

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