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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact:
, ID No.

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Refer Reply To:
CC:PSI:B04
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Date: MAY 13, 2005

LEGEND:

Decedent	=
Son	=
Sibling	=
Trust	=
Local Court	=
Trust A	=
Trust B	=
Unitrust	=
Trustee	=
Charity 1	=
Charity 2	=
Charity 3	=
Charity 4	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
$x	=

Dear :

This is in response to the May 14, 2004 letter and other correspondence from your authorized representative requesting rulings on the estate and income tax consequences of the reformation of Trust.

Decedent died testate on Date 1. In Article Fifteenth of his will, he created Trust and bequeathed the residue of his estate to it. Trustee, a corporate fiduciary, was designated as the trustee of Trust and the executor of Decedent's estate. The Trust provisions are set forth in Article Fifteenth of Decedent's will as follows.

Under Paragraph A, subparagraph 3, Trustee is to pay to Decedent's adult child, Son, 50 percent of the trust income. Trustee may also pay any portion of the remaining income which the trustee, in Trustee's discretion, deems necessary for Son's comfort, maintenance or support. Any remaining income is to be added to corpus. Under subparagraph 4, Trustee may pay and apply trust principal for such of Son's medical expenses as Trustee, in Trustee's sole discretion, deems reasonably necessary.

Under subparagraphs 5 and 6, at the end of the ten years, if Son is then living, Trustee is to distribute outright to him 50 percent of the Trust principal. The other 50 percent of Trust principal is to continue in Trust until Son's death (unless earlier distributed to Son under Trustee's discretionary power to distribute the principal for his medical expenses). On Son's death, the remaining Trust principal and income are to be distributed equally among Charity 1, Charity 2, Charity 3, Charity 4, and Sibling. Charity 4's share is to be held in trust.

The charitable remainder interests in Trust do not qualify for the estate tax charitable deduction provided under § 2055(a) of the Internal Revenue Code. Therefore, the following actions were taken to reform Trust.

Son's disclaimer

First, on Date 2, Son disclaimed the discretionary invasions of principal for his medical expenses allowed under Article Fifteenth, Paragraph A, subparagraph 4. It is represented that Son never received any distributions pursuant to the interest in Trust and Son never accepted or received any benefits from the interest. The disclaimer was delivered to Trustee and filed with the Local Court on Date 3, a date not more than nine months after the date of Decedent's death, Date 1. It is represented that Son's disclaimer is a qualified disclaimer for estate tax purposes.

First step of the reformation: Trust partitioned

On Date 3, Trustee instituted a judicial proceeding in the Local Court to reform Decedent's will in two steps. In the first step, Trust is to be severed into two trusts, effective as of the Decedent's date of death. One-half of the estate residue is allocated to Trust A. The other half is allocated to Trust B. Son will receive 50 percent of the income of both Trust A and Trust B along with such additional income as, in Trustee's discretion, Trustee deems necessary for his comfort, maintenance or support. Based on the particular circumstances of this case, Son, in effect, has the right to receive all of the income of Trust A and Trust B. If Son survives the ten-year period following Decedent's death, he will receive outright the Trust A principal. If Son dies during the ten-year period, the Trust A principal will thereupon be distributed equally to Charity 1, Charity 2, Charity 3, Charity 4, and Sibling (if he survives Son). Charity 4's share will be distributed outright.

With respect to Trust B, the half of the residue distributable to Trust B is to be held until Son's death at which time it is distributable in equal shares to Charity 1, Charity 2, Charity 3, Charity 4, and Sibling (if he survives Son). Charity 4's share is distributable outright.

Trust B as a unitrust

In the second step in the judicial reformation, Trust B will be replaced by a unitrust ("Unitrust") intended to qualify as a charitable remainder unitrust within the meaning of § 2055(e)(2)(A). Trustee will distribute $x outright to Sibling as the value of his partial contingent remainder interest in Trust B.

Under the reformed Unitrust provisions, effective as of the date of Decedent's death, Trustee will pay each year, in quarterly installments, an amount equal to 5 percent of the net fair market value of the Unitrust assets (valued as of the first business day of the taxable year). A fractional portion of the unitrust amount will be paid in equal shares to Charity 1, Charity 2, Charity 3, and Charity 4. The charities' portion of the unitrust amount will be determined by a formula under which the actuarial value of the charities' remainder interests in Unitrust and the charities' portion of the unitrust amount, when added together, equal the actuarial value of the charitable remainder interests in Trust B prior to reformation as a unitrust. The remaining portion of the unitrust amount will be paid to Son. On Son's death, the Unitrust property will be distributed in equal shares to Charity 1, Charity 2, Charity 3, and Charity 4. It is represented that Charity 1, Charity 2, Charity 3, and Charity 4 are charitable organizations described in § 2055(a).

The Local Court approved the first step of the reformation and, contingent on a favorable ruling from the Service, the second step of the reformation as well.

You have asked us to rule that:

(1) The reformation of Trust B will be a qualified reformation under § 2055(e)(2)(B).

(2) An estate tax charitable deduction will be allowed for the value of the charities' interests in Unitrust.

(3) The proposed transaction will not constitute a sale, exchange or other disposition of property that will cause the estate, a trust, or beneficiary to realize gain or loss for purposes of § 1001 or income for purposes of § 61.

Rulings 1 and 2:

Section 664(d)(2) provides that a charitable remainder unitrust is a trust -

(A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, 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 section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 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 section 170(c) or is to be retained by the trust for such a use, and

(D) with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

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 the use of 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 subsection (a), and an interest (other than an interest which is extinguished on 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 subsection (a), no deduction shall be allowed for the interest which passes or has passed to the person, or for the use, described in subsection (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 section 664) or a pooled income fund, 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).

Section 2055(e)(3)(A) provides that a deduction shall be allowed under subsection (a) in respect of any qualified reformation. Under § 2055(e)(3), if a trust is reformed in order to qualify under § 2055(e)(2), the reformation will be a qualified reformation and the charitable interest will be deductible under § 2055(a) if the following requirements are met:

1. The interest is one for which a deduction would be allowable under § 2055(a) at the time of the decedent's death but for the requirements in § 2055(e)(2);

2. The nonremainder interest both before and after the qualified reformation must terminate at the same time;

3. The reformation is effective as of the date of the decedent's death;

4. The difference between the actuarial value of the qualified interest determined as of the date of the decedent's death and the actuarial value of the reformable interest does not exceed 5 percent of the actuarial value of the reformable interest; and

5. If all noncharitable interests in the trust prior to reformation are not expressed in specified dollar amounts or a fixed percentage of the fair market value of the property, then a judicial proceeding is commenced no later than 90 days after the date the federal estate tax return (including extensions) is due, or if no federal estate tax return is required to be filed, the last date (including extensions) for filing the income tax return for the first taxable year for which such a return is required to be filed by the trust.

Section 20.2055-2(a) of the Estate Tax Regulations provides that if a trust is created for both charitable and a private purpose, deduction may be taken for the value of the charitable beneficial interest only insofar as that interest is presently ascertainable and, hence severable from the noncharitable interest.

In this case, Son disclaimed his interest in the Trust principal. Assuming his disclaimer is a qualified disclaimer, within the meaning of § 2518, the interest is treated as never having passed to Son. Thus, for estate tax purposes, as of the date of Decedent’s death, Son’s right to receive the income of the one-half of estate residue partitioned as Trust B, is deemed to be the only noncharitable interest in Trust B. Therefore, we conclude that, assuming that Son’s disclaimer meets the requirements for a qualified disclaimer, the charitable interests in Trust B prior to reformation would have

qualified for an estate tax charitable deduction under § 2055(a), but for the provisions of § 2055(e)(2). Accordingly, the first requirement for a qualified reformation under § 2055(e)(3) is met.

The reformation satisfies the second requirement for a qualified reformation under § 2055(e)(3), since Son's interest both before and after the reformation will terminate at the same time (i.e., at his death). The reformation also satisfies the third requirement because the reformation is effective as of Decedent's date of death.

With respect to the fourth requirement, the actuarial value of the qualified interest determined as of the date of Decedent's death and the actuarial value of the reformable interest are identical. Accordingly, the reformation satisfies the fourth requirement under § 2055(e)(3).

The proposed reformation will satisfy the fifth requirement under § 2055(e)(3) since, even though Son's interest in Trust B (the half portion of Trust subject to the charitable remainder interests) is not expressed in a specified dollar amount or a fixed percentage of the fair market value of the trust, it is represented that the judicial proceeding to reform Trust was commenced within 90 days of the date that the federal estate tax return for Decedent's estate was due.

Based on the facts submitted and the representations made, we conclude that the reformation of Trust B, as described above, is a qualified reformation for purposes of § 2055(e)(3) provided that the reformation is effective under local law, and Trust B as reformed satisfies the requirements for a charitable remainder unitrust under § 664(d)(2). Accordingly, an estate tax deduction under § 2055(a) is allowable for the value of the charitable interests in the unitrust.

Ruling 3:

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) states that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1011(c), except as otherwise provided in Subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), concerns the issue of whether a sale or exchange has taken place resulting in realization of gain or loss under § 1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court of the United States in Cottage Savings, 499 U.S. at 560-61, concluded that § 1.1001-1 reasonably interprets § 1001 and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-65. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. At 566.

In this case, the Local Court approved the first step and, contingent on a favorable ruling, the second step of the reformation. Provided that the proposed reformation is retroactive to the date of Decedent's death, the interests will be the same before and after the reformation. It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries will not differ materially because the reformation is retroactive to the date of Decedent's death. Accordingly, the proposed transaction will not result in a material difference in kind or extent to the legal entitlements enjoyed by the beneficiaries, and no income, gain, or loss is recognized for purposes of §§ 61 and 1001(a).

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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 yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy of letter for section 6110 purposes