

Internal Revenue Service

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Person To Contact:

, ID No.

Telephone Number:

In Re:

Refer Reply To:

CC:ITA:B05 – PLR-104891-04

Date: June 22, 2004

Legend:

X	=
Y	=
Company	=
County	=
State A	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
<u>w</u>	=
<u>x</u>	=
<u>y</u>	=
<u>\$z</u>	= \$

Dear . :

This is in response to your request dated December 16, 2003, for a private letter ruling on behalf of X and Y. You have requested a ruling that X's payment of a lump sum of money to Y in exchange for Y's community property interest in a nonqualified deferred compensation plan payable to X by Company will constitute nontaxable transfers between former spouses that are related to the cessation of their marriage under section 1041 of the Internal Revenue Code, and that the "assignment of income doctrine" will not cause Y to be taxed when X receives payment of that deferred compensation from Company. You have also requested a ruling that the exchange is a transfer "for full and adequate consideration in money or money's worth" under § 2516 of the Code that will not result in a taxable gift by either X or Y to the other.

According to the facts submitted, X and Y were married on Date 1. On Date 2, several years after their marriage, X secured employment with Company. X remains employed by Company. On Date 3, X and Y were separated. On Date 4, X and Y entered into a Marital Settlement Agreement (MSA). X and Y were divorced pursuant to a Judgment of Dissolution entered by the Superior Court for County, State A, on Date 5. The MSA was incorporated into the Date 5 Judgment.

It is represented that X's earnings from personal services for Company during the last w years of X and Y's x-year marriage constitute community property under the laws of State A, and that X's earnings from personal services for Company during the w years since Date 3, the date of separation, constitute X's separate property (or community property with Husband's current wife). X intends to retire on Date 10 at y years of age.

During their marriage, X's compensation for services to Company in which Y has a community property interest includes deferred compensation under Company's Supplemental Executive Retirement Plan (SERP), a non-qualified employee benefit plan. Under the terms of the SERP, if X retires after age 55 but before age 65 with more than 10 years of service, X will receive a benefit that is reduced by a certain percentage for each month that X's retirement date precedes X's 65th birthday.

The SERP Trust Agreement (Trust) describes the terms of the benefits under the SERP. Section 3.3 provides that a participant may not voluntarily or involuntarily, assign, anticipate, alienate, commute, pledge or encumber any benefits to which he is or may become entitled to under the SERP nor may the same be subject to attachment or garnishment by any creditor of a Participant. Section 9.2 provides that the interests of a Participant (or beneficiary) in the trust estate shall be no greater than the interest of any general unsecured creditor of Company. No right or interest of any Participant (or beneficiary) in the trust estate shall be transferable or assignable or subject to alienation, anticipation, encumbrance, garnishment, attachment or execution. Section 9.3 provides that nothing in the trust instrument is to be construed to relieve Company of its obligation to pay the Retirement Benefit of any Participant except to the extent that the obligation is satisfied by actual payment from the trust estate.

Under the terms of the above MSA, Article II, Section 1, X will transfer, assign and convey to Y, as Y's sole and separate property, all right, title and interest in and to those items of community property more fully described in Schedule A, attached to the MSA. Schedule A, Item 9 conveys to Y one-half of the community interest in the Pension Plan and the Company SERP held for the benefit of X through X's employment with Company as set forth in a Domestic Relations Order that is to be prepared and submitted to the plan for approval as a Qualified Domestic Relations Order.

On Date 6 the Superior Court issued a "Stipulation and Order for Division of the Company SERP" (Stipulation). The Stipulation awarded Y one-half of the community property interest in X's Company SERP. The Stipulation provides that the community property interest in the SERP is to be a pro rata portion of each payment, if any, (after reduction for payments to be made under any qualified plan as provided in the Plan) as each payment is received. Community property is to be determined by a fraction, the numerator of which is the number of months of credited service from the date of employment (Date 2) until the date of separation (Date 3). The denominator is the total number of months of credited service from date of employment to date of retirement or other termination of X's employment.

The Stipulation also provides that X will receive all SERP payments from Company or Trust and that within 10 days of receipt of such payment, X will pay Y's share to Y, without reduction for taxes. Y is to include Y's share of the SERP payments in Y's income for Federal income tax purposes and indemnify and hold X harmless from all taxes attributable to Y's share of the SERP.

Several years after the Superior Court issued Stipulation, X reached the age of eligibility for retirement but had not yet retired from Company. Therefore, no amounts were yet payable under the SERP. Y wanted to commence receiving Y's share of the benefits under the SERP, but because X had not yet retired, no amounts were yet payable under the SERP. On Date 7 Y filed a motion seeking an order from the Superior Court to require X to buy out Y's interest in the SERP. On Date 8, X delivered to Y's counsel a Responsive Declaration in opposition to the motion. Y argued, inter alia, citing certain court cases, that because the commencement of benefits under the SERP was delayed by X's unilateral decision (for the benefit of his separate estate) not to retire, X should be compelled either to commence paying Y's share of the SERP benefits from X's own funds or X should be required to buy out Y's interest in the SERP in a lump sum or in interest-bearing installments.

After a lengthy period of negotiations, X and Y entered into, and the Superior Court approved, a Stipulation and Order Re Division of the SERP Benefits (Final Stipulation) on Date 9. Under the terms of the Final Stipulation, X will pay Y \$z together with the tax-exempt earnings on the investment of \$z in full satisfaction of all of Y's claims with respect to the SERP. Paragraph 3 of the Final Stipulation provides that the parties intend that neither party will have a gift or income tax consequence from the transfer of

the \$z amount. The payment is intended to be nontaxable to Y and nondeductible by X under section 71(b)(1)(B) of the Internal Revenue Code.

Pursuant to the Final Stipulation, X has paid the \$z amount into a trust fund held by X's attorney. Those funds have been invested in a tax-exempt investment as agreed upon by the parties. It has been represented that this amount acts as security for the performance of X's obligations under the Final Stipulation. If, but only if, a satisfactory private letter ruling is received from the Internal Revenue Service, must the attorney transfer the funds to Y. Accordingly, it has further been represented that X has not, and will not, surrender dominion and control over the funds until a ruling satisfactory to X and Y is received from the Service. Y has therefore received no economic benefit from the \$z amount in trust, nor is Y in constructive receipt of such money. X expressly represents that X will continue to be treated as the owner of \$z amount while it is held in trust by the attorney, and X will include in X's income for Federal income tax purposes any nontax-exempt income earned on such amounts while held in trust by X's attorney.

X also represents that X will be taxable for Federal income tax purposes on the full amount of SERP deferred compensation payments made by Company.

Ruling Request No. 1

You have requested a ruling that both the transfer by X to Y (through X's attorney's trust account) of the \$z amount (including the earnings held in trust by X's attorney) and Y's transfer to X of Y's interest in the SERP constitute transfers between former spouses that are "incident to divorce" within the meaning of section 1041(a) of the Code because they are related to the cessation of their marriage within the meaning of section 1041(c)(2). You have requested a further ruling that the assignment of income doctrine will not apply to these transfers with the result that neither X nor Y will be required to include any amount in gross income with respect to these transfers.

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 §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 of the Temporary Income Tax Regulations 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 § 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, on Date 4, X and Y entered into an MSA that provided for the division of the community estate's interest in X's SERP. X and Y were divorced pursuant to a Judgment of Dissolution entered by the Superior Court for County, State A, on Date 5. The MSA was incorporated into that Judgment of Dissolution. On Date 9, X and Y entered into and the Superior Court approved the Stipulation and Order Re Division of the SERP (Final Stipulation). The Final Stipulation provides that X will pay Y \$z together with the tax-exempt earnings on the investment of \$z in full satisfaction of all of Y's claims with respect to the SERP.

The transfers contemplated under the Final Stipulation are governed by § 1041 of the Code and the regulations thereunder. Q&A-7 of § 1.1041-1T(b) 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 § 1041. In this case, any transfer of property under the Final Stipulation will clearly occur outside the six-year rule set forth in that regulation. Nevertheless, Q&A-7 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 years after the divorce. See, e.g., Young v. Commissioner, 113 T.C. 152 (1999), aff'd, 240 F.3d 369 (4th Cir. 2001) (Tax Court held that the purpose of a 1992 Agreement was to resolve a dispute between former spouses concerning the terms of their 1989 Property Settlement, and therefore the 1992 Agreement was incident to their divorce decree, notwithstanding that it modified a prior agreement and was executed years after the divorce decree.)

In this case, the parties have received an order issued by the Superior Court essentially amending their original divorce instrument to incorporate the terms and provisions of the Final Stipulation with respect to the division of the SERP. Pursuant to Q&A-7, we conclude that, based on the representations set forth in the submission and the Final Stipulation issued by the Superior Court, the following transfers are related to the "cessation of the marriage" within the meaning of § 1041(c)(2) of the Code and are therefore considered "incident to divorce" for purposes of § 1041(a): the transfer by X to Y (through X's attorney's trust account) of the \$z amount (including the earnings held in trust by X's attorney), and Y's transfer to X of Y's interest in the SERP. Accordingly, pursuant to § 1041(a), no gain or loss will be recognized on these transfers by X or Y.

With respect to the assignment of income component of this ruling request, we note that the payment of the \$z amount to Y from X is controlled by Balding v. Commissioner, 98 T.C. 368 (1992). That case addressed the question of whether payments received by a spouse in settlement of her claim to a community property share of her ex-husband's military retirement pay are includible in her income. In Balding, petitioner and her husband resided in California, a community property state, during their 19-year marriage. They were divorced in 1981, after ex-husband retired from the military. The divorce court ordered a division of their community property and affirmed that the ex-husband's military retirement pay was his sole and separate property. In 1984, because of changes in California's community property law, petitioner asked the divorce court to reopen its judgment of divorce and award her a community property share of the military retirement pay. Before the divorce court could act, petitioner and her ex-husband reached a settlement with regard to the military retirement pay. Petitioner relinquished any claim to ex-husband's military retirement pay in consideration of his promise to pay to her \$ 15,000, \$ 14,000, and \$ 13,000 in 1986, 1987, and 1988, respectively. The Tax Court held that, under § 1041 of the Code, no income was recognized to petitioner on account of receipt of the settlement payments.

With respect to the present case, Balding is consistent with the above determination that under §1041(a), Y is not taxable on the \$z to be received from X. Balding, however, focused on the amounts paid for the transfer of petitioner's interest in certain retirement benefits, not on which party is taxable when the retirement benefit payments are made. The court stated: "Accordingly, we have no occasion to consider whether the assignment of income doctrine would require petitioner's share of those retirement payments to be taken into petitioner's income as paid by the Government to Balding, notwithstanding petitioner's lack of entitlement to such payments." Balding at 373, n. 8.

In Rev. Rul. 2002-22, 2002-1 C.B. 849, the Service rejected applying the assignment of income doctrine to certain transfers of property incident to divorce. In that revenue ruling, a taxpayer transferred nonstatutory stock options and nonqualified deferred compensation rights to the taxpayer's former spouse incident to their divorce. The ruling first notes that Congress indicated that § 1041 of the Code should apply broadly to transfers of many types of property, including those that involve a right to receive ordinary income that has accrued in an economic sense (such as interests in trusts and annuities). Accordingly, and consistent with Balding, the ruling provides that stock options and unfunded deferred compensation rights may constitute property within the meaning of § 1041. Rev. Rul. 2002-22 then notes that the courts and the Service have long recognized that the assignment of income doctrine does not apply to transfers of income rights between divorcing spouses because such transfers are not voluntary assignments within the scope of the assignment of income doctrine. See Meisner v. United States, 133 F.3d 654 (8th Cir. 1998); Kenfield v. United States, 783 F.2d 966 (10th Cir. 1986); Schulze v. Commissioner, T.C.M. 1983-263; Cofield v. Koehler, 207 F. Supp. 73 (D. Kan. 1962).

Rev. Rul. 2002-22 concludes that a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rev. Rul. 2002-22 further concludes that the former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse. (We note that this revenue ruling expressly does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer.)

Pursuant to Rev. Rul. 2002-22 and Balding, we conclude that the assignment of income doctrine does not apply to the transfer by X to Y (through X's attorney's trust account) of the \$z amount (including the earnings held in trust by X's attorney), and Y's transfer to X of Y's interest in the SERP with the result that neither X nor Y will be required to include any amount in gross income with respect to these transfers. Therefore, the assignment of income doctrine will not cause Y to be taxable on any part of the SERP deferred compensation payments received by X from Company.

As stated above, X has represented that X will be taxable for Federal income tax purposes on the full amount of SERP deferred compensation payments made by Company.

Ruling Request No. 2

You have also requested a ruling that the above exchange is a transfer "for full and adequate consideration in money or money's worth" under § 2516 of the Code that will not result in a taxable gift by either X or Y to the other.

Section 2501(a) of the Internal Revenue Code imposes a gift tax for each calendar year on the transfer of property by gift during the calendar year.

Section 2511 of the Internal Revenue Code 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 a 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 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.

Section 25.2516-1 of the Gift Tax Regulations 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 and, therefore, exempt from the gift tax (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.

On Date 3, X and Y were separated. On Date 4, X and Y entered into an MSA that provided for the division of the community estate's interest in X's SERP. X and Y were divorced pursuant to a Judgment of Dissolution entered by the Superior Court for County, State A, on Date 5. The MSA was incorporated into the Judgment. On Date 9 X and Y entered into and the Superior Court approved the Final Stipulation and Order Re Division of the SERP. The Final Stipulation provides that X will pay Y \$z together with the tax-exempt earnings on the investment of \$z in full satisfaction of all of Y's claims with respect to the SERP.

The transfer of \$z by X to Y is made pursuant to the Judgment of Dissolution. The transfer is in full satisfaction of Y's interest in the SERP. Accordingly, based on the facts submitted and representations made, we conclude that, to the extent of Y's interest in the SERP, the transfer of \$z will be made for full and adequate consideration under § 2516 and therefore the exchange will not result in a taxable gift by X or Y to the other.

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

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

John M. Aramburu
Senior Counsel, Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)