

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-119421-00/CC:PSI:B4

March 22, 2001

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Date of Death:
Date of Conference:

LEGEND:

Decedent	-
Spouse	-
Cousin	-
Date 1	-
Date 2	-
Date 3	-
Date 4	-
Date 5	-
Date 6	-
Trust	-
Will	-
Fiduciary	-
Association	-
City	-
Real Property A	-
\$A	-
\$B	-

ISSUE:

Does an amount transferred directly to a municipality, resulting from a settlement of a controversy relating to a decedent's will and trust, qualify for a charitable deduction under § 2055(a)(1) of the Internal Revenue Code?

CONCLUSION:

A transfer directly to a municipality under the terms of a settlement agreement between the charitable and noncharitable beneficiaries of a trust qualifies for a charitable deduction under § 2055(a)(1).

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FACTS:

On Date 1, Decedent married Spouse. On Date 2, Decedent executed Trust, a revocable trust that is governed by the laws of Texas. Fiduciary, an unrelated corporation, is the trustee of Trust.

Section III of Trust provides that the corpus and income are for the benefit of Decedent during his lifetime. Upon Decedent's death, Spouse is to receive the entire income not in excess of \$1,000 per month unless Spouse has an illness that requires more to meet her needs. Upon Spouse's death, if she survives Decedent, "the interest" is to be paid to Cousin during his lifetime. In the event that Cousin dies and is survived by issue, "the interest" is to be paid to the issue.

Section XII of Trust states that:

This Trust may be terminated at any time during [Decedent's] lifetime. Upon the death of [Decedent], this Trust shall become irrevocable.

This Trust shall terminate twenty (20) years after the last to die of [Decedent] and [Cousin]. At the expiration of the twenty (20) years after the last to die of the hereinabove named, the residue of the corpus and undistributed income shall be delivered to [Association], which corpus and income will be used in a trust for the benefit of [Association], and such new trust shall be governed by the laws of the State of Oklahoma.

Association is the governing body of a cemetery that is owned and operated by City located in Oklahoma.

Shortly thereafter on Date 3, Decedent executed Will. Article III of the Will provides that Spouse and Cousin will receive all personal property (except money, bonds, and valuable papers). Article IV provides that Cousin is to receive Real Property A. However, if Cousin predeceases Decedent and has no surviving issue, Real Property A will pass with the rest and residue of Decedent's estate.

Under Article V of Decedent's Will, \$A is to be paid to Association as a fund for the sole use of placing flowers on the graves of certain members of Decedent's family. The cost of the flowers is to be deducted from the fund until the fund is exhausted.

Article VI of Decedent's Will provides that "All the rest, residue and remainder of my estate I give, devise and bequeath unto [Trust], to be administered by [Fiduciary]."

Decedent died on Date 4, survived by Spouse and Cousin. At the time of his death, Decedent was a resident of Texas. Fiduciary is also the executor of Decedent's estate.

Shortly after Decedent's death, differences arose concerning the rights and interests of each of the beneficiaries under both the Will and the Trust. The documents submitted indicate that Spouse and Cousin held conflicting views of their interests created under Decedent's Will and Trust, both as to the entitlement and amount of any entitlement. In addition, Spouse alleged that, during their marriage, Decedent had transferred some of her property to Trust

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without her knowledge or concurrence. Through their respective legal counsel, Spouse, Cousin, a guardian ad litem for the unborn issue of Cousin, Fiduciary, and City set forth their positions and entered into negotiations over the course of a year that resulted in an agreement to settle the issues involved and the parties' interests in the Will and the Trust.

On Date 5, Spouse, Cousin, the guardian ad litem, Fiduciary, and City entered into the settlement agreement, the purpose of which was to compromise and settle all claims and causes of action of the parties arising out of the validity, construction, or interpretation of Decedent's Will and Trust. Under the terms of the agreement, the parties agreed to a judicial termination of Trust and distribution of the assets of Decedent's estate as follows: (1) \$B would be distributed to City in satisfaction of its claims against the Trust and estate of Decedent; (2) Fiduciary would pay the expenses of administration, attorneys' fees, trustee fees, and estate taxes (up to a set limit); (3) Spouse would receive a sum representing her community property interest, an additional sum in full satisfaction of her remaining interest in Decedent's estate and Trust, specified unimproved real property, and certain personal property; and (4) Cousin would receive the balance of funds in both Decedent's estate and Trust, and specified real and personal property. In addition, Cousin agreed to assume the Association's responsibility for placing flowers on the graves of members of Decedent's family as specified Article V of Decedent's Will. On Date 6, after reviewing the proposed agreement, the local court issued an order that terminated Trust and provided for distribution of Trust and estate assets as set forth in the settlement agreement.

Decedent's estate timely filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return claiming a charitable deduction of \$B for the amount passing to City pursuant to the terms of the settlement agreement.

LAW AND ANALYSIS:

Section 2055(a)(1) of the Internal Revenue Code provides that for estate tax purposes, the value of the taxable estate shall be 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 the United States, any State, any political subdivision thereof, or the District of Columbia, for exclusively public purposes.

Section 2055(e)(2) disallows the estate tax charitable deduction where an interest in property (other than an interest described in section 170(f)(3)(B)) passes or has passed from the decedent to a person, or for a use, described in § 2055(a), and an interest (other than an interest which is extinguished upon the decedent's death) 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), unless –

(A) 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)), or

(B) in the case of any other interest, such interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).

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Congress enacted § 2055(e) to eliminate an abuse of the estate tax charitable deduction through the use of split interest trusts. This type of transfer involves the bequest of an interest in property to an individual with a simultaneous bequest of an interest in the same property to a charity. Oetting v. United States, 712 F.2d 358, 360 (8th Cir. 1983). Congress was concerned with situations in which a noncharitable beneficiary retained a substantial interest in the estate, and benefitted from a charitable deduction for a remainder or other interest that was significantly disproportionate to the actual value ultimately received by the charity. S. Rep. No. 552, 91st Cong., 1st Sess. 1969-3 C.B. 423, 479. To correct the abuse, § 2055(e)(2) provides that a charitable remainder bequest will qualify for the estate tax charitable deduction only if it is in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.

In this case, neither the bequest to Association in Decedent's Will nor the transfer of the remainder interest in the Trust to the Association qualifies for the estate tax charitable deduction under § 2055(a). The transfer under the Will was for private purposes (placing flowers on grave sites of family members) and the Trust was not in the form required by § 2055(e)(2). The estate, however, argues that § 2055(e) is not applicable to this case because the amount that passed to Association was the result of a settlement agreement of a bona fide will contest.

In Flanagan v. United States, 810 F.2d 930 (10th Cir. 1987), the decedent created a revocable trust during his life, which provided that, upon his death, the trustees were to make certain provisions for his nieces, nephews, and an employee. The trust further provided the trustee with the discretionary authority to pay a portion of the net income or principal for his sister's care, comfort, and support during her lifetime. The residue of the trust principal and any accumulated income was to be put to use for "charitable, educational, and public uses or purposes as the trustee may from time to time appoint, order or direct." Decedent's sister, together with his other intestate heirs, challenged the validity of the trust as a testamentary instrument. A settlement was reached and, under the agreement, a charity received certain specific properties. Subsequently, the Decedent's estate filed its federal estate tax return claiming a charitable deduction for the value of the properties that passed to the charity. The Internal Revenue Service challenged the deduction asserting that the charitable interest was traceable to a nonqualifying split interest trust that did not meet the requirements of § 2055(e)(2). The court held that an amount that passes outright to the charity under the settlement agreement or compromise of a bona fide will contest qualifies for a charitable deduction under § 2055(a)(2). In these circumstances, there is no split interest transfer to which § 2055(e)(2) applies and a charitable deduction under § 2055(a)(2) is allowable for the value of the property that actually passes directly to the charity. The court reasoned that the case involved none of the abuses of the charitable deduction that § 2055(e)(2) was enacted to eliminate because the actual amount passing to charity had been established.

In Estate of Strock v. United States, 655 F.Supp. 1334 (W.D. Pa. 1987), the decedent died testate. His will provided the residue of his estate was to pass to a split-interest trust whereby certain designated life beneficiaries were to receive the major portion of the income for their lives, and upon the death of the survivor of those beneficiaries, the remainder was to be paid to certain charities. One of the life beneficiaries and his children challenged the will claiming a paragraph had been left out of the will that would have dictated that, upon the death of the last life beneficiary, the remaining principal was to pass under the law of intestacy. Subsequently, the parties entered into a settlement agreement pursuant to which the executor of the decedent's estate paid \$45,000 to the charities specified in the will. The Internal

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Revenue Service disallowed the charitable deduction on the ground that the distribution did not meet the statutory prerequisites of § 2055(e). The court, citing Flanagan v. United States, supra, held that the amount was deductible because the settlement eliminated the split-interest trust and the noncharitable and charitable beneficiaries received their interests directly. Moreover, no attempt was made to preserve life and remainder aspects of the interests such that the exact interest passing to charity could not be determined. Therefore, the abuses that § 2055(e) was designed to prevent were not present in this case. See also, Northern Trust Co. v. United States, 41 A.F.T.R.2d 78-1523 (N.D. Ill. 1977).

In Rev. Rul. 89-31, 1989-1 C.B. 277, the decedent died testate. Under his will, the decedent bequeathed the residue of the estate to a trust the terms of which provided that income was to be paid to A, an individual, for A's life and the remainder was to be paid to a charitable organization described in §§ 170(c) and 2055(a). In good faith, A challenged the validity of the will, and as a result of a settlement, the estate made an immediate payment to A and distributed the balance of the trust to the charitable organization. The revenue ruling holds that the amount paid to the charitable organization qualifies for the estate tax charitable deduction under § 2055. The revenue ruling also states that the Service will no longer challenge the deductibility of immediate payments to charities made in lieu of a split interest that does not satisfy the requirements under § 2055(e)(2)(A) pursuant to a settlement of a bona fide will contest.

The facts in this case are similar to the facts in the cases and revenue ruling discussed above. Shortly after Decedent died, differences arose among the beneficiaries with respect to the rights and interests under Decedent's Will and Trust. In addition, Spouse maintained that she had a right to certain properties that Decedent had transferred to the Trust without her knowledge or concurrence. Subsequently, Spouse, Cousin, the guardian ad litem, Fiduciary, and City entered into an agreement to settle the issues involved. City was no longer responsible for placing flowers on the graves of the members of Decedent's family. In addition, City, acting on behalf of Association, received an outright accelerated payment in the amount of \$B in lieu of a nondeductible remainder interest as a result of the settlement of a bona fide will contest. The settlement in this case did not create split interests, and therefore, § 2055(e)(2)(A) does not apply. Rev. Rul. 89-31, supra. Accordingly, we conclude that the outright payment of \$B to City under the settlement agreement is considered to have been received from Decedent by outright bequest and is deductible from Decedent's gross estate under § 2055(a).

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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