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THE PRACTITIONER | MITCHELL A. JACOBS

The IRS Loses One, in a Case Of Divorce and Following Gain

FAMILY LAW: Stock redemption pursuant to a settlement agreement is held eligible for nonrecognition.

In a recent case, *Arnes v. United States*, 92 Daily Journal D.A.R. 16627, the 9th U.S. Circuit Court of Appeals held that a taxpayer need not recognize for income tax purposes the gain she realized when, pursuant to a divorce settlement, a corporation redeemed her half of the stock, the remaining stock being owned by her former husband.

The Arneses, Joann and her then-husband, John Arnes, had formed a corporation in 1980 to operate a McDonald's franchise. The corporation had issued 5,000 shares of stock in the joint names of John and Joann. Seven years later, in 1987, John and Joann agreed to divorce. Because of McDonald's policy requiring 100 percent ownership of the equity and profits by the franchise owner-operator, John and Joann entered into a marital settlement agreement that provided for their corporation to redeem 50 percent of Joann's interest in the outstanding stock, for a total of $450,000. In accordance with their agreement, and the judgment into which it was later incorporated, Joann surrendered her 2,500 shares to the corporation, which was to pay her $450,000, and canceled her stock certificate. The corporation then issued another 2,500 shares to John, thereby resulting in John having ownership of 100 percent of the outstanding shares.

On her federal income tax return, Joann reported that she sold her stock in the corporation for a price of $450,000 and that her basis was $2,500, resulting in a profit of $447,500. The "buyout" was structured so that the corporation was to pay the $450,000 to Joann by forgiving a debt that she owed the corporation and by paying the balance to her in monthly installments over the next 10 years.

She received $178,042 in the initial year as part of the sale price. Using an installment method, she treated $177,045 as long-term capital gain and the remainder as recovery of a portion of her basis.

The following year, Joann filed a claim for a refund of approximately $53,000 for the initial tax year, on the ground that she was not required to recognize any gain on the transfer of stock because the transfer was made pursuant to a divorce instrument under Internal Revenue Code Section 1041.

The U.S. District Court for the Western District of Washington agreed with Joann. The court found that the redemption of her stock was required by the divorce instrument and that John had benefited from the transaction because it was part of the marital property settlement, which limited future community property claims that Joann might have later brought against John. In applying the IRS regulations, the court found that, although Joann transferred her stock directly to the corporation, the transfers were made on behalf of John and therefore, should have been treated as having been made to John. Accordingly, the court held that the transfer qualified for nonrecognition of gain pursuant to the exemption for transfers made to former spouses related to divorce settlements. See 26 I.R.C. section 1041.

The 9th Circuit began its analysis with IRC section 1041, which provides in part:

"(a) General rule. No 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.

(b) Transfer treated as gift; transferee has transferor's basis. In the case of any transfer of property described in subsection (a)

(1) for the purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

26 I.R.C. section 1041 ('Transfers of property between spouses or incident to divorce')."

The court further referred to Temporary Treasury Regulation 1.1041-1T (1992). The regulation explains that in certain cases the transfer of property to a third party "on behalf of" a spouse or former spouse should be treated as a transfer to the spouse or former spouse. At Q-9, A-9. The regulation specifically provides an example in which a transfer to a third party is required by a divorce or separation instrument. The regulation states that the transfer of property in this situation is treated as made directly to the nontransferring spouse (or former spouse), and the nontransferring spouse will be treated as immediately transferring the property to the third party. However, the "deemed" transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041. Temp. Treas. Reg. 1.1041-1T, A-91 (1992).

The court of appeal focused on the words "on behalf of" in the regulation. The court stated that "a transfer is considered to have been made 'on behalf of' someone if it satisfied an obligation or a liability of that person." The court referred to ***Holt Colony Trust Co. v. Commissioner***, 279 U.S. 716 (1929), which held that when an employer pays an employee's income tax, that payment is income to the employee in that it was made "on behalf of" the employee. In *Schroeder v. Commissioner*, 831 F. 2d 856 (9th Cir. 1987), the court held that where a corporation assumed a shareholder's bank note in exchange for stock, the shareholder receives a taxable constructive dividend.

The court of appeal specifically focused on the fact that John was obligated, pursuant to the marital settlement agreement and judgment, to purchase Joann's stock. Moreover, John had personally guaranteed the corporation's note to Joann to purchase the stock. The court examined Washington law and found that Joann could sue John for payment under Washington law without suing the corporation. Therefore, John was jointly liable with the corporation for the payments due Joann.

The emphasis the court of appeal placed on John's obligation to purchase the stock and on his guarantee of the corporation's note to Joann is important. If John had not agreed to these obligations in the marital settlement agreement and judgment, it is likely the court would have held that the transaction did not constitute a benefit to John and that therefore there was not a constructive transfer to John of the corporation's stock. If so, the result might have been different and Joann might have been required to recognize gain on the transfer of the stock because section 1041 might not have applied.

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