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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-121762-01
Date:
MAY 15, 2002

Re:

LEGEND:

A	=
B	=
Date 1	=
Date 2	=
Date 3	=
the Court	=
Agreement	=
Second Agreement	=
y	=
Age 1	=
Age 2	=
State	=
State Statute	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=

Dear :

This is in response to your letter of January 24, 2002, and other correspondence in which you request rulings on the application of sections 71, 215, 1041, 2512, and

2516 of the Internal Revenue Code to a settlement agreement.

A and B, while married, executed an agreement (the "Agreement") on Date 1, prior to 1984, providing for their separation and a division and settlement of their marital and property rights. Five weeks later, on Date 2, A and B were divorced in State. The Agreement was incorporated into the divorce decree issued by the Court.

Under Article II, paragraphs 1, 2, and 6 of the Agreement, A is to pay to B, for support and maintenance, an annual sum payable at a monthly rate that is adjusted under a formula based on the Consumer Price Index and increases in A's income. A's obligations to make these payments terminate on the earliest to occur of A's death, B's death, or B's remarriage.

Under Article V, paragraphs 1 and 2, at A's death, if B survives and has not remarried, B is to receive a lump sum equal in amount to the value of one-third of A's net estate (less the net proceeds of insurance payable to B). In addition, B is to receive a life interest as sole income beneficiary of a trust, the principal amount of which will be equal to the amount, if any, by which $a exceeds one-third of A's net estate. The term "net estate" is to have the meaning set out in State Statute.

The amount payable at A's death may be provided by life insurance owned by A on his life, with any excess over the amount so provided to B (to the extent not provided by other life insurance on A's life or other assets passing to B in connection with A's death) to constitute a charge against A's estate. Under Article VII, paragraph 4, B must execute a will making A the sole income beneficiary for life of a trust in the amount of $b if she has not remarried as of the date of her death or $c if she has remarried as of the date of her death.

A and B anticipate that, in all events, the value of one-third of A's net estate (regardless of how the term is defined, as discussed below) will be more than $a. B has not remarried and, as of Date 3, A and B were Age 1 and Age 2, respectively. Therefore, the parties anticipate that B will not remarry, and, at A's death, B will be entitled only to a lump sum equal in amount to the value of one-third of A's net estate. However, a dispute has arisen regarding the proper method for computing A's net estate under the Agreement.

State Statute provides a personal right of election for a surviving spouse. If the spouse exercises the right of election, and the decedent is survived by one or more issue, the spouse is entitled to receive one-third of the value of the decedent's "net estate" instead of that which is provided for the spouse in the decedent's will. On Date 1, when A and B executed the Agreement, State Statute provided that real property situated outside of State was not included in determining the value of the net estate. At the time, A did not own real estate situated outside of State. In contrast, State Statute now provides that a decedent's net estate includes all of a decedent's property, wherever situated. Currently, A owns real estate situated outside of State. Thus, if the

definition of “net estate” under State Statute in effect on Date 1 is applied, A’s net estate will not include his real estate situated outside of State. If the definition in effect at A’s death is applied, A’s net estate will be greater as it will include his real estate situated outside of State.

B’s representatives have taken the position that the term net estate, under the Agreement, is properly defined under the statute in effect at A’s death. A’s representatives have taken the position that the term is properly defined by the statute in effect on Date 1, when the Agreement was executed.

In order to liquidate his obligations under the Agreement, and avoid future litigation and delay that might result regarding the lump sum payment due at A’s death, A has agreed to pay B a lump sum amount in satisfaction of A’s obligation to make the lifetime payments, and A’s obligation to make the testamentary transfer. The parties have executed the Second Agreement containing the payment terms. By an order of the Court, the decree of divorce granted to A and B was amended in accordance with the Second Agreement.

The Second Agreement provides that all rights under the Agreement will be satisfied with a single payment (the “Settlement Amount”) of $d to be currently made to B. It is represented that the Settlement Amount was determined as follows.

> A’s obligation to make payments for support and maintenance under Article II of the Agreement is now approximately $e per year. Applying the applicable rate as prescribed for Date 3, and based on the tables prescribed under § 7520, the present value of B’s right to receive $e per year for A’s and B’s joint lives is $f. The present value of B’s right to receive an amount equal to one-third of A’s net estate (excluding property outside of State) if B survives A is $g. The present value of B’s right to receive an amount equal to one-third of A’s net estate (including the real estate outside of State) if B survives A is $h. In view of B’s age, these calculations did not reflect the possibility that B would remarry.

Under the calculations presented, and depending on which statutory definition of net estate is applied to determine the value of A’s net estate, the present value of B’s rights under the Agreement is either $i ($f + $g) or $j ($f + $h). Of the $d Settlement Amount, the parties have calculated that $f is attributable to the liquidation of B’s right to lifetime payments for support and maintenance, and the balance, $k, is attributable to the settlement and liquidation of B’s right to receive the lump sum on A’s death.

Requested rulings:

You have asked for the following rulings:

(1) The support and maintenance settlement payment ($f) will be

deductible by A for federal income tax purposes in the year it is paid;

(2) The payment of the lump sum ($k) will not result in taxable income to A or B; and

(3) No portion of the $d Settlement Amount paid to B will be a taxable gift by A.

Ruling request #1

Section 71(a) provides, in part, that gross income includes amounts received as alimony. Section 71(b) defines alimony, in part, as any payment in cash if such payment is received by (or on behalf of) a spouse under a divorce or separation instrument. See section 71(b)(1)(A). Section 71(b)(2) defines a "divorce or separation instrument," in part relevant here, as "a written instrument incident to such decree [of divorce]."

Section 215(a) provides that an individual shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during the individual's taxable year. Under section 215(b), the term "alimony or separate maintenance payment" means any alimony or separate maintenance payment (as defined in section 71(b)) that is includible in the gross income of the recipient under section 71. Thus, for A's payment of $f to be deductible under section 215, the Second Agreement must be "incident to" the decree of divorce under section 71(b)(2).

In a number of cases, courts have interpreted the definition of the phrase "incident to" in connection with a divorce decree. For example, Young v. Commissioner, 113 T.C. 152 (1999), involved the question of whether a property transfer between spouses to resolve a dispute arising from their property settlement fell under section 1041.[1] In that case, John B. Young and Louise B. Young were married in 1969 and divorced in 1988. On October 9, 1989, they entered into a property settlement agreement (the "1989 Property Settlement"). Pursuant to the terms of the settlement, John delivered to Louise a promissory note secured by a deed of trust on property that John received as part of the settlement. In 1990, John defaulted on the note and Louise initiated collection proceedings. On December 9, 1992, John and Louise executed a second agreement and release (the "1992 Agreement") that resolved Louise's collection suit by transferring the property to Louise in exchange for the discharge of all of John's debts.

[1] Section 1041 (discussed below) provides for the nonrecognition of gain or loss on the transfer of property from an individual to a former spouse, but only if the transfer is "incident to the divorce."

In determining whether the 1992 Agreement was "incident to" the divorce decree, the court stated:

> The parties agree that the 1989 Property Settlement was, pursuant to section 71(b)(2), "incident to" to the divorce decree because its purpose was to divide the marital property. The 1992 Agreement resolved a dispute arising under the 1989 Property Settlement and completed the division of marital property. See, e.g., Stevens v. Commissioner, 439 F.2d 69, 70 n.4 (2d Cir. 1971) (paraphrasing "incident to" as "[implementing] the terms of the decree"); Barnum v. Commissioner, 19 T.C. 401, 407 (1952) (paraphrasing "incident to" as "related to"); Hesse v. Commissioner, 7 T.C. 700, 704 (1946) (paraphrasing "incident to" as "in connection with").

Thus, the court held that the 1992 Agreement was "incident to" the divorce decree, notwithstanding that it modified a prior agreement and was executed four years after the divorce decree. In the instant case, the Second Agreement is "incident to" the divorce decree because the purpose of the Second Agreement is to carry out the terms of the Agreement.

Where a significant amount of time elapses between the date of a decree of divorce and the execution of a written agreement, a question is raised as to whether the two instruments are sufficiently related. Ordinarily, the time period has little consequence in determining whether the agreement is "incident to" the divorce, as noted by the court in Barnum v. Commissioner, 19 T.C. at 401. In Barnum, the Petitioner and her husband, Walter Barnum ("Barnum"), executed four agreements over a 20-year period, two before their divorce and two after. Each related to alimony, child support and the dissolution of their marriage. The divorce occurred in France on January 10, 1922, and provided for monthly alimony payments of 2,060 francs to Petitioner with a conditional reduction to 515 francs.

On January 26, 1922, the parties executed their third agreement to give credence to the monetary disposition set forth in the French divorce decree. Barnum made alimony payments to Petitioner, as required by the third agreement, through 1935, but made no payments in 1936, 1937, 1938, 1939, and 1940. In December 1940, Petitioner filed suit against Barnum under the third agreement for arrears. The court granted Petitioner partial summary judgment. Barnum appealed. On May 29, 1941, while the appeal was pending, Petitioner and Barnum entered into a fourth agreement providing for: (1) settlement of all claims between the taxpayers; (2) release of Barnum from any liability arising from the divorce decree; (3) settlement of the suit; (4) Barnum's promise to pay $3,000; (5) an understanding about life insurance policies; and (6) Barnum's agreement to pay Petitioner $150 per month ($1,800 per year).

The Commissioner asserted that the $150-monthly amount provided as alimony

for Petitioner under the fourth agreement constituted taxable income. The court queried whether the fourth agreement fit the "incident to" requirement. The third agreement, executed two weeks after the final divorce decree, clarified the amount and currency of alimony payable. The court found this third agreement "incident to" the divorce decree. The controversy between the Taxpayers arose as a result of the third agreement. The fourth agreement resolved that and other issues and replaced the third agreement. By replacing the third agreement, the fourth agreement then became "incident to" the decree of divorce. Barnum v. Commissioner, 19 T.C. at 407-408. The court reached this conclusion notwithstanding the 19-year span between the date of the divorce decree and the execution of the fourth agreement.

In the instant case, the length of time between the divorce decree and the Second Agreement does not diminish the purpose of the Second Agreement, to carry out the terms of the Agreement. Thus, similar to the holding in Barnum, the Second Agreement is "incident to" the divorce decree, notwithstanding the time span between the decree and the Second Agreement.

Under section 71, prior to amendment by the Tax Reform Act of 1986 (hereinafter, "Act"), alimony had to be made in periodic payments. A lump-sum payment, therefore, not being a periodic payment, failed to qualify as alimony. This rule applied to divorces or agreements entered into prior to January 1,1985. Arguably, the proposed lump-sum, described in the Second Agreement, viewed in context with the prior alimony payments, could represent one of the series of periodic payments made to B. However, even if the proposed lump-sum payment were not deductible under section 71 prior to amendment, the payment is deductible as alimony under section 71, as amended by the Act. Pursuant to §1.71-1T(e), Q/A-26 of the Temporary Income Tax Regulations, section 71, as amended by the Act, applies to a divorce or separation instrument executed before January 1, 1985, under several enumerated circumstances. One such circumstance is a change in the period over which alimony payments are to continue. Another is a modification of the instrument expressly providing that section 71, as amended by the Act, is to apply to the divorce instrument as modified. Id.

The parties modified the Agreement to change the period over which alimony payments will be paid. Also, the parties elected to apply section 71, as amended by the Act, to the Agreement with respect to payments made after the effective date of the modification. Accordingly, by virtue of the modification, the Agreement becomes subject to section 71, as amended by the Act. As a result, the lump-sum payment may be qualifying alimony under this section and deductible under section 215. Thus, even if the proposed lump-sum payment is not alimony under section 71 prior to amendment, it is alimony under section 71, as amended by the Act.

Consequently, A can deduct payments described as alimony in the Agreement as modified by the Second Agreement, both agreements having been incorporated into the divorce decree. The deduction is allowable under section 215 for alimony

payments described in section 71 made after the effective date of the Court order incorporating the Second Agreement. This result obtains because the Second Agreement is a written instrument incident to the divorce decree under section 71(b)(2)(A), pursuant to which a payment may qualify as alimony.

Ruling request #2

Section 1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce. Section 1041(c) provides that for purposes of section 1041(a)(2), a transfer of property is incident to the divorce if the transfer occurs (1) within one year after the date on which the marriage ceases, or (2) is related to the cessation of the marriage.

Section 1.1041-1T(b), Q&A-7 addresses when a transfer of property is "related to the cessation of the marriage." Q&A-7 provides that a transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and the transfer occurs not more than 6 years after the date on which the marriage ceases. A divorce or separation instrument includes a modification or amendment to such decree or instrument. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

In this case, although section 1041 had not yet been enacted when the divorce became final on Date 1, the transfers contemplated under the Second Agreement are pursuant to a post-1984 document. Therefore, section 1041 and the regulations thereunder are now relevant. Q&A-7 above specifically discusses when a transfer of property is related to the cessation of the marriage for purposes of transfers under instruments executed after enactment of section 1041. In this case, any transfer of property under the Second Agreement will occur more than y years from the date the marriage ceased, and thus is clearly outside the one- and six-year rule in the regulations. In addition, the reason A and B have executed the Second Agreement is to prevent or resolve differences that may arise between B and the heirs or representatives of A's estate regarding the definition of "net estate" at the time of A's death. These differences are not the product of disputes between A and B concerning the division of the marital property owned by them at the time of the divorce as addressed in Q&A-7. Further, there is no indication of any legal or business

impediments to an earlier transfer of property or to the earlier resolution of the areas of concern noted in the submission.

Nevertheless, Q&A-7 also specifically recognizes that a divorce or separation instrument includes a modification or amendment to such decree or instrument. Consequently, any order from the divorce court that specifically modifies an original divorce or separation instrument must be considered related to the cessation of the marriage, even if such order occurs many years after the divorce. In this case, the parties have received an order issued by the Court, amending the original divorce instrument to incorporate the terms and provisions of the Second Agreement.

Accordingly, we conclude that, based on the representations set forth in the submission and the Court order, the following transfers are related to the cessation of the marriage within the meaning of section 1041(c)(2) and Q&A-7 of the temporary regulations: (i) A's transfer of $k in cash to B and B's relinquishment of her right to receive a lump sum payment upon A's death under Article V of the Agreement and A's obligation to provide collateral for that payment (see paragraph 1, pages 8-9 and paragraph 7, pages 10-11 of the Second Agreement); and (ii) B's termination of her obligation to create a trust for A in her will (see paragraph 4, page 9 of the Second Agreement). Therefore, pursuant to section 1041(a), no gain or loss will be recognized on these transfers by A or B.

Ruling request #3

Section 2511 provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

Section 2516 provides that where husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1-year before such agreement is entered into **(**whether or not such agreement is approved by the divorce decree)**,** any transfers of property or interests in property made pursuant to such agreement (1) to either spouse in settlement of his or her marital or property rights, or (2) to provide a reasonable allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money's worth.

Prior to amendment by section 425(b) of the Deficit Reduction Act of 1984 (the "Act"), and effective before July 18, 1984, section 2516 provided that where a husband and wife enter into a written agreement relative to their marital and property rights and

divorce occurs within two years thereafter (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement (1) to either spouse in settlement of his or her marital or property rights, or (2) to provide a reasonable allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money's worth. The Act changed section 2516 only insofar as to allow the parties one year after the divorce to enter into the written agreement.

Section 25.2516-1 provides that transfers of property or interests in property made under the terms of a written agreement between spouses in settlement of their marital or property rights are deemed to be for an adequate and full consideration in money or money's worth (whether or not the agreement is approved by a divorce decree), if the spouses obtain a final decree of divorce from each other within two years after entering the agreement.

Section 2053(a)(3) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for claims against the estate as shall be allowable by the laws of the jurisdiction under which the estate is being administered. Under section 2053(c)(1), the deduction allowed for claims against the estate, when founded on a promise or agreement, is limited to the extent the claim was contracted bona fide and for an adequate consideration in money or moneys worth.

Section 2043(b)(1) provides a general rule that for estate tax purposes, the relinquishment or promised relinquishment of marital rights in a decedent's property or estate is not considered to any extent a consideration in money or money's worth. However, section 2043(b)(2) provides, effective in the case of estates of decedents dying after July 18, 1984, that for purposes of section 2053, a transfer of property that satisfies the requirements of section 2516(1) shall be considered to be made for an adequate consideration in money or money's worth. See also, Rev. Rul. 60-160, 1960-1 C.B. 374, regarding the deduction of amounts paid pursuant to a property settlement agreement to which section 2516 does not apply.

A and B executed the Agreement relative to their marital and property rights. Five weeks after the Agreement was executed, the Court issued the decree of divorce. Therefore, A's obligations to make the inter vivos and testamentary transfers under the Agreement are within the purview of section 2516. The inter vivos transfers are deemed made for a full and adequate consideration, and are not subject to the gift tax.

Similarly, under section 2043(b)(2), the lump sum payment to be made to B at A's death pursuant to Article V, paragraph 1, of the Agreement would be treated as made for adequate and full consideration in money or money's worth for purposes of section 2053(c)(1). Thus, the payment would be deductible under section 2053 for estate tax purposes.

As discussed above, under the terms of the Second Agreement, A is to pay B a single lump sum payment of $d, in lieu of all future payments A (or A's estate) is obligated to make under the Agreement. Of this $d payment, $f is intended to approximate the present value of the alimony and support payments B would otherwise receive under Article II of the Agreement. As noted above, these alimony and support payments would not be subject to gift tax under section 2516(1). Accordingly, we conclude that the $f lump sum payment to be made by A will not be subject to gift tax.

Similarly, under section 2043(b)(2), the lump sum payable by A's estate on A's death under Article V, paragraph 1 of the Agreement, would be treated as made for adequate consideration and, therefore, the payment would be deductible for estate tax purposes. A bona fide dispute was presented regarding the computation of the amount due on A's death, and the $k amount payable under the Second Agreement in satisfaction of this obligation is within the range of reasonable outcomes under the governing instrument and State law. In addition, it is represented that the parties were dealing at arm's length. Under these circumstances, we conclude that the $k lump sum payment to be made by A under the Second Agreement will not be subject to gift tax. Compare, Rev. Rul. 79-118, 1979-1 C.B. 315, concluding, under the circumstances presented, that additional amounts paid pursuant to the donor's voluntary agreement to increase support payments made under a separation agreement constituted taxable gifts by the donor.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by the appropriate party. While this office has not verified any part of the material submitted in support of the request for rulings, it is subject to verification and examination.

Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
George Masnik
Branch Chief, Branch 4
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
copy for § 6110 purposes