Private Letter Ruling 8813023

December 29, 1987

This is in response to the request for a ruling on behalf of A on the federal income tax consequences of payments received by A from B, her former husband, under a modification of a divorce decree.

In December of 1981, A and B's marriage was dissolved pursuant to a court decree in State X. State X is a community property state. At the time of the dissolution of the marriage, the United States Supreme Court's ruling in McCarty v. McCarty, 453 U.S. 210, 69 L. Ed. 2d 589, 101 S. Ct. 2728 (1981), was in effect, which held that a military spouse's retirement benefit was that spouse's separate property in community property states and not subject to division as part of the community property. Pursuant to the McCarty decision, the divorce decree states that B's military retirement plan was the separate property of B.

The McCarty decision was overruled by the Uniformed Services former Spouses' Protection Act ("USFSPA"), Pub.L. 97-252, Title X, 96 Stat. sections 730-738 (1982) (codified in 10 U.S.C. sections l401 ff.). Under the USFSPA, a court may treat disposable retirement pay that is payable to a member of the armed forces for pay periods beginning after June 25, 1981, as property solely of the member or as property of the member and his spouse in accordance with the law of the jurisdiction of such court, provided the court has jurisdiction over such member.

The marriage dissolution law of State X provides that community property settlements, judgments, or decrees that became final on or after June 25, 1981, and before February 1, 1983 may be modified to include a division of military retirement benefits payable on or after February 1, 1983, in a manner consistent with federal law and the law of State X as it existed before June 26, 1981, and as it has existed since February 1, 1983. Modifications of community property settlements, judgments or decrees may be granted whether or not the property settlement, judgment or decree assumed in any manner, implicitly or otherwise, that a pension divisible as community property before June 25, 1981, and on or after February 1, 1983, was not divisible community property.

In June of 1984 A moved to modify the decree of divorce to recognize her interest in the military retirement plan which was community property because it accrued during A and B's marriage. Because of the uncertainty of the effect of the marriage dissolution law, A agreed to relinquish any claims on B's military retirement plan in exchange for payments by B in accordance with a final stipulation and order of the court dated June 23, 1986. The stipulation and order required B to make payments to A of $15,000.00 by July 23, 1986, $14,000.00 by July 23, 1987, and $13,000.00 on July 23, 1988.

A now requests a ruling 1) that the payments from B represent a nontaxable transfer of property under section 1041 of the Internal Revenue Code and 2) whether expenses and attorney's fees incurred by A are deductible.

Section 61(a) of the Code defines gross income as all income from whatever source derived.

Section l041(a) of the Code provides that no gain or loss shall be recognized on a transfer of property from an individual to (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce.

Section 1.1041-1T(a) A-4, of the Temporary Income Tax Regulations provides that only transfers of property (whether real or personal, tangible or intangible) are governed by section 1041.

Under the law in a community property state, the earnings of a married person constitute community income; therefore, one-half of the income is taxable to each member of the community. Poe v. Seaborn, 282 U.S. 101, 75 L. Ed. 239, 51 S. Ct. 58, 1930-2 C.B. 202 (1930). The character of compensation as community or separate income is determined when the compensation is earned rather than when it is paid. Johnson v. United States, 135 F.2d 125 (9th Cir. 1943); Veit v. Commission, 8 T.C. 809 (1947).

In Lowe v. Commissioner, T.C. Memo 1981-350, the court held that military retirement pay earned while the military retiree was married and living in a community property state was community property. Payments to the retiree's former spouse under a divorce decree were taxable to the spouse as her share of community property.

In Rev. Rul. 69-471, 1969-2 C.B. 10, as part of the property settlement in a divorce decree, a wife relinquished her interest in her husband's military retirement pay, which constituted community property. In return she received cash payments from her husband. Rev. Rul. 69-471 held that, because the interest transferred by the wife was a right to future income, the transfer was an assignment of income and the payments from her husband were includible in her gross income in the years received.

Rev. Rul. 87-112, 1987-94 I.R.B. 6 held that a taxpayer who transfers Series E and EE bonds to a former spouse must include in gross income for the year of the transfer the interest on the bonds that is accrued but unrealized at the time of the transfer. Rev. Rul. 87-112 states that section 1041 does not shield from recognition income that is ordinarily recognized upon the assignment of that income to another taxpayer.

In this case, B's military retirement pay was community property, a portion of which A was entitled to receive and which would have been taxable to her as ordinary income. A in effect assigned to B her right to receive payments over B's lifetime in exchange for payments from B over three years. A cannot escape the taxation of ordinary income by recharacterizing her assignment of the income as a nontaxable transfer of property under section 1041(a) of the Code.

It is our conclusion that the payments to A in exchange for her community property interest in B's military pension represent payments for a right to future income rather than gain and therefore are outside the application of section 1041. Thus the payments to A are includible as ordinary income in A's gross income under section 61 of the Code.

The second issue raised in your ruling request is whether expenses and attorney's fees incurred by A and associated with the division of B's military retirement pay are deductible.

Section 212 of the Internal Revenue Code provides that, in the case of an individual, there shall be allowed as a deduction all. the ordinary and necessary expenses paid or incurred during the taxable year (1) for production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of tax.

Section 262 of the Code provides that except as otherwise expressly provided, no deduction shall be allowed for personal, living, or family expenses. Section 1.262-1(b)(7), of the Income Tax Regulations provides that, generally, attorney's fees and other costs paid in connection with a divorce are not deductible (under section 212) by either the husband or the wife except to the extent the expenses are properly attributable to the production or collection of alimony which is included in the recipient's gross income under section 71.

In the instant case, the USFSPA and the Civil Code of State X permit A to modify her divorce judgement to conform it to federal law. The federal law itself, not the court action to modify the judgement brought by A's attorney, gives A the right to a portion of her former husband's military retirement pay. Therefore, since no part of the expense was attributable to the production or collection of income, section 212 does not apply. Accordingly, no part of the attorney's fees allocable to services performed to conform the divorce decree to the requirements of federal law is deductible since the expense is personal in nature. In this regard, the instant case can be contrasted with the situation where a taxpayer incurs legal expenses in litigation undertaken for the purpose of establishing the right to possession of, or participation in, taxable income. However, any legal expenses that are allocable to tax advice in connection with a divorce may be deductible under section 212(3) if properly substantiated. See Rev. Rul. 72-545, 1972-2 C.B. 179.

Except as specifically set forth above, no opinion is expressed as to the federal tax consequences of the above-described facts under any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. final regulations pertaining to one of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See section 16.04 of Rev. Proc. 87-1, 1987-1 I.R.B. 7. However, when the criteria in section 16.05 of Rev. Proc. 87-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

Pursuant to a power of attorney statement on file in this office we are sending a copy of this letter to your authorized representatives.