DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (LARGE AND MID-SIZE BUSINESS)
SAN FRANCISCO OFFICE CC:LM:CTM:SF

FROM: David R. Haglund
Senior Technician Reviewer CC:PSI:1

SUBJECT: TL-N-7217-00

This Chief Counsel Advice responds to your memorandum dated December 12, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Petitioner =

Former Wife =

PRS =

State =
Year 1 =

Year 2 =
Year 3 =

Year 4 =
Year 5 =

Year 6 =

D1 =

D2 =
D3 =

D4 =

D5 =

D6 =
D7 =

ISSUES

Whether the retroactive award of a partnership interest to Petitioner on D6, which was effective as of D5, requires Petitioner to include in income, for Year 6, the amounts of partnership income previously allocated to Petitioner's Former Wife for years subsequent to the effective date of the retroactive award.

CONCLUSIONS

The retroactive award of a partnership interest to Petitioner on D6, which was effective as of D5, does not require Petitioner to include in income, for Year 6, the amounts of partnership income previously allocated to Petitioner's Former Wife for years subsequent to the effective date of the retroactive award.

FACTS

Petitioner and Former Wife were married in State on D1. During their marriage, Petitioner acquired a partnership interest in PRS. Because Petitioner's partnership interest in PRS was acquired during his marriage to Former Wife, it constituted community property.

On D2, Petitioner and Former Wife separated. On D3, Former Wife filed a petition for dissolution of the marriage. On D4, the marriage was dissolved but the Court reserved jurisdiction to divide the marital property at a later date. On D6, the Court entered a judgement dividing the marital property. The Court awarded the community interest in PRS to Petitioner, as of D5. On D7, the Court entered a new judgement, pursuant to a stipulation between Petitioner and Former Wife. The new judgement again awarded the community's interest in PRS to Petitioner. However, the effective date of the new judgement was the date of its entry, D7.

For Year 1, Petitioner filed a Federal income tax return as a single individual. On his Year 1 return, Petitioner reported 100% of his distributive share of PRS partnership items. For Year 1, PRS has a net loss. For Year 2 and Year 3, Petitioner reported half of his distributive share of items of partnership income and loss. Petitioner attached statments to his return stating that Former Wife had reported the other half. [redacted] For Year 2 and Year 3, PRS had a net profit. For Year 4, Year 5, and Year 6, Petitioner claimed the entire amount of his distributive share of items of partnership income and losses. For those years, PRS had net losses.

Notices of deficiency were issued to both Petitioner and Former Wife for Year 2, Year 3, and Year 5. In those notices, the Service took whipsaw positions with respect to the PRS income. In the notice issued to Petitioner, the Service determined that Petitioner was required to report and pay tax on the full amount of his distributive share of partnership income for the Year 2 and Year 3, but was only entitled to half of the losses for the for the years Year 4 and Year 5. [redacted]

Petitioner filed a petition in the Tax Court. [redacted]

The National Office provided Field Service Advise (FSA 200102012) concerning Year 2 through Year 5. The National Office determined that because the marriage was dissolved in a year prior to the years at issue, the PRS interest was not community property because the marital community no longer existed and the PRS income was not community income. Under State law, Petitioner and Former Wife owned the PRS interest as tenants in common. See e.g. Estate of Layton v. Layton 44 Cal.App. 4th 1344, 52 Cal.Rptr. 251 (Cal.App. 6 Dist. 1996). Accordingly, the National Office concluded that Petitioner was entitled to only half of the distributive share of PRS items attributable to the PRS interest held in his name.

At issue is whether the amounts of income previously allocated to Petitioner's Former Wife for years subsequent to the effective date of the retroactive award should be reallocated to Petitioner in Year 6.

LAW AND ANALYSIS

We do not believe that the Year 6 order should be given retroactive tax effect. Retroactive state court orders that retroactively change the rights of the parties or the status of payments are not given retroactive effect for federal tax purposes.[1] See, e.g., Gordon v. Commissioner, 70 T.C. 525 (1978) (state court orders retroactively redesignating divorce-related payments as alimony and not child support–or vice versa–are disregarded for Federal income tax purposes if the order retroactively changes the rights of the parties or the legal status of the payments); White v. Commissioner, T.C. Memo. 1984-65 (payments to ex-wife made prior to retroactive court order are not deductible as alimony since such payments must be made pursuant to an existing order); Steen v. Commissioner, T.C. Memo. 1989-542 (where a state court enters an order purporting to relate back to a prior date, but which reflects an intention or design which originated subsequent to that date, such an order will not be given retroactive effect for Federal tax purposes). See also Turkoglu v. Commissioner, 36 T.C. 552, 555 (1961); Daine v Commissioner, 21 T.C. 349 (1947) aff'd, 168 F.2d 449 (2d Cir. 1948).

The Tax Benefit Rule Argument

The Request for Field Service Advise ("RFSA") advances the tax benefit rule as a theory for including the income at issue in Petitioner's individual return for Year 6. We do not recommend advancing a tax benefit rule argument.

The tax benefit rule is a judicially developed principle codified, in part, under section 111. See Mertens Law of Fed. Income Tax § 7:26. The rule is designed to ameliorate some of the effects of the annual accounting system. Hudspeth v. Commissioner, 914 F.2d 1207, 1212 (9th Cir. 1990). The rule has two components: an inclusionary component and an exclusionary component. Id.

Under the inclusionary component of the tax benefit rule, if an amount deducted from gross income in a prior year is recovered in a later year, the recovery has to be included in income in the later year. See, e.g., Gorton v. Commissioner, T.C.

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[1]There are, however, instances where certain nunc pro tunc orders of state courts will be given retroactive effect for federal tax purposes. Retroactive tax effect will be given to nunc pro tunc orders that retroactively correct clerical errors or misstatements in order to reflect the true intention of the court at the time the previous decree was rendered. See Newman v. Commissioner, 68 T.C. 494 (1977), and cases cited therein. The instant case does not come within this exception because there was no previous court order regarding the partnership interest. The instant court, after granting the divorce in Year 1, merely postponed its judgment on the property division until Year 6. Since there was no previous order regarding the partnership interest, there obviously was no clerical error or misstatement needing correction to reflect the true intention of the court. Thus, the nunc pro tunc exception is not available.

Memo. 1985-45; Allstate Insurance Co. v. United States, 936 F.2d 1271 (Fed. Cir. 1991).

Under the exclusionary component of the tax benefit rule, a later year exclusion is allowed to the extent that the recovered prior year deduction did not result in a prior year tax benefit. See Mertens, supra. The prior year deduction will be deemed to have resulted in a tax benefit if the prior year deduction served to reduce the prior year's tax liability. Id.; Section 111(a).

The tax benefit rule has five elements. Under the rule, an amount must be included in gross income in the current year if, and to the extent that:

1) the amount was deducted in a prior year;[2]

2) the deduction resulted in a tax benefit;

3) there is some type of recovery of the amount previously deducted;

4) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based;[3] and

5) the inclusion of the recovery in gross income is not precluded by a nonrecognition provision of the Code.

See, e.g., Mertens, supra.

The instant case does not involve a prior year deduction or credit. Instead, the instant case involves a Year 6 retroactive court order which transferred Former Wife's community interest to Petitioner and served to vest full ownership of the partnership interest in Petitioner. The RFSA argues that Petitioner' prior year "exclusions" (of half of the partnership interest's distributable share of income)

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[2]It is important to note here that the tax benefit rule also generally applies when a tax credit is taken in a prior year and there is a later year downward price adjustment producing a recovery. See section 111(b). For ease of reference, our references to recoveries of deductions herein shall be taken to include the situation involving credits (when credits are not mentioned). We note that other commentators also tend to refer only to tax deductions, while excluding references to tax credits, when discussing the tax benefit rule. See e.g., Mertens, supra.

[3]This language refers to an event that would have foreclosed the deduction had it occurred in the year of the deduction, for example, recovery of the amount.

resulted in prior year tax benefits that need to be taxed upon "recovery" in Year 6 (under the inclusionary component of the tax benefit rule). However, neither the exclusionary or inclusionary component of the tax benefit rule applies in this case. See Maule, 502 T.M., Gross Income: Tax Benefit, Claim of Right and Assignment of Income, at A-3 ("Technically, the tax benefit doctrine applies to deductions, not to exclusions"). Accordingly, we do not recommend raising the tax benefit argument.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

With respect to the allocation of the distributive share of partnership items for Year 6, Petitioner is required to report his distributive share of partnership income, gain, loss, deduction, or credit attributable to his PRS partnership interest based upon the pro rata portion of the year that Petitioner co-owned the partnership interest and the pro rata portion of the year the Petitioner wholly-owned the partnership interest. Accordingly, nine-twelfths of Petitioner' distributive share of Petitioner' PRS partnership interest must be reported by Petitioner as 50 percent co-owner of the partnership interest, and three-twelfths of the distributive share of PRS partnership items attributable to Petitioner' partnership interest in PRS must be reported by Petitioner as 100 percent owner of the partnership interest. See Adams v. Commissioner, 82 T.C. 563 (1984).

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Please call Barbara MacMillan at (202)622-3050 if you have any further questions.

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By: _____

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