

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:7:PLR-108164-99

Date:

June 3, 1999

Re:

Legend: Estate:
Executor (Trustee):
Trust:
Decedent:
Date 1:
Date 2:
Court:
Date 3:
A:
B:
Charity:
C:
X:

Dear

We received your letter dated _____, submitted on behalf of Estate, of which you are Executor. Rulings are sought concerning the application of § 2055(e)(3) of the Internal Revenue Code to the proposed reformation of Trust, of which you are Trustee. This letter responds to that request.

The facts and representations submitted are summarized as follows. Decedent died on Date 1. Decedent's Will, dated Date 2, was admitted to probate by Court on Date 3.

Article TWO [C] of the Will provides that A percent of the residuary estate is to be distributed outright to certain named individuals.

Article TWO [D] of the Will provides that the remaining B percent of the residuary estate is to be held in trust for a period of ten years and the income is to be distributed during that period, to eleven named charities in such amounts as the Trustee shall determine in the Trustee's sole discretion. Article TWO [D] of the Will further provides that one of the named charities, Charity, shall receive the sum of \$C per year for a period of four years, donated in the memory of a certain named individual, for the purposes of establishing a scholarship.

In addition, Article TWO [D] of the Will provides that, upon the tenth year of the Trust, the Trustee shall distribute fifty percent of Trust equally among the named charities.

Article TWO [E] of the Will provides that if any of the named charities is not a qualified charitable organization as described in the Internal Revenue Code of 1986, as amended, at any time when any principal or income of the Trust is to be distributed to it, the Trustee shall distribute such principal or income to one or more organizations then described as a qualified charitable organization as the Trustee shall select and in amounts that the Trustee shall determine in the Trustee's sole discretion.

Article TWO [F] of the Will provides that the remaining fifty percent of Trust shall be distributed to certain named individuals.

The transfer to Trust, as it is currently written, does not qualify for the estate tax charitable deduction under § 2055(a) because the charitable lead interest is not in the form of a guaranteed annuity or a fixed percentage, distributed annually, of the fair market value of the property. See § 2055(e)(2).

Further, the provision in Article TWO [D] of the Will for the four yearly payments of \$C to Charity is ambiguous. Specifically, the provision relating to the four yearly payments is included in the same paragraph as the provision for the ten-year income interest to the eleven charities, as well as the provision for distribution upon the tenth year of Trust. It is thus possible that the provision for Charity could be interpreted to commence either in the first year of the Trust, or commence after ten years.

The Trustee proposes to petition Court to reform the Trust pursuant to § 2055(e)(3). Pursuant to the proposed reformation, Trust will be divided into two trusts, Trust A and Trust B, each to be funded equally with one-half of the B percent share of the residuary estate. In addition, the petition will request that the Court construe the provision for the payments of \$C for the scholarship as providing that the payments commence immediately, as of the date of Decedent's death. Trustee of Trust will also serve as Trustee of Trusts A and B.

Under the proposed petition, Trust A, for a ten year period, will pay a unitrust amount equal to six percent of the net fair market value of the assets in Trust A, as

determined on the first day of each year, to the charitable beneficiaries. At the end of ten years, the Trustee will be required to distribute the remaining trust principal to the named individual beneficiaries.

Under Trust A, as reformed, the obligation to pay the unitrust amount begins as of the date of Decedent's death, but payment may be deferred from that date to the end of the tax year of Trust A in which it is funded. Payments of the unitrust amount shall be made in quarterly installments. The payments are to be made first from the net income of Trust A, and from principal to the extent that income is not sufficient. Any net income in excess of the unitrust amount not paid out shall be added to principal.

Trust A will also provide that for any short tax year, and for the year Trust A terminates, the trustee shall prorate the unitrust amount on a daily basis.

If the net fair market value of Trust A assets is incorrectly determined by the Trustee for any valuation date, the trust shall pay to the applicable recipients of the unitrust amount (in the case of an undervaluation) or be repaid by the applicable recipients of the unitrust amount (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid such recipients if the correct value were used and the amount which the trust actually paid such recipients.

Trust A will further provide that the Trustee shall make distributions at such time and in such manner as not to subject Trust A to tax under § 4942. The Trustee is prohibited from engaging in any act of self-dealing, as defined in § 4941(d), and shall not make any taxable expenditures, as defined in § 4945(d). The Trustee of Trust A is further prohibited from making any investments that jeopardize the charitable purpose of the trust, within the meaning of § 4944, or retain any excess business holdings within the meaning of § 4943.

The Trustee of Trust B will pay all trust income to the charitable beneficiaries for the ten-year period. After ten years, the Trustee will distribute the remaining trust principal to the charitable beneficiaries.

With respect to the \$C to be paid to Charity, the petition seeks an order authorizing the Trustee of Trust A to pay one-half of \$C each year out of the unitrust amount to Charity for four years, and the balance of the unitrust amount, if any, will be allocated among the named charities as the Trustee, in his discretion, shall determine. The petition also seeks an order authorizing the Trustee of Trust B to pay one-half of \$C each year to Charity for four years, out of trust income to the extent thereof, and out of trust principal to the extent income is not sufficient. The Trustee of Trust B would pay the balance of Trust B income, if any, to the named charities, to be allocated among them as the Trustee, in his sole discretion, shall determine.

The following rulings are requested:

- (1) The proposed reformation of Trust will be a qualified reformation within the meaning of § 2055(e)(3);
- (2) Proposed Trust A will qualify as a charitable lead unitrust; and,
- (3) After the reformation, the bequest to Trust B will qualify for the estate tax charitable deduction under § 2055(a).

Ruling Request 1:

Section 2055(a) provides that 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, and transfers to or for a corporation or certain other organizations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.

Section 2055(e)(2) provides that where an interest in property 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 that 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), no deduction is allowed under § 2055(a) for the interest that passes or has passed to the person, or for a use, described in § 2055(a), unless (A) in the case of a remainder interest, the interest is in 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 a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).

Section 2055(e)(3)(A) provides that a deduction shall be allowable for any "qualified reformation."

Section 2055(e)(3)(B) defines the term "qualified reformation" to mean a change of a governing instrument by reformation, amendment, construction, or otherwise that changes a reformable interest into a qualified interest, but only if - -

- (i) any difference between (I) the actuarial value (determined as of the date of the decedent's death) of the qualified interest, and (II) the actuarial value (as so determined) of the reformable interest does not exceed 5 percent of the actuarial value (as so determined) of the reformable interest,

(ii) in the case of (I) a charitable remainder interest, the nonremainder interest (before and after the qualified reformation) terminated at the same time, or (II) any other interest, the reformable interest and the qualified interest are for the same period, and

(iii) the change is effective as of the decedent's death.

Section 2055(e)(3)(C)(i) defines the term "reformable interest" to mean any interest for which a deduction would be allowable under § 2055(a) at the time of the decedent's death but for § 2055(e)(2).

Section 2055(e)(3)(C)(ii) provides that generally the term "reformable interest" does not include any interest unless, before the remainder vests in possession, all payments to persons other than an organization described in § 2055(a) are expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property.

Section 2055(e)(3)(C)(iii) provides, in part, that § 2055(e)(3)(C)(ii) does not apply to any interest if not later than 90 days after the last date (including extensions) for filing an estate tax return, if an estate tax return is required to be filed, a judicial proceeding is commenced to change the interest into a qualified interest.

Section 2055(e)(3)(D) defines the term "qualified interest" to mean an interest for which a deduction is allowable under § 2055(a).

Section 2055(e)(3)(E) provides that the deduction referred to in subsection (A) shall not exceed the amount of the deduction which would have been allowable for the reformable interest but for paragraph (2).

Prior to reformation, the income interest and remainder interest passing to organizations described in § 2055(a) under the terms of Trust are ascertainable and severable from the noncharitable interests within the meaning of § 20.2055-2(a). Thus, the interests passing to charitable organizations described in § 2055(a) under Trust, as amended, are interests for which a deduction would have been allowable under § 2055(a) but for § 2055(e)(2). Provided that the judicial proceeding to reform Trust is commenced within 90 days after the last date (including extensions) for filing the estate tax return, the interests under Article TWO of the Will are reformable interests within the meaning of § 2055(e)(3)(C).

Under Article TWO of the Will, the interests of the noncharitable and charitable beneficiaries will terminate upon the expiration of the ten-year term. Under Trusts A and B, the beneficiaries' interests will terminate at the same time.

Under the terms of Trust, prior to the reformation, trust income is to be distributed among eleven named charities, in the Trustees' discretion. After the reformation, two

trusts are created. Trust A is intended to qualify as a charitable lead unitrust, with a six percent unitrust amount being paid to charitable beneficiaries for ten years. Trust B is intended to qualify exclusively as a charitable trust.

According to the information submitted, under the terms of Trust, charitable beneficiaries were to receive the income for ten years, and at the end of ten years, the corpus was to be split equally between the charitable and non-charitable beneficiaries. The present worth of the right to receive the income from \$1.00 for ten years plus the right to receive half of the \$1.00 ten years hence is \$0.74103.

Under the proposed reformation, the original Trust corpus is to be divided equally between Trust A and Trust B. Trust B is to pay income annually to charities for ten years and the remainder will then pass to charity. The present worth of the charitable interest in this trust is \$1.00 for each \$1.00 of trust corpus. Trust A is to pay a unitrust amount of 6 percent per year to charity for ten years. After ten years, the remainder is to be distributed to non-charitable beneficiaries. With an adjusted payout rate of 6 percent times .936330 or 5.618 percent (based on an interest rate of X% (which is the § 7520 rate for Date 1), and with annual payments made at the end of the year, the present worth of the income interest in a unitrust that pays for ten years certain is \$0.43908 for each \$1.00 of initial trust corpus. The charitable interest in the reformed trusts is \$0.50000 ($\frac{1}{2}$ times \$1.00) plus \$0.21954 ($\frac{1}{2}$ times \$0.43908) or \$0.71954.

The proposed reformation meets the requirements set forth in § 2055(e)(3)(B). The difference between the actuarial value of the qualified interest and the actuarial value of the reformable interest is less than five percent of the actuarial value of the reformable interest. In addition, the reformable interest and the qualified interest are for the same period. Further, the proposed reformation will be effective as of the date of the Decedent's death.

Ruling Requests 2 & 3:

Under § 20.2055-2(e)(1)(i), in the case of decedents dying after December 31, 1969, where an interest in property passes from the decedent for charitable purposes and an interest in the same property passes from the decedent for private purposes, no deduction is allowed under § 2055(a) for the value of the interest passing for charitable purposes unless the interest is a "deductible interest."

Under § 20.2055-2(e)(2)(vii)(a), the term "deductible interest" includes a unitrust interest. A "unitrust interest" is a right to receive payment, not less often than annually of a fixed percentage of the net fair market value, determined annually, of the property which funds the unitrust interest. The unitrust interest may be paid for a specified term,

or the life or lives of named individuals, each of whom must be living at the creation of the unitrust.

Under § 20.2055-2(e)(2)(vii)(b), a charitable interest is a unitrust interest only if it is a unitrust interest in every respect. Under § 20.2055-2(e)(2)(vii)(e), where a unitrust interest is in a trust, the instrument may provide that income of the trust in excess of the amount required to pay the unitrust interest shall be paid to or for the use of a charity. Nevertheless, the amount of the deduction is limited to the fair market value of the unitrust interest. Under § 20.2055-2(f)(2)(v), the present value of a unitrust interest is determined by subtracting the present value of all interests in the transferred property other than the unitrust interest from the fair market value of the transferred property.

After the proposed reformation, the amount of the unitrust interest payable with respect to Trust A will be determined pursuant to a specified formula. The unitrust amount will be ascertainable and determinable, effective as of the date of Decedent's death.

Accordingly, based on the facts submitted and representations made, we conclude that the charitable interest in Trust A, after the proposed reformation, will constitute a unitrust interest within the meaning of § 2055(e)(2)(B) and § 20.2055-2(e)(2)(vii), provided that Trust A will be a valid trust under local law. Therefore, effective as of the date of Decedent's death, an estate tax charitable deduction will be allowed under § 2055(a) for the present value of the unitrust interest, determined in accordance with § 20.2055-2(f)(2)(v).

In addition, after the proposed reformation, Trust B will only provide for payments to the eleven named charitable beneficiaries. Accordingly, an estate tax charitable deduction will be allowed under § 2055(a) for the bequest to Trust B (as reformed), provided that Trust B will be a valid trust under local law, and provided that such construction is consistent with applicable State law.

Thus, the proposed reformation of Trust, as amended, into a charitable trust and a charitable lead unitrust will be a qualified reformation for purposes § 2055(e)(3).

Except as specifically ruled above, no opinion is expressed or implied as to the federal tax consequences of the situation described above under any other provisions of the Internal Revenue Code.

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

Sincerely,

James C. Gibbons

James C. Gibbons
Assistant to the Chief, Branch 7
Office of the Assistant Chief Counsel
(Passthroughs & Special Industries)

Enclosures:

Copy for § 6110 purposes