Divorcing as a business owner? Don’t let taxes derail your settlement

Divorce is stressful under any circumstances, but for business owners, the process can be even more complicated. Your business ownership interest is often one of your largest personal assets, and in many cases, part or all of it will be considered marital property. Understanding the tax rules that apply to asset division can help you avoid costly surprises.

Tax-free transfers

Most assets — including cash and business ownership interests — can be divided between spouses without triggering federal income or gift taxes. Under this tax-free transfer rule, the spouse receiving the asset assumes its existing tax basis (used to determine gain or loss) and holding period (short-term or long-term).

Example: If you give your spouse the marital home in exchange for keeping 100% of your company stock, the transfer is tax-free. Both the home and the stock retain their original tax basis and holding period for the new owner.

Tax-free treatment applies to transfers made:

- Before the divorce is finalized,
- At the time of divorce, and

- After divorce, if they occur within one year of the marriage ending or within six years if required under the divorce agreement.

Future tax consequences

While transfers may be tax-free at the time, the recipient will owe taxes if he or she later sells an appreciated asset (where fair market value exceeds the tax basis).

For instance, if your ex-spouse receives 48% of your highly appreciated company stock, no tax is due at transfer. However, when he or she sells the stock, your ex will pay any capital gains tax based on your original basis and holding period.

Important: Appreciated assets come with built-in tax liabilities, which generally makes them less valuable than an equal amount of cash or non-appreciated property. Always account for taxes when negotiating a divorce settlement.

This rule also applies to ordinary-income assets — such as business receivables, inventory or nonqualified stock options. These can be transferred tax-free, but the recipient will report the income and pay taxes when the asset is sold, collected or exercised.

Valuation and adjustments for tax liabilities

A critical step in a divorce involving a business is determining its value. When valuing a business interest for this purpose, the valuator must understand what's appropriate under applicable state law and legal precedent because the rules and guidance may vary across jurisdictions. The valuation process may be contentious, especially if one spouse is actively involved in the business and the other isn't (or will no longer be involved after the divorce is settled). A professional valuation considers tangible assets (including equipment, inventory and property), intangible assets (including intellectual property) and other factors.

Potential tax liabilities are also considered during the valuation process. Examples include deferred taxes on appreciated assets, liabilities from unreported income or cash distributions, and implications from goodwill. These adjustments can significantly affect the business interest's value and the fairness of the settlement agreement.

Nontax issues

There are a number of issues unrelated to taxes that a divorcing business owner should be prepared to address, including:

- **Cash flow and liquidity.** Divorce settlements may require significant cash outlays — for example, to buy out a spouse's share of the business or to meet alimony and child support obligations. This can strain the business's liquidity, especially if the owner must take out loans or sell assets to meet these obligations. We can help assess the impact of these financial demands and develop strategies to maintain healthy cash flow, such as restructuring debt or revisiting budgets.
- **Privacy and confidentiality.** Divorce proceedings may expose sensitive business information. Financial statements, client lists and proprietary data may become part of the public record. Business owners should work with legal and financial advisors to protect confidentiality, possibly through protective orders or sealed filings.

Plan ahead to minimize risk

Divorce can create unexpected tax and financial consequences, especially when dividing business interests and retirement accounts (such as 401(k) accounts and IRAs). The financial stakes are often higher for business owners, making careful planning essential.

We can help you navigate these rules and structure your settlement to minimize tax liabilities while complying with state community property laws. The earlier you address potential tax issues, the better your financial outcome after divorce.