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Person To Contact:
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CC:ITA:B03
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LEGEND

Husband =
Wife =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Year 1 =
$A =
$B =
$C =
$D =
$E =
$F =
$G =
W =
X =
Y =

Z =
State =
State Court =

Dear :

This ruling responds to a letter dated June 10, 2011 submitted by your authorized representatives, requesting a ruling regarding the income tax and gift tax consequences of a lump-sum payment in satisfaction of Husband's obligations to Wife to pay alimony and to leave one-third of his net estate to her under the divorce judgment and a settlement agreement incorporated into the divorce judgment.

STATEMENT OF FACTS

The facts submitted are as follows:

Husband and Wife were married on Date 1 and had four children, who are now fully emancipated. On Date 2, the parties entered into a separation agreement (the Separation Agreement) and obtained a divorce judgment (the Divorce Judgment), which was entered on Date 3 by the State Court. The Divorce Judgment incorporated, but did not merge, the Separation Agreement.

The Separation Agreement provides for alimony to be paid by Husband to Wife. The amount Husband must pay is based on a percentage of the first $A of his annual net income plus a smaller percentage of his annual net income exceeding $A but not more than $B, with a $C minimum annual payment. If Wife has annual net income exceeding $D, Husband receives a credit against his alimony obligation for that year. The term "annual net income" of Husband and Wife is generally defined in the Separation Agreement as his or her annual adjusted gross income for federal income tax purposes, disregarding certain types of income, for example, capital gains and losses, dividends and interest. Husband's obligation to pay alimony to Wife terminates on the earliest to occur of Husband's death, Wife's remarriage, or Wife's death.

Currently, Husband is age W and Wife is age X. Wife has not remarried and the parties anticipate that Wife will not remarry during Husband's lifetime. Wife has never had annual net income in excess of $D. At present, Husband is paying the minimum alimony amount of $C per year and the parties anticipate that Husband's alimony obligation will remain at the minimum amount for the duration of his obligation.

The Separation Agreement also requires Husband to leave not less than one-third of his net estate to Wife, if she survives him and has not remarried at his death. The term "net estate" is generally defined in the Separation Agreement as Husband's gross estate passing to others under his will less funeral and testamentary expenses, debts, inheritance and estate taxes, and death duties of every kind, but also includes certain

additions to his net estate; however, limited to the extent that he has provided the corpus thereof.

The parties disagree on the proper method for computing Husband's net estate under the Separation Agreement. Specifically, the parties disagree on what comprises the net estate – whether gifts and inheritances are excluded and whether certain expenses and taxes are deductible. The parties recognize that resolving these issues will be costly to Husband's estate and will delay distributions to his beneficiaries and to Wife. Therefore, the parties agreed to settle the matter by entering into a settlement agreement (the Modification Agreement).

On Date 4, Husband and Wife entered into the Modification Agreement. The Modification Agreement requires Husband to pay Wife a lump-sum amount of $E in full settlement of his obligation under the Separation Agreement to pay alimony and to leave a portion of his net estate to Wife. The Modification Agreement also requires Husband to continue to pay alimony to Wife for a period of Y months as provided in the Separation Agreement after the entry of the amended Divorce Judgment and after he pays the sum of $E. The Modification Agreement further provides that § 71 of the Internal Revenue Code, as amended by the Tax Reform Act of 1984, shall apply to the Modification Agreement and that the lump-sum payment of $E shall not be taxable to Wife or deductible to Husband, but alimony payable for the Y months shall be taxable to Wife and deductible to Husband.

The lump-sum payment of $E was determined by a professional actuary who valued Wife's right to receive alimony for the term of her and Husband's life expectancy and Wife's right to receive one-third of Husband's net estate upon his death if she survives him. The amount of the lump-sum payment was determined using the RP-2000 mortality tables and the rate of investment return based on the current estimated yield-to-maturity on 30-year Treasury bonds. Of the lump-sum payment of $E, $F is attributable to the present value of Wife's right to lifetime payments for alimony as of Date 5. The balance of this payment, $G, represents the present value of Wife's right to receive one-third of Husband's net estate as of Date 6. The value of this testamentary transfer was computed using two alternative valuation methods, one that values the net estate without regard to the deductions or exclusions and another that values the net estate then reduces the net estate by the amount of the contested exclusions and deductions. The amount agreed upon by the parties was an amount in between the alternative values.

The Modification Agreement is contingent upon the parties obtaining (i) an opinion from the Internal Revenue Service (the Service) that the amount paid to Wife shall not be considered income to Wife or result in income tax liability to her, and shall not create any gift tax liability to Husband or Wife and (ii) an amended divorce judgment (the Amended Divorce Judgment) from the State Court which incorporates the Modification Agreement. The parties will seek amendment of the Divorce Judgment in the State

Court after receiving a favorable private letter ruling from the Service. The parties anticipate that there will be no difficulty in obtaining the Amended Divorce Judgment on consent.

The Modification Agreement provides that if a favorable private letter ruling is not received from the Service on the tax consequences of the payment as designated in the Modification Agreement, the Modification Agreement will cease to be effective unless either or both of the parties waive the right to terminate the Modification Agreement. The Modification Agreement further provides that if the Amended Divorce Judgment is not obtained from the State Court by Date 7, the Modification Agreement will terminate and will be void.

The parties represent that each of Husband and Wife has fully performed his or her obligations under the Separation Agreement and no arrears or other breach of the Separation Agreement is outstanding as of the effective date of the Modification Agreement. Further, the parties represent that the Modification Agreement was negotiated in good faith and after extended arm's length negotiations. Throughout the negotiations, both sides were represented by independent counsel. The parties further represent that Wife's right to a share of Husband's estate constitutes a vested property interest under State law as does Wife's release and extinguishment of such right.

RULINGS REQUESTED

You have requested the following rulings:

1. The payment of $F in a lump sum by Husband to Wife in return for the extinguishment of his liability to pay alimony to Wife will not be income to Wife or result in income tax liability to Wife.

2. The payment of $G in a lump sum by Husband to Wife in extinguishment of her claim to one third of his net estate will not constitute income to Wife or result in income tax liability to Wife.

3. The payment of $F in a lump sum by Husband to Wife in return for the extinguishment of his liability to pay alimony to Wife will not constitute a gift which subjects Husband or Wife to a gift tax.

4. The payment of $G in a lump sum by Husband to Wife in extinguishment of her claim to one third of his net estate will not constitute a gift by Husband to Wife which subjects Husband to a gift tax.

5. The acceptance by Wife of the payment of $G in a lump sum in extinguishment of her claim to one third of Husband's net estate will not constitute a gift by Wife

to Husband of the excess value, if any, of her entitlement to one third of Husband's net estate which subjects Wife to a gift tax.

LAW AND ANALYSIS

Ruling Request 1

Section 215(a) of the Internal Revenue Code (the Code) provides that an individual shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year. Section 215(b) defines "alimony or separate maintenance payments" as any alimony or separate maintenance payment (as defined in § 71(b)) which is includible in the gross income of the recipient under § 71.

Section 71(a) of the Code provides that gross income includes amounts received as alimony or separate maintenance payments. Section 71(b)(1) defines the term "alimony or separate maintenance payment" as any payment in cash if: (A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument; (B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under § 71 and not allowable as a deduction under § 215; (C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made; and (D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse. A payment must meet all of the factors to qualify as alimony.

Section 71(b)(2) of the Code defines a "divorce or separation instrument" as (A) a decree of divorce or separate maintenance or a written instrument incident to such decree, (B) a written separation agreement, or (C) a decree requiring a spouse to make payments for the support or maintenance of the other spouse.

Section 1.71-1T(b), Q&A-8, of the Temporary Income Tax Regulations (the Regulations) provides that spouses may designate that payments otherwise qualifying as alimony or separate maintenance payments shall be nondeductible by the payor and excludible from gross income by the payee by so providing in the divorce or separation instrument, as defined in § 71(b)(2) of the Code. See also H.R. Rep. No. 98-432 at 1496 (1984), reprinted in 1984 U.S.C.C.A.N. 697, 1138 ("The parties, by clearly designating in a written agreement, can provide that otherwise qualifying payments will not be treated as alimony for federal income tax purposes and therefore will not be deductible or includible in income."). Section 1.71-1T(b), Q&A-8, further provides that a copy of the divorce or separation instrument containing the designation of payments as not alimony

or separate maintenance payments must be attached to the payee's first filed federal tax return (Form 1040) for each year in which the designation applies.

Section 1.71-1T(e), Q&A-26 of the Regulations provides that § 71 of the Code, as amended by § 422 of the Tax Reform Act of 1984 (the Act), Division A of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 795-799, applies to any divorce or separation agreement instrument executed before January 1, 1985 that has been modified on or after January 1, 1985, if such modification expressly provides that § 71, as amended, shall apply to the instrument as modified.

Where a separate contractual instrument has been entered into by the parties modifying, changing or replacing the provisions of the initial agreement with respect to alimony, the deductibility of a payment made pursuant to the second agreement is governed by the provisions of the second instrument. Lehrer v. Comm'r, T.C. Memo. 1980-256. However, if a lump-sum payment is made in satisfaction of a mixture of alimony arrearages and future alimony obligations, the payment is treated for tax purposes as alimony to the extent of alimony arrearages unless there is an amount specifically allocated to the satisfaction of future alimony obligations. See Grant v. Comm'r, 18 T.C. 1013 (1952), aff'd, 209 F.2d 430 (2nd Cir. 1953); see also Davis v. Comm'r, 41 T.C. 815 (1964); Holloway v. U.S., 428 F.2d 140 (9th Cir. 1970); Olster v. Comm'r, 79 T.C. 456 (1982), aff'd, 751 F.2d 1168 (11th Cir. 1985).

In the instant case, the purpose of the Modification Agreement is to carry out the terms of the Separation Agreement and the Modification Agreement will be incorporated into the Amended Divorce Judgment. Thus, the Modification Agreement is "incident to" a decree of divorce despite the time span of Z years between the Divorce Judgment and the Modification Agreement. See Barnum v. Comm'r, 19 T.C. 401 (1952) (holding that the agreement entered into 19 years after divorce settling disputes in respect of previous agreements was "incident to" the decree of divorce). Under the rule recognized in Lehrer, the provisions of the latter agreement, the Modification Agreement, determine the tax consequences of the payment made pursuant to the modification.

The parties modified the Separation Agreement to change the period over which alimony payments will be paid. In doing so, the parties elected to apply § 71 of the Code, as amended by the Act, to the Modification Agreement by its terms. Accordingly, § 71, as amended by the Act, determines the characteristics of the lump-sum payment of $F made pursuant to the Modification Agreement with regard to whether it qualifies as alimony or not.

The Modification Agreement expressly designates the lump-sum payment provided under the agreement as excludible from Wife's income and non-deductible from Husband's income for federal income tax purposes. Therefore, the lump-sum payment does not meet one of the factors of § 71(b)(1) of the Code that requires no such

designation of the payment in the divorce or separation instrument in order to meet the definition of alimony or separate maintenance payment for purposes of §§ 71 and 215. Further, there are no past-due alimony payments involved in this case. Accordingly, we conclude that the payment of $F in a lump sum by Husband to Wife in return for the extinguishment of his liability to pay alimony to Wife is not alimony or separate maintenance payment as defined in § 71(b), and is not includible in Wife's income under § 71 and not deductible by Husband under § 215. However, the Y month's alimony payments made under the Modification Agreement satisfy all of the factors of § 71(b)(1) and qualify as alimony taxable to Wife under §71 and deductible to Husband under § 215.

Ruling Request 2

Section 1041(a) of the Code 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(b) provides that, in the case of any transfer of property described in § 1041(a), the property shall be treated as acquired by the transferee by gift, and the basis of the transferee in the property shall be the adjusted basis of the transferor. 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 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, although § 1041 of the Code had not yet been enacted when the parties' divorce became final in Year 1, the transfers contemplated under the Modification Agreement are pursuant to a post-1984 document. Accordingly, § 1041 and the regulations thereunder are now relevant. Section 1.1041-1T(b), Q&A-7, 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 Modification Agreement will occur more than Z years from the date the marriage ceased and thus is outside the one-year and six-year periods in the temporary regulations. The parties' reason for executing the Modification Agreement is to resolve differences that may arise at the time of Husband's death between Wife and the heirs or representatives of Husband's estate regarding the interpretation of the definition of "net estate." These differences are not the product of disputes between Husband and Wife 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, § 1.1041-1T(b), Q&A-7, of the Regulations 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 if that is what the parties intend, even if such order occurs many years after the divorce. In this case, the facts submitted and the representations made indicate that the parties will modify the Divorce Judgment and obtain the approval of the modifications by the State Court.

Accordingly, assuming the parties receive an order issued by the State Court amending the Divorce Judgment to incorporate the terms and provisions of the Modification Agreement, we conclude that, based on the representations set forth in the submissions, the following transfers are related to the cessation of the marriage within the meaning of § 1041(c)(2) of the Code and § 1.1041-1T(b), Q&A-7, of the Regulations: (i) Husband's transfer of $G in cash to Wife, and (ii) Wife's relinquishment of her right to receive a lump-sum payment upon Husband's death equal to one-third of Husband's "net estate" pursuant to the Separation Agreement. Therefore, pursuant to § 1041(a), no gain or loss will be recognized on these transfers by Wife or Husband.

Ruling Requests 3, 4, and 5

Section 2511 of the 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) of the Code 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 of the Code 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 one 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 § 425(b) of the Act and effective before July 18, 1984, § 2516 of the Code 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 § 2516 only insofar as to allow the parties an additional year before the divorce to enter into the written agreement. See § 425 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 804.

Section 25.2516-1 of the 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 (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) of the Code 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 § 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 money’s worth.

Section 2043(b)(1) of the Code provides a general rule that for estate tax purposes, a 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, § 2043(b)(2) provides an exception for estates of decedents dying after July 18, 1984; that for purposes of § 2053, a transfer of property that satisfies the requirements of § 2516(1) shall be considered to be made for an adequate and full 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 § 2516 does not apply.

Husband and Wife executed the Separation Agreement relative to their marital and property rights. Less than a year later, the State Court entered the decree of divorce. Therefore, Husband's obligations to make the inter vivos and testamentary transfers under the Separation Agreement are within the purview of § 2516. The inter vivos transfers are deemed made for a full and adequate consideration, and are not subject to the gift tax.

Similarly, under § 2043(b)(2) of the Code, the lump-sum payment to be made to Wife at Husband's death pursuant to the Separation Agreement would be treated as made for adequate and full consideration in money or money's worth for purposes of § 2053(c)(1). Thus, the payment would be deductible under § 2053 for estate tax purposes.

As discussed above, under the terms of the Modification Agreement, Husband is to pay Wife a single lump-sum payment of $E as well as Y monthly alimony payments, in lieu of all future payments Husband (or Husband's estate) is obligated to make under the Separation Agreement. Of this $E payment, $F is intended to approximate the present value of the alimony and support payments Wife would otherwise receive under the Separation Agreement. As noted above, these alimony and support payments would not be subject to gift tax under § 2516(1) of the Code. Accordingly, we conclude that the $F lump-sum payment to be made by Husband and accepted by Wife will not be subject to gift tax. Therefore, neither Husband nor Wife will be considered to make a gift for the payment (in Husband’s case) or acceptance (in Wife’ case) of the lump-sum amount.

Of the $E payment, $G is intended to approximate the present value of the amount due on Husband’s death. As noted above, under § 2043(b)(2) of the Code, the lump-sum amount payable by Husband's estate on Husband's death under the Separation Agreement would be treated as made for adequate and full 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 Husband's death. In addition, it is represented that the parties were dealing at arm's length. The $G amount, as well as the Y months of alimony, payable under the Modification Agreement in satisfaction of this obligation, is within the range of reasonable outcomes under the governing instrument and state law. Under these circumstances, we conclude that the $G lump-sum payment to be made by Husband under the Modification Agreement will not be subject to gift tax. Therefore, neither Husband nor Wife will be considered to make a gift for the payment (in Husband’s case) or acceptance (in Wife’ case) of the lump-sum amount. But cf. Rev. Rul. 79-118, 1979-1 C.B. 315 (concluding 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).

This letter 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.

A copy of this letter ruling must be attached to any tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the proposed transaction under any other provision of the Code or regulations.

Enclosed is a copy of the letter ruling showing the deletions proposed to be made when the letter is disclosed under § 6110 of the Code.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Christopher F. Kane
Branch Chief, Branch 3
(Income Tax & Accounting)

Enclosure (1): Copy for § 6110 purposes

cc: