INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 06, 2005

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 61.44-03, 163.00-00, 691.01-00
CASE-MIS No.: TAM-138354-05
Number: **200624065**
Release Date: 6/16/2006

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
$*b* =
Year 1 =
Spouse #1=
Spouse #2=
Date 1=
Year 2=
Date 2=
Date 3 =
Date 4 =
$*c* =
Date 5 =
$*d* =
x =
$*e* =
Date 6 =
$*f* =
Date 7 =

Date 8 =

ISSUE:

Is a portion of the payments received by an estate pursuant to a promissory note transferred to the decedent incident to a divorce considered to be stated interest that is taxable to the estate as income in respect of a decedent?

CONCLUSION:

While a portion of the payments are stated interest, the payments, which were payable directly to beneficiaries rather than the estate, are not taxable to the estate as income in respect of a decedent.

FACTS:

Spouse #1 and Spouse #2 divorced on Date 1. A property settlement agreement (Agreement) executed by Spouse #1 and Spouse #2 prior to the divorce was incorporated into the divorce decree. The Agreement provided, in part, the following: "Upon the entry of the decree of dissolution, [Spouse #2] agrees to execute and deliver to [Spouse #1] a Promissory Note in the face amount of [$*b*] in the form attached hereto … All of the terms and conditions contained in said Note are incorporated herein by reference and made a part hereof."

The promissory note (Note) provided that, "This note shall not be interest bearing." The Note provided that *$b* is payable 6 months after the death of Spouse #1, or 6 months after the death of Spouse #2, whichever should happen first, but in no event would the Note be payable before Year 2. In the event Spouse #1 was not living on the date the Note payments were due, such payments were to be made in accordance with Spouse #1's will, or, in the absence of a will, equally to four named beneficiaries.

The Note also provided that, notwithstanding the stated principal amount of $*b*, the actual amount payable under the Note would be adjusted in February of each year to reflect changes in the Consumer Price Index for Urban Wage Earners and Clerical Worker Families ("CPI"). In no event would the actual amount payable be reduced below the stated principal amount of $*b*. (The excess of the actual amount payable over the stated principal amount will be referred to as the "CPI adjustment amount.") The property settlement also provided additional property for Spouse #1 including full ownership of residential property, alimony payments, and health and life insurance policies.

Spouse #1 died on Date 2. Spouse #2 died on Date 3. On Date 4, the personal representative of Taxpayer filed a claim in probate against Spouse #2's estate, seeking $*c*. The Date 4 claim was later superseded by an amended claim in probate, filed on Date 5, for $*d* as the amount due and owing under the Note. The amount of the claim was based upon an assumed cost of living index factor of x applied to the stated principal amount of the Note (i.e., $b/x). After allowance of the claim to Taxpayer, Spouse #2's estate paid to Taxpayer $e on Date 6, $f on Date 7, and $b on Date 8 in full payment of the claim. Thus, although the Note was payable by its terms directly to the four named beneficiaries, it was paid to Taxpayer.

Both the IRS office submitting this technical advice request and Taxpayer agree that § 1041 of the Internal Revenue Code does not apply to the transfers of property addressed in this technical advice memorandum. The divorce decree between Spouse #1 and Spouse #2 was executed prior to the effective date of § 1041 and the parties to the decree did not elect the application of § 1041. In addition, both parties agree that the subject payments received by Taxpayer are not alimony because neither the version of § 71 in effect prior to 1985 or § 71 as in effect in 1985 and subsequent years applies.

LAW AND ANALYSIS:

Section 61 defines gross income to mean income from whatever source derived, including interest. Under § 61(a)(4), gross income includes interest.

A long-standing position of the Service and the courts has been that the release of marital rights in exchange for cash or other property is not considered a taxable event as to the spouse releasing the marital rights.[1] Rev. Rul. 67-221, 1967-2 C.B. 63; *Pennington v. Commissioner*, T.C. Memo 1990-446. Further, while the Service and the courts have held that interest should not be imputed in connection with payments incident to a divorce, *see* Rev. Rul. 76-146, 1976-1 C.B. 144; and *Fox v. United States*, 510 F.2d 1330 (3rd Cir. 1975),[2] the non-taxability of post-divorce payments does not extend to payments of stated interest received by a former spouse. *See Gibbs v. Commissioner*, T.C. Memo 1997-196; and *Yankwich v. Commissioner,* T.C. Memo 2002-37. In such cases of payments of principal and interest incident to a divorce, only the portion of the payments that represents principal is excluded from the gross income of the recipient. Thus, in the present case, an issue of importance is whether the provisions of the Note call for payments of stated interest.

Does the amount payable by Spouse #2 or his estate include the payment of stated interest?

---

[1] Enacted in 1984, § 1041 provides that no gain or loss is recognized on the transfer of property from an individual to (1) a spouse or (2) a former spouse if the transfer is incident to a divorce. Prior to the enactment of § 1041, a spouse transferring appreciated property to his or her former spouse in consideration for the transferee spouse's release of marital rights was a taxable event as to only the transferring spouse. *See U.S. v. Davis,* 370 U.S. 65 (1962). Section 1041 was enacted to make such a transaction a non-taxable event as to both former spouses.

[2] Under §§ 1.483-1(c)(3)(i) and 1.1274-1(b)(3)(iii), §§ 483 and 1274 do not apply to any debt instrument issued in consideration for a transfer of property subject to § 1041.

Interest has been defined as the amount one has contracted to pay for the use of borrowed money and as the compensation paid for the use or forbearance of money. *See Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552 (1932); *Deputy v. du Pont*, 308 U.S. 488 (1940).

Interest can be an amount payable entirely at maturity. In *Kena, Inc. v. Commissioner*, 44 B.T.A. 217, 221 (1941), an amount "in lieu of interest" that was measured by a percentage of profits from a business and payable at maturity of a loan was treated as interest. The Board of Tax Appeals explained:

> It is not essential that interest be computed at a stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money, pursuant to the agreement of the lender and borrower. . . . The lender may forego interest if he chooses. He may agree not to charge interest or to reduce the amount of interest, provided certain events occur. . . . The possibility that no interest might be payable does not affect the character of the interest when actually paid.

The formula in the Note for the CPI adjustment produces a CPI adjustment that exactly compensates Spouse #1 or Taxpayer for the decrease in the value of the stated principal amount due to inflation. Taxpayer suggests that the CPI adjustment might have had another purpose related to the fair market value of other property. However, Taxpayer also states that the CPI adjustment protected Spouse #1's interest in the "appreciation" of some property and was necessary in light of the potentially long time before payment. We conclude that the CPI adjustment is compensation for the decrease in the value of the stated principal amount due to inflation.

Taxpayer might argue that compensation for the decrease in the value of an amount due to inflation is different from compensation for the delay in the payment of the amount (and therefore is not interest) because the former merely makes the recipient whole (in inflation-adjusted dollars), whereas the latter puts the recipient ahead. This argument assumes that for federal income tax purposes the concept of "compensation" is measured by inflation-adjusted dollars rather than absolute dollars. Similar arguments that taxpayers should be allowed to adjust basis or exclude interest from income to reflect inflation have been uniformly rejected by the courts. *See Stelly v. Commissioner*, 804 F.2d 868 (5th Cir. 1986) (interest); *Nordtvedt v. Commissioner*, 116 T.C. 165 (2001) (annuity); *Hellermann v. Commissioner*, 77 T.C. 1361 (1981) (gain from sale of property).

In *Hellermann*, the Tax Court relied on "the well-established doctrine that Congress has the power and authority to establish the dollar as a unit of legal value with respect to the determination of taxable income, independent of any value the dollar might also have as a commodity" and "the doctrine of common interpretation" according to which "the meaning of income is not to be construed as an economist might, but as a layperson might." 77 T.C. 1364, 1366.

We conclude that for federal income tax purposes the CPI adjustment amount is compensation for the delay in the payment of the stated principal amount and therefore is interest. Our conclusion is bolstered by several cases.

In *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979), Starker agreed to convey timberland to Crown Zellerbach Corporation ("Crown"), and Crown agreed to acquire and deed over to Starker other real property within five years or pay any outstanding balance in cash. The original balance was the value of the timberland. Crown agreed that until the transaction was completed it would add to the outstanding balance an annual "growth factor" equal to six percent of the outstanding balance. The government argued that the growth factor should be treated as ordinary income because it was "disguised interest." Starker argued that the growth factor merely compensated him for timber growth on the timberland he conveyed to Crown. The court stated:

> We agree with the government that the taxpayer is essentially arguing "that he conveyed $1,502,500 to a stranger for an indefinite period of time (up to five years) without any interest." The 6 per cent "growth factor" was "compensation for the use or forbearance of money", that is, for the use of the unpaid amounts owed to Starker by Crown. Therefore, it was disguised interest.

602 F.2d 1356. The court concluded that the growth factor was interest, in part, because the agreement could run for an indefinite period of time up to five years and provided for no other interest.

In *Utility Trailer Mfg Co. v. United States*, 212 F.Supp. 773 (S.D. Cal. 1962), the taxpayer issued "Registered Inflation Provision Notes" ("Inflation Notes") for which interest was payable quarterly on a "pre-payment value" and which, in addition to that interest, paid a "maturity value" at maturity. The maturity value of the Inflation Notes was determined according to the change in the CPI and could not fall below the face value of the notes. One issue in the case was whether the taxpayer could treat the excess of the maturity value over the face value as discount that could be amortized over the life of the notes. The court treated the excess of the maturity value over the face value as discount equivalent to interest. (However, the court treated the excess as contingent interest that was not deductible until its amount became fixed at maturity.) 212 F.Supp. 792-94.

Our conclusion is also bolstered by the fact that several courts have described interest as compensation for inflation. *See Estate of Cooper v. Commissioner*, 74 T.C. 1373, 1375-76 (1980) ("It is inconceivable that were interest not provided, she would have entered into such an exchange merely to watch the value of her investment erode under the continuous pressure of inflation"); *Bunting v. Secretary of HHS*, 1989 U.S. Cl. Ct. LEXIS 296 ("Presumably investors fearing inflation adjust their demands for interest income to account for the inflation expected"). Numerous courts have also recognized that market interest rates have components reflecting real interest rates, inflation, default risk, and other factors (all of which market interest is treated as interest income for federal income tax purposes). *See Jones & Laughlin Steel Corp. v. Pfeifer*, 462 U.S. 523 (1983); *Scott v. United States*, 884 F.2d 1280 (9th Cir. 1989); *Culver v. Slater Boat Co.*, 722 F.2d 114 (5th Cir. 1983); *Doca v. Marina Mercante Nicaraguense, S.A.*, 634 F.2d 30 (2d Cir. 1980); *Estate of Friedberg v. Commissioner*, T.C. Memo 1992-310.

It is not necessary for the parties to a transaction to label a payment as interest for it to be treated as interest. Rev. Rul. 74-187, 1974-1 C.B. 48; Rev. Rul. 72-315, 1972-1 C.B. 49; Rev. Rul. 69-582, 1969-2 C.B. 29, amplifying Rev. Rul. 69-188, 1969-1 C.B. 54.

The CPI adjustment under the Note is "stated" in the sense that it is "a sum definitely ascertainable . . . pursuant to the agreement." *Kena* at 221. Thus, we conclude that the CPI adjustment amount is stated interest.

Our conclusion is not affected by the provision that the Note "shall not be interest bearing." In *Estate of Berry v. Commissioner*, 43 T.C. 723 (1965), the taxpayers sold a hotel for an 11-year note. The note recited that it was without interest, but it included a prepayment discount schedule (providing that earlier payments were smaller). The Commissioner argued that a portion of the stated purchase price was really interest. The court stated:

> An intention of the parties different from that expressed in the documents witnessing their agreements will not lightly be assumed. The true substance of that intention is to be determined, however, from all of the evidence and is not limited to the formal contract or note. . . . Despite the recitation in the contract that the note is to be without interest, we are satisfied that interest was intended and paid.

43 T.C. 730. Because of the presence of the prepayment discount schedule, taxpayers' argument that the sales agreement provided for no interest implied that, for reasons unknown, the agreement provided for different purchase prices applicable depending on the date the note was paid. The court found instead that interest was intended and paid, and rejected the taxpayers' alternative argument that, even if interest was intended, the amount of the interest was neither identifiable nor ascertainable. 43 T.C. 731.

In the present case, Taxpayer argues that the Note was not transferred in Year 1 because it was not assignable or transferable until Spouse #2 or Spouse #1 passed away. Rather, according to Taxpayer, the Note was merely a format for documenting the part of the divorce decree that called for a future post-death payment. Thus, according to Taxpayer, the Note transfer occurred when, pursuant to the obligation under the divorce decree, Spouse #2's estate made the required payments.

For a number of reasons, Taxpayer's Note transfer argument does not affect our conclusion that the CPI adjustment amount is stated interest. First, as described above, Spouse #2 delivered a promissory note to Spouse #1, in Year 1, thus undertaking an obligation to make payments in exchange for the release of Spouse #1's marital rights. Simply because Spouse #1 could not assign or transfer the instrument obligating Spouse #2 to make such payments does not mean that there was no Note transfer in Year 1. More importantly, however, our position that the CPI adjustment amount is stated interest for federal income tax purposes is not based on there being a Note separate and apart from the divorce decree. Rather, our position is based on the fact that Spouse #1, in Year 1, released her marital rights in exchange for, among other things, Spouse #2's obligation to pay *$b* plus the CPI adjustment amount. Accordingly, Taxpayer's argument that the Note was not transferred in Year 1 does not affect our conclusion that the CPI adjustment amount that Spouse #2 was obligated to pay is compensation for the delay in the payment of the stated principal amount and therefore is stated interest.

Does the payment of stated interest give rise to IRD to the estate?

Section 691(a)(1) provides that the amount of all items of gross income in respect of a decedent (IRD) which are not properly includible in the taxable period of the decedent's death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) must be included in the gross income, for the taxable year when received, of--

(A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

In the present case, the CPI adjustment amount, representing the excess of the amount payable ($*d*) under the Note as of Date 2 over the stated principal amount of the Note, is IRD because that amount would have been taxable to Spouse #1 as interest income had the Note been paid to her. However, because, under the terms of the Note, all amounts were payable to the four named beneficiaries rather than to Taxpayer, Taxpayer did not acquire the right to receive the amount from Spouse #1 under

§ 691(a)(1)(A). Therefore, the CPI adjustment amount is not taxable to Taxpayer as IRD in the taxable years of the Taxpayer in which the payments under the Note were received.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.