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PRO-CHOICE TAXATION: CONSISTENT TAX TREATMENT OF STOCK REDEMPTIONS AT DIVORCE

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Abstract: The Ninth Circuit and the Tax Court have disagreed on the circumstances in which nonrecognition of gain under § 1041 of the Internal Revenue Code may extend to a spouse who redeems stock at divorce. This conflict is representative of a larger problem surrounding the question of which spouse to tax on the redemption of stock incident to divorce. This Comment examines the tension between the policy underlying § 1041 and the temporary regulations, and identifies the tension as the cause of inconsistent judicial decisions. This Comment also proposes an amendment to the Code that provides both certainty to the divorcing spouses and ensures that gain is recognized by one spouse.

Section 1041 of the Internal Revenue Code provides that no gain is recognized on the transfer of property between spouses or former spouses incident to divorce.[1] Gain is deferred through a carryover basis, until property is transferred to a third party. Temporary regulations under § 1041 extend nonrecognition to transfers to third parties in limited circumstances where a spouse transfers property to a third party "on behalf of" the nontransferring spouse.[2] These regulations are the focal point for confusion where, incident to divorce, a closely held corporation redeems the stock of one or both of the spouses.

By inconsistently applying the regulations to the taxation of stock redemptions, the courts have frustrated the policy underlying § 1041 and created room for divorcing spouses to maneuver against one another and against the Internal Revenue Service (IRS). This has resulted in spouses litigating the issue of who should be taxed, even where one had first assumed the tax burden. Additionally, the unpredictable judicial application of the regulations often has forced divorcing spouses to face the inconvenience and expense of obtaining private letter rulings from the IRS. Ultimately, this maneuvering room has expanded to where in one instance, neither spouse was taxed on the redemption of stock.[3]

This Comment examines the relationship between the regulations under § 1041, the underlying policy of deferral embodied in § 1041, and the inconsistent judicial decisions. It concludes by proposing an amendment to the Internal Revenue Code that would ensure that spouses

1. I.R.C. § 1041(a) (1988).

2. Temp. Treas. Reg. § 1.1041-1T(c), Q & A 9 (1984).

3. Arnes v. United States, 981 F.2d 456 (9th Cir. 1992); Arnes v. Commissioner, 102 T.C. 522 (1994).

treat the redemption of stock at divorce consistently. Part I describes the background to nonrecognition under § 1041. Part II explains how stock redemptions incident to divorce fit within the framework of § 1041 and its corresponding regulations. This part also outlines how the courts have inconsistently decided the cases. Part III analyzes the aftermath of the judicial decisions. Part IV outlines the current position of the IRS and contends that its position neither clears the confusion of the cases, nor is consistent with the policy of § 1041. Part V argues for an amendment to section 302 of the Internal Revenue Code that would resolve the confusion and provide spouses freedom to choose who will recognize gain on a stock redemption contemplated by a divorce agreement.

I. PROPERTY TRANSFERS BETWEEN DIVORCING SPOUSES: BACKGROUND OF I.R.C. § 1041

Whenever property is sold or otherwise disposed of, the seller must recognize any realized gain unless a specific nonrecognition provision in the Code applies.[4] Section 1001 of the Internal Revenue Code states that gain from the sale or other disposition of property is the amount realized from the sale over the property's adjusted basis.[5] This realized gain is recognized (taxed) except as otherwise provided in the Code.[6] A taxpayer's adjusted basis in property is generally the amount it cost.[7]

There are a number of nonrecognition provisions in the Internal Revenue Code.[8] Based on a variety of policies, Congress has enacted these provisions to allow taxpayers to defer gain recognition. With rare exception,[9] a mechanism exists in each of these sections to ensure that deferred realized gain will be recognized on a subsequent taxable transaction.[10] Among the deferral mechanisms is the carryover basis

4. I.R.C. § 1001(c) (1988).

5. I.R.C. § 1001(a) (1988).

6. I.R.C. § 1001(c).

7. I.R.C. § 1012 (1988).

8. *See, e.g.*, I.R.C. § 1031 (1988) (providing nonrecognition of gain on exchanges of property of "like-kind").

9. The basis of property acquired by a decedent is given a fair market value basis at the time of the decedent's death. I.R.C. § 1014 (1988). Thus, if the person who receives the property from the decedent sells it immediately, none of the gain that may have been recognized by the decedent on a sale will ever be realized on the property.

10. *See, e.g.*, I.R.C. § 1031(d) (1988).

requirement where the property's basis literally carries over from the transferor to the transferee.[11]

A. *Property Transfers Between Spouses*

Although the Code provides that the sale or disposition of property ordinarily would require gain recognition, the question of whether one spouse had to recognize gain on the transfer of appreciated property to the other was unresolved for years. Much of the confusion on this issue stemmed from the U.S. Supreme Court's decision in *United States v. Davis.*[12] In that case, Davis transferred appreciated property to his wife incident to divorce; the Commissioner treated the transfer as a tax recognition event for him.[13] The Court noted that while the division of jointly owned property may not have been a recognition event, the transfer of property pursuant to divorce was.[14] Subsequent cases and rulings held that the mere division of jointly owned property is not taxable.[15]

This holding led to maneuvering by practitioners and state legislatures, who tried to make property settlements appear as much like divisions of property interests as possible.[16] The *Davis* holding also created the possibility that neither spouse would recognize any gain. This would happen if the transferor treated the exchange as a nonrecognition event, while the transferee, believing that the transferor recognized gain, took a fair market value basis in the property.[17] This problem of taxpayers avoiding gain recognition without a nonrecognition provision is known as the whipsaw. [18]

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11. *See, e.g.*, I.R.C. § 1041(b) (1988). Suppose *B* transfers property to *A* in an exchange that qualifies for nonrecognition under some provision of the Internal Revenue Code. Suppose that *A* is required to take a carryover basis from *B*. If *B* had an adjusted basis of 10 in the property worth 50, *A* must take an adjusted basis of 10 in the property, even if the property cost *A* 50. Most nonrecognition provisions have no effect on who pays tax, only on when tax is paid. Section 1041, however, affects both the *person* paying and the *timing* of tax.

12. 370 U.S. 65 (1962).

13. *Id.* at 66.

14. *Id.* at 69.

15. *See* Alan L. Feld, *Divorce and Redemption*, 64 Tax Notes 651 (Aug. 1, 1994).

16. *Id.* By giving courts discretion over the technical form of property settlement agreements, state legislatures could provide that individually held property could be "divided between owners" instead of transferred. *Id.*

17. *Id.* at 652.

18. *See, e.g.*, Arnes v. Commissioner, 102 T.C. 522, 541–42 (1994) (Beghe, J., concurring).

In 1984, the posturing ended when Congress enacted I.R.C. § 1041, which rejected the holding in *Davis* by providing that no gain is recognized on a transfer between spouses.[19] Gain will not be recognized on a transfer of property to a former spouse where the transfer was "incident to divorce."[20] A transfer is incident to divorce when it occurs within one year of the cessation of the marriage, or when it is related to the cessation of the marriage.[21] To alleviate the possibility of the whipsaw, Congress further provided that the transferee spouse takes a carryover basis in the property.[22]

B. *Policy of Deferral*

Section 1041 embodies a policy of deferring gain until a recognition event occurs subsequent to an interspousal transfer of property. The carryover basis preserves any gain, which is recognized when the transferee spouse ultimately disposes of the property to a third party. The policy of deferral is intended to provide spouses with certainty over who will recognize the gain on appreciated marital property.[23] This ensures flexibility over the division of assets at divorce.

II. STOCK REDEMPTIONS INCIDENT TO DIVORCE

A. *Redemption as Third-Party Transfer*

Nonrecognition of gain under I.R.C. § 1041 generally is limited to transfers of property between spouses or former spouses incident to divorce. In most circumstances, transfers to third parties will result in recognition of gain. A redemption of stock is a transfer of property to a

19. § 1041(a).

20. *Id.*

21. I.R.C. § 1041(c) (1988).

22. I.R.C. § 1041(b) (1988).

23. The House Committee report states:

> The Committee believes that, in general, it is inappropriate to tax transfers between spouses. . . .
>
> 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 as, for example, where the parties view property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property on divorce triggers recognition of gain.
>
> Furthermore, in divorce cases, the Government often gets whipsawed.

H.R. Rep. No. 432, 98th Cong., 1st Sess. 191–92 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1134–35.

third-party (or more exactly, a third-party corporation). So long as stock is held by one or both spouses, no gain will be recognized under § 1041.

Often a divorcing couple's most valuable asset is the stock of a closely held corporation. To ensure a fair division of property at divorce, it is often necessary to withdraw some portion of the equity in the corporation. A third-party transfer accordingly is required to effectuate this withdrawal. There are a few ways in which the division of corporate assets may be accomplished. First, one spouse may transfer stock to the transferee spouse, and the transferee would then cause the corporation to redeem the stock for assets (Case 1).[24] Second, the spouses may divide jointly owned stock, with one spouse redeeming the resulting interest (Case 2).[25] Third, one spouse may retain exclusive stock ownership and agree to reimburse the other for the value of a certain interest in the stock; thereafter, the remaining shareholder spouse may or may not cause the corporation to discharge the obligation (Case 3).[26]

In Cases 1 and 2 set out above, both spouses agree on the manner in which corporate assets will be used to divide marital property interests. There is a property transfer of some sort between the spouses, followed by a transfer to the third-party corporation. In Case 3, however, there is no transfer of stock between the spouses. Instead, the remaining shareholder discharges an obligation by using assets of the corporation.

B. *Temporary Regulation 1.1041-1T(c) Q&A 9*

As set out above, nonrecognition under § 1041 is not applied to transfers of property to third parties. In limited situations, however, § 1041 has been extended to certain third-party transfers by regulation.[27] In 1984, the Treasury Department issued temporary regulations under § 1041 in a question and answer format. One of these, "Q & A 9," provides that under § 1041 a spouse who transfers property to a third party "on behalf of" the nontransferring spouse will not recognize gain.[28]

The regulations describe three instances in which a transfer will be "on behalf of" the nontransferring spouse. The first is where the transfer

24. *E.g.*, Priv. Ltr. Rul. 94-27-009 (July 8, 1994).

25. *E.g.*, Arnes v. United States, 981 F.2d 456 (9th Cir. 1992).

26. *E.g.*, Hayes v. Commissioner, 101 T.C. 593 (1993).

27. Temp. Treas. Reg. § 1.1041-1T(c), Q & A 9 (1984).

28. *Id.*

is "required by a divorce or separation agreement."[29] The regulations provide that where a transfer is "on behalf of" the nontransferring spouse, it will be treated as made directly to the nontransferring spouse. No gain is recognized by the transferring spouse on this deemed transfer under § 1041. Thereafter, the nontransferring spouse is treated as immediately transferring the property to the third party in a transaction that does not qualify under § 1041. This process ensures that one, but only one, spouse will recognize gain from the transaction.[30]

C. *Judicial Application of "On Behalf Of" Test to Stock Redemptions at Divorce*

The "on behalf of" language in Temp. Treas. Reg. § 1.1041-1T(c), Q & A 9 has caused inconsistent outcomes in the recognition of gain on stock redemptions incident to divorce. As stated above, it is often necessary for a divorcing couple to withdraw the assets of a closely held corporation to effect an equitable division of marital property interests. This is generally done through a transfer of stock from one spouse to the third-party corporation in exchange for assets.

In applying the "on behalf of" language in the temporary regulation to such third-party redemptions at divorce, courts have struggled to define the circumstances under which a spouse redeeming stock will not recognize gain under § 1041. More precisely, the issue is whether a redemption of stock can be "on behalf of" the nonredeeming spouse[31] within the meaning of Temp. Treas. Reg. § 1.1041-1T(c), Q & A 9.

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29. *Id.* The two other instances detailed in the regulations are not relevant for the present discussion. They are "where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse)" and "where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party." *Id.*

30. It is feasible that both spouses could recognize gain if the transferring spouse recognizes capital gain from the redemption of stock, and the nontransferring spouse is held to have had a constructive dividend if the redemption discharges a primary and unconditional obligation.

31. In this instance, the "nonredeeming spouse" is the same as the "nontransferring spouse," as used in part II.B. Both terms refer to the individual who has *not* actually caused his or her own property (stock in a closely held corporation) to be transferred outside of the spousal unit. Because this discussion is focused on the redemption of stock, "nonredeeming spouse" and "redeeming spouse" will be used in place of "transferring spouse" and "nontransferring spouse." These terms will be used only to refer to the third-party transfer and not to *actual* transfers between spouses.

1. The Arnes *Cases*

The case of John and Joann Arnes represents the conflicting judicial application of Temp. Treas. Reg. § 1.1041-1T(c). To bring about a fair property settlement at divorce, the Arneses redeemed the appreciated stock of a corporation in which they were the sole shareholders. However the Arneses whipsawed the IRS by convincing different courts that neither should be taxed on the redemption.[32]

John and Joann Arnes jointly held all of the stock of Moriah Corporation (Moriah).[33] Through Moriah, they operated a McDonald's franchise in Washington state. When the couple entered divorce proceedings, McDonald's notified them that only one spouse could retain equity ownership in the corporation to keep the franchise.[34] The spouses agreed to divide their joint interest in the stock, and have Moriah redeem Joann's 50%.[35] Moriah redeemed Joann's stock for $450,000 of consideration, including debt forgiveness, cash, and Moriah's note, on which John was secondarily liable. This agreement was incorporated into the divorce decree.[36]

a. Arnes v. United States *(Joann Arnes)*

Joann initially reported capital gain from the redemption but later sued for a refund in federal district court. The district court found in Joann's favor, holding the redemption of her stock was "on behalf of" John within the meaning of Temp. Treas. Reg. § 1.1041-1T(c), Q & A 9.[37] The court reasoned that a transfer to a third party (here Moriah) would be "on behalf of" the nontransferring spouse when that spouse received *any benefit*. The court found that John received the benefit of having all future community property claims relieved by the redemption.[38]

The IRS appealed to the Ninth Circuit Court of Appeals, which rejected the "any benefit" test used by the district court, but still found in

32. Arnes v. United States, 981 F.2d 456 (9th Cir. 1992); Arnes v. Commissioner, 102 T.C. 522 (1994).

33. Arnes v. United States, 981 F.2d at 457.

34. *Id.*

35. The form used by the Arneses models Case 2 redemptions. *See supra* part II.A.

36. *Arnes*, 981 F.2d at 457.

37. Arnes v. United States, No. C90-728C, 1991 WL 82830 (W.D. Wash. Apr. 11, 1991), *aff'd on other grounds*, 981 F.2d 456 (9th Cir. 1992).

38. *Id.*

favor of Joann.[39] The court held that the transfer would be "on behalf of" the nontransferring spouse if the nontransferring spouse had an obligation that was relieved by the transfer.[40] The court reasoned that John was obligated to see the terms of the divorce decree through and that he was secondarily liable on the corporate note.[41]

b. Arnes v. Commissioner *(John Arnes)*

While *Arnes v. United States* was pending, the IRS asserted a deficiency against John Arnes, who then sued in the Tax Court.[42] The IRS argued that John had received a constructive dividend from Moriah and that, if the stock redemption were held to be a transfer to which § 1041 applies, John would automatically be liable for the tax burden. The IRS caused the court to delay the decision in John's case until the Ninth Circuit decided Joann's case.[43]

The Tax Court held that John Arnes could be liable for tax only if he had received a constructive dividend from Moriah on the stock redemption. Determining that the stock redemption did not discharge a "primary and unconditional obligation"[44] of John Arnes, the Tax Court held that he received no constructive dividend.[45] As a result, neither spouse was taxed on the withdrawal of corporate funds.

2. Blatt v. Commissioner

In a case arising in the Sixth Circuit, with facts similar to the *Arnes* cases, the Tax Court held that the "on behalf of" language of Temp. Treas. Reg. § 1.1041-1T(c), Q & A 9 did not shift gain recognition to the nontransferring spouse.[46] Gloria Blatt and her husband each owned stock representing 50% of the ownership of Phyllograph Corporation (the Corporation).[47] Incident to the divorce decree, the Corporation redeemed

39. *Arnes*, 981 F.2d at 459–60.

40. *Id.*

41. The court also noted that under state law, if the corporation defaulted, Joann could sue John without seeking any recourse against the corporation. *Id.*

42. Arnes v. Commissioner, 102 T.C. 522 (1994).

43. *Id.* at 526.

44. This is the long-accepted standard for constructive dividends as adopted in Rev. Rul. 69-608, 1969-2 C.B. 42.

45. *Arnes*, 102 T.C. at 530.

46. Blatt v. Commissioner, 102 T.C. 77 (1994).

47. *Id.* at 78.

Gloria Blatt's stock for consideration of $45,384.[48] Mrs. Blatt did not recognize any gain on the transaction and the Commissioner claimed a deficiency.[49] Mrs. Blatt sued in the Tax Court.

A majority of the court stated that the issue was whether the redemption of Mrs. Blatt's stock by the Corporation was "on behalf of" her husband within the meaning of Temp. Treas. Reg. § 1.1041-1T(c).[50] It reasoned that a transfer of property by one spouse is "on behalf of" the nontransferring spouse in the limited situation where: (1) the nontransferring spouse owes a debt or is obligated to a third party, and (2) the other spouse transfers property to discharge (in whole or in part) the nontransferring spouse's obligation.[51] Without giving specific reasons, the court held that the stock redemption was not "on behalf of" Mr. Blatt as he did not have an obligation to the third-party corporation.[52] The Tax Court majority explicitly disagreed with the Ninth Circuit's decision in *Arnes v. United States.*[53]

Judge Halpern, in a concurring opinion, argued that the majority failed to clearly articulate its reasons for disagreeing with *Arnes v. United States* and gave no indication as to how it would decide if confronted with Arnes-type facts.[54] Thus, in at least Judge Halpern's opinion, the issue of when or whether a stock redemption is "on behalf of" the nontransferring spouse was not settled by the *Blatt* majority.

In a separate concurring opinion, Judge Beghe outlined yet another interpretation of the "on behalf of" language in the temporary regulation. In Judge Beghe's opinion, a stock redemption would not be "on behalf of" the nontransferring spouse unless it discharges the nontransferring spouse's "primary and unconditional obligation" to purchase the stock.[55]

There were a total of five opinions[56] issued in *Blatt*, indicating that even after *Blatt*, the application of the "on behalf of" language in the temporary regulations to a stock redemption at divorce is hardly a settled

48. *Id.*

49. *Id.*

50. *Id.* at 80–81.

51. *Id.* at 81.

52. *Id.* at 82.

53. "[W]e do not agree with *Arnes* and respectfully refuse to follow it." *Id.* The court found the fact that John Arnes was secondarily liable on the corporate note and that McDonald's required sole ownership of the corporation by one spouse to be distinguishable facts. *Id.* at 82–83.

54. *Id.* at 84 (Halpern, J., concurring).

55. *Id.* at 85 (Beghe, J., concurring).

56. The majority opinion was issued by Judge Laro, Judge Cheichi issued a concurring opinion in addition to Judges Halpern and Beghe, and Judge Parr dissented.

matter. What is clear after the decision, however, is the existence of a conflict between the Ninth Circuit and the Tax Court sitting in the Sixth Circuit.

3. *Hayes v. Commissioner*

Both the *Arnes* and *Blatt* stock redemptions were Case 2 redemptions,[57] where stock is owned by both spouses, one of whom redeems stock incident to a divorce agreement. A Case 3 fact pattern[58] reached the Tax Court in the consolidated case of Mary Ruth and Jimmy Hayes.[59] Mr. and Mrs. Hayes were the sole shareholders of JRE Corporation (JRE) through which they operated a McDonald's franchise.[60] Jimmy Hayes owned a majority of the stock of JRE, and Mary Ruth Hayes owned the remainder.[61] As with the Arneses, McDonald's required that only one spouse have sole ownership of JRE after the divorce.[62]

Unlike the *Arnes* cases, the Hayeses entered into a separation agreement which obligated Mr. Hayes to purchase Mrs. Hayes's shares for $128,000.[63] After the separation agreement was incorporated into the divorce decree, Mr. Hayes's attorney proposed to have Mrs. Hayes redeem her shares to JRE instead of having Mr. Hayes buy them.[64] The reasons given for this change were Mr. Hayes's lack of cash, and the expectation that the resulting tax to Mrs. Hayes would be lower than if Mr. Hayes withdrew money from JRE to buy the stock.[65]

Thereafter, JRE redeemed Mrs. Hayes's stock, and the divorce court entered a *nunc pro tunc* order "correcting" the divorce decree to include a provision requiring JRE to redeem Mrs. Hayes's shares.[66] Neither spouse reported any gain from the transaction, and the Commissioner

57. *See supra* part II.A. (Joint ownership of stock is dissolved; one spouse redeems his or her resulting interest).

58. *See supra* part II.A. (One spouse retains ownership of stock, agreeing to compensate the other, corporation discharges that obligation).

59. Hayes v. Commissioner, 101 T.C. 593 (1993).

60. *Id.* at 595.

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.* at 596.

determined deficiencies against both.[67] The cases went to the Tax Court and were consolidated to prevent the possibility of the whipsaw. The IRS agreed that if the court found one spouse responsible for the recognition of gain on the redemption, it would drop its claim against the other. [68]

The court was faced once more with the issue of whether a stock redemption by a divorcing spouse was made "on behalf of" the nonredeeming spouse within the meaning of Temp. Treas. Reg. § 1.1041-1T(c), Q & A 9. In the consolidated case, the Commissioner chose to argue that the redemption of Mrs. Hayes's shares was "on behalf of" Jimmy Hayes. The court dismissed the validity of the *nunc pro tunc* order[69] and framed the dispositive question as whether Mr. Hayes had a "primary and unconditional obligation" to buy Mrs. Hayes's shares.[70] If Mr. Hayes had such an obligation, according to the court, the use of JRE's assets to discharge the obligation was a constructive dividend to him.[71] Further, the stock redemption by Mrs. Hayes would be a transfer of property "on behalf of" Mr. Hayes, and she would not recognize gain by virtue of § 1041.[72]

The court so held, adding that the obligation of Mr. Hayes continued until the time that JRE redeemed Mrs. Hayes's shares. Accordingly, the court held that Mr. Hayes received a taxable constructive dividend.[73] Thus, the Commissioner conceded that as to Mrs. Hayes, the redemption was a transfer of property for which no gain was recognized pursuant to § 1041.[74]

The negative implication of the Commissioner's concession is that where a nontransferring spouse has a "primary and unconditional obligation" to buy the shares of the other spouse which is discharged by the corporation, the transfer of stock will be "on behalf of" the nontransferring spouse.[75] This may be the outcome where, as in *Hayes*, both cases are consolidated in front of one court. However, even the *Hayes* court recognized the remaining possibility of extending Temp. Treas. Reg. § 1.1041-1T(c) to stock redemptions where there is no

67. *Id.* at 597.

68. *Id.* at 606.

69. *Id.* at 603.

70. *Id.* at 598–99.

71. *Id.* at 599.

72. *Id.*

73. *Id.* at 605.

74. *Id.* at 606.

75. *See* Blatt v. Commissioner, 102 T.C. 77, 85 (1994) (Beghe, J., concurring).

constructive dividend.[76] Thus, there is still room for the spouses in a Case 3 redemption to whipsaw the IRS if the obligation of the nontransferring spouse is not "primary and unconditional," or if the cases are not consolidated.

4. *Summary of Decisions*

The conflicting decisions of the courts in these cases have left divorcing spouses little certainty. The courts have focused on whether a transfer of stock from a divorcing spouse to the third-party corporation is "on behalf of" the nontransferring spouse. As *Blatt*, *Hayes*, and the *Arnes* cases illustrate, courts have disagreed on the appropriate resolution of this issue.

Courts have used at least four different tests to determine when a transfer by a transferring spouse will be "on behalf of" the nontransferring spouse: (1) whether the nontransferring spouse receives any benefit from the transfer;[77] (2) whether the nontransferring spouse had an obligation that was relieved by the transfer of stock to the corporation;[78] (3) whether the nontransferring spouse has an obligation to transfer property to a third party that is discharged by the transfer of property to the third party by the transferring spouse;[79] and (4) whether the nontransferring spouse has a "primary and unconditional obligation" to buy the property of the transferring spouse, and causes the obligation to be discharged by the third-party corporation.[80]

Thus, the answer to the question of which spouse should be taxed on a stock redemption incident to divorce currently depends on which of these tests a court elects to apply. The possibility of the whipsaw (as seen in the *Arnes* cases) arises when the parties bring their cases in different venues and different tests are applied to each spouse. That is to say, a single stock redemption may be said to be "on behalf of" the nontransferring spouse under one test, but not under another.

76. "Even if we were not to agree with respondent that Mr. Hayes should bear the tax associated with the transaction at issue here, a question may still arise as to whether sec. 1041 would in any event protect Ms. Hayes from recognizing a long-term capital gain on the disposition of her stock." *Hayes*, 101 T.C. at 598 n.3.

77. Arnes v. United States, No. C90-728C, 1991 WL 82830 (W.D. Wash. Apr. 11, 1991), *aff'd on other grounds*, 981 F.2d 456 (9th Cir. 1992).

78. Arnes v. United States, 981 F.2d 456 (9th Cir. 1992).

79. *Blatt*, 102 T.C. 77.

80. *Hayes*, 101 T.C. 593; *Blatt*, 102 T.C. at 85 (Beghe, J., concurring).

III. AFTERMATH OF THE DECISIONS

These conflicting decisions have opened the door to spouses looking to escape taxation. Giving spouses control over who will recognize gain on property can work only if they treat the transfer consistently. If one spouse transfers appreciated property to the other, and does not recognize gain pursuant to I.R.C. § 1041, the gain will be preserved only by a carryover basis. This happens in transfers between spouses where no third party is involved. When the property is transferred to a third party, gain is recognized by the transferor.

Because inconsistent judicial decisions have extended § 1041 nonrecognition to certain property transfers to third parties, there is an opportunity for spouses to treat property transfers inconsistently. This occurs where one spouse, incident to the divorce property settlement, first agrees to bear the tax burden on stock to be redeemed, and then undergoes a change of mind, seeking nonrecognition under § 1041.[81] It is difficult to expect spouses to treat a transfer of property consistently for tax purposes when one who has agreed to bear the tax burden chooses not to some months later.

A. Frustration of the Policy of Deferral

The possibility of escaping taxation under this regime frustrates the goal of § 1041: the deferral of gain recognition until property is transferred to a third party.[82] Under § 1041, spouses are given control over when and to whom the recognition of gain will fall. Deferred gain is preserved by the carryover basis requirement of § 1041(b).[83] This consistency requirement of § 1041 effectuates the policy of deferral and prevents the possibility of the whipsaw.

Nevertheless, the manner by which § 1041 has been applied to stock redemptions incident to divorce has encouraged the whipsaw and the very maneuvering it was enacted to prevent. The frustration of the policy of deferral leads to two problems surrounding stock redemptions incident to divorce: the inequitable division of assets and the possibility of the whipsaw.

81. Arnes v. Commissioner, 102 T.C. 522, 525 (1994).

82. *See supra* part I.B.

83. I.R.C. § 1041(b) (1988).

B. Inequitable Division of Assets

Apportioning marital assets as equitably as possible at divorce usually is desirable. To accomplish this, it is necessary to take the potential tax burden of appreciated property into account at the time the marital property is divided by the state court.[84]

The confusion surrounding the taxation of stock redemptions incident to divorce creates two problems in this area. First, it may be difficult at the time of the property settlement to predict which spouse will recognize gain on the redemption of stock. This leads to expense and inconvenience as many divorcing spouses must solicit private letter rulings from the IRS to ensure a fair dissolution of property.

A second outcome arises when the expectations of the spouses are not fulfilled. It may be the case that the state divorce court will divide property on the understanding that one spouse will recognize the gain on the redemption of stock.[85] If these expectations are frustrated by the courts' application of the "on behalf of" provision, an inequitable division of marital assets may result.

Suppose that spouses *A* and *B* enter into divorce settlement proceedings. The only asset of *A* and *B* is 100 shares of a closely held corporation which they jointly owned, with a basis of 10 and a value of 100. Suppose further that an equitable division of the marital assets will be achieved only by a fifty-fifty division, and it is agreed that *A* should not remain as a shareholder. At first glance it may seem that dividing the stock in half and redeeming *A*'s shares would be fair. However, *A* would dispose of fifty shares with a basis of five and a value of fifty, so there would be a taxable gain of forty-five. On basic tax principles, the gain would have to be recognized by someone.

If it is agreed that *A* should recognize the gain on the redemption, it will be necessary to give *A* more than fifty shares to effect a fifty-fifty division of the assets to account for the tax payable. Suppose that *A* initially pays tax on the gain, but some time later decides to sue for a refund arguing that the redemption was a transfer of property "on behalf of" *B* within the meaning of Temp. Treas. Reg. § 1.1041-1T(c). If the

84. Roland Hjorth, *The Effect of Federal Tax Consequences on Amounts of Property Allocated to Spouses in State Court Dissolution Proceedings*, 24 Fam. L.Q. 247 (1990) Professor Hjorth notes that state courts generally do not take inherent tax liabilities into account when structuring divorce settlements. However, there are exceptions, including circumstances where the divorce decree itself will require the sale of property with a tax burden. *Id.* at 252. That certainly would be the case where a couple holds stock in a closely held corporation.

85. *Id.*

court applies a test favorable to *A*, *B* may have to recognize the gain of forty-five. The net result is a dissolution of the marital assets that gives A more than fifty percent.

C. The Whipsaw

As evidenced by the *Arnes* decisions, the possibility of the whipsaw exists in stock redemptions incident to divorce. The conditions most favorable to the whipsaw exist when the spouses' cases are not consolidated, when the courts apply different tests to measure whether a transfer is "on behalf of" the nontransferring spouse, and when a spouse has changed his or her mind.[86] While it appears that the decision in *Blatt v. Commissioner* and private letter rulings have eliminated the possibility of the whipsaw in these transactions, the *Arnes* decisions still stand.

IV. THE IRS'S CURRENT POSITION

A. Private Letter Rulings

The IRS has attempted to reconcile the cases through private letter rulings.[87] In two of these,[88] the IRS applied the "on behalf of" language of Temp. Treas. Reg. § 1.1041-1T(c), Q & A 9 to Case 2 fact patterns.[89] In both cases, the IRS ruled that I.R.C. § 1041 covered the transactions. Two separate transfers of property were identified: (1) a stock transfer from one spouse to the other, and (2) a transfer of stock to the third-party corporation. The IRS respected the first as a § 1041 nonrecognition transfer, but held that gain would be recognized on the second transfer by the redeeming spouse.[90]

The IRS first analyzed the issue in these rulings by raising the step-transaction doctrine.[91] The question was whether the stock redemption should be respected as an independent transfer of property by a

86. *See* Arnes v. United States, 981 F.2d 456 (9th Cir. 1992); Arnes v. Commissioner, 102 T.C. 522 (1994).

87. *IRS Holds Transferee Has Gain in Arnes-Type Redemption*, 81 J. Tax'n 261 (1994).

88. Priv. Ltr. Rul. 94-27-009 (July 8, 1994); Priv. Ltr. Rul. 90-46-004 (July 20, 1990).

89. *See supra* part II.A. (Pursuant to a divorce decree, *H* transfers stock to *W*, *W* redeems stock to corporation).

90. Priv. Ltr. Rul. 94-27-009 (July 8, 1994).

91. *See, e.g.*, McDonald's Restaurants v. Commissioner, 688 F.2d 520 (7th Cir. 1982). *McDonald's* is an example of the application of the step-transaction doctrine generally. It is not directly an application of the doctrine to a stock redemption at divorce case, of which none have been found by this author.

stockholder, or recharacterized as a constructive redemption by the other spouse, followed by a transfer of the proceeds.[92] There is no question that spouses in a Case 1 transfer could accomplish the same outcome through different means. The spouse originally owning the shares could cause shares to be redeemed, and thereafter transfer the proceeds to the other spouse. Such a situation is ordinarily a prime case for the application of the step transaction doctrine.

Nevertheless, the IRS did not apply the step transaction doctrine, citing § 1041. According to the IRS, § 1041 (and specifically Temp. Treas. Reg. § 1.1041-1T(c)) contemplated that the spouse who exercises sufficient ownership over property transferred to a third party would recognize gain.[93] It found that the redeeming spouse exercised sufficient ownership control in the agreement to redeem the shares immediately after receiving them, thus causing the spouse who redeemed the shares to recognize gain.[94]

The IRS position can be summarized from a review of the private letter rulings and its arguments in the cases. Essentially, the policy of § 1041 is interpreted to be satisfied: (1) if the spouse who exercises the control over the stock sufficient to cause it to be redeemed will recognize gain (usually, the transferring spouse);[95] and (2) the nontransferring spouse will be taxed only where a primary and unconditional obligation to buy the shares of the transferring spouse is discharged by the corporation.[96]

It is unclear whether this position will continue to be applied through letter ruling only, or if it will be reduced to regulation.[97] The American Institute of Certified Public Accountants (AICPA) has proposed amendments to the regulations under § 1041 that would codify the IRS's position.[98] The AICPA proposal would add two examples to the

92. Priv. Ltr. Rul. 90-46-004 (July 20, 1990).

93. Priv. Ltr. Rul. 94-27-009 (July 8, 1994); Priv. Ltr. Rul. 90-46-004 (July 20, 1990).

94. Priv. Ltr. Rul. 94-27-009 (July 8, 1994). In the ruling, the IRS noted the fact that the transferring spouse was not technically obligated by the divorce decree to redeem the shares..

95. Thus, the "on behalf of" language of the temporary regulation presumably would not apply to individuals like Joann Arnes. However, the IRS continues to distinguish *Arnes v. United States* in letter rulings. *See* Priv. Ltr. Rul. 94-27-009 (July 8, 1994).

96. *E.g.*, Hayes v. Commissioner, 101 T.C. 593 (1993).

97. Some have argued that the letter rulings are sufficient to settle the issue. *See IRS Holds Transferee Has Gain in Arnes-Type Redemption*, 81 J. Tax'n 261 (1994).

98. American Institute of Certified Public Accountants, *AICPA Domestic Relations Task Force Proposes Regulatory Changes (Part 3, "Proposal for Changes to Temp. Treas. Reg. Section 1.1041-1T(c), Q & A 9 — Regarding Stock Redemptions Incident to Divorce")*, 95 Tax Notes Today 61-30 (Mar. 29, 1995).

temporary regulations under § 1041. The first proposed example is based on Case 2 facts.[99] It applies § 1041 nonrecognition to the division of ownership of the stock, but not to the subsequent redemption by one spouse.[100] Thus, the exercise of ownership in the form of the redemption causes gain recognition. The second proposed example is based on Case 3 facts.[101] The discharge of a primary and unconditional obligation by the corporation is considered a transfer "on behalf of" the continuing shareholder.[102] Whether or not examples like those proposed by the AICPA are adopted, it is reasonable to expect that the IRS will continue to apply the principles embodied in them.

B. *What's Wrong with This Solution*

The approach taken by the IRS is similar to the argument made by Judge Beghe in *Blatt v. Commissioner.*[103] Although providing a greater degree of uniformity in determining outcomes in the cases, this approach is flawed in a number of ways. All of these are reducible to the continuing frustration of the policy of deferral underlying § 1041.[104]

First, the IRS has improperly applied the "exercise of control" standard to stock redemptions incident to divorce. It is disingenuous to argue that a divorcing spouse exercises control over stock by providing for its disposition before it is transferred from the other spouse. When a couple's largest asset is closely held stock, it is often impossible for both to remain as shareholders after divorce. In such situations it is necessary to redeem some of the stock. This decision is made by both spouses, with court approval or mandate. Further, the decision to redeem stock benefits both spouses by accomplishing the division of marital property and finalizing property claims.

Thus, the decision to redeem shares is made well before the spouse who ends up redeeming the actual shares may ever own them, and the decision is not made by that spouse alone. Instead, both spouses agree

99. *See supra* part II.A. (Couple own stock jointly, divorce decree requires division of stock, and the redemption of the stock by one spouse).

100. American Institute of Certified Public Accountants, *supra* note 98.

101. *See supra* part II.A. (Divorce decree awards all stock to one spouse, and requires that spouse to pay the other. Thereafter, the stockholder causes the corporation to discharge that obligation).

102. *See supra* note 80 and accompanying text.

103. 102 T.C. 77, 85 (1994) (Beghe, J., concurring) ("[N]o redemption should be considered to be 'on behalf of' the remaining spouse unless it discharges that spouse's primary and unconditional obligation to purchase the subject stock. . . .").

104. *See supra* part III.A.

that one should continue as a shareholder, and the other should receive assets from the corporation.[105] The redemption itself is a mere step in the process of equitably allocating marital claims. Under these circumstances, it is difficult to accept the formal "ownership exercise" reasoning proffered by the IRS in causing gain to be recognized by one spouse.

Further, it remains theoretically possible for both spouses to recognize gain under the approach taken by the IRS. So long as there is some degree of overlap between the test of primary and unconditional obligations and the exercise of ownership control test, this possibility lingers. Suppose that a divorce decree awards all of the previously jointly held stock of spouses *A* and *B* to *B*, and further requires *B* to pay *A* for the value of *A's* interest in the stock. Suppose also that the corporation is secondarily liable for the obligation. Thereafter, prior to *B* receiving sole ownership of the stock, suppose *B* defaults on the obligation to *A*, and *A* receives satisfaction of the obligation from the corporation. In this case, the corporation has discharged a primary and unconditional obligation of *B*. It may also be argued that *A* has exercised control over the one-half interest in the shares by requiring the corporation to pay for the stock, transferred to *B*.

This outcome is possible where the spouses bring their claims in different venues.[106] Consolidation of cases is preferable, but not always possible, so long as people have freedom to brings claims where they wish. Presumably, however, both spouses will not be taxed because the IRS will allow nonrecognition to extend to one spouse, conditioned on the recognition of gain by the other.[107] However, even when the IRS has provided for such a conditional outcome, as in *Hayes*, the court has noted

105. It may appear that this is also true with more common "buy-sell" agreements. That is, when a closely held corporation is formed, shareholders usually enter into agreements that require shares to be redeemed under explicit circumstances (usually death or retirement of shareholders). In these cases, the shareholders are together deciding before the fact when, and under what circumstances, shares will be redeemed. Remaining shareholders benefit from these agreements by ensuring that control will remain in the hands of a few, predetermined individuals. However, these buy-sell agreements differ significantly from stock redemptions incident to divorce. Buy-sell agreements are entered into on the expectation that the shareholders will continue as equity holders in the corporation for a significant period of time. The triggering circumstances are distant. A divorcing spouse, on the other hand, may have transitory "ownership" of the stock to effectuate the property settlement. There is often no expectation of holding equity in the corporation beyond the limited settlement purposes. Instead, the stock is a mere tool in the process of splitting up property. *But see* Arnes v. Commissioner, 102 T.C. 522, 538–41 (1994) (Beghe, J., concurring).

106. *E.g.*, *Arnes*, 102 T.C. at 530.

107. *E.g.*, Hayes v. Commissioner, 101 T.C. 593 (1993).

the overlap of the two standards employed in the IRS's approach to the cases.[108]

Conversely, the possibility of the whipsaw has not been eliminated. The IRS continues to distinguish *Arnes v. United States* in its letter rulings.[109] The overlap of the primary and unconditional obligation test, and the exercise of control test allow for the lingering presence of the whipsaw. With a redeeming spouse in front of it, one court may find that the remaining spouse had a primary and unconditional obligation discharged by the corporation. With the remaining shareholder spouse in front of it, another court may find that the obligation did not rise to this level, but that the redeeming spouse exercised ownership control over the stock.

So long as both spouses bring consolidated cases, and the IRS agrees that only one should recognize gain, these problems disappear. However, this will likely continue to be impossible. Even if it were possible, the formal approach taken by the IRS continues to allow for the frustration of the policy of deferral in other ways. Specifically, the problems of changing minds[110] and the inequitable division of assets[111] persist.

Although spouses together may decide that one of them will continue as a shareholder and the other will receive corporate assets in exchange for the shares, neither is given control over who will recognize gain from the withdrawal of corporate assets.[112] Instead, gain recognition rests on the formal determination of which spouse was the last in control of the redeemed stock. This formal inquiry does not lessen the necessity for spouses to receive letter ruling approval from the IRS, nor does it give spouses reason to stop maneuvering against one another.

V. PROPOSED STATUTORY AMENDMENT

A. Giving Spouses Control: A Clear Consistency Requirement

In place of the formal "exercise of ownership" inquiry, I.R.C. § 1041's policy of deferral should be carried through by giving the spouses the freedom to choose who will be taxed. The best vehicle for

108. *See supra* note 76.

109. *See* Priv. Ltr. Rul. 94-27-009 (July 8, 1994).

110. *See supra* part III.

111. *See supra* part III.B.

112. This applies except to the extent that the spouses strictly comply with the formal requirements as applied by the IRS.

this freedom of choice is an amendment to I.R.C. § 302.[113] Together with I.R.C. §§ 316, 317, and 301, § 302 controls whether a stock redemption will be taxed as an exchange of property or a shareholder dividend.[114] Amending § 302 would be preferable to amending § 1041. This would keep the newly created "incident to divorce" standard in § 302 separate from the one currently embodied in § 1041. Further, the language of an amendment should refer internally to parts of § 302.

The amended code section[115] would apply only to situations in which the redemption of stock is required by a divorce decree, or other agreement incident to divorce.[116] In such cases, the parties would be obligated to file a letter with the IRS, signed by both spouses. The letter would describe the contemplated redemption and state to which spouse any tax consequences would attach.[117] Thereafter, the spouses would be required to conduct themselves according to the terms of the letter.

The proposed amendment fits within the framework of § 1041 by providing that where property is transferred to a third party, one spouse will be taxed. In consolidated cases and letter rulings, the IRS has held that only one spouse should recognize gain on the redemption of stock incident to divorce.[118] Accordingly, it should not matter to the government which spouse will recognize gain, as long as it is assured that one, and only one, will.[119] In light of this, divorcing spouses should be given the freedom to determine who will bear the tax burden at the same time they both agree on who will remain as a shareholder and who will receive corporate funds.

113. I.R.C. § 302 (1988).

114. "If a corporation redeems its stock (within the meaning of § 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock." I.R.C. § 302(a) (1988).

115. For the text of the proposed amendment, *see infra* note 135.

116. "Incident to divorce" is defined to include transfers of property related to the "cessation of the marriage" or transfers within one year of divorce. I.R.C. § 1041(c). The proposed amendment would further limit the scope of "incident to divorce" by including only those redemptions required by a divorce agreement. *See infra* note 135.

117. *See* I.R.C. § 302(c) (1988) (requiring filing of letter by terminating shareholder that obligates taxpayer to have no impermissible interest in corporation for term of years).

118. *E.g.*, Hayes v. Commissioner, 101 T.C. 593 (1993); Priv. Ltr. Rul. 94-27-009 (July 8, 1994).

119. The only difference could be the character of the gain. One spouse may receive capital gain treatment under § 302, while the other may receive a taxable dividend. This difference has no impact on the present argument, because under the IRS's current position, the redeeming spouse will almost always recognize capital gain. *See supra* part IV. This is the case because the spouse who exercises control of the stock being redeemed usually will be making a complete termination of his or her interest and thus be entitled to capital gain treatment under I.R.C. § 302(a) by virtue of § 302(b)(3).

B. *Advantages of the Proposed Amendment*

Taxing stock redemptions incident to divorce in this manner would have many advantages, among them: (1) giving effect to the policy of deferral; (2) providing certainty to the spouses, and thereby eliminating the inconvenience and expense of obtaining letter rulings; and (3) bringing the recognition of gain at divorce into line with the realities of marital property dissolution.

1. *Furthering the Policy of Deferral*

There is no chance of double taxation or whipsaw where divorcing spouses are made to decide which of them will recognize gain in a contemplated stock redemption. This is especially true if they are required to inform the IRS of the decision. Presently, buoyed by decisions permitting both spouses to escape taxation,[120] opportunistic spouses who first expected to recognize gain are trying to transfer that gain to their former spouses.[121]

The best way to foreclose the opportunities for escaping or transferring taxation is to require spouses to decide up front who will be taxed. Knowing that the letter filed with the IRS is binding, divorcing spouses will not have any room to change their minds and whipsaw the government. Thus, the deferral sought under § 1041 is ensured. Because property is being transferred to a third party, one spouse is taxed; the proposed amendment is a vehicle for the spouses to choose which one.

2. *Certainty*

In light of the inconsistent judicial decisions, divorcing spouses presently seeking absolutely certain tax treatment of a stock redemption incident to divorce need to petition the IRS for a private letter ruling. This is expensive and time-consuming. If the spouses are permitted to decide for themselves who will be taxed, the need for letter rulings would be eliminated. The certainty of this process would facilitate the equitable division of marital assets at divorce[122] because the tax liability could be clearly accounted for.

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120. *See* Arnes v. United States, 981 F.2d 456, 457 (9th Cir. 1992).

121. *See* Blatt v. Commissioner, 102 T.C. 77, 78 (1994).

122. *See supra* part III.B.

3. *Accordance with Reality of Divorce*

The IRS has based its holdings on the proposition that a divorcing spouse exercises ownership control by directing stock to be redeemed.[123] However, the realities of divorce call for different presuppositions. A divorcing couple that owns stock in a closely held corporation usually will not remain as co-shareholders. There may be a number of reasons for this: a requirement by franchise agreement,[124] the inability to get along, or one's desire for cash instead of an equity interest in a corporation. Regardless of the reasons, the decision to redeem some of the stock is made by, and for the benefit of, both spouses.

In light of this, divorcing spouses should not be taxed on the presumption that the last one to formally direct the disposition of the stock really transferred it to the third party. The spouses decide that one should remain as a shareholder, and the other should not. They decide to use corporate assets, through a stock redemption, to compensate the spouse who will not continue as a shareholder. The continuing shareholder benefits by satisfying marital property claims, and by gaining a greater control interest in the corporation.[125] The noncontinuing shareholder benefits by receiving cash or other property. Because the spouses decide together to redeem stock, and because both benefit from the decision, they should be allowed to decide who will be taxed on the redemption.

C. *Scope of the Proposed Amendment*

The proposed amendment would apply to cases where an agreement incident to divorce contemplates the redemption of closely held stock.[126] Thus, the letter would be filed only when an agreement, formal or informal, mandates a stock redemption to satisfy marital property rights. There are two cases that are not covered by the scope of the proposed amendment: (1) where a divorce instrument divides stock between spouses, and where one of the spouses, not pursuant to any divorce agreement, thereafter redeems stock; and (2) where one spouse has a primary and unconditional obligation to transfer cash or property to the other and causes the corporation to discharge that obligation. A third

123. *See supra* part IV.A.

124. *E.g., Arnes*, 981 F.2d at 457; Hayes v. Commissioner, 101 T.C. 593 (1993).

125. Alan L. Feld, *Divorce and Redemption*, 64 Tax Notes 651, 655 (1994).

126. *See infra* note 135.

case, where the redemption is contemplated by a divorce agreement but where the parties do not agree on who will recognize the gain and do not file a letter with the IRS, needs to be addressed by the proposed amendment.

1. Independent Redemption

To satisfy marital property claims, a divorce property settlement may divide jointly held stock, or it may require one spouse to transfer stock to the other. It is entirely possible that both spouses will expect to continue as shareholders. In such cases, no redemption will be contemplated at the time of divorce. However, one of the former spouses may thereafter redeem shares.

These cases are not covered by the proposed amendment because no redemption is required by a divorce agreement. In this case, a shareholder has caused stock to be redeemed, independent of any agreement with the former spouse. This case also is outside the scope of § 1041 because it is not a transfer to a spouse or former spouse, nor "on behalf of" a former spouse. Accordingly, the spouse who redeems the shares should recognize gain.

2. Discharge of a Primary and Unconditional Obligation

If a spouse discharges a primary and unconditional obligation to transfer cash or property to a former spouse by using assets of a corporation, the transfer is outside the scope of the proposed amendment. This is because no redemption was required by a divorce agreement. Rather, it is a transaction covered in Rev. Rul. 69–608.[127] Thus, the transfer of property from the corporation to the former spouse is a constructive dividend to the spouse whose obligation was discharged.[128]

This is treated as a deemed distribution by the corporation to the shareholder spouse, who thereafter transfers the proceeds to the former spouse incident to divorce. No gain is recognized by the former spouse on this deemed transfer of the proceeds under § 1041.

127. Rev. Rul. 69-608, 1969-2 C.B. 42.

128. *See Hayes*, 101 T.C. at 599.

3. *Spouses Fail To Agree*

If a divorce agreement contemplates the redemption of stock, but the spouses fail to agree on who will be taxed, the old "on behalf of" inquiry would seem to have to be invoked. However, it would be unacceptable to provide certainty only for those who comply with the filing requirement, while allowing others to continue under the regime that exists under *Arnes v. United States*,[129] *Blatt v. Commissioner*,[130] and the "exercise of control" test.[131]

Certainty, and elimination of the possibility of the whipsaw, should be available not only where the spouses decide who will be taxed, but also where they do not. However, because the spouses in this case have not taken advantage of their ability to choose, the choice must be made for them. This imposed choice should reflect the realities of marital property dissolution but should not be a burden on the IRS.[132] It should account for the special nature of using closely held stock to divide marital property at divorce,[133] as well as the benefits that accrue to both spouses from the use of corporate assets.[134]

Taking these factors into account, the proposed amendment provides for the default treatment of cases where a stock redemption is required by a divorce agreement, but the spouses fail to agree as to who will recognize the gain. Specifically, in these cases, the proposed amendment provides for two deemed stock redemptions of one-half of the redeemed stock. Each spouse would be treated as having received the proceeds of one of the deemed stock redemptions.[135] Thus, if the spouses do not or cannot agree, the gain from the redemption would be shared equally.[136]

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129. 981 F.2d 456 (1992).

130. 102 T.C. 77 (1994).

131. *See supra* part IV.A.

132. This would be the case if the IRS was required to look into the facts of each case to determine the most fair allocation of the tax burden upon accounting for the division of property. This should remain the province of the state divorce court.

133. *See supra* part IV.B.

134. *See supra* text accompanying note 124.

135. The proposed amendment would read as follows:

(f) *Stock Redemptions Incident To Divorce* — This subsection shall apply to any redemption of stock by a corporation to a shareholder, incident to divorce.

(1) A redemption to which this subsection applies will be deemed to be two separate redemptions (one by each spouse or former spouse) of one-half of the shares of the redeemed stock, unless an agreement is filed with the Secretary pursuant to subsection (f)(2).

(2) If, at least 10 days before stock is redeemed, incident to divorce,

VI. CONCLUSION

Courts have been unable to consistently apply I.R.C. § 1041 and the corresponding regulations to stock redemptions incident to divorce. The resulting confusion and maneuvering room given to divorcing spouses should be overcome by an amendment to § 302 of the Internal Revenue Code. The amendment would provide divorcing spouses with the freedom to choose which of them will be taxed when a divorce agreement contemplates the stock redemption. This solution ensures that gain will be recognized and provides certainty and flexibility to divorcing spouses in planning for the equitable division of marital property claims. The amendment would also provide for instances where the spouses fail to decide who will be taxed by requiring the spouses to bear the tax burden equally. This can be accomplished by creating deemed redemptions of one-half of the stock by both spouses.

(A) both spouses agree as to which one of them will be treated as the shareholder who redeems stock incident to divorce, and

(B) an agreement, signed by both spouses, that names which spouse will be treated as the redeeming shareholder under subsection (f)(2)(A), is filed with the Secretary,

the spouse who agrees to be treated as the shareholder who redeems the shares, incident to divorce, will be so treated.

(3) *Incident to* divorce — For the purposes of this subsection, a redemption of shares is incident to divorce if a divorce decree or other agreement entered into by the divorcing spouses requires that shares in a corporation be redeemed within one year of divorce.

136. This is the theoretical treatment of stock redemptions entertained by Professor Chirelstein many years ago. Marvin Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 Yale L.J. 739 (1969).