

## Internal Revenue Service

## Department of the Treasury

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Washington, DC 20224

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Refer Reply To:

**CC:P&SI:7-PLR-111919-01**

Date:

April 10, 2001

### Legend

Decedent's Estate

Decedent's Trust or Trust:

Decedent:

State:

Surviving Spouse:

A:

B:

Account:

Charity:

State Supreme Court Decision:

Date 1:

Date 2:

Date 3:

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Date 4:

Date 5:

z:

Dear

We received a letter and several subsequent submissions requesting rulings on behalf of Decedent's Trust and Decedent's Estate concerning the transfer tax consequences of a proposed settlement agreement. This letter responds to that request.

The facts and representations submitted are summarized as follows:

Decedent died testate on Date 1, a resident of State. Decedent was survived by Surviving Spouse.

Decedent established and funded Trust, an inter vivos, revocable trust, under an agreement dated Date 2. Decedent amended Trust on Date 3 and Date 4. Trust became irrevocable on Decedent's death. Decedent's will directs that all assets, except certain designated items, be transferred to Trust.

Under Trust agreement, after Decedent's death, trustee is to distribute Trust assets as follows:

(1) To A and B, the assets held in Account;

(2) To or for the benefit of Surviving Spouse, z dollars per month during her lifetime, the cost of maintaining health insurance coverage similar to such coverage as she had during Decedent's lifetime, and any additional amounts from principal or income if the trustee, in the trustee's sole discretion deems such expenditure necessary or advisable for her medical care or support in reasonable comfort taking into consideration other resources available to her; and

(3) Upon the death of Surviving Spouse, the entire remaining balance of Trust assets, to Charity.

Surviving Spouse filed an election in Probate Court to take her elective share of Decedent's estate. In addition, Surviving Spouse filed a Complaint that named A, B, Charity, Trustee, and Personal Representative of Decedent's estate as defendants. In her Complaint, Surviving Spouse seeks a Declaratory Judgment that she is entitled to her elective share based on the value of Decedent's probate estate and the value of Trust assets.

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Surviving Spouse's Complaint was removed from Probate Court to Civil Court. The defendants have filed an Answer and a Counterclaim to Surviving Spouse's Complaint denying the allegations of the Complaint that Surviving Spouse is entitled to an elective share based on the value of Trust assets.

When Surviving Spouse filed her suit, the executors of Decedent's estate recognized that the charitable remainder trust provided for Charity under Decedent's estate did not meet the requirements of § 2055(e)(2) and that, either in the absence of Surviving Spouse's litigation, or if the litigation were decided against her, a reformation of the split-interest under § 2055(e)(3) would be required.

Because of the pending litigation, trustee was uncertain about making distributions from Trust. Therefore, Decedent's estate has been paying the sum of z dollars a month to Surviving Spouse based on the terms of Trust agreement.

In State Supreme Court Decision, State Supreme Court found that a revocable, inter vivos trust over which the settlor retained substantial control was illusory and thus, invalid. As a result, the invalid trust reverted to the settlor's probate estate and was subject to the surviving spouse's elective share claim.

State Code provides that a revocable inter vivos trust may be created either by declaration of trust or by transfer of property and is not rendered invalid because the trust creator retains substantial control over the trust. State Code also provides that nothing herein, however, shall prevent a finding that a revocable inter vivos trust, enforceable for other purposes, is illusory for purposes of determining a spouse's elective share rights. A finding that a revocable inter vivos trust is illusory and thus invalid for purposes of determining a spouse's elective share rights shall not render that revocable inter vivos trust invalid, but would allow inclusion of the trust assets as part of the probate estate of the trust creator only for the purpose of calculating the elective share and would make available the trust assets for satisfaction of the elective share only to the extent necessary.

Surviving Spouse and the defendants have actively pursued the litigation through the filing of motions, the taking of depositions, and other means. In order to avoid the expense, delay, and uncertainty which would be involved if the matter were litigated, the parties entered into a settlement agreement approved by the Court on Date 5. The settlement resolves all of the issues raised in the pleadings and satisfies all of the claims of all parties to the litigation.

Under the terms of the settlement agreement, Trust is to be divided into two trusts: (1) Noncharitable Trust and (2) Charitable Trust. Noncharitable Trust shall consist of assets held in Account. The assets held in Noncharitable Trust shall be paid directly to A and B. After the distribution of assets to A and B, Noncharitable Trust will terminate.

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The balance of Trust assets are to be transferred to Charitable Trust to be held and administered as follows:

Within a reasonable time after complete funding of Charitable Trust, trustee shall pay to Decedent's estate the amount necessary to repay Decedent's estate the advances to Surviving Spouse equal to the difference between the annuity actually paid to Surviving Spouse from the date of Decedent's death and the amount due from the date of Decedent's death. Charitable Trust shall also pay interest as described in § 664 and the regulations thereunder on the annuity amount.

Trustee of Charitable Trust shall pay Surviving Spouse, during her lifetime, an annuity amount equal to five percent of the initial net fair market value of the assets passing to the Charitable Trust, provided that the payout percentage (as adjusted to reflect the timing and frequency of the annuity payments) shall not exceed the percentage that would result in a five percent probability that the trust corpus would be exhausted before the death of Surviving Spouse determined as of the date of Decedent's death. The annuity amount shall be paid in monthly installments from income, and, to the extent that income is not sufficient, from principal on the last day of each month. Any income of Charitable Trust for a taxable year in excess of the annuity amount shall be added to principal. If the net fair market value of Charitable Trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay Surviving Spouse, in the case of an undervaluation, or receive from Surviving Spouse, in case of an overvaluation, an amount equal to the difference between the annuity amount properly payable and the annuity amount actually paid.

The obligation to pay the annuity amount begins on the date of Decedent's death, but payment may be deferred from that date to the end of the tax year of Charitable Trust in which it is funded. Within a reasonable time after the end of the tax year in which Charitable Trust is funded, trustee must pay Surviving Spouse, in the case of an underpayment, or receive from Surviving Spouse, in case of an overpayment, an amount equal to the difference between (1) the annuity amount actually paid, plus interest compounded annually computed for any period at the rate of interest that the regulations under § 664 prescribe for such computation, and (2) the annuity amount payable plus interest compounded annually computed for any period at the rate of interest that the regulations under § 664 prescribe for such computation.

In determining the annuity amount, trustee shall prorate the annuity amount, on a daily basis, for a short taxable year and for the taxable year in which noncharitable interests terminate.

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Upon the death of Surviving Spouse, trustee shall distribute all of Charitable Trust principal and income (other than any amount due Surviving Spouse or the estate of Surviving Spouse), to Charity. If Charity is not an organization described in §§ 170(b)(1)(A), 170(c) and 2055(a) when any principal or income is to be distributed to it, then trustee shall distribute such principal or income to such one or more organizations described in §§ 170(b)(1)(A), 170(c) and 2055(a) as trustee shall select in its sole discretion.

No additional contributions may be made to Charitable Trust after the initial contribution. The initial contribution, however, shall be deemed to consist of all property passing to Charitable Trust by reason of Decedent's death.

Trustee shall make distributions at such time and in such manner as not to subject Charitable Trust to tax under § 4942. Except for the payment of the annuity amount to Surviving Spouse, trustee shall not engage in any act of self dealing, as defined in § 4941(d) and shall not make any taxable expenditures, as defined in § 4945(d). Trustee shall not make any investments that jeopardize the charitable purposes of Charitable Trust, within the meaning of § 4944, or retain any excess business holdings, within the meaning of § 4943, if those sections apply to Charitable Trust under § 4947(b)(2).

The taxable year of Charitable Trust is the calendar year.

The operation of Charitable Trust is governed by the Laws of State. Trustee is prohibited from exercising any power or discretion granted under State laws that are inconsistent with the qualification of Charitable Trust under § 664(d)(1) and the regulations thereunder.

Trustee has the power to amend Charitable Trust in any manner required for the sole purpose of ensuring that Charitable Trust qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of § 664(d)(1).

Nothing in Charitable Trust agreement may be construed to restrict trustee from investing the assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of Charitable Trust assets.

Decedent's Trust and Decedent's estate request the following rulings:

(1) Charitable Trust qualifies as a charitable remainder annuity trust within the meaning of § 664(d)(1);

(2) The value of Charity's interest in Charitable Trust is deductible by Decedent's Estate under § 2055(a); and

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(3) The value of Surviving Spouse's interest in Charitable Trust is deductible by Decedent's Estate under § 2056(b)(8).

#### Law and Analysis

Section 2055(a)(2) provides that for estate tax purposes, the value of the taxable estate is determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises or transfers to or for the use of any corporation, organized and operated exclusively for religious, charitable, scientific, literary or educational purposes.

Section 2055(e)(2)(A) provides that where an interest in property passes or has passed from the decedent to a person, or for a use, described § 2055(a), and an interest in the same property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to a person, or for a use, not described in § 2055(a), no deduction shall be allowed under § 2055 for the interest which passes or has passed to the person, or for the use, described in § 2055(a) unless, in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (described in § 664) or a pooled income fund (described in § 642(c)(5)).

Section 664(d)(1) provides that, for purposes of § 664, a charitable remainder annuity trust is a trust--

(A) from which a sum certain (which is not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in § 664(d)(1)(A) and other than qualified gratuitous transfers described in § 664(d)(1)(C) may be paid to or for the use of any person other than an organization described in § 170(c),

(C) following the termination of the payments described in § 664(d)(1)(A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in § 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in § 664(g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in § 4975(e)(7)) in a qualified gratuitous transfer (as defined by § 664(g)), and

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(D) the value (determined under § 7520) of such remainder interest is at least 10 percent of the initial net fair market value of all property placed in the trust.

Section 2056(a) allows an estate tax deduction for the value of any interest in property that passes or has passed from a decedent to a surviving spouse, to the extent that the interest is included in determining the value of the decedent's gross estate.

Section 2056(b)(1) provides that where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, the interest passing to the surviving spouse will terminate or fail, no deduction is allowed under § 2056(a) with respect to such interest (a) if an interest in the property passes or has passed (for less than adequate and full consideration in money or money's worth) from the decedent to any person other than the surviving spouse (or the estate of such spouse), and (b) if by reason of such passing the person (or his heirs or assigns) may possess or enjoy any part of the property after the termination or failure of the interest passing to the surviving spouse.

Section 2056(b)(8) provides that if the surviving spouse of the decedent is the only beneficiary of a qualified charitable remainder trust who is not a charitable beneficiary nor an ESOP beneficiary § 2056(b)(1) will not apply to any interest in the trust which passes or has passed from the decedent to the surviving spouse.

Section 20.2056(c)-2(d)(2) of the Estate Tax Regulations provides that, if as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to the surviving spouse" only if the assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.

In Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981), the court held that property distributed to a spouse pursuant to a compromise settlement will be treated as passing from the decedent for marital deduction purposes, only if the distribution represents a good faith settlement of an enforceable claim. Relying on Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the court held that:

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Either a good faith settlement or a judgment of a lower state court must be based on an enforceable right under state law properly interpreted, in order to qualify as "passing" pursuant to the estate tax marital deduction.

Ahmanson Foundation v. United States, 674 F.2d at 775.

In view of Ahmanson, property passing pursuant to the settlement of a claim asserted by a spouse will be treated as passing from the decedent, to the extent the compromise is a bona fide settlement of a legally enforceable claim. The claims must be settled pursuant to arm's length negotiations. Thus, at issue in determining if Estate may claim a marital deduction for the Surviving Spouse's interest in Charitable is whether the settlement agreement is a bona fide settlement of a legally enforceable claim.

After Decedent's death, Surviving Spouse filed suit to contest the validity of the transfer of assets to Decedent's Trust and attempted to elect her elective share under State law. Under State law, if the litigation had proceeded to judgment and Surviving Spouse prevailed, the court would have determined that Trust is illusory and thus invalid for purposes of determining Surviving Spouse's elective share rights. Surviving Spouse then would be entitled to her elective share based on the value of Decedent's probate estate and the value of Trust assets. That is, Surviving Spouse would receive an outright distribution of one-third of the assets in Decedent's estate and one-third of the assets transferred to Decedent's Trust. Under State law, if the litigation had proceeded to judgment and Surviving Spouse failed in her suit, the court would have determined that Surviving Spouse is not entitled to an elective share based on the value of Decedent's probate estate and the value of Trust assets and she would have received only those interests provided for her under Decedent's will and Decedent's Trust.

Further, the State Supreme Court has found that a revocable, inter vivos trust over which the settlor retained substantial control may be illusory and thus invalid. If such a trust is invalid, the invalid trust will revert to the settlor's probate estate and is subject to the surviving spouse's elective share claim.

The settlement agreement resulted from a bona fide adversarial proceeding and was the product of arm's length negotiations. Surviving Spouse and the defendants had significant interests to protect and the settlement agreement, negotiated at arm's length, reflects those interests.

Based on the facts and representations made and the information submitted we conclude as follows:

The governing instrument of Charitable Trust meets the requirements of a charitable remainder annuity trust under § 664(d)(1), provided that the trust is a valid



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trust under the applicable local law. The governing instrument of Charitable Trust contains the provisions set forth in Rev. Rul. 72-395, 1972-2 C.B. 340, as modified by Rev. Rul. 80-123, 1980-1 C.B. 205, and Rev. Rul. 82-128, 1982-2 C.B. 71, and clarified by Rev. Rul. 82-165, 1982-2 C.B. 117. Accordingly, Charitable Trust will qualify as a charitable remainder annuity trust, for federal income tax purposes, for any year in which it continues to meet the definition of and functions exclusively as a charitable remainder annuity trust. For such year, Charitable Trust will be exempt from taxes imposed by subtitle A of the Code unless it has any unrelated business taxable income as defined in § 512 and the regulations applicable thereto.

Because the settlement agreement resulted from a bona fide adversarial proceeding, was the product of arm's length negotiations, and reasonably reflects the rights of the parties under State law, the amounts received by Charitable Trust pursuant to the settlement agreement are regarded as having passed from Decedent to Charitable Trust. Thus, the present value of Surviving Spouse's interest in Charitable Trust is deductible by Decedent's Estate under § 2056(a) and (b)(8). Further, because Charitable Trust will qualify as a charitable remainder annuity trust, the present value of the remainder interest in Charitable Trust will qualify for an estate tax charitable deduction under § 2055(a). See § 20.2055-2(f)(2) regarding the determination of the present value of this interest.

Except as specifically ruled under the cited provisions of the Code, we express or imply no opinion about the tax consequences of the settlement agreement under those provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return or estate tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted and accompanied by a penalty 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 rulings, it is subject to verification on examination.

Sincerely,  
Christine E. Ellison  
Chief, Branch 7  
Associate Chief Counsel (P&SI)

Enclosure