Hayes v. Commissioner, 101 T. C. 593 (1993)

A shareholder receives a constructive dividend when a corporation redeems stock to satisfy the shareholder's primary and unconditional obligation to purchase it, even in the context of a divorce.

Summary

In Hayes v. Commissioner, the U. S. Tax Court ruled that a husband received a constructive dividend when his corporation redeemed his wife's stock to satisfy his obligation under their divorce decree. The court invalidated a subsequent nunc pro tunc order that attempted to change the original obligation because it violated Ohio law. The ruling established that the husband's tax liability arose from the corporation's action to redeem the stock on his behalf, even though the redemption was incident to the couple's divorce. The decision emphasizes the importance of understanding the legal effect of agreements and court orders in divorce proceedings for tax purposes.

Facts

Jimmy and Mary Hayes, sole shareholders of JRE, Inc. , were divorcing. Their separation agreement obligated Jimmy to purchase Mary's stock for $128,000. This was incorporated into their divorce decree. Due to Jimmy's financial constraints, JRE agreed to redeem Mary's stock on the same day the divorce decree was entered. A later nunc pro tunc order attempted to retroactively change the decree to require JRE to redeem the stock directly, but it did not comply with Ohio law for such orders.

Procedural History

The Commissioner of Internal Revenue determined that Jimmy received a constructive dividend from JRE's redemption of Mary's stock and that Mary recognized gain on the redemption. The Tax Court consolidated their cases, and after trial, invalidated the nunc pro tunc order and upheld the Commissioner's determination against Jimmy.

Issue(s)

1. Whether the nunc pro tunc order, which attempted to change the original divorce decree to require JRE to redeem Mary's stock, was valid under Ohio law.
2. Whether Jimmy Hayes received a constructive dividend from JRE's redemption of Mary's stock.

Holding

1. No, because the nunc pro tunc order did not comply with Ohio law requiring clear and convincing evidence of the original judgment and an explanation for the

correction.
2. Yes, because JRE's redemption of Mary's stock satisfied Jimmy's primary and unconditional obligation under the original divorce decree to purchase her stock, resulting in a constructive dividend to Jimmy.

Court's Reasoning

The court applied Ohio law to determine the validity of the nunc pro tunc order, finding it invalid because it did not reflect the original judgment and lacked the necessary evidence and justification for correction. The court then applied federal tax law principles, concluding that JRE's redemption of Mary's stock constituted a constructive dividend to Jimmy because it satisfied his obligation to purchase her stock. The court noted that even if the nunc pro tunc order were valid, Jimmy would still have received a constructive dividend either at the time of redemption or when JRE assumed his obligation. The court's decision was influenced by policy considerations to prevent shareholders from avoiding tax liabilities through corporate actions. There were no dissenting or concurring opinions.

Practical Implications

This decision informs legal practice in divorce cases involving corporate stock by emphasizing that corporate redemptions to satisfy personal obligations can result in constructive dividends to the obligated party. Attorneys should carefully draft and review separation agreements and divorce decrees to avoid unintended tax consequences. The ruling affects business planning in divorce scenarios, as corporations may need to consider the tax implications of redeeming stock on behalf of shareholders. Subsequent cases like Arnes v. United States (9th Cir. 1992) have distinguished this ruling where the redemption benefits the non-obligated spouse.

