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Taxation for Lawyers

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Qualifying for nonrecognition on transfers between spouses or as part of a divorce

Since spouses are viewed as a single economic unit, transfers of property between them or in connection with a divorce are generally tax free. This article discusses the requirements for nonrecognition and presents planning strategies and techniques to ensure such treatment.

by* SHELDON D. POLLACK, *Attorney

WHEN SPOUSES divorce, there is usually a division and transfer of marital property made pursuant to a settlement agreement. In such divisions, tax consequences that might otherwise be triggered by an exchange are deferred under the general nonrecognition rule of Section 1041. This nonrecognition rule is mandatory and applies to transfers between spouses during marriage on the theory that a husband and wife are a single economic unit. It also applies to all transfers between former spouses that are incident to a divorce, including any transfer of property (including cash) made within one year of the effective date of the divorce even though not made pursuant to a property settlement or divorce or separation agreement. However, Temp Reg. 1.1041-1T, Q&A, 6 & 7, provides that when the transfer occurs more than one year but less than six years after the divorce, it must be made pursuant to such an instrument to qualify. Furthermore, a transfer between former spouses occurring more than six years after the divorce, even if made pursuant to a divorce or separation instrument, is presumed to be unrelated to the cessation of the marriage, and therefore not protected by the nonrecognition rule of Section 1041. However, in special circumstances there may be facts sufficient to overcome this presumption.

Section 1041 is designed to end the extensive litigation and controversy arising from transfers of appreciated property during a divorce, which could result in taxation to the transferor spouse. A transfer under Section 1041 is treated as a gift, with the recipient spouse taking a carryover basis in the transferred property.

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Under Section 1041(a), no gain or loss is recognized on the qualifying transfer of property. Thus, no gain or loss is recognized when the transfer of property (including money) is for the release of marital rights or other consideration. In the case of a division of marital property in which, for example, the husband agrees to pay his wife a lump sum in satisfaction and release of her marital rights and both parties divide the marital property, there is no recognition of gain or income by either party. This much is clear under Section 1041. However, many of the nuances in its application have yet to be worked out, or even fully conceptualized, by the Service, the courts, and tax practitioners.

Installment payments

In many property settlements, the husband does not have sufficient cash available to fund a lump-sum payment to equalize the division of property. Since the parties recognize that it is undesirable to require the husband to liquidate marital property that he has received pursuant to the settlement (such as stock in a closely held family business), a promissory note may be given by the husband representing his obligation under the settlement agreement. The husband thereby becomes obligated to make installment payments of the unpaid outstanding balance on his note. To make the wife whole in comparison to receiving a lump sum, the installment payments must carry interest at a market interest rate.

Example. Husband agrees to pay Wife $1 million in a lump sum for the release of her marital rights and to equalize the division of property. Husband keeps

the former marital residence and stock in a closely held business; Wife keeps a second vacation residence, various other personal property, and is to receive the lump sum of $1 million. Husband will pay $400,000 in cash outright, and make six equal payments of $100,000 every year for six years (payment to be made pursuant to the agreement and completed within six years to keep the transaction within the protection of Section 1041). The outstanding balance of the $600,000 installment obligation carries a market rate of interest at the applicable Federal rate (AFR), and the interest is payable semiannually.

In this common transaction, for six years after the divorce the former wife will receive annual payments of $100,000 plus accrued and paid interest. While the $100,000 payments of principal are governed by Section 1041, and are thus tax free to the wife and nondeductible to the husband, what is less clear is the tax treatment of the interest paid by the husband.

Interest paid by spouse

Neither the Service nor the courts have considered the recognition of income relating to interest payments made on an obligation incurred in a division of property subject to Section 1041. It could be argued that Congress intended that Section 1041 should apply to all transfers (including interest) between former spouses made pursuant to a divorce. Since recapture income and discharge of indebtedness income are afforded nonrecognition treatment under Section 1041 (although technically both represent income rather than gain), by analogy it can be argued that interest income should also be tax free to the wife as payee and nondeductible to the husband as payor.

In support of this broad reading is language from several cases that suggests that the tax treatment of any payment between spouses (or former spouses incident to a divorce) is to be governed exclusively by Sections 71 and 215.[1] Only a payment constituting income and a deduction under these sections would have tax consequences to the parties in a divorce: Sections 61 and 163 simply would not apply.

However, one commentator has flatly stated that the stated interest paid is taxable to the wife (and deductible by the payor-husband) regardless of being paid within the context of a divorce.[2] While this argument is broad, and would appear to include the interest payments in the above example, it could also refer only to payments designated as relating to the acquisition of an interest in property. Under this narrower interpretation, only interest payments relating to the husband's acquisition of property (for instance, his purchase of the wife's share of the principal marital residence) would be the kind of interest taxable to the wife and deductible by the husband.

While there is no authority as to the payment of interest within the context of a transaction subject to Section 1041, other related issues have arisen as the Service has been forced to consider the outer bounds of the application of the nonrecognition rule. The Service has considered the issue as to the application of Section 1041 to annual payments made by a husband to his wife in exchange for her relinquishment of all claims and rights relating to the husband's military retirement benefits.[3] The nature and extent of the wife's rights were uncertain at that date due to a change in the applicable law. The Service found that the wife had, in effect, assigned to the husband her rights to receive payments during the husband's lifetime from the pension plan in exchange for the right to receive future installment payments from the husband over three years. Viewing the transaction as one involving payments for a right to future income rather than as gain or property received by the wife, the Service held that Section 1041 did not apply. It was further held that the wife could not avoid taxation on ordinary income by an assignment of such income to her former husband. Merely characterizing the assignment of income as a transfer of property made pursuant to Section 1041 was insufficient to bring the payments under the nonrecognition rule applying to gain. The payments to the wife from her former husband were includable as ordinary income.

The Service has taken a similarly restrictive approach to the application of Section 1041. In *Rev. Rul.* 87-112,[4] the husband transferred to his wife Series E and EE bonds as part of a divorce property settlement. The Service again held that while Section 1041 bars the recognition of gain on the sale or exchange of property, it does not apply to income that is assigned by one former spouse to another incident to a divorce. Therefore, the accrued deferred interest income on the bonds as of the date of transfer was includable in the income of the husband, and an amount equal to that taxable income increased the carryover basis in the bonds in the hands of the wife. Similarly, interest that accrued after the date of transfer would be includable in the wife's income.

These rulings merely apply a doctrine of constructive receipt. For instance, if a husband could transfer accrued interest or his rights to receive pension benefits to his former wife in a tax-free exchange, the interest and pension payments would effectively escape taxation. Conversely, if the interest or pension payments were actually paid to the husband, and he then transferred payments in an equal amount to his former wife, the husband would clearly be liable for the tax on the income he received.

However, these holdings unnecessarily invoke troubling language to the extent that Section 1041 is found not to apply to the assigned income to the extent that

it is not gain. The implication is that nonrecognition is only afforded gain (*i.e.,* to the transferor where the fair market value of the property exceeds its basis). This leaves in doubt the tax treatment of an interest payment on an installment obligation since such interest represents income, and not gain, to the recipient.

In *Ltr. Rul.* 8645082, facts similar to those at issue were present, but the actual question addressed by the Service was somewhat different. Spouses entered into a separation agreement under which the husband received certain assets, and to equalize the division of property, he delivered to his wife a promissory note carrying a variable interest rate ranging from 5.5% to 7.5%, payable in monthly installments of interest only for ten years, and interest and amortized principal payable for another ten years. At issue was whether the note was subject to the unstated interest provisions of Section 483, the original issue discount rules, or the below-market interest provisions of Section 7872. The Service concluded that neither section applied because a transfer of property between spouses is not treated as a sale or exchange. The Service also noted that neither Section 483 nor Section 1274 applies to recharacterize principal payments as interest deductible by the husband or includable by the wife. Section 7872 does not apply to payments under the note.

While not expressly stating so, the ruling implies that the interest actually paid (as opposed to some additional amount that would be imputed under one of these sections if they applied) would be deductible to the husband and includable in income by the wife. Again, while nothing in the ruling states that interest paid on a note given in a division of property subject to Section 1041 is taxable to the recipient and deductible by the payor (subject to the limitations of Section 163), this treatment appears to be implied. At the very least, there is doubt as to the proper tax treatment of the stated interest paid on an installment obligation issued incident to a divorce.

Unstated interest

As noted above, the Service has adopted the view that none of the provisions of the Code that impute interest to a debt obligation apply in the context of a property settlement. Thus, a debt obligation issued in a property settlement or between former spouses need not carry any statutorily prescribed minimum amount of interest, contrary to the general rules imposed by Sections 483 and 1274. This principle is firmly established.[5] Under this doctrine, a husband's obligation to his wife incurred in a property settlement could be represented by a note issued at a below-market interest rate, or even carrying no interest, and interest will not be imputed. Similarly, principal paid will not be recharacterized as being an interest payment. Thus, there is at least certainty to the effect that if an agreement provides for fixed installment payments of principal by the husband to the wife, with such payments to be made over the course of six years or less, and providing for no amounts of interest to be paid, the proper tax treatment of such payments is that no amount is deemed to be interest income includable to the wife and no amount will create an interest deduction allowable to the husband. Accordingly, the total amount of principal to be paid by the husband could be grossed up in an amount equal to that which would have been treated in the agreement as interest payable on the outstanding balance of principal, had a market rate of interest been charged.

This is a curious outcome to the extent that expressly labeling a payment from the husband to the wife as interest could be found to result in taxable income to the wife and a deduction to the husband (now limited by Section 163(h)), while labeling a payment in an equal total amount as principal only and applying a zero interest rate to deferred payments will clearly result in a tax-free transaction. Generally, substance rather than form determines the characterization of a transaction for tax purposes. Here, form appears to determine the tax treatment of such payments.

On the other hand, perhaps the ability of the parties to choose the tax treatment of payments between them is not such an aberration. For instance, under Section 71(b)(1)(B), the parties to a divorce are now free to decide between themselves as to whether payments otherwise qualifying as alimony should be so treated for tax purposes (*i.e.,* deductible to the payor, and includable in the income of the recipient) or whether such payments should be treated as not constituting alimony. Under this elective provision, the parties can choose whether the payments should be tax free or taxable to the payee, as it suits their own best interests. Furthermore, such payments can extend indefinitely and still be tax-free as long as the obligation to make such payments ceases upon the death of the recipient spouse. Therefore, perhaps the same opportunity for choice and tax planning is appropriate as well under Section 1041 regarding the interest payments at issue. There is a strong argument that interest payments are included under the nonrecognition provision of Section 1041, in effect applying it to all transfers between spouses pursuant to their divorce.

In order to minimize the possibility of incurring any tax consequences on the wife's receipt of installment payments (including a portion representing interest) the following steps can be taken:

1. No amounts should be expressly treated or characterized as interest in the agreement. The husband should simply agree to pay the wife designated amounts of principal with payment scheduled over the course of the next six years, or sooner.

2. The husband's total obligation regarding payment of principal under the agreement should be grossed up to an amount that includes the desired interest that would have been paid had a market rate of interest been charged on the unpaid principal. The annual payments should also be grossed up to include such amounts that would have been accrued and paid as interest—again, with all payments labeled as principal.

While the economic substance of the grossed-up zero interest-bearing installment payments appears to be identical to that of interest-bearing payments, there is one significant difference. The provision of a typical pre-payment without penalty clause assures the payor of the right and benefit of being able to refinance his obligation if market interest rates decline. In the context of a grossed-up zero interest-installment obligation, such a clause is meaningless—indeed, the husband always would have an incentive to let the note run to maturity regardless of the market interest rate. Presumably, with the loss of this economic benefit to the husband, the parties could reach agreement upon a lesser total obligation to reflect the added risk that the payor-husband would assume concerning fluctuations in market interest rates. Another approach would be to attempt to provide for the functional equivalent to a pre-payment clause within the context of a zero interest obligation. Thus, one possibility is to restructure the agreement granting the husband the right to prepay his obligation at a discount. If the husband has such a right, then in substance he is in no worse an economic position than under the agreement providing for interest on installment payments without grossing up the principal obligation. Thus, the husband can be granted the right to pre-pay the grossed-up principal, but with the benefit of a pre-payment bonus or discount. Obviously, because this arrangement precisely mirrors an interest-bearing obligation in its economic substance, it could be so challenged and recharacterized by the Service as a payment of principal and unstated interest. However, the absence of interest payments should be respected by a court as the form of the transaction chosen by the parties.

Acquisition indebtedness

As argued above, parties to a divorce who seek certainty as to the tax-free treatment of all portions of installment payments made in a property settlement can achieve their goal simply by not charging a stated interest rate. Where it is actually desired that interest be paid and deductible to the husband, however, there is much less certainty in achieving this result. In fact, it was previously unclear whether such a result was possible in the context of a divorce. Curiously, an avenue for achieving such a result (at least in part) was recently provided by the IRS in *Notice* 88-74.[6] There, the Service offered guidance as to various issues relating to the deduction of home mortgage interest under Section 163(h)(3), which provides that qualified residence interest is deductible without regard to the general limitation on personal interest. Qualified residence interest is interest paid or accrued during the taxable year on acquisition indebtedness or home equity indebtedness with respect to a qualified residence of the taxpayer. The aggregate amount of acquisition indebtedness is limited to $1 million ($500,000 in the case of a married individual filing a separate return) and the aggregate amount of home equity indebtedness is limited to $100,000 ($50,000 in the case of a married individual filing a separate return).

Acquisition indebtedness is debt incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and which is secured by such a qualified residence. In the Notice, the Service addressed the issue of whether debt incurred to acquire a spouse's interest in a qualifying residence (*i.e.,* the couple's former marital residence which will be used by one party as a principal residence or a designated second residence) can fall within the favorable category of deductible acquisition debt. The Service concluded that debt incurred to acquire the interest of a spouse or former spouse in a residence, incident to a divorce or legal separation, is eligible to be treated as debt incurred in acquiring a residence for purposes of Section 163, without regard to the treatment of the transaction under Section 1041.

It is clear that the Service was contemplating a debt incurred through third-party financing (*e.g.,* a bank loan) when it announced that such interest payments are deductible as acquisition indebtedness. Indeed, the husband could obtain third-party financing to purchase the wife's interest in the residence, thereby incurring deductible interest payments on the loan, while simultaneously reducing the amount of his obligation owed his wife for the property settlement. However, an alternate scenario may also be sanctioned by the language of this Notice. Consider the example posited above of a divorcing couple where the husband pays the wife $1 million pursuant to their property settlement. The husband retained the marital residence (with a fair market value of $400,000, and assumed $200,000 of total equity in the property) to be used thereafter as his principal residence or as a designated second residence. Under the rule established by *Notice* 88-74, the

CITATIONS

[1] See, *e.g.*, *Gammill*, 710 F.2d 607, 82-2 USTC ¶9514, 50 AFTR2d 82-5469 (CA-10, 1982), *aff'g* 73 TC 921 (1980).
[2] O'Connell, *Divorce Taxation*, ¶6404 (1985).
[3] *Ltr. Rul.* 8813023.
[4] 1987-2 CB 207.
[5] *Fox*, 510 F.2d 1330, 75-1 USTC ¶9250, 35 AFTR2d 75-710 (CA-3, 1975). See also *Gammill, supra* note 1.
[6] IRB 1988-27, 27.

husband could designate $100,000 out of the total of $1 million as the purchase price for the wife's one-half interest in the marital residence (with the husband assuming full liability on the remaining balance on the mortgage). Indeed, two separate obligations could be issued, one for $100,000 secured by the marital residence as a second mortgage, and the other for the unpaid balance of the remaining total portion of the total obligation (in this case, $500,000 of additional debt) not paid in cash at the time of the settlement. The interest relating to the purchase of the marital residence is deductible to the husband under Section 163(h)(3) only if the obligation is secured by the residence. This means that the debt must be perfected (and generally recorded) under local state law giving the creditor (here the wife) priority over a subsequent purchaser. Absent a perfected security interest, the interest would otherwise be nondeductible personal interest under Section 163(h).

Under this transaction as so restructured, the wife would essentially be self-financing the sale of her one-half interest in the residence, and the husband would be offsetting his total obligation to the wife in the property settlement by an amount equal to this second mortgage. The husband would take a carryover basis in the house, and thus be liable for gain, if any, on a future sale of the property. Of course, Section 1034 would still be available to him at that time to defer such gain on the sale of his principal residence, assuming that he satisfies its requirements.

As a result of this transaction, the interest paid by the husband relating to the wife's interest in the residence could be carved out from Section 1041 nonrecognition treatment, thereby gaining an interest deduction for himself (and resulting in taxable interest income to his former wife). This much can be achieved with certainty by the use of third-party financing. Where the wife finances the sale of her interest in the property, there is always the chance that the Service will argue that Section 1041 overrules the Section 163 deduction for interest. Given the uncertainty as to the treatment of interest payments between the husband and wife under Section 1041, this must be recognized as an inherent risk of such an arrangement when the wife finances the sale.

Where the parties have a particularly strong incentive to provide for a portion of deductible payments in a property settlement, this use of acquisition indebtedness can be used by relying upon financing by the wife. An interest rate can be charged at the upper limits of a market rate negotiated in an arm's-length transaction, with a corresponding reduction in the principal owed by the husband. This payment as structured above (self-financing by the wife) does not qualify as alimony under Section 71 since the husband's obligation to make such payments does not cease upon the wife's death. Hence, this particular transaction could not be replicated or achieved under Section 71 or any other provision under the Code.

Conclusion

This suggested use of acquisition indebtedness appears to be the sole method of insuring deductions for at least some portion of payments made pursuant to a property settlement in a divorce subject to the general rule of nonrecognition of Section 1041. As such it could be a useful tool in tax planning where a significant obligation is incurred by one party to the other in a division of marital property pursuant to a divorce. In other cases, where certainty is desired that no amount of the payments should be taxable to the recipient (or deductible by the payor), such result can be achieved by providing for zero interest on the obligation. However, this may be redundant since the interest payments may be covered under Section 1041. As yet there is no authority directly on point. ★

Two tiers of trusts may be S corp. shareholders

TRUSTS THAT were beneficiaries of a voting trust may be shareholders in an S corporation, according to *Ltr. Rul.* 8847084. There, a wholly owned subsidiary corporation was split off by its parent. The parent's shareholders entered into an agreement establishing a voting trust that was taxed as a grantor trust. As such, all income from the trust was taxed in proportional part to the beneficial owners under Section 677. The beneficiaries of the voting trust included trusts that were established by the grantors for the benefit of their grandchildren. The terms of these trusts provide that, until the beneficiary reaches the age of 21, the trustee may pay out as much of the income or principal as he wants. The trusts terminate when the beneficiary turns 21. At that time, any remaining trust property is turned over to the beneficiary unless he timely elects to extend the trust for an additional period not to exceed nine years.

A trust may be a shareholder in an S corporation if it is a qualified Subchapter S trust. Under Section 1361(d)(3), these are trusts all of the income of which is distributed currently to an individual who is a citizen or resident of the U.S. In addition, these trusts must require that during the life of the current income beneficiary there may be only one income beneficiary and that any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary. The current income beneficiary's income interest must end on the beneficiary's death or