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Sec. 1041 Nonrecognition Warranted in Company's Redemption of Stock

By: John E. Barrett, Jr., CPA, ABV, CVA, MST
Chair, RISCPA Business Valuation Committee

In Read V. Commissioner, 114 T.C. No. 2, (Filed February 4, 2000) the full Tax Court considered whether IRC Sec. 1041, nonrecognition of gain on appreciated property transferred incident to a divorce, should be applied to Mrs. Read's transfer of stock to the parties' corporation. This is another in a series of conflicting cases that have created uncertainty as to which spouse is subject to taxation when a redemption of stock by the corporation is made incident to a divorce.

Mr. and Mrs. Read owned an auto parts business in Florida. They divorced in 1986. As part of their divorce instrument, Mrs. Read was required to transfer her shares in the business to either her husband or, if he elected, to the business for $838,724 ($200,000 down with the remainder being paid over time at 9-percent interest). The payment had to be personally guaranteed by Mr. Read. He elected to have the corporation buy out his wife. The repurchase of her shares left Mr. Read in control of all the outstanding stock.

The IRS looked into Mrs. Read's, Mr. Read's and the corporation's tax returns for the tax years 1988, 1989 and 1990. The wife did not report any gain on the sale of the stock to the corporation. She did, however, report all the interest she received on the corporation's note. She took the position that IRC sec. 1041 was applicable. The corporation deducted the interest payments for the tax years at issue, and the husband did not report any income with respect to the stock transaction. The IRS concluded that Mrs. Read failed to report the gain from the principal payments made under the corporation's note, Mr. Read received a constructive dividend from the corporation in the amount of the payments made to his former spouse, and that the interest payments were not deductible by the corporation. Mrs. Read, and Mr. Read and the corporation filed cross-motions for partial summary judgment.

Before the full Tax Court, Mrs. Read argued that Sec. 1041 applied to the transfer of her corporate stock to the company. She claimed that the transfer to the company was a transfer on behalf of the nontransferring spouse in accordance with the temporary regs. See sec. 1.1041-1T(c), Q&A-9. Mr. Read and the corporation held that Q&A-9 did not apply here. They argue that the transfer of her stock to the corporation should be treated as a corporate redemption.

The issue before the tax court was what legal standard should apply when determining whether the transfer to a third party is subject to nonrecognition under IRC sec. 1041. The husband argued that the "on behalf of" standard in Q&A-9 was the same as the "primary-and-unconditional-obligation" standard of constructive dividend law. The majority concluded that "The judicially created primary-and-unconditional-obligation standard is well established in the tax law. If in issuing Q&A-9 the Treasury Department had intended that in the case of, and solely in the case of, a corporate redemption in a divorce setting the on-be-half-of standard may be satisfied only by satisfaction of the primary-and-unconditional-obligation standard, the Treasury Department would have expressly so indicated in Q&A-9. It did not." Thus, the majority of the Tax Court found that the less stringent on-behalf-of standard was the appropriate standard for determining nonrecognition for IRC Sec. 1041. It found that the wife was eligible for nonrecognition treatment under IRC sec. 1041 while the husband and the business should treat the payments made by the corporation to the wife as a constructive dividend to him. A number of judges dissented to the majority's opinion. ❖