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IRS Rules No Gain on Divorce-Related Transfer of ESOP Qualifying Replacement Property

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The Internal Revenue Service has ruled that an individual's transfer of employee stock ownership plan (ESOP) replacement property to his spouse in connection with their divorce won't trigger gain under Code Section 1042(e)(1) because the transfer qualifies for the gift exception under Code Section 1042(e)(3). *Private Letter Ruling 201024005*.

Facts. Taxpayer sold company stock to an ESOP and made a timely election to defer gain under Code Section 1042(a). He invested all of the proceeds from the sale into qualifying replacement property, which he still owns.

Taxpayer is in the process of getting a divorce. As a part of the division of marital property, he would like to transfer to his spouse all or a significant percentage of the QRP. To this end, he requested a ruling that the transfer of the QRP to his spouse as part of the marital settlement agreement incident to their divorce will be treated as a gift under Code Section 1042(e)(3)(C) because the transfer is treated as a gift to the spouse under Code Section 1041(b)(1).

Law. A individual taxpayer can elect to

defer gain under Code Section 1042(a) on a sale of qualified securities to the issuing company's ESOP if he timely purchases qualifying replacement property and meets a number of other requirements. For stock sales to ESOPs this election is available if:

- The taxpayer held the securities for at least three years before the date of sale;
- After the sale, the ESOP meets a 30% stock ownership requirement;
- Within a fifteen month period (beginning three months before the sale), QRP is purchased; and
- The ESOP consents to being subject to Code Sections 4978 and 4979A.

Qualifying securities are Code Section 409(l) employer securities issued by a domestic C corporation that has no stock outstanding that is readily tradeable on an established securities market. QRP is any security issued by a domestic corporation (other than the one that issued the securities involved in the nonrecognition transaction) that does not have passive investment income exceeding 25% of gross receipts for the tax year preceding the tax

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year of the sale.

Under Code Section 1042(d), a taxpayer's basis in QRP purchased during the qualified replacement period is reduced by the amount of gain not recognized because of Code Section 1042(a).

Code Section 1042(e)(1) provides that "if a taxpayer disposes of any QRP, then, notwithstanding any other provision of this title, gain (if any) shall be recognized to the extent of the gain which was not recognized under subsection (a) by reason of the acquisition by such taxpayer of such QRP." There are limited exceptions to this rule.

Result. The IRS observed that gain realized from the disposition of any QRP by a taxpayer who made an election under Code Section 1042 generally must be recognized at the time of the disposition regardless of any other nonrecognition provisions of the Code that may otherwise apply. Gifts are excepted from the recognition rule under Code Section 1042(e)(3)(C) but neither the statute nor the regulations define gifts for this purpose.

The IRS noted that, in the case of a divorce-related transfer, Code Section 1041(b) treats the transfer as a gift to the transferee but it does not affirmatively treat the transferor as making a gift. However, the IRS further noted that the legislative history speaks in terms of the transfer as being treated as a gift.

Accordingly, the IRS noted that treating the

transferor as having made a gift for purposes of Code Section 1042(e)(3)(C) is consistent with Code Section 1041 and its legislative history. Further, since the transferee is treated as receiving a gift under Code Section 1041(b), it follows that the transferor should be treated as making a gift.

The Private Letter Ruling concluded that the proposed transfer of the QRP by the taxpayer to his spouse will be treated as a gift and will not cause the taxpayer to recapture deferred gain on the QRP under Code Section 1042(e)(1).

Comment. Assuming the transferred property does not decline in value, the spouse will be taxed on the deferred gain if and when she sells the QRP.

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