and W decide to share a "tax subsidy" provided by Uncle Sam.

Thus, as an alternative to the $25,000 nondeductible/nontaxable annual payments for ten years, they agree that the

H will make taxable/deductible payments to W of $32,500 annually for ten years, subject to termination in the event of the wife's death, which will qualify the payments under Section 71. H will draw additional salary from the business to fund his payments to W. By converting the payments to taxable/deductible, H and W each end up with $2,000 plus more per year after tax, compliments of Uncle Sam, as follows:

	Husband	Wife	Uncle Sam
Payments of $32,500	(32,500)	32,500	0
Tax Benefit (Cost)	9,750	(4,875)	4,875
After-Tax	22,750	27,625	4,875
Annual Benefit Via Section 71 Payments	2,250	2,625	4,875
Ten Year Benefit	22,250	26,250	48,750

So, by using Section 71 Payments, Uncle Sam effectively paid $48,750 of the $250,000 obligation – almost twenty-five percent.

Planning Opportunity

For 2018 divorces in which a business or practice owner is in a meaningfully higher tax bracket than the non-owner spouse, consider the use of Section 71 payments as a means of structuring buyout installment payments.

This tax saving technique will no longer be available for divorces entered after December 31, 2018.

Neither will other uses of Section 71 payments such as those noted above.

About the Author

__Joe Cunningham__ has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy, though his practice is statewide.

Endnote

1 *Greenwood v. Commissioner*, 57 TCM 1058 (1989).

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