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Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B04-PLR-113668-02
Date:

Re:

OCTOBER 29, 2002

Legend:

- Trust 1 =
- Trust 2 =

- University =
- Grantor =
- Son =
- State Court =
- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- Date 5 =
- Date 6 =
- a =
- b =
- c =
- d =

Dear :

This is in response to your March 5, 2002 letter and other correspondence requesting rulings concerning the estate tax consequences of the reformation of a trust.

You have requested the following rulings:

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1. The reformation of Trust 2 is a qualified reformation under section 2055(e)(3) of the Internal Revenue Code.
2. Trust 2 as reformed meets the requirements of a charitable remainder annuity trust under section 664, provided that Trust 2 is a valid trust under applicable local law.
3. Trust 2 as reformed qualifies as a charitable remainder annuity trust for federal tax purposes, for any year in which it continues to meet the definition of and functions exclusively as a charitable remainder annuity trust; and will be exempt for such year from taxes imposed by subtitle A of the Code unless it has unrelated business taxable income as defined in section 512.
4. A charitable deduction will be allowed under section 2055(a) for the present value of the remainder interest in Trust 2.
5. The portion of the annuity amount that is to be paid annually to University will constitute a guaranteed annuity within the meaning of section 2055(e)(2)(B) and a charitable deduction will be allowed under section 2055(a) for the present value of such interest.

The facts submitted are as follows:

Grantor executed a will on Date 1 that was modified by codicil on Date 2 and Date 3. Under the terms of the will, all of Grantor's property is to be given to the Trustees of Trust 1 and added to the principal thereof and disposed of as provided thereunder. Trust 1 is a revocable trust established by Grantor during his lifetime.

Article Fifth of Trust 1 provides that upon Grantor's death, if Son is then living, \$a is to be retained by the Trustees in a trust (Trust 2). In each taxable year of Trust 2, the Trustees shall pay to Son an amount equal to \$b in equal quarterly installments out of income and, to the extent income is not sufficient, out of principal. Any income of Trust 2 in excess of the annuity amount shall be added to principal. Upon the death of Son, Trust 2 will terminate and the then remaining principal and income of Trust 2 shall be paid to University to establish a scholarship fund.

If University is not a "qualified charitable organization" at the time the trust terminates, then the trustee is directed to pay the remaining trust corpus to one or more qualified charitable organizations as the trustees shall select. The term "qualified charitable organization" is defined as an organization described in section 170(c), contributions to which are deductible for federal, estate, gift, and income tax purposes.

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The terms of Trust 2 contain language satisfying the requirements of section 1.664-1(a)(3) (regarding prohibition on restrictions on investments), section 1.664-1(a)(5) (regarding deferral of the annuity amount in the case of testamentary transfers), section 1.664-2(a)(1)(iv) (regarding payment of the annuity in a short taxable year), and section 1.664-2(a)(6)(b) (regarding prohibition of additional contributions.) In addition, under the terms of the trust, the trustee is precluded from engaging in any act of self dealing, failing to make distributions, retaining any excess business holdings, or making any taxable expenditures, so as to subject the trust to any tax under sections 4941, 4942, 4943, 4944, and 4945 of the Internal Revenue Code.

Under Articles Ninth and Thirteenth of Trust 1, administration expenses, funeral expenses, and all estate taxes are to be paid from the remaining balance of the Trust 1 corpus (after payment of specific and general bequests, including the pecuniary bequest to Trust 2 under Article Fifth).

Grantor died on Date 4. On Date 5, the Trustees of Trust 1 petitioned State Court to reform the terms of Trust 2 to provide that the trustee will pay annually an annuity amount of \$c, equal to 5% of the initial fair market value of the assets of Trust 2. Of this amount, \$b will be paid annually to Son for life and the remaining \$d will be paid annually to University. Upon the death of Son, Trust 2 will terminate and the then remaining principal and income of Trust 2 will be paid to University to establish a scholarship fund. In all other respects, the terms of Trust 2 remain the same. State Court granted the petition and ordered the trust reformed accordingly on Date 6.

It is represented that University is a charitable organization described in section 2055(a).

Rulings 1-4

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 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),

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(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 or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by subsection (g)), and

(D) the value (determined under section 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 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 no deduction will be allowed for an interest passing to a charitable organization where an interest in the same property, other than an interest which is extinguished upon the decedent's death, passes to a noncharitable beneficiary unless: 1) in the case of a remainder interest, the 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 described in section 642(c)(5); or 2) in the case of any other interest, the interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly.

Section 2055(e)(3) provides that a trust may be reformed in order to qualify under section 2055(e)(2). In order to be effective, the reformation must be a "qualified reformation." A qualified reformation is a change of the governing instrument by reformation, amendment, construction, or otherwise that meets the following requirements:

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

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4. The difference between the actuarial value of the qualified interest (the interest after reformation) determined as of the date of the decedent's death and the actuarial value of the reformable interest (the interest prior to reformation) 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 private purposes, a deduction may be taken for the value of the charitable interest only insofar as that interest is presently ascertainable and, hence severable from the noncharitable interest.

In the instant case, under the terms of Trust 2, \$b will be paid to Son annually while Son is alive. On son's death the trust remainder will be paid to a qualified charity. Prior to reformation, Trust 2 did not qualify as a charitable remainder annuity trust under section 664 because less than 5% of the initial fair market value of the property placed in trust was to be paid annually. The charitable interest in the trust prior to reformation would have qualified for an estate tax charitable deduction under section 2055(a), but for the provisions of section 2055(e)(2) which require that a charitable remainder trust meet the requirements of section 664. Accordingly, the first requirement for a qualified reformation under section 2055(e)(3) is satisfied.

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

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

The reformation satisfies the fifth requirement under section 2055(e)(3), since Son's interest is expressed in a specified dollar amount.

Accordingly, based on the facts submitted and the representations made, we conclude that the reformation of Trust 2, as described above, is a qualified reformation for purposes of section 2055(e)(3) provided that the reformation is effective under local

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law. Furthermore, Trust 2 as reformed will meet the requirements of a charitable remainder annuity trust under section 664(d)(1), assuming the requirement of section 664(d)(1)(D) is satisfied. For any year in which it continues to meet the definition of and functions exclusively as a charitable remainder annuity trust, Trust 2 will be exempt from taxes imposed by subtitle A of the Code unless it has any unrelated business taxable income as defined in section 512. A charitable deduction will be allowed under section 2055(a) for the present value of the remainder interest in Trust 2, determined in accordance with section 20.2055-2(f)(2)(i).

Ruling 5

Section 20.2055-2(e)(2)(vi) provides, in part, that a guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term of years or for the life or lives of certain individuals, each of whom must be living at the date of death of the decedent and can be ascertained at such date.

In this case, the portion of the annuity amount that is to be paid annually to University under Trust 2 as reformed will constitute a guaranteed annuity within the meaning of section 2055(e)(2)(B). Accordingly, based on the facts submitted and the representations made, we conclude that a charitable deduction will be allowed under section 2055(a) for the present value of the interest, determined in accordance with section 20.2055-2(f)(2)(iv).

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.

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This ruling is directed only to the taxpayer(s) requesting 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 the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

Copy of letter for section 6110 purposes