

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9035]

RIN 1545-AX99

Constructive Transfers and Transfers of Property to a Third Party on Behalf of a Spouse

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the tax treatment of redemptions, during marriage or incident to divorce, of stock in a corporation owned by a spouse or former spouse.

DATES: *Effective Date:* These regulations are effective January 13, 2003.

Applicability Date: These regulations are applicable to redemptions of stock on or after January 13, 2003 that are pursuant to instruments in effect after January 13, 2003. These regulations are also applicable to redemptions before January 13, 2003 or that are pursuant to instruments in effect before January 13, 2003 if the spouses or former spouses execute a written agreement on or after August 3, 2001, that satisfies the requirements of § 1.1041-2(c)(1) or (2).

FOR FURTHER INFORMATION CONTACT: Edward C. Schwartz at (202) 622-4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:**Paperwork Reduction Act**

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1751. Responses to this collection of information are required for certain taxpayers to redeem stock in a corporation and utilize the special rule in § 1.1041-2(c) of these regulations.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent/recordkeeper varies from 20 minutes to one hour, depending on individual circumstances, with an estimated average of 30 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for

reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On August 3, 2001, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking under section 1041 relating to certain redemptions, during marriage or incident to divorce, of stock in a corporation owned by a spouse or former spouse (REG-107151-00)(2001-2 C.B. 370)[66 FR 40659]. Written and electronic comments were solicited, and a public hearing was scheduled for December 14, 2001. Several comments were received and are discussed below. Because no requests to speak were timely received, the public hearing was cancelled. After consideration of all comments received, the proposed regulations under section 1041 are adopted as revised by this Treasury decision.

Explanation and Summary of Comments*1. Special Rules in Cases of Written Agreements Between the Spouses*

The proposed regulations provided generally that if a corporation redeemed stock owned by a transferor spouse and the redemption resulted in a constructive distribution to the nontransferor spouse under applicable tax law, then the redemption would be taxable to the nontransferor spouse as if the nontransferor spouse had actually received the redemption proceeds. The proposed regulations contained a special rule in § 1.1041-2(c) allowing the spouses the option of treating the redemption as resulting in a constructive distribution to the nontransferor spouse, and therefore taxable to the nontransferor spouse, even if the redemption would not result in a constructive distribution to the nontransferor spouse under applicable tax law. The proposed regulations provided that the spouses could elect the special rule by providing in the divorce or separation instrument, or

other written agreement, that the spouses must file their Federal income tax returns in a manner that reflects that the transferor spouse transferred the redeemed stock to the nontransferor spouse in exchange for the redemption proceeds and the corporation redeemed the stock from the nontransferor spouse in exchange for the redemption proceeds. The proposed regulations also provided that the special rule would be effective for written agreements executed on or after August 3, 2001, that met these requirements.

Commentators expressed concern that the proposed regulations contained no provision addressing the situation where the redemption results in a constructive distribution to the nontransferor spouse under applicable tax law, but the spouses nevertheless would like to agree that the redemption will be treated as a redemption distribution to the transferor spouse. They suggested that the final regulations expand the special rule in § 1.1041-2(c) to allow the spouses to agree in the divorce or separation instrument, or other valid written agreement, that the redemption will be taxable to the transferor spouse notwithstanding that the redemption might otherwise result in a constructive distribution to the nontransferor spouse under applicable tax law.

The IRS and Treasury Department believe that this suggestion is consistent with the policy of section 1041 and its legislative history, which is to provide flexibility to spouses and former spouses concerning the structuring of their property transfers during marriage and incident to divorce. Accordingly, this suggestion has been adopted in § 1.1041-2(c) of the final regulations. *New Example 2* in § 1.1041-2(d) illustrates the application of this new special rule.

The manner of electing the special rule also has been modified somewhat in the final regulations. Under the final regulations, the spouses can elect the special rule by expressly providing, in a divorce or separation instrument or other valid written agreement, that expressly supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption, their mutual intent concerning whether the redemption should be treated as a redemption distribution to the transferor spouse or to the nontransferor spouse. The IRS and Treasury Department will treat a divorce or separation instrument or other valid written agreement executed on or after August 3, 2001, and before May 13, 2003 that meets the

requirements of the special rule of the proposed regulations as also meeting the requirements of the special rule in paragraph (c)(2) of the final regulations.

2. Constructive Distribution Standard

Some commentators also expressed concern that taxpayers and divorce practitioners may not be aware of the situations in which a redemption of stock owned by the transferor spouse could result in a constructive distribution to the nontransferor spouse under applicable tax law. They therefore suggested that the final regulations either provide that the redemption will be treated as a redemption distribution to the transferor spouse regardless of applicable tax law, unless the spouses provide otherwise in a written agreement and file their federal income tax returns accordingly, or provide specific definitions and examples of situations in which a redemption would result in a constructive distribution to the nontransferor spouse under applicable tax law.

The IRS and Treasury Department continue to believe that the approach in the proposed regulations is appropriate. Under existing tax law, a redemption of stock owned by one shareholder may result in a constructive distribution to another shareholder if such nonredeeming shareholder has a primary and unconditional obligation to purchase the redeeming shareholder's stock. See *Rev. Rul. 69-608* (1969-2 C.B. 42), *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947), and *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966). This "primary and unconditional obligation" standard applies to all redemptions, including those involving stock of closely held corporations by spouses or former spouses. A rule that provides that a redemption of stock owned by the transferor spouse will always be treated as a redemption distribution to the transferor spouse would be inconsistent with this established law. Furthermore, if taxpayers and divorce practitioners are uncertain about the application of the "primary and unconditional obligation" standard, they may take advantage of the special rules of § 1.1041-2(c), which permit spouses to avoid any question of whether a redemption results in a constructive distribution to the nontransferor spouse under applicable tax law relating to the primary and unconditional obligation standard by providing in a written agreement which spouse will bear the tax consequences of the redemption.

3. Withdrawal of § 1.1041-1T(c), Q&A-9

Section 1.1041-1T(c), Q&A-9, of the temporary Income Tax Regulations provides that there are three situations in which a transfer of property to a third party on behalf of a spouse or former spouse will qualify under section 1041 (provided all other requirements of that section are met): (1) if such transfer is required by the divorce or separation instrument; (2) if the transfer is pursuant to a written request of the other spouse; and (3) where the transferor spouse receives a written consent or ratification from the nontransferor spouse. Under Q&A-9, a transfer of property made to a third party on behalf of a spouse is treated first as a deemed transfer of the property made directly to the nontransferor spouse in a transfer to which section 1041 applies, and then as a deemed transfer of the property from the nontransferor spouse to the third party in a transaction to which section 1041 does not apply.

Two commentators recommended that Q&A-9 be withdrawn. They suggested that retaining that provision would lead to confusion since it would apply to all transfers of property other than stock redemptions while this final regulation would apply only to stock redemptions. Another commentator advocated replacing existing Q&A-9 with a single standard applicable to all transfers of property to third parties under which the tax consequences of the transfer would follow the transfer's form unless the spouses agreed in writing otherwise.

The "on behalf of" standard has not led to the same confusion and litigation outside the area of stock redemptions because, in such cases, it does not conflict with any other standard of tax law. See, e.g., *Ingham v. United States*, 167 F.3d 1240 (9th Cir. 1999). In addition, as discussed above, a single standard applicable to all transfers of property to third parties under which the tax consequences of the transfer would follow the transfer's form would be inconsistent with the primary and unconditional obligation standard applicable to stock redemptions under existing tax law. Consequently, the IRS and Treasury Department continue to believe that the final regulations should be limited to stock redemptions and that Q&A-9 should not be withdrawn.

4. Use of IRS Form To Designate Intent

One commentator proposed that the final regulations include a requirement that the spouses or former spouses attach a form to their Federal income tax

returns showing which spouse or former spouse has the tax consequences of the redemption. After careful consideration, the IRS and Treasury Department have concluded that requiring spouses, and particularly spouses who have divorced or are divorcing, to complete and file an additional form in order to obtain the result of the special rules would unnecessarily increase the administrative burden on taxpayers and on the IRS. The divorce or separation instrument, or other valid written agreement of the spouses, provides adequate evidence of the spouses' intent regarding which spouse has the tax consequences of the redemption.

5. Legal Guardians and/or Executors of Estates of Spouses

One commentator suggested that the final regulations provide specific authority for a legal guardian of a spouse or former spouse or the executor of a spouse's or former spouse's estate to elect the application of one of the special rules of § 1.1041-2(c). However, a legal guardian, custodian, or executor of an estate that has the general authority to act on behalf of a spouse or former spouse (or his or her estate) for federal income tax purposes needs no additional or special authority to elect one of the special rules under § 1.1041-2(c). Accordingly, this suggestion has not been adopted.

6. Other Changes

In an effort to improve the clarity of the final regulations, the order of the two paragraphs in § 1.1041-2(a) has been reversed and conforming changes have been made in the remainder of the final regulations. Also, the final regulations remove the provision of the proposed regulations that would have limited their application to transactions in which both spouses or former spouses own stock immediately before or after the redemption. On further reflection, the IRS and Treasury Department believe it is appropriate to apply the regulations to all stock redemptions, regardless of whether both spouses own stock of the corporation before or after the redemption.

7. Effective Date

One comment was received suggesting that the effective date provision of the final regulations be changed to include all stock redemptions that were pending on the day the proposed regulations were issued (August 2, 2001) and to include all cases involving stock redemptions at issue on that date at any level of audit, review, appeal, or collection by the IRS or before the Tax Court or any other

federal court. It was argued that this proposal would be consistent with the current state of the law and would resolve numerous cases involving taxpayers and the IRS. Adopting this suggestion would have the effect of making the application of the final regulations retroactive. Apart from the special rules of § 1.1041-2(c), which are based upon the stated intent of the spouses, the IRS and Treasury do not believe it is appropriate to apply the final regulations retroactively. Therefore, the final regulations do not adopt this suggestion.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Edward C. Schwartz of the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.1041-1T, paragraph (c) is amended by adding a sentence at the end of A-9 to read as follows:

§ 1.1041-1T Treatment of transfers of property between spouses or incident to divorce (temporary).

* * * * *

(c) * * *

A-9: * * * This A-9 shall not apply to transfers to which § 1.1041-2 applies.

* * * * *

Par. 3. Section 1.1041-2 is added to read as follows:

§ 1.1041-2 Redemptions of stock.

(a) *In general*—(1) *Redemptions of stock not resulting in constructive distributions.* Notwithstanding Q&A-9 of § 1.1041-1T(c), if a corporation redeems stock owned by a spouse or former spouse (transferor spouse), and the transferor spouse's receipt of property in respect of such redeemed stock is not treated, under applicable tax law, as resulting in a constructive distribution to the other spouse or former spouse (nontransferor spouse), then the form of the stock redemption shall be respected for Federal income tax purposes. Therefore, the transferor spouse will be treated as having received a distribution from the corporation in redemption of stock.

(2) *Redemptions of stock resulting in constructive distributions.* Notwithstanding Q&A-9 of § 1.1041-1T(c), if a corporation redeems stock owned by a transferor spouse, and the transferor spouse's receipt of property in respect of such redeemed stock is treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the redeemed stock shall be deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock shall be deemed first to be transferred by the corporation to the nontransferor spouse in redemption of such spouse's stock and then to be transferred by the nontransferor spouse to the transferor spouse.

(b) *Tax consequences*—(1) *Transfers described in paragraph (a)(1) of this section.* Section 1041 will not apply to any of the transfers described in paragraph (a)(1) of this section. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or

section 1368 if received from a Subchapter S corporation.

(2) *Transfers described in paragraph (a)(2) of this section.* The tax consequences of each deemed transfer described in paragraph (a)(2) of this section are determined under applicable provisions of the Internal Revenue Code as if the spouses had actually made such transfers. Accordingly, section 1041 applies to any deemed transfer of the stock and redemption proceeds between the transferor spouse and the nontransferor spouse, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041, however, will not apply to any deemed transfer of stock by the nontransferor spouse to the redeeming corporation in exchange for the redemption proceeds. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(c) *Special rules in case of agreements between spouses or former spouses*—(1) *Transferor spouse taxable.*

Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, and shall not be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as a redemption distribution to the transferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(2) *Nontransferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, and shall not be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, if a divorce or separation instrument, or a

valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(3) *Execution of agreements.* For purposes of this paragraph (c), a divorce or separation instrument must be effective, or a valid written agreement must be executed by both spouses or former spouses, prior to the date on which the transferor spouse (in the case of paragraph (c)(1) of this section) or the nontransferor spouse (in the case of paragraph (c)(2) of this section) files such spouse's first timely filed Federal income tax return for the year that includes the date of the stock redemption, but no later than the date such return is due (including extensions).

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. Corporation X has 100 shares outstanding. A and B each own 50 shares. A and B divorce. The divorce instrument requires B to purchase A's shares, and A to sell A's shares to B, in exchange for \$100x. Corporation X redeems A's shares for \$100x. Assume that, under applicable tax law, B has a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption results in a constructive distribution to B. Also assume that the special rule of paragraph (c)(1) of this section does not apply. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for \$100x in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the \$100x to A in a transfer to which section 1041 applies.

Example 2. Assume the same facts as *Example 1*, except that the divorce instrument provides as follows: "A and B agree that the redemption will be treated for Federal income tax purposes as a redemption distribution to A." The divorce instrument further provides that it "supersedes all other instruments or agreements concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption." By virtue of the special rule of paragraph (c)(1) of this section and under paragraphs (a)(1) and (b)(1) of this section,

the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X and shall not be treated as resulting in a constructive distribution to B. See section 302.

Example 3. Assume the same facts as *Example 1*, except that the divorce instrument requires A to sell A's shares to Corporation X in exchange for a note. B guarantees Corporation X's payment of the note. Assume that, under applicable tax law, B does not have a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption does not result in a constructive distribution to B. Also assume that the special rule of paragraph (c)(2) of this section does not apply. Accordingly, under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X. See section 302.

Example 4. Assume the same facts as *Example 3*, except that the divorce instrument provides as follows: "A and B agree the redemption shall be treated, for Federal income tax purposes, as resulting in a constructive distribution to B." The divorce instrument further provides that it "supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption." By virtue of the special rule of paragraph (c)(2) of this section, the redemption is treated as resulting in a constructive distribution to B for purposes of paragraph (a)(2) of this section. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for a note in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the note to A in a transfer to which section 1041 applies.

(e) *Effective date.* Except as otherwise provided in this paragraph, this section is applicable to redemptions of stock on or after January 13, 2003, except for redemptions of stock that are pursuant to instruments in effect before January 13, 2003. For redemptions of stock before January 13, 2003 and redemptions of stock that are pursuant to instruments in effect before January 13, 2003, see § 1.1041-1T(c), A-9. However, these regulations will be applicable to redemptions described in the preceding sentence of this paragraph (e) if the spouses or former spouses execute a written agreement on or after August 3, 2001 that satisfies the requirements of one of the special rules in paragraph (c) of this section with respect to such redemption. A divorce or separation instrument or valid

written agreement executed on or after August 3, 2001, and before May 13, 2003 that meets the requirements of the special rule in Regulations Project REG-107151-00 published in 2001-2 C.B. 370 (see § 601.601(d)(2) of this chapter) will be treated as also meeting the requirements of the special rule in paragraph (c)(2) of this section.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

CFR part or section where identified and described	Current OMB control No.
* * *	
(b) * * *	
1.1041-2	1545-1751
* * *	

David A. Mader,

Assistant Deputy Commissioner of Internal Revenue.

Approved: December 30, 2002.

Pamela F. Olson,

Assistant Secretary of the Treasury.

[FR Doc. 03-646 Filed 1-10-03; 8:45 am]

BILLING CODE 4830-01-P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 300

[FRL-7436-7]

National Oil and Hazardous Substances Pollution Contingency Plan; National Priorities List

AGENCY: Environmental Protection Agency.

ACTION: Direct final notice of deletion of the Wildcat Landfill Superfund Site from the National Priorities List.

SUMMARY: The Environmental Protection Agency (EPA) Region III is publishing a direct final notice of deletion of the Wildcat Landfill Superfund Site (Site), located in Kent County, near Dover, Delaware, from the National Priorities List (NPL). The NPL, promulgated