

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:4 – PLR-103732-03

Date: JANUARY 16, 2004

Re:

Legend:

Decedent

Spouse

Trust

Bank

Charity

Date 1

Date 2

Date 3

Date 4

Date 5

Date 6

Date 7

\$X

\$Y

\$Z

Court

County 1

County 2

W

V

State

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Dear _____ :

This is in response to your letter, dated January 16, 2003, requesting a ruling that the estate is entitled to a marital deduction under section 2056 of the Internal Revenue Code for property passing to a surviving spouse pursuant to a settlement agreement.

On Date 1, prior to their marriage, Decedent and Spouse entered into a pre-nuptial agreement. Under the terms of the pre-nuptial agreement, the parties to the agreement agreed that, in the event that Decedent predeceased Spouse, Decedent would designate Spouse as beneficiary of certain life insurance policies insuring Decedent's life and provide Spouse with use and occupancy of certain properties for the remainder of her lifetime or until such time as she may remarry, or live with another male, who is not a blood relative, whichever event first occurs. The agreement further provided that the parties would not elect to take against the other's last will and testament or claim any other right of dower, courtesy, or other statutory allowance provided to a surviving spouse under the law of any state of which they may reside

On Date 2, Decedent executed an irrevocable trust (Trust), that among other things, provided certain benefits to Spouse. The Trust was amended and restated on Date 3. ARTICLE FOURTH of Trust, provides, in part:

4.01 – Distribution of Remainder – Spouse Survives. Upon the death of Settlor [Decedent], in the event the spouse of the Settlor, [Spouse], survives the Settlor, then the Successor Trustee, after paying or making provision for payment of the obligations set forth in Article Second hereof [provision for taxes and expenses], shall set aside the sum of [\$X] Dollars, said amount to be satisfied with assets in cash or in kind as the Trustee determines, and hold the same in further Trust under the terms and conditions hereinafter set forth.

Under the terms of Trust, the ARTICLE FOURTH Trust was intended to qualify as a "Marital QTIP Trust" under section 2056(b)(7). Upon the death of Decedent, the trustee shall pay all of the net income in the ARTICLE FOURTH Trust, no less than annually, to Spouse, during her lifetime. The trustee has the sole discretion to invade the principal of the trust to provide for the health needs of Spouse. Upon the death of Spouse, the trustee shall distribute the remainder to Charity.

ARTICLE FIFTH, in part, states:

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5.01- Distribution of Remainder. Upon the death of the Settlor [Decedent] with this Trust Agreement still in effect, the entire remainder of the Trust estate shall be distributed as follows:

A. Real Estate Distribution. If the assets of this Trust include an interest in residential real estate, (the "Property") including but not limited to:

1. Real estate located in [County 1] . . . described as . . . W.
2. Real estate located in [County 2], [State] . . . described as . . . V;

the Trustee shall continue to hold such Property in Trust so long as the surviving spouse requests that such Property be held as a residence. The surviving spouse shall be permitted to use and occupy the Property rent free. It is the Settlor's intent that the surviving spouse own an equivalent "life estate" interest in the deceased Settlor's ownership interest in the Property, coupled with the authority of the surviving spouse to direct the Trustee to sell the Property and to purchase another residence (which said surviving spouse may select) to be held by the Trustee under the terms provided in this Trust.

A. Sales Proceeds and Reinvestment. Upon the sale of the Property held hereunder, the surviving spouse shall have two (2) years from the date of the sale of the Property to direct the Trustee to reinvest the proceeds into another residence of the surviving spouse's choosing. Any residence selected must be owned in fee simple by the Trust, and may not be a lesser interest, such as a life estate in an assisted living facility. If the surviving spouse does not select a qualifying property within the time frame outlined above, the proceeds from the sale not reinvested shall be added to the Article Fourth Marital Trust and distributed in accordance with said provisions.

1. During the term after the sale of the Property, but before the reinvestment of the proceeds, the Trustee shall continue to distribute the income earned on these investments in accordance with the distribution of income provisions of the Article Fourth Marital Trust.
2. The spouse of the Settlor shall enjoy a subsequent right to direct the Trustee to sell any subsequent Property and reinvest in a different property under the same terms provided for herein.

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3. Notwithstanding anything to the contrary contained in this paragraph 5.01, the spouse of the Settlor shall have the ability to direct the Trustee to convert underproductive property to productive property. . . .

C. Upon Death or Termination. Upon the death of the surviving spouse, the amounts or Property held in this Trust shall be distributed to [Charity].

ARTICLE FIFTH 5.02 provides:

5.02 – Distribution of Remainder. Upon the death of the Settlor, the remainder of this Trust shall be distributed outright and free of trust to [Charity].

On Date 4, Decedent and Spouse entered into a post-nuptial agreement where Spouse agreed to waive, except as otherwise provided, all rights as Spouse may acquire as surviving spouse in Decedent's estate upon the death of Decedent, but not by way of limitation, any and all rights of intestacy and any and all rights of election to take against the Decedent's will. This provision is intended to and shall serve as a waiver and release of Spouse's rights of election in accordance with the requirements of the laws of this jurisdiction and any other jurisdiction, including but not limited to State homestead rights and spousal elective share rights.

Approximately a year later, on Date 5, Decedent amended Trust and increased the amount passing under the ARTICLE FOURTH Trust to \$Y dollars. Decedent died 9 days later on Date 6. Bank was appointed as the personal representative of Decedent's estate.

Following the death of Decedent, Spouse filed a complaint in Court alleging there is a discrepancy in ARTICLE FIFTH of Trust and alleging that under ARTICLE FIFTH, read in its entirety, the remainder of Trust, not held in the ARTICLE FOURTH Trust, is to be held for her use and benefit during her lifetime. Spouse contends that the waivers in the post-nuptial agreement are invalid because the post-nuptial agreement was the product of overreaching and duress on the part of Decedent and, as a result, the waivers are not binding on Spouse. Charity contended that the pre- and post-nuptial agreements were valid and binding on Spouse and, accordingly, Spouse waived the right to elect against Decedent's estate. In settlement negotiations between Spouse and Charity, Spouse also alleged she has the right to elect against Decedent's will and that the elective share includes all of the assets of Trust. Charity disagreed with the Spouse's interpretation of ARTICLE FIFTH and maintained that the Trust property

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remaining after funding the ARTICLE FOURTH Trust and the real estate trust provided in ARTICLE FIFTH should be distributed to Charity outright.

After lengthy negotiations among the parties, Spouse and Charity entered into a settlement agreement, which was approved on Date 7 by Court. Under the terms of the settlement agreement, the ARTICLE FOURTH Trust is to be funded with \$Z dollars plus the ARTICLE FIFTH real property. Spouse is entitled to the greater of income or a 5% unitrust payment for life from the \$Z dollars and is entitled to possess and enjoy the real Property W and V, for life. In the event that any real property is sold and not reinvested in a replacement residence, the proceeds will continue to be held in Trust and administered as principal of the ARTICLE FOURTH Trust. The trustee of the ARTICLE FOURTH Trust has the discretion to invade the corpus for the health of Spouse. Upon the death of Spouse, the remainder of the ARTICLE FOURTH Trust is payable to Charity. Any remaining Trust property, after funding the ARTICLE FOURTH Trust, is to pass under ARTILCE FIFTH outright to Charity.

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 ARTICLE FOURTH Trust treated as qualified terminal interest property (QTIP) under section 2056(b)(7) of the Internal Revenue Code. The estate paid the estate tax that would be due if the settlement agreement becomes effective.

Bank has requested a ruling that the estate is entitled to a marital deduction under section 2056(b)(7) for property passing to Spouse under the settlement agreement.

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 section 2056(a), 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 under section 2056(b)(7)(v) applies. A qualifying income interest for life is defined as the surviving spouse being entitled to all of the income from the property 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 litigation had proceeded to judgment the court could have construed ARTICLE FIFTH to provide that property remaining in Trust after funding the

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ARTICLE FOURTH Trust did not pass on Decedent's death to Charity, or in the alternative, such property passed to Charity. Also, the court could have determined that the pre- and post-nuptial agreements were invalid which would allow Spouse to elect against Decedent's estate or the court could have determined that the agreements were valid, in which case Spouse would not be allowed to elect against Decedent's estate.

The settlement agreement resulted from a bona fide adversarial proceeding and was the product of arm's length negotiations. Under the settlement agreement, the ARTICLE FOURTH Trust is to be funded with \$Z dollars and Property W and V. The surviving spouse has an income interest (greater of income or a 5% unitrust amount) \$Z dollars and the right to use and occupy Property W and V, for her lifetime. Under the agreement, Spouse will not receive any assets outright, which would be the case if she elected against the estate, and Charity will be the ultimate beneficiary of ARTICLE FOURTH Trust. Further, the property in Trust not used to fund the ARTICLE FOURTH Trust will pass outright to Charity pursuant to ARTICLE FIFTH. 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 the settlement agreement provides an allocation of the Trust'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 the settlement agreement passes from Decedent for marital deduction purposes under section 2056.

Accordingly, based on the representations made, information submitted, and QTIP election made by the estate's representative on the Decedent's Form 706, we rule that the property passing under settlement agreement to the ARTICLE FOURTH trust qualifies for the federal estate tax marital deduction under section 2056.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the foregoing transactions under any other provisions of the Code or regulations.

Under a power of attorney on file with this office, we are sending a copy of this letter to Trustee's authorized representative.

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

Sincerely,
Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel

(Passthroughs & Special Industries)

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Enclosures (2)
Copy of this letter