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Redemption of Stock: Which Spouse Pays the Taxes?

One spouse may buy out the other spouse's interest in a corporation by having the corporation redeem the other spouse's shares of the corporation. A tax issue then arises as to which spouse will pay the tax on the amounts withdrawn from the corporation. This tax issue became difficult when the Tax Court disagreed with the U.S. 9th Circuit Court of Appeals over which spouse should pay the tax.

Arnes v. U.S., 981 F.2d 456 (9th Cir. 1992) (*Arnes I*) is the leading case on the issue of whether the spouse whose shares are redeemed (the transferring spouse) must pay the tax. In *Arnes I* the parties jointly owned stock in a corporation that owned a McDonald's franchise. The agreement with McDonald's required that the husband be the sole owner of the corporation after divorce.

The parties first surrendered to the corporation their jointly owned stock, and the corporation issued equal numbers of shares to each party in their own names. The parties then entered into a marital settlement agreement (MSA), which provided in part that the parties were to cause the corporation to redeem the wife's stock at a stated price. The MSA further provided that the husband personally guaranteed to purchase the shares from the wife.

A few days after entering into the MSA, the wife entered into an agreement with the corporation for redemption of the stock, with the husband guaranteeing payment. Then, after the corporation redeemed the wife's stock, it canceled those shares, and reissued an equivalent number of shares to the husband.

The 9th Circuit applied I.R.C. Section 1041 and Temporary Treasury Regulation section 1.1041-T, Q-9, A-9 (question 9) to hold that the wife should not be taxed. Section 1041 provides that no gain is recognized on a transfer of property either between spouses or between former spouses if the transfer is incident to divorce. Question 9 provides that transfers to a third party required by a divorce or separation instrument will be treated as a transfer to the other spouse if the transfer is "on behalf of" the other spouse.

The court ruled that a transfer "on behalf of" the other spouse occurred "if [the transfer] satisfied an obligation or a liability

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Given the disagreement between the 9th Circuit and the Tax Court, it is better to take care of the problem in the settlement agreement.

ity of that person." 981 F.2d at 459. Applying this test, the court concluded that the wife's transfer of shares to the corporation was on behalf of the husband because the transfer satisfied the husband's guarantee to pay the wife. The court treated the wife's transfer of the shares to the corporation as first a transfer of the stock to the husband and then to the corporation.

Although the husband was not before the court, the opinion suggests that the husband should be taxed: "The transfer of the \$450,000 from the corporate treasury need not escape taxation, if we hold, as we do, that [wife] is not required to recognize any gain on the transfer of her stock, because it is subject to Section 1041." 981 F.2d at 459.

Presumably the court meant that the basis of the stock the wife transferred to the corporation is the wife's adjusted basis, so that when the stock is sold the appropriate tax would be paid. The government argued, however, that since the corporation canceled the stock that the wife transferred and issued new shares to the husband, no asset with a carryover basis exists.

The court responded to this argument by stating simply, "[W]e reject the Government's application of the statute. The Regulations, particularly question 9, demonstrate that the statute is meant to apply to situations such as this one, where a transfer is made on behalf of one's former spouse." 981 F.2d at 460. Thus, according to *Arnes I*, if the redemption is "on behalf of" the nontransferring spouse, the transferring spouse will not be taxed.

In *Arnes v. Commissioner*, 1994 U.S. Tax Ct. Lexis 22, 102 T.C. No. 20 (1994) (*Arnes II*), under the same facts as those in *Arnes I*, the Tax Court surprisingly held that the husband should not be taxed.

The government argued that the husband should be taxed, on the theory that he received a constructive dividend when the corporation redeemed the wife's shares. (The court in *Arnes I* did not discuss this theory.) The Tax Court explained that "if a corporation redeems stock that its remaining shareholder was obligated to buy, a constructive dividend results to the remaining shareholder. However, this rule is limited to those circumstances where the obligation of the

remaining shareholder is both 'primary and unconditional.'" 1994 U.S. Tax Ct. Lexis at 10-11.

Applying this test, the Tax Court held that the husband's obligation was not "primary and unconditional" because the corporation was obligated to redeem the stock, with the husband guaranteeing the obligation. The court also stated that under applicable Washington state law, "the property settlement agreement created at most a secondary obligation, which could only mature on the corporation's default on its primary obligation." 1994 U.S. Tax Ct. Lexis at 15.

The court said it was not expressing an opinion on the relationship between the "on behalf of" test and the "primary and unconditional" test. However, the court also said that its conclusion in *Arnes II* was consistent with its conclusion in *Blatt v. Commissioner*, 1994 U.S. Tax Ct. Lexis at n.3.

In *Blatt v. Commissioner*, 1994 U.S. Tax Ct. Lexis 22, 102 T.C. No. 20, the Tax Court taxed the non-transferring spouse in a transaction similar to that in *Arnes*. The court held that the transfer of stock from the wife to the corporation was not on behalf of the husband.

According to the court, *Arnes* was easily distinguishable for the following reasons: (1) the parties in *Arnes* were contractually obligated with a third party to have only one of the parties own the corporation after the divorce while the parties were not so obligated in *Blatt*; (2) the husband in *Arnes* was obligated to be the sole owner of the corporation but the husband was not so obligated in *Blatt*; (3) the husband in *Blatt*, unlike the husband in *Arnes*, did not guarantee the obligation of the corporation to purchase the wife's shares; and (4) unlike the parties in *Blatt*, the parties in *Arnes* were divorced under community property laws.

The Tax Court added that taxing the wife "harmonizes" with the rule that the nontransferring spouse is taxed only if the corporation's redemption of the stock satisfies that spouse's primary and unconditional obligation to purchase the stock. 102 T.C. at n.13. The Tax Court also stated, without giving any reason, that it did "not agree with *Arnes* and respectfully refuse[d] to follow it" 1994 Tax Ct. Lexis at 12.

A recent private letter ruling held, on facts it said were close to those of *Blatt*, that the non-transferring spouse should be taxed for reasons similar to those stated in *Blatt*. Private Ruling 9427009, 1994 PRL Lexis 667. The parties involved in the private letter ruling also specified in the MSA that the redemption was not intended to be on behalf of the husband.

Presumably, this provision was intended to prevent the wife from changing her mind and seeking a refund, thus having the tax subsequently imposed on the husband.

A final Tax Court case relevant to this issue is *Hayes v. Commissioner*, 101 T.C. 539, 101 T.C. No. 40. The relevant differences between the facts of *Arnes* and those of *Hayes* are that the judgment ordered the husband to purchase the shares from the wife, and that the corporation agreed to undertake the husband's obligation. Accordingly, the Tax Court taxed the husband on the theory that he received an actual or constructive dividend because his obligation to purchase the shares was "primary and unconditional." The Tax Court suggested in a footnote that even if the husband were not taxed, *Arnes I* could still protect the wife from taxation. 101 T.C. at n.3.

It is tempting to structure a buyout as close as possible to that in *Arnes* to try to take advantage of the present uncertainty in the law. However, if neither party reports the income from the redemption, then the parties should expect that at least one of them or the corporation will be audited and will have to defend the position in court.

In any case, it does not appear likely that both parties can escape taxation in the future. Post-*Arnes II* cases are cognizant of the result in *Arnes I* and *Arnes II* and will avoid the same result, presumably by consolidating the actions against both spouses. Moreover, *Arnes* involved the unique facts of a Washington state statute that made the husband's obligation secondary to the corporation's.

In addition, *Arnes* involved a contract with a third party that after divorce only one spouse should own the corporation, a fact that may not be present in all cases. While the court did not discuss the importance of this factor with respect to the taxation issue, a subsequent court could use this as a distinguishing fact. Consequently, it seems prudent for the parties to agree in advance how any tax liability will be allocated.

If the parties agree that one of them will pay the taxes, then the settlement documents should clearly state the appropriate language under the "on behalf of" test or the "primary and unconditional" test to ensure that liability is placed on the agreed-upon party. The private letter ruling contains language that can serve as a guide.

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