

Internal Revenue Service

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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4 - PLR-154183-02
Date: AUGUST 27, 2003

Re:

Legend:

Decedent =
Trust =

Daughter =
Grandson 1 =

Grandson 2 =

Grandson 3 =

Charity 1 =
Charity 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Bank =

Dear :

This is in response to a letter dated September 23, 2003, and subsequent correspondence, requesting rulings regarding the proposed reformation of Trust under § 2055(e)(3) of the Internal Revenue Code.

Facts

The facts submitted and representations made are as follows. Decedent executed Trust, a revocable trust, prior to July 28, 1997. Trust provides for payments of income and principal to Decedent during his life. Paragraph (B) of Item II of Trust also provides that, during periods of Decedent's illness or disability, the Trustee may distribute income and principal as the Trustee deems necessary for the comfort, support, maintenance, and care of Daughter for her life, to supplement government assistance paid for Daughter's benefit for her special needs (due to a legal incapacity).

Paragraph (B) 6. of Item II provides that, at Daughter's death, Trust will continue for Decedent's benefit unless Decedent predeceases Daughter, in which case Trust will continue as provided under Paragraph (C) 4. of Item II.

Paragraph (C) of Item II provides for payments from Trust after Decedent's death. The supplemental payments under Paragraph (B) of Item II for Daughter's benefit are to continue. In addition, during Daughter's life, the trustee is to distribute any excess income (after payments for Daughter's benefit) up to a maximum of \$1000 per month, at the end of each month, from the income of Trust, to each of Daughter's children, Grandson 1, Grandson 2, and Grandson 3, for his respective life. Any remaining income is to be accumulated with the principal and administered under the provisions of Trust.

Paragraph (C) 4. of Item II provides for payments "[u]pon my daughter's death, if she should survive me," of \$1000 per month, payable at the end of each month, from the income or principal (or both) of Trust to each of Decedent's grandchildren, Grandson 1, Grandson 2, and Grandson 3, for his respective life. Any excess income is to be accumulated with the principal and administered under the provisions of Trust. Paragraph (C) 5. of Item II provides that, upon the death of the last to die of Grandson 1, Grandson 2, and Grandson 3, and Daughter, the trustee must distribute the remaining income and principal of Trust outright to Charity 1, or, if no longer in existence, to Charity 2, or, if neither then exists, to a specified type of charity, for "funding educational scholarships, with first priority to be given to those members of the church that are pursuing religious training." Based on values as of the date of Decedent's death, the \$36,000 annual payment to the grandsons was less than 5% of the initial value of the Trust corpus.

Paragraph (C) 6. of Item II provides that, regardless of any of the foregoing provisions, if Trust contains assets of less than \$50,000 in value after the deaths of Decedent and Daughter, the trustee is authorized, but not directed, to distribute the assets of Trust among Decedent's then living grandsons or the issue of a deceased grandson.

Daughter died on Date 1. At the time of her death, the major portion of her assets were held in a brokerage account. Under Daughter's Will, the assets held in the account passed to Decedent, as sole beneficiary of Daughter's estate. Decedent died on Date 2, in 1998. Under his Will, executed on Date 3, prior to July 28, 1997, Decedent bequeathed his tangible personalty to Grandsons 1, 2, and 3, and the residue of his probate estate to Trust.

On Date 4, Grandsons 1, 2, and 3, Bank as executor of Decedent's estate and trustee of Trust, and Charities 1 and 2 all signed a Settlement Agreement and Release of Claims (Settlement Agreement). The Settlement Agreement states that Grandsons 1, 2, and 3 assert that Daughter intended for them to receive her brokerage account, that her Will did not accurately reflect her intent, and that the assets in the account should have been distributed to them, rather than to Decedent and then to Trust. Further, the Settlement Agreement states that although Daughter's will was admitted to probate, the grandsons did not waive their rights to challenge that admission and that their release of those rights would permit a determination of the rights of Decedent's estate and of Trust to the brokerage account.

In the Settlement Agreement, the parties agreed to seek court approval for a proposed modification of Trust as follows. First, the scrivener's error in Paragraph (C) 4. of Item II will be corrected to clarify Decedent's intent that Grandsons 1, 2, and 3 were each to receive payments of \$1000 per month for life upon the death of the survivor of Decedent and Daughter, regardless of the order of their deaths.

Second, Trust will be modified under the terms of a document designated as Second Amendment to Revocable Trust Agreement (Second Amendment). The Second Amendment provides that Paragraph (C) 4. of Item II of Trust will be replaced with a paragraph providing for the creation, upon the death of the survivor of Daughter and Decedent, of a Charitable Remainder Annuity Trust (CRAT). The new Paragraph (C) 4. of Item II will provide that a fractional share of Decedent's estate will fund a CRAT "equal to the amount required to fund a charitable annuity remainder trust which complies with all requirements which a charitable annuity remainder trust must meet in order for [Decedent's] estate to receive a charitable deduction against taxes for the full value of the remainder interest". No further additions of property may be made to the CRAT.

From the date of Decedent's death, the trustee will distribute from the CRAT \$1000 per month at the end of each month to each of Grandsons 1, 2, and 3 for his life. Within a reasonable period after the CRAT is funded, payments and interest will be made to the grandsons for any payments owed them since the date of Decedent's death. The payments to the grandsons will be paid first from the income of Trust and, second, only to the extent such income is insufficient, from principal. At the death of the first grandson to die, one-third of the remaining assets of the CRAT will be distributed outright to the charitable remainder beneficiary determined under Paragraph (C) 5. of Item II. At the death of the second grandson to die, one-half of the remaining

assets of the CRAT will be distributed outright to the charitable remainder beneficiary. At the last grandson's death, the remaining assets of the CRAT will be distributed outright to the charitable remainder beneficiary. The amount to be paid a grandson for the month of his death will be paid to his estate and prorated, as necessary, for the days prior to his death. The Second Amendment further authorizes the trustee to amend Trust to ensure its qualification under § 664(d)(1) and prohibits the trustee from exercising any powers inconsistent with that qualification. The Second Amendment deletes Paragraph (C) 6. of Item II, which authorizes distribution of Trust to the then-living grandsons or their issue if, after the deaths of Daughter and Decedent, Trust contains assets of less than \$50,000 in value. The CRAT will be funded with \$720,000 (\$36,000\05).

After funding of the CRAT, the balance of the Trust assets will be distributed as follows. An outright payment will be made to Grandsons 1, 2, and 3 of a fractional share of the balance of the trust equal to "the maximum allowable amount that (1) does not cause a federal estate tax and (2) allows the parties to pass the five percent test under IRC Section 2055(e)(3)(B)(i)." This fractional amount will be distributed in equal shares to Grandsons 1, 2, and 3 to induce them to release their rights to claim assets in Daughter's estate or in the brokerage account and to agree to the terms of the Settlement Agreement. The remaining balance of Trust will be distributed outright to the charitable remainder beneficiary determined under Paragraph (C) 5. of Item II as though the death of the survivor of Daughter and Grandsons 1, 2, and 3 had then occurred.

The Settlement Agreement states that the proposed reformation correcting the scrivener's error will be requested from the court in all circumstances. However, the trustee will not seek to reform Trust to create a CRAT, and to distribute the balance of Trust outright to charity and to Grandsons 1, 2, and 3, unless the trustee receives a favorable letter ruling from the Internal Revenue Service.

On Date 5, Bank, as trustee of Trust, filed a petition with the local court to request an order incorporating Settlement Agreement and reforming Trust pursuant to that agreement so that Trust will contain the terms provided under the Second Amendment. The petition also requested the appointment of a guardian ad litem.

We have been asked to rule as follows:

1. The proposed reformation of Trust will be a qualified reformation under § 2055(e)(3).

2. Decedent's estate is entitled to a federal estate tax charitable deduction for the present value, determined as of the date of death, of the charitable remainder interest in the CRAT created under the proposed reformation.

3. Decedent's estate is entitled to a federal estate tax charitable deduction for the date of death value of the fractional share paid outright to charity under the proposed reformation.

4. Decedent's estate is not entitled to a federal estate tax charitable deduction for the date of death value of any outright payment to Grandsons 1, 2, and 3 under Settlement Agreement from the balance of the assets of Trust as reformed after the CRAT is funded.

Law and Analysis:

Section 664(d)(1) provides that a charitable remainder annuity trust is a trust –

(A) from which a sum certain (which is not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons at least one of which is not an organization described in § 170(c), and, in the case of individuals, only to an individual living at the creation of the trust, for a term of years not in excess of 20 years, or for the life or lives of the such individuals.

(B) from which no amount other than the payments described in subparagraph (A) (or qualified gratuitous transfers described in subparagraph (C)) may be paid to or for the use of any person other than an organization described in § 170(c).

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in § 170(c) or is to be retained by the trust for such use (or is to be used for qualified gratuitous transfers defined in subsection (g)), and

(D) the value (determined under § 7520) of such remainder interest is at least 10 percent of the initial net fair market value of all property placed in the trust.

Section 2055(a) provides that for purposes of the federal estate tax, 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 a person or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, no part of the net earnings of which inures to the benefit of any private stockholder or individual.

Section 2055(e)(2) provides generally, that where an interest in property passes or has passed from the decedent for charitable purposes and an interest in the same property passes or has passed from the decedent for noncharitable purposes, then a deduction is allowed for the charitable interest under § 2055(a) only if the charitable interest is in certain prescribed forms. In the case of a charitable remainder interest, the interest must pass in a trust that is a charitable remainder annuity trust or a

charitable remainder unitrust (described in § 664) or a pooled income fund (described in § 642(c)(5)). In the case of any other charitable interest, the interest must be in the form of a guaranteed annuity or unitrust interest (a fixed percentage distributed yearly of the fair market value of the property determined yearly).

Section 2055(e)(3) provides for the reformations of charitable interests to comply with the requirements of § 2055(e)(2). Section 2055(e)(3)(A) provides that a deduction shall be allowed under § 2055(a) in respect of any qualified reformation.

Section 2055(e)(3)(B) provides that the term "qualified reformation" means a change of a governing instrument by reformation, amendment, construction, or otherwise which 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 five 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) such change is effective as of the date 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 the rules of § 2055(e)(2). Under § 2055(e)(3)(C)(ii) 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)(I) provides, however, that § 2055(e)(3)(C)(ii) shall not apply to any interest if a judicial proceeding is commenced to change such interest into a qualified interest not later than the 90th day after the last date (including extensions) for filing an estate tax return, if an estate tax return is required to be filed.

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

The legislative history underlying the enactment of section 2055(e)(3) indicates that Congress desired to establish permanent rules authorizing the reformation of

charitable trust to comply with the requirements of section 2055(e)(2). However, Congress was concerned that the rules contain adequate safeguards to avoid abuse. The House committee report states:

...[T]he committee believes that any reformation proceedings necessary to cure defective governing instruments should not be an opportunity to significantly revise the substance of the split interest transfer, especially where the change reduces charity's share of the trust. Accordingly, the committee believes that the relative actuarial values of the interests of each beneficiary before and after the reformation should not differ by more than 5 percent and that the durations of the interests before and after the reformation should be same.

H. R. Rep. No. 98-432, pt. 2, at 1517 (1984).

In this case, under the terms of Trust (assuming the local court amends Paragraph (C) 4. of Item II on the basis of scrivener's error to provide for payment of the annuities to Grandson's 1, 2, and 3 after the death of the survivor of Decedent and Daughter), an interest in Trust will pass for both charitable and noncharitable purposes. However, as executed, Trust does not meet the requirements of § 664(d)(1) and therefore, the property passing to Trust does not qualify for the charitable deduction under § 2055(e)(2)(A).

Further, the reformation of Trust, as proposed under the Second Amendment to Revocable Trust Agreement, does not constitute a qualified reformation under § 2055(e)(3). Specifically, rather than funding a CRAT with the amount that passed under the original terms of Trust¹ (in compliance with § 2055(e)(3) as described below, page 8, *infra*), in the proposed reformation, the CRAT is funded with only a portion of the Trust corpus and a lump sum payment is to be made to charity.

As discussed above, the provisions of § 2055(e)(3) were intended to permit trust reformations to comply with § 2055(e)(2) in situations where the reformation did not significantly revise the substance of the split interest transfer. In this regard, the legislative history indicates that Congress contemplated that the charitable interest provided in the original instrument remain in trust after the reformation. For example, the legislative history uses the terms "qualified interest" and "charitable interest of the reformed trust" interchangeably and refers to the "charitable interests of the reformed trust and the unreformed trust." H.R. Rep. No. 98-432, Pt. 2, at 1517-1518 (1984). Similarly, under the statute, the "actuarial value" of the charitable remainder interest after reformation must be within 5 percent of the actuarial value of the charitable interest before reformation. In addition, the duration of the noncharitable annuity

¹ We assume that the lump sum payment made to Grandsons 1, 2 and 3 reflects a bona fide settlement of their claims regarding the brokerage account.

interest must be the same before and after reformation, ensuring that the charitable remainder interest is distributed at the same time before and after reformation.

In this case, prior to reformation charity was to receive a portion of the trust corpus only after the deaths of Grandsons 1, 2 and 3. However, under the reformation as proposed, a portion of the Trust corpus will be paid immediately to charity. This immediate payment significantly revises the substance of the split interest transfer originally provided for under the terms of Trust, and alters the time for distribution of a portion of the charitable remainder interest. The reformation does not comply with the requirements of section 2055(e)(3)(B)(i) and (ii) and is not a qualified reformation.

We note that the Trust could be reformed in compliance with § 2055(e)(3). In general, the Trust could be reformed to provide for an annual payment of 5 percent of the initial net fair market value of the Trust corpus. From this 5 percent amount, \$36,000 would be paid, as provided in the original trust instrument, to Grandsons 1, 2, and 3. The balance of the 5 percent amount would be paid to the charity determined under Paragraph (C) 5. of Item II of Trust as if Daughter and Grandsons 1, 2, and 3 had died on the date of payment. As each grandson dies, his \$1,000 per month share of the 5 percent amount would be paid to that charity, until the last grandson's death when the remaining assets of Trust would be paid to the charitable remainder beneficiary.

Finally, we note that the situation presented here is distinguishable from that presented in Rev. Rul. 89-31, 1989-1 C.B. 277. This revenue ruling concludes that a charitable deduction is allowable under § 2055 for a lump sum distribution to charity that is paid, pursuant to the settlement of a bona fide will contest, in satisfaction of the charity's claim to a remainder interest that would not be deductible under § 2055(e)(2)(A). In the instant case, a portion of the Settlement Agreement addresses the dispute arising under Daughter's will involving the Grandsons' claim to the brokerage account by providing for a lump sum payment to the Grandsons. The portion of the agreement providing for the creation of CRAT and the lump sum payment to charity addresses the reformation of Trust to comply with §2055(e)(2), rather than the settlement of a dispute regarding Trust. The lump sum payment to charity provided for in the Settlement Agreement does not come within the purview of Rev. Rul. 89-31. See, Estate of Burdick v. Commissioner, 96 T.C. 168 (1991), aff'd, 979 F.2d1369 (9th Cir. 1992).

Accordingly, based on the facts submitted and the representations made we rule as follows:

1. The proposed reformation of Trust will not be a qualified reformation under § 2055(e)(3).

2. Decedent's estate will not be not entitled to a federal estate tax charitable deduction for the date of death value of the charitable remainder interest in the CRAT created under the proposed reformation.

3. Decedent's estate is not entitled to a federal estate tax charitable deduction for the date of death value of the fractional share paid outright to charity under the proposed reformation.

4. Decedent's estate is not entitled to a federal estate tax charitable deduction for the date of death value of any outright payment to Grandsons 1, 2, and 3 under Settlement Agreement from the balance of the assets of Trust as reformed after the CRAT is funded.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the modification 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,

George L. Masnik
Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure
Copy for section 6110 purposes

cc: