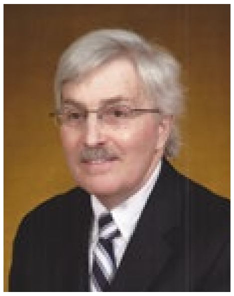

Use of Stock Redemptions

by which a Business Owner Spouse Buys Out the Other Spouse's Marital Interest Will Be a Good Fit in Many Situations

By Joseph W. Cunningham, JD, CPA

General

Use of a stock redemption can be a "tax-smart" way to structure a divorce-related buy-out of the non-owner spouse's marital interest in the stock. To do so, the owner spouse transfers stock to the non-owner, which is then immediately redeemed by the corporation. The difference between what the non-owner receives and the owner's carryover tax basis in the stock is taxed favorably as a capital gain or loss. Stock redemptions can be particularly suitable in the following circumstances:

- The company has excess liquidity.
- The stock has a relatively high tax basis, as is not uncommon if the company is an S corporation.
- The spouse who will not end up with the business individually owns stock.
- The owner spouse may not draw more compensation because of "reasonable compensation" tax constraints or legal restrictions.
- The dilution, if any, caused by the redemption will not be problematic for the owner spouse.

Other than in a divorce context, this approach would be treated by the IRS as a step transaction—the non-owner spouse's stock ownership would be considered merely transitory and lacking independent legal significance, which would result in a constructive dividend to the owner spouse. However, this technique is available in a divorce setting because of an expansive IRS interpretation of IRC 1041 incorporated in regulations issued by the IRS. Treas Reg 1.1041-2.

Regulations and Illustrations

The following example explains the essential provisions of the regulations by way of illustration:

- H and W each own 50 percent of ABC Company. They agree that H will continue to own and operate the company while W will tender her stock for redemption.
- H has at no time assumed a "primary and unconditional obligation" to acquire W's stock.
- He has agreed, however, (1) to cooperate in his role as a corporate officer and shareholder so that the company implements the planned redemption and (2) to guarantee the company's payment of the redemption proceeds.
- Because H does not have a "primary and unconditional obligation" to acquire W's stock before ABC redeems it, the redemption is not a constructive distribution to him.
- Thus, W will be taxed at the long-term capital gain rate on the difference between the redemption proceeds she receives and her tax basis in the stock.

In the above illustration, both spouses own stock in the company. It is more common, of course, for the interest in the company to be owned by one of the spouses. The regulations do not directly address the situation involving (1) one spouse—say, H—owning 100 percent of the stock and (2) a divorce settlement providing for the following transactions:

- H's transfer of 50 percent of his stock to W.
- W's tender of the stock to the company in redemption of her newly acquired stock interest.

Though not specifically addressed in the regulations, it appears that the tax treatment for this fact pattern would be the same that applies when both spouses initially own stock, as follows:

- The form of the transactions—(1) the nontaxable transfer under IRC 1041 of stock from, in our example, H to W, followed by (2) the redemption of W's stock taxable at capital gains rates—will be honored, provided H does not have a primary and unconditional obligation to pay W for her interest in the stock.
- Alternatively, if there is such a primary and unconditional obligation, the redemption distribution would be deemed constructively received by H and taxed to him as a dividend.

To illustrate, assume that H is the sole owner of the company and that, as part of his divorce settlement with W, they agree he will transfer a 50 percent interest to her, which she will tender to ABC in exchange for redemption proceeds. Though not expressly covered in the regulations, this fact scenario would appear subject to the following tax treatment:

- Provided H does not have a preexisting primary and unconditional obligation to pay W for her marital interest in the stock, the form of the two-step transaction will be honored for tax purposes.
- In effect, the transfer of the 50 percent interest from H to W as part of the divorce settlement will be tax free under IRC 1041, and the redemption distribution is not a taxable dividend to H.

A principal reason to assume the above tax treatment will apply when one spouse owns all the stock is the following statement in the background section of the regulations:

> "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."
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> 66 Fed Reg 40,659 (2001).

Viability of Redemptions in Divorce

Certainty of Tax Treatment. Provided there is no such primary and unconditional obligation, the parties may structure a divorce-related redemption with certainty of the tax treatment. Nonetheless, because things change, including the minds of divorcing parties, a savings clause appears advisable.

Guarantee Allowed. With the IRS's clear statement that a primary and unconditional obligation does not include a guarantee of another party's performance, there should be no concern to provide that the remaining shareholder guarantee the corporation's performance under the redemption agreement.

This is highly significant because, without a guarantee, it is conceivable, particularly where the remaining spouse would transfer a minority interest to the other spouse, that the remaining spouse would use his or her influence to obstruct the redemption, leaving the other spouse with a minority interest in a closely held company.

About the Author

Joe Cunningham *has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy, though his practice is statewide.*

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