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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEC 19 2006

UICs: 408.02-01
2033.01-00
2051.00-00

T:EP:RA:T3

LEGEND:

Decedent A:

Taxpayer B:

Taxpayer C:

Taxpayer D:

Taxpayer E:

Taxpayer F:

Judge G:

State S:

County T:

Court C:

Case T:

Company M:

Company N:

Company O:

Company P:

IRA X:

Date 1:

Date 2:

Date 3:

 

Date 4:

Date 5:

Amount 1:

Settlement Y:

Dear :

This is in response to the May 16, 2006, letter submitted on your behalf by your authorized representative, as supplemented by correspondence dated August 21, 2006, September 13, 2006, and an E-Mail dated October 26, 2006, in which you request letter rulings that there are no adverse income, estate or gift tax consequences to under sections 408(d)(1), 2033 and 2501 of the Internal Revenue Code ("Code") if you enter into Settlement Y dated Date 4, 2006. The following facts and representations support your ruling requests:

FACTS:

During his life, Decedent A owned assets including investment accounts with Company M, Company N, Company O, and Company P (collectively, Investment Accounts). Decedent A also owned IRA X, an individual retirement arrangement rollover account, with Company M.

On or about Date 1, 1996, Decedent A executed a durable power of attorney appointing Taxpayer B as his attorney-in-fact. On or around Date 2, 1996, Decedent A executed his Will leaving his estate equally to Taxpayer B and Taxpayer C. Taxpayers B and C are Decedent A's cousins.

Prior to his death, Decedent A executed a beneficiary designation form for his IRA X Account naming Taxpayer E, Taxpayer F, and Taxpayer D as equal beneficiaries of the account upon Decedent's death. Taxpayers E, F, and D are Taxpayer B's children.

Decedent A, a resident of County T, State S, died on Date Taxpayer C was appointed the executor of Decedent A's estate.

Shortly after Decedent A's death, the IRA X account was transferred to three separate IRA sub-accounts, one each for the benefit of Taxpayer D, Taxpayer E, and Taxpayer F. Taxpayers D, E, and F have received the required minimum distributions from the respective IRA sub-accounts and have reported the distributions as income on their respective income tax returns.

Also, shortly after Decedent A's death, litigation ensued between Taxpayer C and Taxpayer B involving the disposition of Decedent A's estate. One of the central allegations against Taxpayer B in this litigation was that he engaged in wrongdoing by acting as Decedent A's attorney-in-fact for his own personal benefit in a manner that avoided the terms of Decedent A's Will. It was further alleged that Taxpayer B took an excessive fee for his duties as Decedent A's attorney-in-fact.

As part of the litigation, Taxpayer C, in his capacity as executor of Decedent A's estate, filed a Complaint for Declaratory Judgment (Complaint) with Court C of County T. The Complaint alleges that, during Decedent A's life, Taxpayer B engaged in a pattern of misconduct designed to defraud Decedent A and the beneficiaries of his estate and that Taxpayer B wrongfully converted more than Amount 1 of Decedent A's assets for his own benefit and that of his children. Specifically, the Complaint alleges that between 1996 and 2003, Taxpayer B systematically changed or had Decedent A change all of his investment accounts to include Taxpayer B's children as the designated beneficiaries of these accounts. The Complaint also alleges that between 1996 and 2003, Taxpayer B used or had Decedent A use his own funds to open several bank accounts and/or certificates of deposit in Taxpayer B's sole name or in the name of Taxpayer B and Decedent A with rights of survivorship. The Complaint further alleges that Decedent A's actions were due to Taxpayer B's fraud, duress, and/or undue influence.

As part of the litigation, the parties engaged in extensive discovery including the review of Decedent A's medical records, bank records, brokerage account records, and other financial and legal documents pertaining to Decedent A and Taxpayer B. Discovery revealed that substantially all of the assets owned by Decedent A had been set up by Taxpayer B as either payable to Taxpayer B on Decedent A's death or as joint and survivorship assets. At pre-trial hearings, the status of the evidence was discussed with the Court C Judge, Judge G.

It has been represented that the parties in the above-referenced litigation were represented by counsel.

In State S, undue influence is defined as any improper or wrongful constraint, machination, or urgency of persuasion whereby the will of a person is overpowered and he or she is induced to do or forebear an act which he or she would not do or would do if left to act freely. In addition, the holder of a power of attorney has a fiduciary relationship with the principal. Where a fiduciary relationship exists between the decedent and a payable on death beneficiary, there is a presumption of undue influence. Once this presumption arises, the beneficiary has the burden to show that his conduct was free of undue influence over the decedent. (Case T).

Prior to trial, the parties entered into a settlement agreement (Settlement Y), under the supervision of Court C. Court C agreed to the terms of Settlement Y and, in connection therewith, issued a judgment (Judgment) on Date 4, 2006. In the Judgment, Court C reformed the beneficiary designation of the IRA X Account to designate Taxpayer C as the beneficiary of the IRA X Account retroactive to Date 5, 2003, the day immediately preceding Decedent A's death. Court C indicated in the Judgment that it had reformed the beneficiary designation because at the time Decedent A designated Taxpayer B's children as beneficiaries of his IRA X, he was visually impaired and subject to the influence and domination of Taxpayer B who at the time held Decedent A's power of attorney. Court C determined in the Judgment that, as a matter of law, Decedent A did not "knowingly or advisedly" execute the beneficiary designation form.

The value of IRA X is approximately 50 percent of the value of Decedent A's estate. Under Settlement Y and the Judgment, which must be approved by Court C, Taxpayer D and his siblings will transfer their interests in the IRA X Account to an IRA set up and maintained in the name of Decedent A to benefit Taxpayer C as consideration for the settlement of all the litigation between the parties. Taxpayer D and his siblings, however, will not refund to Taxpayer C the minimum distributions they received from the IRA X Account, which they included in their Federal taxable income.

Taxpayer D has requested several rulings as follow:

1. That he will not be subject to the gift tax under Code section 2501 if he enters into the Settlement Agreement ("Settlement Y");

2. That the IRA X account will not be includible in his (Taxpayer D's) gross estate under Code section 2033; and

3. That distributions from IRA X will not be taxable to him ("Taxpayer D") under Code section 408(d)(1).

<u>LAW and ANALYSIS</u>:

With respect to your first two ruling requests, Code section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Code section 2501 imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual.

Code section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(c)(1) of the Gift Tax Regulations states that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. United States, 674 F.2d 761,774-75 (9th Cir. 1981) citing Commissioner v. Estate of Bosch, 387 U.S. 456, 87 S. Ct. 1776, 18 L. Ed. 2d 886 (1967). Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Internal Revenue Service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

In this case, a bona fide controversy existed between the parties concerning the distribution of Decedent A's assets. Specifically, Taxpayer C argued that Taxpayer B diverted Decedent A's assets from distribution under Decedent A's Will by (1) causing Decedent A's funds to be used to open several bank accounts and/or certificates of deposits in Taxpayer B's sole name or in the name of Taxpayer B and Decedent A with rights of survivorship, and (2) by changing the beneficiary designations of the Investment Accounts and the IRA X account so that Taxpayer B and/or Taxpayer B's children would benefit from the assets held in those accounts.

To resolve the dispute, the parties entered into Settlement Y under the supervision and with the approval of Court C. The parties were represented by legal counsel. Court C, in connection with Settlement Y, entered the Judgment reforming the beneficiary designation of the IRA X account so that Taxpayer C was the sole beneficiary of the IRA X account at Decedent A's death.

The assets in the IRA X account represent approximately one-half of the assets Decedent A owned at his death and, under Settlement Y and Judgment, Taxpayer C becomes the sole beneficiary of the IRA X Account. This outcome is consistent with the terms of Decedent A's Will, which provides that Decedent A's assets are to be distributed equally between Taxpayer C and Taxpayer B. Therefore, the terms of Settlement Y and the related Judgment are reflective of the rights of the parties under the applicable State S law that would be applied by the highest court of that state.

Accordingly, based on the facts submitted and the representations made, we conclude with respect to your first two ruling requests as follows:

1. That entering into Settlement Y will not result in your ("Taxpayer D") being deemed to have made a taxable gift under Code section 2501; and

2. Further, Taxpayer D will not be deemed to be the owner of the IRA X account at his death under Code section 2033. The minimum distributions previously received from the IRA X account, however, will be included in Taxpayer D's gross estate under Code section 2033 unless these assets have been exhausted prior to Taxpayer D's death.

With specific respect to your third ruling request, Code section 408(d)(1) provides that, except as otherwise provided in section 408(d), any amount paid or distributed out of an IRA shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72 of the Code.

Although the Code does not define "payee" or "distributee," in general, the terms mean the plan participant (IRA holder) or his/her beneficiary who is entitled to receive distributions under the plan or IRA document. The term "distributee" for purposes of Code section 408 is not synonymous with "recipient".

Revenue Ruling 78-406, 1978-2 C.B. 157, provides that the direct transfer of funds from one IRA trustee to another IRA trustee, even if at the behest of the IRA holder, does not constitute a payment or distribution to a participant, payee or distributee as those terms are used in Code section 408(d). Furthermore, such a transfer does not constitute a rollover distribution.

Finally, Rev. Rul. 78-406 is applicable if the trustee to trustee transfer is directed by the beneficiary of an IRA after the death of the IRA owner as long as the transferee IRA is set up and maintained in the name of the deceased IRA owner for the benefit of the beneficiary.

In this case, as noted previously, Court C has reformed Decedent A's IRA X beneficiary designation so that Taxpayer C is entitled to receive the IRA X funds (with limited exceptions noted above). Furthermore, as noted above, the transaction described herein, consisting of Settlement Y and the Judgment, does not constitute a gift from Taxpayer D to Taxpayer C. Thus, pursuant to said reformation, Taxpayer C will be treated as the "payee" or "distribute" of Decedent A's IRA X and the person to be taxed on distributions from IRA X.

Furthermore, as noted previously, to effectuate Taxpayer A's reformed beneficiary designation, Taxpayer D will transfer the amounts standing in the IRA set up to benefit him into an IRA set up in the name of Decedent A to benefit Taxpayer C. Distributions will then be made from said IRA to the beneficiary thereof ("Taxpayer C").

Under this set of facts, with respect to your third ruling request, we conclude as follows:

3. That distributions from the IRA set up and maintained in the name of Decedent A to benefit Taxpayer C, pursuant to the above referenced Court C Judgment, which will hold amounts transferred from the sub-IRA benefiting Taxpayer D, mentioned above, will not be taxable to Taxpayer D under Code section 408(d)(1).

This letter ruling is based on the assumption that IRA X either is or was valid within the meaning of Code section 408(a) at all times relevant thereto. It also assumes that Settlement Y is a valid settlement under the laws of State S as represented. Additionally, it assumes that the transfer of the assets from IRA X to the sub-IRAs referenced above, were in fact transfers, and not distributions. It also assumes that the above-referenced transfers from said sub-IRAs to the IRA set up and maintained in the name of Decedent A to benefit Taxpayer C will be a transfer, as described in Rev. Rul. 78-406, which does not give rise to immediate tax consequences under Code section 408(d)(1) and not a distribution. Furthermore, it assumes that the IRA set up and maintained in the name of Decedent A to benefit Taxpayer C will comply with the requirements of Code section 408(a) at all times relevant thereto. Finally, it assumes the correctness of all representations contained therein.

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations which may be applicable thereto. Specifically, this letter ruling does not address the "required distribution" implications with respect to either IRA X or the IRA to be set up to benefit Taxpayer C. In this respect it does not address the issue of who, if anyone, is the designated beneficiary as defined in Code section 401(a)(9)(C), of either IRA X, or the IRA to be set up to benefit Taxpayer C.

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

Pursuant to a power of attorney on file with the Service, a copy of this letter ruling is being sent to each of the individuals authorized by you to receive such under the power of attorney on file with the Service.

If you wish to inquire about this ruling, please contact (I.D. # - ), at Please address all correspondence to

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures:
Deleted copy of letter ruling
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