

Internal Revenue Service

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Department of the Treasury

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Person to Contact:

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Refer Reply To:

CC:DOM:P&SI:4 - PLR-106234-99

Date: March 8, 2000

Re:

Legend:

Decedent =

Trust =

Trust A =

Trust B =

Individual =

Charity 1 =

Charity 2 =

Date 1 =

Date 2 =

Date 3 =

X =

Y =

State =

Dear :

This is in response to your September 28, 1999 letter and prior correspondence in which you requested rulings under section 2055 of the Internal Revenue Code.

Facts

The facts submitted and representations made are as follows: On Date 1, Decedent created a revocable trust (Trust) which became irrevocable at her death on Date 2. At Decedent's death, the value of the Trust was approximately \$X. Approximately 26

percent of this value was comprised of agricultural realty, and 74 percent consisted of shares of stock, cash, and a house on a small city lot. The house was not the personal residence of the Decedent.

Article II, paragraph 2 of Trust provides that following Decedent's death, Individual is to be given the right to use and possess the house, rent free, for her life or until such time as she no longer desires to use or possess the house. In addition, the trustee is to pay as much income of Trust as is necessary "for the upkeep, expenses and repair of this real estate; including but not limited to real estate taxes, insurance against loss, theft or damage at its fair value, alterations and improvements." At Individual's death, the house is to be administered under Article II, paragraph 3, and other applicable provisions of Trust. Individual is not related to Decedent.

Article II, paragraph 3 of Trust provides that, upon Decedent's death, except as provided in paragraph 2 of Article II, the trustee is to retain the corpus of Trust in perpetuity for the benefit of Charity 1 and Charity 2, or their successors-in-interest. Under Article II, paragraph 4, the trustee has sole discretion to distribute, at least annually, any amounts of principal and interest of Trust to the charities in any proportions as the trustee deems appropriate. Under Article IV, if Charity 1 or Charity 2 ceases to qualify as a charitable organization under § 508 [sic] of the Internal Revenue Code, the trustee may select another charity with similar purpose and design that does so qualify.

Under Article V, paragraph 7, the trustee has no power to sell or distribute any portion of the agricultural real property which is held in the Trust. Article V, paragraph 8 authorizes the trustee to lease the agricultural real property "on any reasonable terms" for agricultural purposes and provides that the trustee "shall offer to lease and lease the agricultural real property" to two designated individuals so long as either wants to lease the property.

As Trust presently exists, it does not qualify as a charitable remainder trust under section 664 and, therefore, Decedent's estate may not deduct the value of the remainder interest in the Trust as an estate tax charitable deduction under § 2055(e)(2).

In order to qualify Trust for the estate tax charitable deduction, on Date 3, before the due date for filing the Decedent's federal estate tax return, the estate initiated a judicial proceeding to seek reformation of Trust under the provisions of State law and § 2055(e)(3).

Under the proposed reformation, Trust will be divided into two separate trusts, Trust A and Trust B. Trust A will be funded with \$Y. Trust A will be a charitable remainder annuity trust, drafted to comply with the requirements of Section 6 of Rev. Proc. 90-32. Trust A will pay Individual an annuity amount of 7.1 percent of the initial net fair market value of the trust assets, provided that the payout percentage will not exceed the percentage that would result in a 5 percent probability that the trust corpus would be exhausted before the death of Individual determined as of the date of Decedent's death. The annuity amount will be paid monthly, on the first business day of each month. Individual will use the annuity payments to pay fair market rental value for the house and to pay for the upkeep, expenses and repair of house, including real estate taxes, insurance against loss, theft, or damage, and for alterations and improvements.

Upon Individual's death, the assets remaining in Trust A will be paid to Trust B, provided that, at that time, Trust B is an organization described in §§ 170(c) and 2055(a) of the Code (hereinafter referred to as a "charitable organization"). If, at the time of Individual's death, Trust B is not a charitable organization, the assets of Trust A will be distributed in equal shares to Charity 1 and Charity 2 (or their successors-in-interest), or, if either of them is not then a charitable organization, its share will be distributed to such one or more other charitable organizations with a similar purpose and design as the trustee shall select in its sole discretion.

Under the proposed reformation, all of the assets of Trust, including the house but excluding \$Y used to fund Trust A, will fund Trust B. Trust B will be held in perpetuity and be administered as a wholly charitable trust for the benefit of Charity 1 and Charity 2. The trustee may distribute, at least annually, any amounts of principal and interest of Trust B to Charity 1 and Charity 2 in any proportions as the trustee deems appropriate. If either or both charities or their successors-in-interest cease operation or cease to qualify as an organization exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3) and also as an organization described in §§ 170(c)(2), 2055(a), and 2522(a), the trustee may select another charity with similar purpose and design that does so qualify.

The provision under the original Trust that no part of the agricultural realty be sold or distributed, but that it may be leased on any reasonable basis, and shall be leased to two named persons if those persons should desire to enter into a lease agreement, remains the same under the proposed reformation.

It is represented that the trustee of Trust will apply for a determination from the Service that Trust B is an organization described in § 501(c)(3).

You have requested the following rulings:

1. The proposed reformation of Trust is a qualified reformation under § 2055(e)(3).
2. A federal estate tax charitable deduction is allowable to the estate under § 2055(a) for the date of death value of the remainder interest in Trust A that will pass to Trust B.
3. A federal estate tax charitable deduction is allowable to the estate under § 2055(a) for the date of death value of the assets of Trust B at Decedent's death (minus \$Y, which will be used to fund Trust A).
4. The requirement under Article V, paragraph 8 of Trust that the trustee offer to lease and lease the agricultural real property to designated individuals does not create a split interest trust that must qualify as a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund under § 2055(e)(2).

Law and analysis

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) disallows the estate tax charitable deduction where an interest in property (other than an interest described in § 170(f)(3)(B)) 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 which 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), 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 § 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 is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).

The charitable split interest rules of § 2055(e)(2) were enacted by the Tax Reform Act of 1969 and are applicable, with exceptions not relevant here, to estates of decedents dying after December 31, 1969. With respect to decedents dying before January 1, 1970, § 20.2055-2(a) of the Estate Tax Regulations provides that if a trust is created or property is transferred for both a charitable and a private purpose, a 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.

Section 2055(e)(3) provides for reformations of 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 split interest 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).

Section 664(d)(1), prior to amendment by the Taxpayer Relief Act of 1997 (1997 Act), provided, in part, that a charitable remainder annuity trust is a trust from which a sum certain (which is not less than 5 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 such individuals. Under § 664(d)(1) as amended by the 1997 Act, the sum certain can be no less than 5 percent and no more than 50 percent of the initial net fair market value of the trust assets, and the actuarial value of the remainder interest must be at least 10 percent of the initial net fair market value of the property placed in the trust.

Under § 1.664-1(a)(3) of the Income Tax Regulations, a trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

In the present case, Trust, before reformation, provides Individual with a life estate in the house and provides that all expenses of maintaining the house for the life of Individual are to be paid from Trust income. With this exception, the assets of Trust are to be held in perpetuity for the benefit of Charity 1 and Charity 2. The charitable interest in the Trust, before reformation, is a reformable interest under § 2055(e)(3)(C)(i) because, at the date of the Decedent's death, the value of Individual's life estate and the amount of money needed to pay expenses of maintaining the house could be determined and subtracted from the full value of the Trust to arrive at the

value of the charitable interest. Hence, pursuant to § 20.2055-2(a), the charitable interest was ascertainable and severable from the noncharitable interest as of the date of the Decedent's death.

Prior to reformation, the interest of Individual in Trust is not expressed in a specified dollar amount or a fixed percentage of the fair market value of the property, as required by § 2055(e)(3)(C)(ii). The estate, however, commenced a judicial proceeding to reform the Trust on or before the 90th day after the last date (including extensions) for filing the estate tax return. Therefore, pursuant to § 2055(e)(3)(C)(iii), § 2055(e)(3)(C)(ii) does not apply.

The proposed reformation will satisfy the requirements of § 2055(e)(3)(B). The difference between the actuarial value of the qualified interest and the actuarial value of the reformable interest does not exceed 5 percent of the actuarial value of the reformable interest. Both before and after the proposed reformation, Individual's interest will terminate at Individual's death. It is represented that the proposed reformation will be effective as of Decedent's date of death.

The governing instrument of Trust A, under the proposed reformation described above, contains the provisions set forth in Rev. Rul. 72-395, 1972-2 C.B. 340, as modified by Rev. Rul. 80-123, 1980-1 C.B. 205, and Rev. Rul. 82-128, 1982-2 C.B. 71, and clarified by Rev. Rul. 82-165, 1982-2 C.B. 117. Therefore, we conclude that the governing instrument of Trust A will meet the requirements of a charitable remainder annuity under section 664, provided that the trust will be a valid trust under the applicable local law. Moreover, the actuarial value of the remainder interest in Trust A exceeds 10 percent of the initial net fair market value of Trust A.

Further, Trust A will qualify as a charitable remainder annuity trust, for federal estate tax purposes, for any year in which it continues to meet the definition of and functions exclusively as a charitable remainder annuity trust. For such year, Trust A 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 and the regulations applicable thereto.

Under the proposed reformation, as under the terms of the original Trust, the trustee of Trust B is authorized to lease the agricultural real property held by Trust B "on any reasonable terms." The trustee is further required to offer the agricultural property for lease to two designated individuals. The designated individuals are required, like any other lessee, to make reasonable rental payments in order to lease the agricultural property from Trust B. Under both the original and

reformed Trust, the trustee would not realize less than a reasonable income from any rental of agricultural property to the designated individuals. Thus, the requirement that the trustee lease the agricultural property to the designated individuals does not create a beneficial interest in these individuals, in either the original or the reformed Trust, for purposes of the split interest rules under § 2055(e)(2).

Based on the information submitted and the representations made, we rule as follows:

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

2. A federal estate tax charitable deduction is allowable to the estate under § 2055(a) for the date of death present value of the remainder interest in Trust A that will pass to Trust B, provided Trust B qualifies as an organization described in § 2055(a).

3. A federal estate tax charitable deduction is allowable to the estate under § 2055(a) for the date of death value of the assets allocable to Trust B at Decedent's death, provided Trust B qualifies as an organization described in § 2055(a).

4. The requirement that the trustee offer to lease and lease the agricultural real property to designated individuals does not create a split interest trust that must qualify as a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund under § 2055(e)(2).

The rulings above, except for the ruling regarding the requirement that the trustee lease agricultural property to designated individuals, are expressly contingent on the issuance of a court order requiring the proposed reformation.

Except as we have specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions of the Code 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,
Assistant Chief Counsel
(Passthroughs and Special Industries)
By Katherine A. Mellody
Senior Technician Reviewer, Branch 4

Enclosure

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