INTERNAL REVENUE SERVICE
NATIONAL OFFICE LEGAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-145856-02/CC:ITA:B5

Director, Appeals (Area 6)

Taxpayer Name:
Taxpayer Address:

Taxpayers' Identification No:
Years Involved:
Date of Conference:

LEGEND:

ISSUE:

Whether payments received by a U.S. resident alien, pursuant to interests in three foreign business enterprises created in her favor under foreign law by her father, should be included in her gross income under I.R.C. § 61.

CONCLUSION:

The purported transfers to taxpayer do not effectively convey dominion and control of the income-producing assets involved; thus, “ownership” has not been effectively transferred to the taxpayer and she does not have income under section 61 as a result of the payments made to her pursuant to those purported transfers.

FACTS:

In Contract Year A, when taxpayer was a minor resident in and a national of Foreign Nation, her appointed guardian and her father executed certain documents creating “gift” and “sub-interests” in three foreign business enterprises in favor of taxpayer. The documents created binding rights and obligations on the businesses and the parties under the law of Foreign Nation. We assume for purposes of this advice that the created sub-interests are neither trusts, partnerships, nor corporations for U.S. income tax purposes. It has been represented, and we expressly assume, that under U.S. income tax principles the enterprises are properly treated as partnerships.

Translations of the relevant documents state that the father may demand at any time during his life the return of the “gifted” sub-interest and/or determine how the income derived from or the proceeds from disposal of such interest are used for the benefit of taxpayer. Moreover, father retains the right to receive and/or manage any proceeds from the disposal of the interests. Upon the father’s death, the retained rights would devolve to his wife.

In Tax Year 1, Taxpayer and her husband (hereinafter, taxpayers) became U.S. resident aliens and commenced filing joint U.S. income tax returns. Taxpayers reported $AmountA as income on their U.S. income tax return for that year attributable to the sub-interests. Subsequently, taxpayers filed an amended return (before expiration of the relevant statute of limitations period) for Tax Year 1 excluding the income from the foreign businesses. This position, together with certain collateral adjustments, would result in a refund for Tax Year 1. On later years’ U.S. returns, taxpayers did not include the sub-interest payments in income. Taxpayers attached Form 8275 (Disclosure Statement) to their Tax Year 3 return, noting that the income from the three foreign enterprises was being excluded because the father retained sufficient ownership interests such that, for U.S. income tax purposes, the assignment of income doctrine prevented the “transfers” from being effective.

Consistent with their position as stated on Form 8275, taxpayers now argue that the transfers of the sub-interests are essentially without substance for purposes of establishing ownership under the Internal Revenue Code. They contend that under U.S. tax principles, the transfers are properly treated as anticipatory assignments of income which have no effect in shifting the responsibility for income taxation.

The Service, relying on section 61, has included in taxpayer's income the payments made to her for Tax Years 1, 3, 4, and 5. (Tax Year 2 is closed.) This treatment gives rise to the following deficiencies: Tax Year 3, $AmountC; Tax Year 4, $AmountD; Tax Year 5, $AmountE.

LAW AND ANALYSIS:

Under section 61(a) of the Internal Revenue Code, except where otherwise provided, gross income means all income from whatever sources derived, including, but not limited to, certain categories thereunder enumerated. Because the parties agree that the payments in issue here from the foreign business enterprises would be the functional equivalent of distributive shares of domestic partnership income (see section 61(a)(13)), it is assumed that specific characterization is appropriate. See Rev. Rul. 93-4, 1993-1 C.B. 225. That characterization would be appropriate, however, only in so far as the initial source payout from the business enterprise is concerned. See Rev. Rul. 73-254, 1973-1 C.B. 613.

The judicially-created assignment of income doctrine applies in determining which taxpayer must include an item of income. Under the doctrine, income from personal services (e.g., wages) must be included in the gross income of the person who rendered the services. Lucas v. Earl, 281 U.S. 111 (1930). Similarly, income from property (e.g., rents) must be included in the gross income of the person who owns the property. Blair v. Commissioner, 300 U.S. 5 (1937). Mere legal title is not dispositive of ownership; the significant factual inquiry goes to the actual beneficial interest and who controls the economic benefits (or shoulders the burdens) of that property. See, e.g., Serianni v. Commissioner, 80 T.C. 1090 (1983), aff'd, 765 F.2d 1051 (11th Cir. 1985); Hang v. Commissioner, 95 T.C. 74 (1990); Hook v. Commissioner, 58 T.C. 267 (1972). Taxpayer maintains that if there were two U.S. taxpayers involved, her father would still be liable for U.S. income taxes on any income generated by the assets "legally" transferred. If the degree and manner of control over the income-producing property is not significantly altered by the purported transfer, then the incidence of taxation does not shift. See P.R. Farms, Inc. v. Commissioner, T.C. Memo. 1984-549.

Under section 102, gifts are specifically excluded from gross income. Once the payments passed to taxpayer through her father's control, even if merely his constructive control, the nature of the payment must necessarily be reexamined. The actual nature of the payments to the daughter–as received in her hands--determines whether she has gross income under the Code, i.e., a distributive share of partnership income or a gift from her father (or mother, in the event of his death). While this determination might involve a factual inquiry, the ultimate characterization is a legal determination. Whether the doctrine prohibiting the anticipatory assignment of income is invoked or the payments are ruled gifts under section 102 from the father to the taxpayer, the relevant inquiry is the same: did the father retain dominion and control–and, hence, ownership–of the foreign assets?

Purported sale transactions and alleged gifts must meet the same test to be effective transfers of ownership and, thus, effective transfers of the incidence of income taxation. See, e.g., National Lead Co. v. Commissioner, 40 T.C. 282 (1963), aff'd, 336 F.2d 134 (2d Cir. 1964), cert. denied, 380 U.S. 908 (1965) (purported sale); Urbanovsky v. Commissioner, T.C. Memo. 1965-276 (purported gift). There must be a significant change in the economic relationship of the transferor to the property involved to effect a valid transfer of that property for income tax purposes. See Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984), aff'g 79 T.C. 714 (1982). If the transferor retains dominion and control, then ownership and the incidence of income taxation thereon has not been shifted. See, e.g., Chase v. Commissioner, T.C. Memo. 1990-164, aff'd, 926 F.2d 737 (8th Cir. 1991); Estate of Applestein v. Commissioner, 80 T.C. 331 (1983).

The facts presented support the finding that taxpayer's father retained the essential right to receive the income generated by the enterprise. He retains the right to "call back" this income throughout his life and has passed that right in the event of his death to his wife. Any payouts from the enterprises appear to be subject to his decision to do with what he wishes–including those payments due to his daughter on her sub-interests. The fact of the father's control of the payments is insurmountable, irrespective of whether he has ultimately gifted those amounts to the daughter.

On the basis of the specific language of the ineffectual "transferring" documents cited above, the legal conclusion based upon the facts presented is that for U.S. income tax purposes beneficial ownership never really changed. The taxpayer has not received effective ownership of the "sub-interests" and, thus, has no gross income with respect to the "sub-interests" in question.

Accordingly, the taxpayer's U.S. taxable income does not include any amounts attributable to the sub-interests.

CAVEAT:

We express no opinion as to U. S. gift tax implications, if any, of these transactions under sections 2501 and 2511 of the Code.

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.