

ANOTHER STOCK REDEMPTION CASE

Although it is not yet a final decision, a case pending in the Eleventh Circuit Court of Appeals bears watching by discussion group members. The case is *Linda Karen Brownlow Craven v. United States*, 11th Cir. Dkt. No. 99-12803-BB. The taxpayer's brief has been filed (Tax Notes Doc. No. 1999-36795), as has the government's brief (Tax Notes Doc. No. 1999-34130). In the two briefs, the taxpayer (an ex-wife) and the Justice Department are disagreeing whether her redemption of stock in a corporation that she jointly owned with her ex-husband resulted in recognizable gain. Section 1041 you say?

Not so fast. The Cravens were the sole owners of a pottery company and commenced a divorce in 1999. Linda Craven named the company as a defendant in the divorce. In 1999, the divorce case settled, with the corporation pledging to redeem her stock for \$4.8 million.

The amount was to be repaid commencing in 2000, without interest. The agreement permitted prepayments. The divorce required Billy Joe Craven to guarantee the payments to Linda.

The payments commenced. In fact, Linda received prepayments from both Billy Joe and the company. The company reported imputed interest on the note for 1992 through 1994. Linda did not report imputed interest as taxable income on her return, nor did she report capital gain on the stock redemption. She filed disclosure statements with her tax return, asserting that the interest was not taxable. Her reasoning was that she is a cash basis taxpayer, and that any imputed interest was nontaxable under Section 1041.

Predictably, the IRS determined that Linda recognized a capital gain on the stock redemption when the company made prepayments, and that she had interest income for 1992 through 1994. Linda paid the assessments and sued for a refund in district court. The district court found that the stock redemption was entitled to nonrecognition under Section 1041 as a transfer to a former spouse incident to divorce. However, the district court couldn't help her on the imputed interest question, finding that to be taxable income.

Linda, however, was not about to give up yet. She is now arguing in the Eleventh Circuit that the redemption was purely divorce driven, and that under Section 1041 it could not give rise to any tax liability. She asserts in her brief that the redemption arose solely from Billy Joe's insistence that she sever her connections to the company as an essential element of the divorce. She also argues that the redemption provided her ex-husband with a means to satisfy his marital property obligations and protect his assets.

Government Response

Equally predictably, the government is arguing that Linda is all wrong. In fact, the government is not limiting its response to the notion that the interest is taxable. The government is arguing that the entire redemption of Linda's stock simply does not qualify under Section 1041. The reason? The transfer was to a third party rather than to Billy Joe. Thus, says the Justice Department, it was not an interspousal transaction. The Justice Department also points out that the transfer was not made on Billy Joe's behalf because it gave Linda the right to collect \$4.8 million from the company, and her ex-husband did not have a primary obligation to buy the stock. The redemption, thus, says the Justice Department, is not shielded from recognition under Section 1041.

Caution: I feel like a broken record, saying that the entire divorce field is wrought with difficulties (tax difficulties, I mean). Not only is the alimony and child support area often entirely fouled up, but something that seems as straightforward as Section 1041 is often the subject of controversy. This is an example of something where the parties probably thought that they had agreement on economic terms and now the ex-wife has probably already spent sizable sums fighting the applicability of Section 1041. And that fight isn't over. We'll keep you posted. But, planning should be much better than this!