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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4 - PLR-108386-00
Date: April 04, 2001

Re:

Legend

Decedent =

Date 1 =

Spouse =

Son =

Daughter =

Will =

Trust =

IRA1 =

IRA2 =

IRA3 =

IRA4 =

IRA5 =

IRA6 =

Plan =

Objection =

Court =

Settlement Agreement =

Court Order =

X =

Y =

Z =

W =

Date 2 =

Year 1 =

Year 2 =

Dear :

This is in response to a letter dated March 9, 2000, and subsequent correspondence, requesting rulings regarding the federal gift, estate, and income tax consequences of the settlement of a will contest.

Facts

The facts submitted and representations made are as follows:

Decedent died testate on Date 1, survived by Spouse, and by Son, and Daughter, adult children from a previous marriage. During his life, Decedent executed a will (Will) and a revocable trust (Trust).

Article II, paragraph (B), of Decedent's Will expressly excludes Daughter, her spouse, and her issue from any devise or benefit of any kind under the will and

disinherits them “fully and completely.” Tangible personal property passes to Spouse and Son, and the residuary estate passes to Trust.

Article II, paragraph (C), of Trust expressly disinherits Daughter, her spouse, and her issue, using the same language employed in the Will. Under the terms of Trust, at Decedent’s death, the trust estate is to be divided into a “Credit Trust,” holding assets equal in value to Decedent’s unified credit equivalent, and a “Qualified Interest Trust,” holding the balance of the trust assets.

Spouse is to receive the net income of the Qualified Interest Trust, at least annually, and any amount of principal the trustee deems advisable for Spouse’s care, support, and maintenance. The trustee may consider funds reasonably available to Spouse and her “accustomed style of life.” At Spouse’s death, the remaining assets of the Qualified Interest Trust pass to Son, if then living, or to Son’s then living children.

Article V, paragraph (E)(1), provides that Daughter has no interest in the assets of the Qualified Interest Trust remaining at Spouse’s death. Article VIII provides that Spouse may compel the conversion of any non-productive property in the Qualified Interest Trust to productive property.

Decedent’s personal representative or trustee has absolute discretion to make an election under § 2056(b)(7) to treat any part of the Qualified Interest Trust as qualified terminable interest property. Any part for which an election is not made will be held as a separate trust.

Trust provides that the Credit Trust is to be distributed outright to Son.

At his death, Decedent owned six IRAs (IRA1, IRA2, IRA3, IRA4, IRA5, and IRA6) and had an interest in a qualified retirement plan (Plan). Decedent reached age 70 ½ on Date 2, and shortly thereafter, began to receive minimum distributions from the IRAs and Plan.

Daughter challenged the validity of Will and Trust. She claimed that Son and Decedent’s advisors unduly influenced Decedent and also claimed that Decedent had mistakenly relied on misrepresentations of facts made by Son and the advisors. As a result of this pending litigation, Son and Spouse each hired attorneys. If the claim had been litigated and the court had determined that Will and Trust were invalid, Will would have been set aside and the parties would have been entitled to their intestate shares of Decedent's estate under state laws of intestacy, 50 percent to Spouse, and 25 percent to each of Son and Daughter.

After strenuous negotiations, Spouse, Son, and Daughter executed Settlement Agreement, which was approved by Court in Court Order. Settlement Agreement is contingent upon the receipt of a favorable letter ruling from the Internal Revenue Service. Under Settlement Agreement, the parties agreed to set aside Will and Trust.

Of Decedent's property, other than joint property but including the amounts from the IRAs and Plan, Y percent will pass to Spouse and Z percent will pass to Son. Daughter will receive $X. Court in Court Order indicated that this reflects Decedent's intent.

On the Schedule M of a timely filed federal estate tax return, Decedent's estate made a protective election to have the entire date of death value of the Qualified Interest Trust treated as qualified terminal interest property (QTIP) under § 2056(b)(7) of the Internal Revenue Code. The estate attached a copy of Settlement Agreement, a copy of the estate's request for a letter ruling as required under Settlement Agreement, and an additional estate tax return reporting the tax that would be due under the Settlement Agreement if the Agreement becomes effective. The estate also submitted a request for an extension to file and paid the estate tax that would be due if Settlement Agreement becomes effective.

The following rulings have been requested:

1. The distributions under Settlement Agreement directly to Spouse qualify for the federal estate tax marital deduction under § 2056 of the Internal Revenue Code.

2. The distributions to Son and Daughter under Settlement Agreement are not gifts by Spouse.

3. The distributions to Spouse, Son, and Daughter under Settlement Agreement, rather than under the Qualified Interest Trust provided under Trust, will not be a disposition under § 2519.

4. When Spouse receives her share of the proceeds from IRAs 1-6 and Plan under Settlement Agreement, within 60 days of receiving these proceeds, she may roll them over to her own IRA under §§ 402(c)(2) and 408(d)(3).

Law and Analysis

Ruling 1

Section 2056(a) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to the surviving spouse.

Section 2056(b)(7)(A) provides that, in the case of qualified terminable interest property for purposes of the marital deduction, such property shall be treated as passing to the surviving spouse and not to any person other than the surviving spouse.

Section 2056(b)(7)(B) provides that the term "qualified terminable interest property" (QTIP) is property that passes from the decedent, in which the surviving

spouse has a qualifying income interest for life, and to which an election applies. A qualifying income interest for life is defined as the surviving spouse being entitled to all of the income payable annually or at more frequent intervals and no person having the power to appoint any part of the property to anyone other than 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. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which the deductibility of the property interest depends. 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.

Rev. Rul. 66-139, 1966-1 C.B. 225, states that a valid claim by the surviving spouse to a share in the decedent's estate, made in good faith and settled as a result of arm's length negotiations without any court contest, will qualify as a bona fide claim within the meaning of the regulations. The ruling holds that where such claim is paid by the decedent's estate, the payment will qualify for the marital deduction to the extent that the interest that would have passed to the surviving spouse as a result of the completed exercise of the spouse's right (i.e., in a court contest) would have been a deductible interest.

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 stated that

> [E]ither 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 to a spouse (or charity) pursuant to the settlement of a claim will be treated as passing from the decedent, to the extent the compromise is a bona fide settlement of a legally enforceable claim. The claim must be settled pursuant to arm's length negotiations.

In this case, if the litigation had proceeded to judgment, there were two possible outcomes: (1) the court could have determined that the Will and Trust were invalid, in which case, 50 percent of Decedent's estate would have been distributed to Spouse and 25 percent each to Son and Daughter; or (2) the court could have determined that the Will and Trust were valid, in which case, Spouse would have been entitled to her lifetime interests in the Qualified Interest Trust, Son would have been entitled to his interests in the Qualified Interest Trust and the Credit Trust, and Daughter would have had no interest in Decedent's estate.

Settlement Agreement resulted from a bona fide adversarial proceeding and was the product of arm's length negotiations. Under Settlement Agreement, of Decedent's property, other than joint property but including the amounts from the IRAs and Plan, Spouse will receive Y percent outright and Son will receive Z percent outright. Daughter will receive $X. Under the agreement, Spouse will receive, in value, less than what she would have received if she had been successful in claiming her right to her interests in the Qualified Interest Trust. Son will receive less than what he would have received if he had successfully defended his right to his interests in the Credit Trust and Qualified Interest Trust. Daughter will receive less than the intestate share she would have received if successful in litigation. We recognize that, because of the uncertainty of litigation over the issues presented, determining a precisely correct allocation of trust assets in a settlement is difficult. We believe that Settlement Agreement provides an allocation of the estate's assets that is within a range of reasonable settlements. That is, the interests to be received by the parties (both as to the nature of the interests and their economic value) reflect the enforceable rights of the parties. Consequently, the property passing to Spouse under Settlement Agreement passes from Decedent for marital deduction purposes under § 2056.

Accordingly, based on the representations made and the information submitted, we rule that the distributions under Settlement Agreement directly to Spouse qualify for the federal estate tax marital deduction under § 2056.

Ruling 2

Section 2501 provides for a gift tax on the transfer of property by gift. Section 2511 provides that the gift tax imposed by § 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

Under § 2512(b), where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift. However, under § 25.2512-8 of the Gift Tax Regulations, a transaction which is bona fide, at arm's length, and free from any donative intent will be considered as made for an adequate and full consideration in money or money's worth.

Based on the discussion above, because the interests to be received by the parties reflect the enforceable rights of the parties and because Settlement Agreement provides an allocation of the trust assets that is within a range of reasonable settlements, Settlement Agreement is regarded, for transfer tax purposes, as properly reflecting the substantive rights of the parties. Accordingly, we rule that the direct distributions to Son and Daughter under Settlement Agreement are not gifts by Spouse.

Ruling 3

Section 20.2056(b)-7(c)(1) provides that a protective election may be made to treat property as qualified terminable interest property only if, at the time the federal estate tax return is filed, the executor of the decedent's estate reasonably believes that there is a bona fide issue that concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive, i.e., whether property that is includible is eligible for the qualified terminable interest property election. The protective election must identify either the specific asset, group of assets, or trust to which the election applies and the specific basis for the protective election.

Section 20.2056(b)-7(c)(2) provides that the protective election, once made on the return of tax imposed by § 2001, cannot be revoked. For example, if a protective election is made on the basis that a bona fide question exists regarding the inclusion of trust corpus in the gross estate and it is later determined that the trust corpus is so includible, the protective election becomes effective with respect to the trust corpus and cannot thereafter be revoked.

Section 2519(a) provides that, for purposes of the federal estate and gift tax, any disposition of all or part of a qualifying income interest for life in any property to which § 2519 applies will be treated as a transfer of all interests in such property other than the qualifying income interest. Section 2519(b) provides that § 2519 applies to any property if a deduction was allowed with respect to the transfer of such property to the donor under § 2056 by reason of § 2056(b)(7) or under § 2523 by reason of § 2523(f).

In the present case, the effectiveness of Settlement Agreement is conditioned upon the receipt by Decedent's estate of a favorable ruling letter from the Service. If an unfavorable letter were issued, Settlement Agreement would not become effective and the Qualified Interest Trust would be funded; but if a favorable letter were issued, the Qualified Interest Trust would not be funded. Consequently, the estate filed a protective QTIP election for the Qualified Interest Trust, indicating that the inclusion of the value of the trust corpus in the gross estate is conditioned upon the estate's receipt of a favorable ruling letter.

As a result of this letter ruling, Settlement Agreement will become effective and the Qualified Interest Trust will not be funded. Thus, under § 20.2056(b)-7(c)(2), the protective QTIP election will not become effective; and, for purposes of § 2519, a deduction will not be allowed to Decedent's estate under section § 2056 by reason of the estate's making an election under § 2056(b)(7). Consequently, based on the

representations made and the information submitted, we rule that § 2519 does not apply in this case and that, therefore, the distributions to Spouse, Son, and Daughter under Settlement Agreement, rather than under the Qualified Interest Trust provided under Trust, will not be a disposition under § 2519.

Ruling 4

Decedent became age 70 ½ on Date 2 and shortly thereafter began to receive minimum distributions from the IRAs and from Plan.

Section 401(a)(9)(B)(i) states that a trust shall not constitute a qualified trust unless it provides that, if the distribution of the employee's interest has begun in accordance with § 401(a)(9)(A)(ii) and the employee dies before his entire interest has been distributed to him, the remaining part of such interest will be distributed at least as rapidly as under the method of distribution being used under § 401(a)(9)(A)(ii) as of the date of his death. Under § 408 (a)(6), § 401(a)(9) applies to IRAs. Thus, under § 401(a)(9)(B)(i), Spouse, as beneficiary, must receive the balance of Decedent's IRAs at least as rapidly as he was receiving the distributions. The facts are not clear as to whether Decedent was recalculating his life expectancy or not. It does not matter. Under § 401(a)(9)(B)(i), if Spouse remains the beneficiary of an interest in Decedent's IRAs, Spouse is bound to continue to receive the balance in the IRAs at least as rapidly as the method that Decedent was using.

Section 408(d)(3)(C)(i) denies rollover treatment by an individual who inherits an IRA. Section 408(d)(3)(C)(i), however, does not treat a surviving spouse of the owner of the IRA as having inherited an IRA and permits the surviving spouse to roll over the IRA into his or her own IRA.

Prior to the changes to the proposed regulations published in the Federal Register on January 17, 2001, Prop. Treas. Reg. § 1.408-8, Q&A-4 provided guidance with respect to a beneficiary spouse who wishes to acquire the IRA of his or her deceased spouse. That section states in relevant part:

> A-4. Q. May an individual's beneficiary elect to treat such beneficiary's entire interest in the trust upon the death of the individual (or the remaining part of such interest if distribution to the beneficiary has commenced) as the beneficiary's own account?
>
> A.(b) In the case of an individual dying after December 31,1983, the only beneficiary of the individual who may elect to treat the beneficiary's entire interest in the trust (or the remaining part of such interest if distribution thereof has commenced to the beneficiary) as the beneficiary's own account is the individual's surviving spouse. If the surviving spouse makes such an election, the spouse's interest in the account would then be subject to the distribution requirements of § 401(a)(9)(A), rather than those of § 401(a)(9)(B). An election will be considered to have been made by the surviving spouse if either of the following occurs: (1) any required amounts in the account (including any

amounts that have been rolled over or transferred, in accordance with the requirements of § 408(d)(3)(A)(i), into an individual retirement account or individual retirement annuity for the benefit of the surviving spouse) have not been distributed within the appropriate time period applicable to the decedent under § 401(a)(9)(B), or (2) any additional amounts are contributed to the account (or to the account or annuity to which the surviving spouse has rolled such amounts over, as described in (1) above) which are subject, or deemed to be subject, to the distribution requirements of § 401(a)(9)(A). The result of such an election is that the surviving spouse shall then be considered the individual for whose benefit the trust is maintained.

Further, a surviving spouse who elects to treat an IRA of a decedent (or a portion thereof) as her own, becomes the owner of the IRA and ceases to be the beneficiary thereof. Thus, as owner, she is not subject to the "as least as rapidly" rule under § 401(a)(9)(B)(i). The surviving spouse would then be subject to the minimum distribution rules as if the decedent had never existed.

In this case, pursuant to Settlement Agreement and Court Order, as discussed above, Spouse is the named beneficiary of a Y% interest in each of Decedent's IRAs. As such, based upon § 408(d)(3) and Prop Treas. Reg. 1.408-8, Q&A-4 Spouse is eligible to roll over her Y% interest in Decedent's IRAs into an IRA set up and maintained in her name.

The minimum distribution provisions under § 401(a)(9) apply to Plan which is a § 401(k) plan. Distributions from a § 401(k) plan are governed by § 402. Section 402(c)(9) states that, if any distribution attributable to an employee is paid to the spouse of the employee after the employee's death, the preceding provisions of the subsection shall apply to such distribution in the same manner as if the spouse were the employee. Thus, §§ 402(c)(1) through 402(c)(8) apply to a surviving spouse as if he or she were the employee.

Section 402(c)(4) defines eligible rollover distribution as any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust, except that such term shall not include any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made for the life or life expectancy of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or for a specified period of ten years or more. An eligible rollover distribution also does not include any distribution to the extent that such distribution is required under § 401(a)(9).

Q&A 5 (c) of Treas. Reg. § 1.402(c)-2 provides the following:

However, a new determination is not made merely because, upon the death of the employee, the spouse or former spouse of the employee becomes the distributee. Thus, once distributions commence over a period that is at least as long as either the first annuitant's life or 10 years (e.g., as provided by a life annuity with a five-year or ten-year certain guarantee), then substantially equal

> payments to the survivor are not eligible rollover distributions even though the payment period remaining after the death of the employee is or may be less than the period described in section 402(c)(4)(A). For example, substantially equal periodic payments made under a life annuity with a five year term certain would not be an eligible rollover distribution even when paid after the death of the employee with three years remaining under the term certain.

Thus, if Spouse will receive from Plan any payments under a term certain annuity, over a period referenced in Q&A-5(c), above, she is not eligible to roll over such amounts.

Q&A 6 of Treas. Reg. § 1.402(c)-2 provides in relevant part:

> Similarly, if an employee's surviving spouse receives a survivor life annuity of $1,000 per month plus a single payment on account of death of $7,500, the single payment is treated as independent of the payments in the annuity and is an eligible rollover distribution unless otherwise excepted.

It is not clear how Spouse will receive payments from Plan. However, as noted above, any type of fixed annuity over a period referenced in Q&A-5(c), above, that she receives will not be eligible for rollover treatment.

Q &A 7 of Treas. Reg. § 1.402(c)-2 states:

> Except as provided in paragraphs (b) and (c) of this Q&A, if a minimum distribution is required for a calendar year, the amounts distributed during that calendar year are treated as required minimum distributions under § 401(a)(9), to the extent that the total required minimum distribution under § 401(a)(9) for the calendar year has not been satisfied. Accordingly, these amounts are not eligible rollover distributions. For example, if an employee is required under § 401(a)(9) to receive a required minimum distribution for a calendar year of $5,000 and the employee receives a total of $7,200 in that year, the first $5,000 distributed will be treated as the required minimum distribution and will not be an eligible rollover distribution and the remaining $2,200 will be an eligible rollover distribution if otherwise qualified.

It is not clear if there have been any distributions from Plan in Year 1 and Year 2. The minimum distributions for these two years must be made. Furthermore, except as noted above, the remaining amount can be rolled over by Spouse into her own IRA. Thus, for example, if Spouse intends to receive a single sum distribution, during calendar Year 2, of her full Y% interest in Decedent's Plan account, she may roll over the entire single sum to the extent it exceeds the § 401(a)(9) required distribution for calendar Year 2.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

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

Sincerely yours,
Associate Chief Counsel
(Passthroughs and Special Industries)
By James F. Hogan
Assistant to the Chief
Branch 4

Enclosure
Copy for section 6110 purposes