

Notice of Proposed Rulemaking and Notice of Public Hearing

Constructive Transfers and Transfers of Property to a Third Party on Behalf of a Spouse

REG-107151-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 1041 of the Internal Revenue Code relating to the tax treatment of certain redemptions, during marriage or incident to divorce, of stock owned by a spouse or former spouse. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by November 1, 2001. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Friday, December 14, 2001, must be received by November 23, 2001.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-107151-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG-107151-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslst.html. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Edward C. Schwartz (202) 622-4960; concerning submissions and the hearing, Guy Traynor (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by October 2, 2001. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in § 1.1041-2(c) of these regulations. Section 1.1041-2(c) permits spouses or former spouses to treat a redemption of stock of one spouse (the first spouse) as a transfer of that stock to the other spouse (the second spouse) in exchange for the redemption proceeds and a redemption of the stock from the second spouse in exchange for the redemption proceeds if they reflect their intent to do

so in a written agreement or if a divorce or separation agreement requires such treatment. This information must be retained and is required for the spouses or former spouses to report properly the tax consequences of the redemption. The likely respondents are individuals.

Estimated total annual reporting and/or recordkeeping burden: 500 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: 30 minutes.

Estimated number of respondents and/or recordkeepers: 1,000

Estimated annual frequency of responses: On occasion

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 1041 was added to the Internal Revenue Code by section 421 of the Tax Reform Act of 1984 (1984 Act), Public Law 98-369. Section 1041(a) provides that no gain or loss will be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or former spouse if the transfer is incident to a divorce. Under section 1041(b), for purposes of subtitle A, the transferee is treated as having acquired the property by gift from the transferor with a carryover basis from the transferor.

The House Report accompanying the 1984 Act states:

The current rules governing transfers of property between spouses or former spouses incident to divorce have not worked well and have led to much controversy and litigation. Often the rules have proved a trap for the unwary

Furthermore, in divorce cases, the government often gets whipsawed. The transferor will not report any gain

on the transfer, while the recipient spouse, when he or she sells, is entitled under [*United States v. Davis*, 370 U.S. 65 (1962)] to compute his or her gain or loss by reference to a basis equal to the fair market value of the property at the time received.

The committee believes that to correct these problems and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and between former spouses should be changed. . . .

The bill provides that the transfer of property to a spouse incident to a divorce will be treated, for income tax purposes, in the same manner as a gift. Gain (including recapture income) or loss will not be recognized to the transferor, and the transferee will receive the property at the transferor's basis Thus, uniform Federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws.

H. R. Rep. No. 432, 98th Cong., 2d Sess., Part 2, at 1491–92 (1984) (House Report).

By enacting the carryover basis rules in section 1041(b), Congress has, in essence, provided spouses with a mechanism for determining between themselves which one will pay tax upon the disposition of property outside the marital unit. For example, assume Spouse A owns appreciated property that he or she wishes to sell to a third party. The spouses may agree that Spouse A will sell the property to the third party and recognize the gain. Any subsequent transfer from Spouse A to Spouse B of the sales proceeds will be nontaxable under section 1041. In the alternative, the spouses may agree that Spouse A will first transfer the property to Spouse B. This transfer is nontaxable under section 1041, with Spouse B taking a carryover basis in the transferred property. Spouse B will then recognize the gain or loss on the sale of the property to the third party because a sale to a third party is not covered by section 1041. In this latter scenario, the tax consequences of the sale are shifted to Spouse B.

Under § 1.1041–1T(c), Q&A-9, of the Temporary Income Tax Regulations (Q&A-9), section 1041 will apply to a transfer of property by the transferor

spouse to a third party that is on behalf of the other spouse or former spouse (non-transferor spouse) if: (i) the transfer to the third party is required by the divorce or separation instrument; (ii) the transfer to the third party is pursuant to the written request of the nontransferor spouse; or (iii) the transferor spouse receives from the nontransferor spouse a written consent or ratification of the transfer to the third party. If Q&A-9 applies, a direct transfer of property to a third party is treated first as a transfer to the nontransferor spouse in a transaction governed by section 1041 and then as an immediate transfer by the nontransferor spouse to the third party in a transaction not governed by section 1041.

Q&A-9 has provided spouses and former spouses with the ability to shift between themselves the tax consequences of a sale of property outside the marital unit. However, the questions of what standard should be applied for purposes of determining whether a transfer of property is, or is not, “on behalf of” the non-transferor spouse for purposes of section 1041, and whether the same standard should be applied for purposes of determining the tax treatment of the transferor spouse and the nontransferor spouse under provisions of the Internal Revenue Code other than section 1041, have become the source of much confusion and litigation in the context of certain stock redemptions. For instance, the United States Court of Appeals for the Ninth Circuit in *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992) (regarding the tax treatment of the transferor spouse), and the Tax Court in *Arnes v. Commissioner*, 102 T.C. 522 (1994) (regarding the tax treatment of the nontransferor spouse), applied different standards to determine the tax treatment of the transferor spouse and the nontransferor spouse, respectively, in the context of a redemption of stock owned by the transferor spouse. Consequently, neither spouse was taxed on the redemption proceeds, a result that Congress clearly sought to avoid in enacting section 1041. See House Report at 1491.

In the *Arnes* cases, a husband and wife owned all the stock of a corporation. The divorce instrument required the wife to tender her stock to the corporation for redemption. The Ninth Circuit held that

the redemption was on behalf of the husband and, therefore, was not taxable to the wife, because it found that the husband had an obligation under the property settlement to purchase the wife's stock and the husband was benefitted by the redemption. The Ninth Circuit did not address the tax treatment of the husband, although it implied that the husband might be taxable on the redemption.

The Tax Court in *Arnes* addressed whether the husband was taxable on the redemption. The Tax Court stated that the question was whether the husband had a constructive dividend; that is, whether he had a “primary and unconditional obligation” to purchase the stock. The court concluded that the husband did not have a primary and unconditional obligation to purchase the wife's stock and, therefore, the redemption of the wife's stock did not result in a constructive dividend to the husband. This conclusion, the court stated, was supported by the IRS's position in Rev. Rul. 69–608 (1969–2 C.B. 43). Rev. Rul. 69–608 holds that a corporation's redemption of its stock from a shareholder (the first shareholder) results in a constructive distribution to another shareholder (the second shareholder) if the redemption is in satisfaction of the second shareholder's primary and unconditional obligation to purchase the first shareholder's stock. The majority opinion of the Tax Court in *Arnes* expressly declined to opine as to whether the “on behalf of” standard of Q&A-9 is the same as the “primary and unconditional obligation” standard applicable to constructive distributions.

The uncertainty has persisted in subsequent cases. In *Read v. Commissioner*, 114 T.C. 14 (2000), the Tax Court rejected equating the “primary and unconditional obligation” standard with the “on behalf of” standard in Q&A-9 for purposes of determining the tax consequences of a stock redemption to the transferor spouse. The Tax Court concluded that the appropriate standard for determining whether a transfer of property to a third party by a transferor spouse was on behalf of the nontransferor spouse under Q&A-9 was whether the transferor spouse was acting “as the representative of” or “in the interest of” the nontransferor spouse or whether the transfer satisfied a liability or an obligation of the nontransferor spouse.

See also *Blatt v. Commissioner*, 102 T.C. 77 (1994).

Because of these inconsistent standards, the regulations must be amended to provide greater certainty in determining which spouse will be taxed on certain stock redemptions occurring during marriage or incident to divorce.

Explanation of Provisions

The proposed regulations apply where, under current law, the “primary and unconditional obligation” standard applicable to constructive distributions governs the tax consequences to one spouse or former spouse of a redemption of stock owned by the other spouse or former spouse. Accordingly, the proposed regulations provide that they apply only where the nontransferor spouse owns stock of the redeeming corporation either immediately before or immediately after the stock redemption.

The proposed regulations provide that, if a corporation redeems stock owned by a transferor spouse, and the transferor spouse’s receipt of property in respect of such stock is treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the stock redeemed is deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to the redeeming corporation. Section 1041 applies to the deemed transfer of the stock by the transferor spouse to the nontransferor spouse, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041 does not apply to the deemed transfer of stock from the nontransferor spouse to the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock is deemed first to be transferred by the redeeming corporation to the nontransferor spouse in exchange for the stock in a transaction to which section 1041 does not apply, and then to be transferred by the nontransferor spouse to the transferor spouse in a transaction to which section 1041 applies, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. The tax consequences of the deemed transfer of stock from the nontransferor spouse to the

redeeming corporation in exchange for the redemption proceeds from the redeeming corporation are determined under applicable provisions of the Internal Revenue Code (other than section 1041) as if such transfers had actually occurred.

Where applicable law does not treat a transferor spouse’s receipt of property in respect of stock redeemed as resulting in a constructive distribution to the nontransferor spouse, the form of the stock redemption is respected. In other words, the transferor spouse and the redeeming corporation are respected as parties to the redemption transaction, and thus the transferor spouse, not the nontransferor spouse, is treated as a party to the redemption.

The approach of the proposed regulations recognizes that applicable tax law currently imposes the primary and unconditional obligation standard, which has its origins in well-established case law including *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947), and *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966), for determining whether a shareholder has received a constructive distribution. The proposed regulations are designed to remove inconsistencies caused by the simultaneous potential application of the on behalf of standard of Q&A-9 for one spouse and the primary and unconditional obligation standard of the case law for the other spouse. Thus, for example, if the rules of the proposed regulations had applied in the *Arnes* case, because the husband did not have a primary and unconditional obligation to purchase the wife’s stock, the redemption would have been taxed in accordance with its form with the result that the wife would have incurred the tax consequences of the redemption.

The proposed regulations provide a special rule that permits spouses and former spouses to treat a redemption of the transferor spouse’s stock as a deemed transfer of the redeemed stock by the transferor spouse to the nontransferor spouse and then a deemed transfer of the redeemed stock by the nontransferor spouse to the redeeming corporation, and to treat any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock as first transferred by the redeeming corporation to the nontransferor spouse in

exchange for the stock and then to be transferred by the nontransferor spouse to the transferor spouse. The special rule will apply if a divorce or separation instrument, or a written agreement between the transferor spouse and the nontransferor spouse, requires the transferor spouse and the nontransferor spouse to file their Federal income tax returns in a manner that reflects that the transferor spouse transferred the redeemed stock to the nontransferor spouse in exchange for the redemption proceeds and the corporation redeemed the stock from the nontransferor spouse in exchange for the redemption proceeds. Such divorce or separation instrument must be effective, or the written agreement must be executed by both spouses or former spouses, prior to the date on which the nontransferor spouse files such spouse’s first timely filed Federal income tax return for the year that includes the date of the redemption, but no later than the date such return is due (including extensions). The special rule is provided to give spouses and former spouses a means of ensuring the application of those Federal income tax consequences that would have resulted had applicable tax law treated the transferor spouse’s stock redemption as resulting in a constructive distribution to the nontransferor spouse.

Proposed Effective Date

The proposed regulations are applicable to redemptions of stock on or after the date the regulations in this section are published as final regulations, except for redemptions of stock that are pursuant to instruments in effect before the date the regulations in this section are published as final regulations. For redemptions of stock before the date the regulations in this section are published as final regulations and redemptions of stock that are pursuant to instruments in effect before the date the regulations in this section are published as final regulations, see § 1.1041-1T(c), A-9. However, these regulations will be applicable to redemptions described in the preceding sentence if the spouses or former spouses execute a written agreement on or after August 3, 2001, that satisfies the requirements of paragraph (c) of these regulations with respect to such redemption.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) and electronic comments that are submitted timely to the IRS. The IRS is also interested in receiving comments regarding the proper treatment of transfers of property to third parties by a spouse or former spouse other than transfers under these proposed regulations that solely govern certain redemptions of stock owned by a spouse or former spouse. Further, comments are specifically requested concerning the effective date provisions in the proposed regulations. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 14, 2001, at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit timely written or electronic comments and must submit an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by November 23, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Edward C. Schwartz of the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.1041-1T, paragraph (c) is amended by adding a sentence at the end of A-9 to read as follows:

§ 1.1041-1T Treatment of transfers of property between spouses or incident to divorce (temporary).

* * * * *

(c) * * *

A-9: * * * This A-9 shall not apply to transfers to which § 1.1041-2 applies.

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Par. 3. Section 1.1041-2 is added to read as follows:

§ 1.1041-2 Certain redemptions of stock.

(a) *In general* — (1) *Redemptions of stock resulting in constructive distributions.* Notwithstanding Q&A-9 of § 1.1041-1T(c), if a corporation redeems stock owned by a spouse or former spouse

(transferor spouse), and the transferor spouse's receipt of property in respect of such redeemed stock is treated, under applicable tax law, as resulting in a constructive distribution to the other spouse or former spouse (nontransferor spouse), then the stock redeemed shall be deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock shall be deemed first to be transferred by the redeeming corporation to the nontransferor spouse in exchange for the redeemed stock and then to be transferred by the nontransferor spouse to the transferor spouse.

(2) *Redemptions of stock not resulting in constructive distributions.* Notwithstanding Q&A-9 of § 1.1041-1T(c), if a corporation redeems stock owned by the transferor spouse, and the transferor spouse's receipt of property in respect of such redeemed stock is not treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the form of the stock redemption shall be respected for Federal income tax purposes. Therefore, the transferor spouse and the redeeming corporation will be respected as engaging in a redemption transaction to which the nontransferor spouse is not a party.

(b) *Tax consequences* — (1) *Transfers described in paragraph (a)(1).* The tax consequences of each deemed transfer described in paragraph (a)(1) of this section are determined under applicable provisions of the Internal Revenue Code as if the parties had actually made such transfers. Accordingly, section 1041 applies to any deemed transfer of the stock and redemption proceeds between the transferor spouse and the nontransferor spouse, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041, however, will not apply to any deemed transfer of stock by the nontransferor spouse to the redeeming corporation in exchange for the redemption proceeds. See section 302 for rules relating to the tax consequences of certain corporate redemptions.

(2) *Transfers described in paragraph (a)(2).* Section 1041 will not apply to any

of the transfers described in paragraph (a)(2) of this section. See section 302 for rules relating to the tax consequences of certain stock redemptions.

(c) *Special rule.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of redeemed stock will be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(1) of this section if a divorce or separation instrument, or a written agreement between the transferor spouse and the nontransferor spouse, requires the transferor spouse and the nontransferor spouse to file their Federal income tax returns in a manner that reflects that the transferor spouse transferred the redeemed stock to the nontransferor spouse in exchange for the redemption proceeds and the corporation redeemed the stock from the nontransferor spouse in exchange for the redemption proceeds. Such divorce or separation instrument must be effective, or written agreement must be executed by both spouses or former spouses, prior to the date on which the nontransferor spouse files such spouse's first timely filed Federal income tax return for the year that includes the date of the stock redemption, but no later than the date such return is due (including extensions).

(d) *Limited scope.* Paragraphs (a) and (c) of this section shall apply only to stock redemptions where, either immediately before or immediately after the stock redemption, the nontransferor spouse owns directly stock of the redeeming corporation.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. Corporation X has 100 shares outstanding. A and B each own 50 shares. A and B divorce. The divorce instrument requires B to purchase A's shares, and A to sell A's shares to B, in exchange for \$100x. Corporation X redeems A's shares for \$100x. Assume that, under applicable tax law, the stock redemption results in a constructive distribution to B. Paragraph (a)(1) of this section applies to the transfers of stock and redemption proceeds in connection with the redemption transaction. Accordingly, A will be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied). B will be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for \$100x in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B will be treated as transferring the \$100x to A in a transfer to which section 1041 applies.

Example 2. Assume the same facts as *Example 1*, except that the divorce instrument requires A to sell A's shares to Corporation X in exchange for a note. B guarantees Corporation X's payment of the note. Assume that, under applicable tax law, B does not have a primary and unconditional obligation to purchase A's stock. Also assume that the special rule of paragraph (c) of this section does not apply to the transfer of stock and redemption proceeds in connection with the redemption transaction. Under applicable tax law, the stock redemption does not result in a constructive distribution to B, because B does not have a primary and unconditional obligation to purchase A's stock. Paragraph (a)(1) of this section does not apply to the transfers of stock and redemption proceeds in connection with the redemption transaction. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, the tax consequences of the redemption will be determined in accordance with its form as a redemption of A's shares by Corporation X. See section 302.

Example 3. Assume the same facts as *Example 2*, except that the divorce instrument provides as follows: "A and B agree that A's Federal income tax return for the year that includes the date of the redemption will reflect that A transferred A's shares of Corporation X to B in exchange for the redemption proceeds of \$100x and B's Federal income tax return for such year will reflect that Corporation X redeemed such shares from B in exchange for such proceeds." By virtue of the special rule of paragraph (c) of this section, the redemption is treated as resulting in a constructive distribution to B. Accordingly, A will be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied). B will be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for \$100x in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B will be treated as transferring the \$100x to A in a transfer to which section 1041 applies.

(f) *Effective date.* Except as otherwise provided in this paragraph, this section is applicable to redemptions of stock on or after the date these regulations are published as final regulations in the **Federal Register**, except for redemptions of stock that are pursuant to instruments in effect before the date these regulations are published as final regulations in the **Federal Register**. For redemptions of stock before the date these regulations are published as final regulations in the **Federal Register** and redemptions of stock that are pursuant to instruments in effect before the date these regulations are published as final regulations in the **Federal Register**, see § 1.1041-1T(c), A-9. However, these regulations will be applicable to redemptions described in the preceding sentence of this paragraph (f) if the spouses or former spouses execute a written agreement on or after August 3, 2001,

that satisfies the requirements of paragraph (c) of this section with respect to such redemption.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on August 2, 2001, 8:45 a.m., and published in the issue of the Federal Register for August 3, 2001, 66 F.R. 40659)