



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

October 23, 2001

Number: **200203061**
Release Date: 1/18/2002
CC:ITA:04/TL-N-5022-00
UILC: 61.15-00; 61.17-04;
163.00-00; 301.07-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE)
ST. LOUIS, MISSOURI CC:SB:5:STL

FROM: Associate Chief Counsel CC:ITA

SUBJECT:

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This Chief Counsel Advice responds to your memorandum dated January 24, 2001. By memorandum dated June 11, 2001, you responded to our request for additional documents. In accordance with I.R.C. section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

H =
W =
C =
Year 1 =
Year 2 =
Year 3 =
X =
Y =

ISSUES

1. Whether any portion of the payments received by W in connection with promissory notes given to her in exchange for her marital rights in the stock of C is income to W.
2. Whether C's incurring and satisfying an obligation to pay W for her marital interest in the stock of C constitutes a constructive distribution to H.

3. If the arrangement constitutes a constructive distribution, does the constructive distribution occur at the time the obligation is incurred or at the time C discharges the obligation, and must H include the distributions in income? Is H entitled to an interest deduction for the interest paid to W?

4. Whether C's assignments to H of any marital interest it acquired and of its payment obligations have any tax consequences.

CONCLUSIONS

1. W has no income as a result of receiving the promissory note or payments on the note to the extent those payments constitute payments of the principal amount of the indebtedness. Any interest received by W on the principal, however, must be included in W's income under section 61(a)(4).

2. C's incurring and satisfying the obligation to pay W for her marital interest in C constitutes a constructive distribution to H. C is not entitled to a section 163 interest deduction for any portion of the distribution paid to H.

3. The constructive distribution occurred at the time C made payments pursuant to the obligations. Thus, H is treated as receiving distributions as the liabilities were paid by C. Whether H must include the distribution in income depends on the amount of C's accumulated adjustment account, C's accumulated earnings and profits, and H's basis in the C stock. H is not entitled to a section 163 deduction for interest amounts paid to W.

4. C's assignment of the marital interest is meaningless in this case, and the assignments of the obligations are also of no consequence because H was already primarily liable to pay them pursuant to the divorce decree.

FACTS

H and W were divorced in Year 1. The judgment of dissolution entered in their divorce provided for a division of personal and real property of H and W. At the time of the divorce, H held 100% of the shares in C, an S corporation. C previously was a Subchapter C corporation and has retained earnings and profits derived from when it was a C corporation. The divorce judgment ordered H to pay \$X to W over a term of ten years. According to the judgment, H and C were required to execute a promissory note for the amount H became obligated to pay W. The interest-bearing note was to be paid by C. The judgment further provided that the payments to W were for W's "marital interest" in the C stock. To secure the note, H was required to execute a deed of trust on real estate used by C for its business.

H was also ordered to pay \$Y to W no later than ten years after the divorce. The judgment provided further that C would make the \$Y payment. This payment also

was described as in exchange for W's marital interest in the C stock. This obligation was to be secured by a deed of trust on the business property.

In Year 2, C made a payment to W. C treated part of the payment as principal and the remainder as interest. On its Form 1120S for Year 2, C deducted the amount it treated as interest.

C issued a Form K-1 reflecting a distribution to H for Year 2. The distribution was not related to the payments C made to W. Thus, the payments to W were not reflected on the K-1 issued to H.

On his individual income tax return for Year 2, H did not report any income arising out of the payment made by C to W. W included in her income for Year 2 only the interest portion of the payments made by C to W.

During Year 3, C assigned to H any interest in the C stock that C may have acquired from W. Further, C assigned to H the obligation to pay W. This was done at the request of a bank from whom C was seeking a loan.

Under state law, W's marital interest in the stock does not rise to the level of a property interest.

LAW AND ANALYSIS

ISSUE 1. Tax consequences to W.

No gain or loss is recognized on a transfer of property from an individual to a former spouse, if the transfer is incident to a divorce. Section 1041(a).¹ Any such qualifying transfer is treated as a gift and the transferee spouse acquires the transferor's basis in the property. Section 1041(b). A transfer of property is incident to the divorce if such transfer occurs within one year after the date the marriage terminates or is related to the cessation of the marriage. Section 1041(c).

In enacting section 1041, Congress chose to treat a husband and wife and divorcing couples as one economic unit and to defer the recognition of any gain or loss on interspousal transfers of property until such property is conveyed to a stranger to the relationship. See Blatt v. Commissioner, 102 T.C. 77, 80 (1994). Thus, where a taxpayer receives a promissory note in a sale or exchange incident to divorce, receipt of the note and payments of the principal amount of the indebtedness on the note are governed by section 1041. The interest on the indebtedness, however, is not governed by section 1041.

¹ The provision is not limited to transfers incident to a divorce but applies also to transfers between spouses who are not contemplating divorce. Section 1041(b).

Section 61 defines gross income to mean income from whatever source derived, including interest. Sec. 61(a) (4). Treas. Reg. § 1.61-7(a) provides, as a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. The regulation further lists examples of such taxable interest, including interest on savings or other bank deposits and interest on a promissory note or mortgage.

As a general matter, interest is treated differently than the underlying obligation to which it relates. In the typical debtor-creditor situation, principal repayments do not constitute income to the lender, but interest payments do. Different treatment also occurs in other contexts. For example, in Rozpad v. Commissioner, T.C. Memo. 1997-528, aff'd, 154 F.3d 1 (1st Cir. 1998), the courts concluded that the portion of a lump sum settlement properly allocable to interest on exempt personal injury damages was includible in the taxpayer's income. This treatment of interest has also been extended to divorce situations. In Gibbs v. Commissioner, T.C. Memo 1997-196 (1997), it was held that stated interest paid to a taxpayer from her former spouse in connection with an indebtedness arising from a division of marital property was not governed by section 1041 and was includible in the taxpayer's income.

In the present case, W received a promissory note in exchange for her marital rights in the stock of C. That exchange was incident to the divorce of H and W and, as such, no gain or loss is recognized by W as a result of receiving the note or payments on the note to the extent those payments constitute payments of the principal amount of the indebtedness. Any interest received by W on the note, however, is not governed by section 1041, nor any other non-recognition provision, and therefore must be included in W's income under section 61(a)(4).

ISSUE 2. Constructive distribution.

Pursuant to sections 301(a), 301(c) and 316, an actual corporate distribution to a shareholder constitutes a dividend that must be included in the recipient's gross income by virtue of section 61(a)(7). A corporation, however, may make a constructive distribution to a shareholder without formally declaring a dividend. Distributions have been deemed received when the shareholder has received an economic benefit as a result of a payment made to him or for his benefit by a corporation. See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 8.05[1] (6th ed. 1994) ("the hallmark of a constructive distribution is value passing from, or a sufficiently specific economic benefit conferred by, the corporation to the shareholder, for which the shareholder does not give equivalent value in exchange"). An assumption, reduction or cancellation of a liability of a taxpayer by a corporation may give rise to the requisite economic benefit, for instance, because of the freeing of the debtor's assets from liability for the debt. See Sullivan v. United States, 363 F.2d 724, 729 (8th Cir. 1966), cert. denied, 387 U.S. 905 (1967).

A constructive distribution can also result where a corporation discharges a joint obligation of the corporation and its shareholder, if the corporation gratuitously incurred the liability for the benefit of the shareholder. See, e.g., Yelencsics v. Commissioner, 74 T. C. 1513, 1529 (1980). In Yelencsics, a corporation made payments on notes which it had executed as a co-maker for the purchase of stock by its shareholders. After determining that the corporation's obligation was incurred without consideration and served no valid corporate business purpose, the court concluded that the corporate payments were constructive dividends to its shareholders.

In this case, the divorce decree entered by the court required both H and C to execute a promissory note and for C to make monthly payments to W for her marital interest in the common stock of C. When C made a payment to W, it was paying a joint liability of both C and H. Therefore, if C gratuitously assumed H's personal liability to W without any valid corporate business purpose, H would be treated as receiving a constructive distribution even though C was also legally obligated to satisfy the promissory notes.

It appears that there was no valid corporate business purpose for C to assume, as co-maker on the promissory notes, the personal obligations of H. The promissory notes were created as part of a personal settlement agreement between H and W to divide their marital property. In order for H to retain all of his C stock, H was required to give W a note for her share of the marital property. The divorce court, in approving the settlement agreement, ordered H to make the payments, and for H and C to execute a promissory note to be paid by C. The only purpose for C to assume H's personal obligation was to secure W's judgment against H with C's property.

C might argue that the payment to W should be treated as a redemption of a portion of W's stock in C. The facts of the case indicate otherwise. All of the stock of C was owned by H. There was no stock issued in W's name that could have been redeemed from W. The fact that, as between H and W, W may have had a marital interest in H's marital property did not make any of the stock W's under relevant state law.

Because there was no valid corporate business purpose for C's assumption and payment of H's personal liability, H received a constructive distribution.²

ISSUE 3. Timing of the constructive distribution/tax consequences to H.

The next issue concerns whether H received the constructive distribution at the time of C's assumption of the obligation or at the time C made payments thereunder, and the tax consequences to H of the payments to W. In cases where a

² Because the amounts paid by C to W are considered constructive distributions to H, it follows that the amounts are not deductible by C as payments of interest.

corporation has assumed a personal obligation of a shareholder in one year, and satisfied that obligation in a later year, Service position is that the shareholder realizes a taxable dividend only in the year in which the obligation was paid. See Rev. Rul. 77-360, 1977-2 C.B. 86 (the Service will follow Maier v. Commissioner, 469 F.2d 225 (8th Cir. 1972), rev'g 55 T.C. 441 (1970), nonacq., 1977-2 C.B. 2, regarding when a distribution resulting from an assumption of a liability is taxable to a shareholder). Thus, H received constructive distributions as the liabilities were paid by C.

The extent to which the distributions are includible in H's income depends on the amount of C's accumulated adjustment account (AAA), C's accumulated earnings and profits (AEP), and H's basis in the C stock. Under section 1368, the distribution from C is treated as a non-taxable distribution to H to the extent of the AAA and H's basis in the C stock. If the distribution exceeds H's stock basis, the remainder (to the extent of the AAA) is treated as gain from the sale or exchange of property. If the distribution exceeds the AAA, the excess amount is treated as a dividend and taxed as ordinary income to H up to the amount of C's AEP. If the distribution exceeds both the AAA and the AEP, the distribution is a non-taxable return of capital to the extent of H's basis in the C stock. Any amount in excess of H's basis is treated as gain from the sale or exchange of property.

Because the payments from C to H are treated as constructive distributions to H, it follows that, for tax purposes, the payments to W should be treated as having been made by H. The tax treatment of those payments from H to W must, therefore, be examined. First, it is clear the payments do not constitute alimony under section 71 because the payments will not discontinue at the death of the payee spouse. Section 71(b)(1)(D). Second, no portion of the payment is deductible interest under section 163.

Section 163(a) allows a deduction for amounts paid as interest. Under section 163(h), however, individual taxpayers may not deduct interest considered to be "personal interest". Personal interest is interest other than trade or business interest, investment interest, passive interest, qualified residence interest, section 6601 interest, or interest on educational loans.

Treas. Reg. § 1.163-8T provides rules for allocating interest expense. Under those rules, debt is allocated to expenditures in accordance with the manner in which the taxpayer uses the debt proceeds. Thus, for example, if borrowed funds are used to purchase property held for investment (as defined in section 163(d)(5)), the interest incurred to finance the purchase is considered investment interest.

In the present case, it is our position that any interest H paid to W is personal interest, which is not deductible under section 163(h). H may argue that the debt was incurred to purchase W's interest in the C stock and, therefore, the interest expense is properly allocable to one of the non-personal interest items mentioned above. That contention, however, is not correct. H, at the time of the divorce, already owned 100% of the C stock. Thus, H did not incur debt to purchase C

common stock. Rather, H incurred a personal expenditure (as defined in section 1.163-8T(b)(5)) relating to his former spouse's marital interest. Accordingly, any interest paid by H is non-deductible, personal interest.

ISSUE 4. Assignment by C to H.

The last question relates to any tax consequences of the assignments by C to H of W's marital interest and of C's liabilities to W. The assignment of the marital interest is meaningless because the marital interest does not constitute property. W's claim to marital property was extinguished by the issuance of the notes to W. The assignment of the liability to H was also meaningless. H was already primarily liable for such obligation at the time of the purported assignment.³

Finally, as to the tax consequences to C as a result of C's assignment of the divorce obligations to H, it is important to note that no part of the obligation was actually discharged by the creditor, W. Either H or C continues to be liable for the entire amount set forth in the divorce agreement. Further, if W was not a part of the assignment agreement, W continues to be able to seek payment of the divorce obligations from C. Therefore, C does not have discharge of indebtedness income under section 61(a)(12).

Please call if you have any further questions.

HEATHER C. MALOY
By: STEPHEN TOOMEY
Assistant to Branch Chief
Branch 4
Income Tax and Accounting

³ However, if H, and not C, made the payments to W, H would not be in receipt of a constructive distribution with respect to the amount paid by H.