ALL IN THE FAMILY?
FEDERAL INCOME TAXATION AND TRANSFERS
OF PROPERTY WITHIN THE FAMILY

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As the old adage goes, “Nothing is certain but death and taxes.” While this may not be entirely accurate, there is certainly no denying that everyone is born and eventually dies, and federal income taxes are a large part of life between the two events. A large part of the federal income taxation process involves determining what is includable in gross income. While a comprehensive and in-depth analysis of the concept of gross income could exhaust the years from birth until death, if completed even then, this article focuses on three issues regarding what constitutes gross income in the context of transfers of property between spouses. In particular it explores, at the most basic level, federal income tax consequences (1) when property is transferred between spouses upon divorce, (2) of stock redemptions when both spouses own stock in a corporation, and (3) of stock redemptions between spouses upon divorce.

I. FEDERAL INCOME TAXATION IN GENERAL
A. BASICS OF INDIVIDUAL INCOME TAXATION

Generally, “gross income means all income from whatever source derived.” With source being irrelevant, the United States Supreme Court has held that the intent of Congress in this regard was to tax all gains except those specifically exempted. All gains are taxable, if clearly realized,

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1 I.R.C. § 61.
whether traceable to labor, capital, or mere good fortune.\(^3\) Other important concepts to know when dealing with federal income taxation in general are basis and gain. Basis is merely a reflection of the impact events have had on the original investment made in property, such as decreases from depreciation or increases from improvements.\(^4\) A gain is the excess of the amount realized (what was received in exchange for the property on disposition) over the unrecovered basis for the property sold or exchanged.\(^5\) An individual is taxed on taxable income. A simplified definition is: taxable income is gross income (all income from whatever source) less certain deductions and exemptions.

**B. BASICS OF CORPORATE INCOME TAXATION**

A corporation is known as a double-tax regime; that is, the corporation is taxed on profits and shareholders are taxed on the dividends they receive. The same method that is used to calculate an individual's gross income is also used to determine a corporation's gross income; however, a corporation cannot deduct any personal exemptions or other various deductions that may be available to the individual.\(^6\)

1. Basis and Gains

The organization of a corporation is essentially a nonrecognition transaction. In other words, neither the corporation nor the contributing shareholder realizes any gain from the receipt of money or property upon formation or incorporation.\(^7\) The deferment of gain is based on the theory that such is only a change in form of ownership of the asset. Basis is "the value assigned to a taxpayer's investment in property and used primarily for computing gain or loss from a transfer of the property."\(^8\) The basis of the property in the hands of the corporation is the same as it was in the hands of the shareholder, increased by any gain recognized by the shareholder.\(^9\) The basis of the shareholder's stock, the property the shareholder receives in exchange for the assets contributed to the corporation, is the basis that the shareholder had in the property transferred less any cash or other property received plus any gain recognized.\(^10\)

\(^3\) Id.; Treas. Reg. § 1.61-1(a).
\(^4\) I.R.C. § 1016.
\(^5\) Treas. Reg. § 1.61-6(a).
\(^6\) For example: (1) expenses for the production of income [I.R.C. § 212], (2) medical expenses [I.R.C. § 213], (3) expenses for dependent care [I.R.C. § 211], (4) certain cooperative housing deductions [I.R.C. § 216], and (5) moving expenses [I.R.C. § 217].
\(^7\) Keep in mind, however, that certain requirements must be met in order for the corporation to take advantage of this nonrecognition treatment. I.R.C. § 351.
\(^8\) BLACK'S LAW DICTIONARY 118 (7th ed. 2000).
\(^9\) I.R.C. § 362(a)(2).
\(^10\) I.R.C. § 358(a)(1).
2. Distributions

A distribution is "a corporation's direct or indirect transfer of money or other property, or incurring of indebtedness to or for the benefit of its shareholders, such as a dividend payment out of current or past earnings." The Tax Code defines a dividend as any distribution of property made by a corporation to its shareholders out of its current taxable year or accumulated earnings and profits. In general, when a corporation distributes money or property, other than stock, to shareholders, the amount is usually taxed to the shareholder in this way: (1) the portion that is a dividend is included in gross income; (2) the portion that is not a dividend reduces the basis of the shareholder's stock until it reaches zero; and (3) if there is any additional distribution, then it will be treated as a capital gain. So, if a distribution is made out of the corporation's earnings and profits, it will be a dividend and the shareholder will be taxed on the gain. On the other hand, if the distribution is not made out of the corporation's earnings and profits, it will be treated as a tax-free recovery of the shareholder's basis in the stock. This distribution will reduce the shareholder's basis in the stock, and if the distribution exceeds the shareholder's basis, the excess is treated as a gain from the sale of a capital asset.

3. Stock Redemptions

A stock redemption occurs when a corporation purchases (redeems) shares directly from shareholders.

II. BASIS, GAINS, AND FEDERAL INDIVIDUAL INCOME TAX WITHIN THE FAMILY

In general, when a taxpayer transfers property that has a fair market value in excess of the taxpayer's basis, the taxpayer realizes a taxable gain. This occurs because gross income is defined as "all income from whatever source derived, including ... gains derived from dealings in property." Therefore, if Bob owns stock in ZZ Bottom, Inc. worth $1000, and if Tom owns a classic rock record collection worth $1000, and if the two trade their assets, neither realizes a gain or loss on the transaction and both have a $1000 basis in the new property. However, if Bob's stock is worth $1500 and Tom's record collection is worth $900, and they make the same trade, Bob has realized a loss of $600 and Tom, a gain of $600. Bob then has a $1500 basis in the record collection worth $900, and Tom has a basis of

11 BLACK'S LAW DICTIONARY at 385.
12 I.R.C. § 316.
13 I.R.C. § 301.
14 See I.R.C. § 1221 et seq. for the rules for determining capital gains and losses.
15 I.R.C. § 317.
16 I.R.C. § 61.
$900 in the stock worth $1500. The question is whether these simple principles should apply in the family setting as they apply in the commercial context. If a husband transfers appreciated property to his wife in exchange for her agreement to release her marital property rights, should this be considered a taxable exchange?

In Farid-Es-Sultaneh v. Commissioner, the husband and wife had an antenuptial agreement in which the wife received shares of stock in exchange for surrendering all of her marital property rights in the husband’s estate. The husband’s basis in the stock prior to the transfer was $0.15 a share, but when the shares were transferred to the wife pursuant to the agreement, the stock had a fair market value of $10 a share. The wife later sold the shares and the question became what was the basis of the shares in the wife’s hands at the time of sale? The Commissioner argued that her basis was the same as her husband’s ($0.15) since the shares were a “gift” to her. However, the court found that the transfer from husband to wife was not a gift; rather, it was an exchange of valuable property interests, that is, stock for valuable marital property rights. Accordingly, it held that the wife’s basis for the share was $10, which was their fair market value at the date of the exchange.

United States v. Davis involved a property settlement incident to divorce. According to the agreement the parties reached during the dissolution proceedings, the husband transferred appreciated securities to his wife in exchange for her surrendering her marital property claims. The Supreme Court found that the transfer was not a gift, nor was it a division of property belonging to the marital partnership that might be true in community property states. Rather the husband had realized a taxable gain on the exchange because his basis was less than the fair market value of the securities at the time of transfer to the wife.

The problem then is this: If transfers of property between spouses are “gifts” when they take place during marriage so that the basis of the property in the transferor’s hands carries over to the transferee, why are transfers prompted by the formation of marriage treated differently? Similarly, in the end-of-marriage context, if transfers from deceased spouses to surviving spouses are viewed as nonrealization events, then why are transfers, prompted by the termination of a marriage by divorce treated differently?

17 160 F.2d 812 (2d Cir. 1947).
18 I.R.C. § 102 excludes gifts as well as property acquired from a decedent through bequest, devise, or inheritance from inclusion in gross income.
20 I.R.C. §§ 102 and 1015.
22 I.R.C. § 102.
23 Chrielstein, supra note 21.
The 1984 Congress addressed these concerns by enacting section 1041. This provision, which overruled Davis, provides that no gain or loss is to be recognized on a transfer of property from an individual to a spouse or former spouse, but only if the transfer is incident to divorce. This section further provides that the transferee’s basis of property subject to such a transfer shall be the adjusted basis of the transferor. Section 1041 is not limited to transfers of property incident to divorce. Section 1041 also applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arm’s length. A divorce or legal separation need not be contemplated between the spouses at the time of the transfer, nor must a divorce or legal separation ever occur. Interestingly, section 1041 would not have applied to the Farid case. In that case, the stock transfer took place before the marriage; in fact, the husband was married to someone else at the time. Therefore, the wife would not have qualified as a “spouse” under section 1041 at the time of transfer.25

Individual gross income in the family setting has been greatly affected by the enactment of section 1041 of the Internal Revenue Code. Previously, the transferring spouse incident to divorce would fail to report their taxable gains, but invariably the spouse who acquired the appreciated property would use a basis equal to the fair market value of the property at the time it was received to compute gain or loss on the disposition. Therefore, unless the Treasury wanted to audit every substantial property settlement, it ran the risk that neither spouse would report the taxable gain.26 So what had been a complicating factor in family and divorce law was simplified by the enactment of section 1041.

III. STOCK REDEMPTIONS, CORPORATE INCOME TAXATION, AND THE FAMILY

A. STOCK REDEMPTIONS WITHIN THE FAMILY IN GENERAL

As mentioned above, a stock redemption occurs when a corporation acquires its stock from a shareholder in exchange for property.27 In an active corporation, under certain circumstances, such a redemption will be considered a dividend, and therefore, includable in gross income.28 If the redemption is partially pro rata, then the redemption is almost always considered a dividend. In other words, if the corporation has five shareholders who each own 100 shares, and the corporation redeems the same number of shares from each shareholder, such is a dividend since, immediately after the distribution, each shareholder has an identical interest in the corporation.

24 Treas. Reg. § 1-1041-1T.
25 CHIESTEIN, supra note 21 at 90.
26 Id.
However, if there is a complete redemption of all the stock of a corporation, that is, the corporation is being liquidated or a stockholder is being totally or partially bought out, but the corporation is continuing, the redemption will be treated as a sale or exchange. Therefore, the stockholders will compute their capital gain, if applicable, by subtracting their adjusted basis in the stock from the amount they receive from the corporation for the stock. The caveat, however, is in relation to stock held by related shareholders.

If a stockholder is selling shares to the corporation instead of the corporation being liquidated, section 318 becomes critical. This section provides that stock owned by a taxpayer includes stock such taxpayer directly owns as well as stock constructively owned. Under section 318, an individual is considered to own the stock owned, directly or indirectly, by or for her spouse (other than a spouse who is legally separated under a decree of divorce or separate maintenance), and by or for her children, grandchildren, and parents. Therefore, if a stockholder Jill is selling half of her shares in the corporation back to the corporation, and her husband Jack also owns stock in this same corporation, Jill still directly owns half of her own shares, and she constructively owns Jack's shares as well. For this reason, the sale of half of Jill's shares to the corporation is now no longer considered a sale or exchange, but rather it is a dividend. Jill's basis in her sold shares will not now reduce the amount of taxable gain she must report on her income tax returns. Instead, the amount received is entirely included in her gross income.

B. STOCK REDEMPTIONS WITHIN THE DIVORCING FAMILY

When a stock redemption occurs during a divorce, and one spouse continues the corporation and the other spouse sells shares to the other, a multitude of concerns and issues arise, and section 1041 again becomes applicable.

The redemption of stock is divided into two groups: redemptions that result in a constructive distribution to the nontransferor spouse and redemptions that do not. Applicable law determines whether a stock redemption is treated as a constructive redemption to the nontransferor spouse. Generally, when there is a constructive distribution, the nontransferor spouse will be taxed on the transaction. On the other hand, when there is not a constructive distribution, the transferor spouse will bear the tax burden. The reason depends on the applicability of section 1041. For ease of understanding, we will track the divorce of Jill and Jack, our couple from above, during their divorce. Their marital estate includes Creative Cattery, Inc.

29 I.R.C. § 331.
30 I.R.C. § 318.
("Cattery"), a corporation the couple owns and operates, that breeds and sells high quality felines. Jill will keep the corporation and run it as her own business; Jack will sell his shares in the corporation to Jill in exchange for other marital assets.

When a stock redemption results in a constructive distribution to the nontransferor spouse (Jill), the redeemed stock is deemed to be transferred first by the transferor spouse (Jack) to Jill and then by Jill to the Cattery.\(^\text{32}\) Working backwards, any redemption proceeds are deemed to be transferred from the Cattery to Jill and then from Jill to Jack.\(^\text{33}\)

The final regulations specify that section 1041 applies only to transfers between the transferor spouse and the nontransferor spouse. Consequently, any transfer between the corporation and Jill is not subject to section 1041. The final result is that Jill is taxed on the transfer of stock to the corporation in exchange for the redemption proceeds.\(^\text{34}\)

If there is no constructive distribution to Jill under applicable tax law, Jack would be taxed on any redemption proceeds because section 1041 does not apply.\(^\text{35}\) This result occurs because there is no deemed transfer from Jack to Jill before the redemption distribution occurs. Instead, Jack redeems his stock with the corporation in exchange for the redemption proceeds and then transfers the proceeds to Jill. The key, therefore, to which spouse will bear the tax burden depends on whether the stock redemption results in a constructive distribution to the nontransferor spouse.

The final regulations leave the issue of whether a redemption will result in a constructive distribution to the spouses and applicable tax law. The problem, however, is that the current tax law standard that determines whether a stock redemption results in a constructive distribution to the nontransferor spouse—the primary and unconditional standard—has yet to be clearly defined. Therefore, it is not uncommon for practitioners and their clients not to recognize situations in which a redemption would result in such a distribution.

Spouses can provide that either the transferor spouse or the nontransferor spouse will be taxed on the transaction if they state in a divorce or separation agreement, or other written agreement, that:

1. Both spouses intend for the redemption to be treated, for federal income tax purposes, either as:
   a. A redemption distribution of the transferor spouse; or
   b. A constructive distribution to the nontransferor spouse; and

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\(^{32}\) Treas. Reg. § 1.1041-2(a)(2).

\(^{33}\) Id.

\(^{34}\) Treas. Reg. § 1.1041-2(b)(2).

\(^{35}\) Treas. Reg. § 1.1041-2(b)(1).
2. The instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of stock.

The instrument or agreement must be executed by both spouses prior to the date on which the transferor spouse, if 1(a) applies, or the nontransferor spouse, if 1(b) applies, first files his or her 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.\textsuperscript{36}

1. The Primary and Unconditional Standard

If spouses do not elect to classify their transaction as either a redemption distribution to the transferor spouse or a constructive distribution to the nontransferor spouse, the final regulations leave us with the primary and unconditional standard. The primary and unconditional standard holds that a payment to a shareholder in a redemption of stock is a constructive dividend to the remaining stockholder if the nonredeeming stockholder had a primary and unconditional obligation to buy the stock.\textsuperscript{37} In \textit{Hayes v. Commissioner}, the court found that the nonredeeming stockholder received a constructive dividend because the settlement agreement required the nonredeeming stockholder to purchase the redeeming stockholder’s shares. The \textit{Hayes} court maintained that the nonredeeming stockholder had a primary and unconditional obligation to purchase the shares, even though the corporation later redeemed the shares because the nonredeeming stockholder did not have sufficient funds to purchase the redeeming stockholder’s shares.

Courts have found that the nonredeeming stockholder did not have a primary and unconditional obligation to buy the other’s stock when the settlement agreement required the corporation to redeem the stock and only required the nonredeeming stockholder to guarantee the corporation’s obligations.\textsuperscript{38} And, in \textit{Elder v. Commissioner}, the Ninth Circuit reached a similar conclusion based on the fact that the divorce order did not reference the nonredeeming stockholder’s obligation to buy the stock.

To be certain about which spouse will bear the tax consequences of a stock redemption, divorcing spouses and their attorneys should negotiate and draft their settlement agreements with specific reference to the Treasury Regulations section 1.1041-2 election. However, this assumes that the spouses and their attorneys recognize the potential adverse tax consequences of their particular situation. If an election is not made, either in-

\textsuperscript{36} Treas. Reg. § 1.1041-2(c).


\textsuperscript{38} \textit{Arnes}, 102 T.C. at 527.
tentionally or unknowingly, the primary and unconditional standard will
determine which spouse will sustain the tax burden.

IV. CONCLUSION

Practicing in the area of federal income taxation law, corporate law, or
family law alone is certainly a challenging endeavor. When combining the
practices, especially in a single case, the problem is compounded. More is
certain than death and taxes: It is certain that in order to successfully man-
age a case that encompasses issues in all three of these areas of law, a prac-
titioner must remember to take additional precautions to “get it right.”
Taxation, especially as it relates to corporations and families, can be highly
technical as well as unsettled; at times there is no published authority on
which to rely for guidance. Business litigators must educate themselves
thoroughly on all the complex and interrelated issues if they are to success-
fully handle these cases.