

Private Letter Ruling 9118040, 2/07/1991, IRC Sec(s). 2055

Date: February 7, 1991

CC: P&SI: Br. 4/TR-31-2698-90

Re: ***

Dear = ***

This is in response to your letter dated December 31, 1990, and prior submissions in which you requested a ruling as to whether a charitable lead trust may be reformed pursuant to section 2055(e)(3) of the Internal Revenue Code, and whether the trust, as reformed will qualify as a guaranteed annuity trust.

You represent that decedent, A, executed a trust agreement called the A Charitable Lead Trust. During the decedent's lifetime, the trust was funded with a nominal cash deposit of \$10 and the trust property was to be held uninvested. Further, the trust could be revoked by the decedent at any time. On the decedent's death, the trust agreement becomes irrevocable. Additional property passing to the trust as a result of the decedent's death is to be held by the trustee in a separate trust called the "Charitable Lead Trust." The trustee of the Charitable Lead Trust is directed each year of the trust term to pay an annuity amount equal to 8% of the initial fair market value of the trust estate to several charitable organizations, all of which qualify as organizations described in sections 170(b)(1)(A), 170(c), and 2055(a) of the Internal Revenue Code, in specified proportions. Upon the expiration of the term of the Charitable Lead Trust, the trustee is directed to pay over the property then being held in trust to another trust which is exclusively for the benefit of noncharitable beneficiaries.

A died in November, 1990. Under the provisions of A's will, after the payment of various specific bequests to named individuals and organizations, the residue of the decedent's estate is to be added to the Charitable Lead Trust to be administered in accordance with its terms. In addition, the will directs that other trust funds over which the decedent had a power of appointment and which are includible in A's gross estate for federal estate tax purposes shall also be added to the Charitable Lead Trust. Thus, the exact amount that is to be added to the Charitable Lead Trust could not have been known until A's death.

In subparagraph 2(e) of the Charitable Lead Trust as in effect at A's death, the duration of the Trust was expressed as follows:

(e) The term of the Charitable Lead Trust shall be for that period of time, not to exceed 20 years, for which the Annuity Amount must be paid in order to enable the Grantor's personal representative or estate to claim a charitable deduction with respect to the value of the payments of the Annuity Amount for purposes of computing the federal estate tax payable by the Grantor's personal representative or estate in such an amount as is necessary to reduce the federal estate taxes payable because of the Grantor's death to zero (or the lowest amount possible), based upon values as finally determined for federal estate tax purposes, taking into account prior taxable gifts, if any, and all other available credits and deductions that may be allowed in determining such tax.

You propose to reform the Charitable Lead Trust, pursuant to section 2055(e)(3) of the Code, through an amendment signed by the trustee pursuant to paragraph 7 of the Trust which provides:

Upon the death of Grantor, this agreement shall be irrevocable, except that the trustee shall have the power to amend this agreement for the sole purpose of qualifying the interests of the charitable beneficiaries under paragraph 2 as guaranteed annuity interests under section 2055(e) of the Internal Revenue Code.

You propose that subparagraph 2(e) of the Trust be reformed as follows:

(e) The term of the Charitable Lead Trust shall be for that period of time, not to exceed 20 years, that results in a charitable deduction allowable with respect to the value of the payments of the annuity amount that is necessary to reduce the federal estate tax payable because of the grantor's death to zero (or the lowest amount possible) based upon values as finally determined for federal estate tax purposes in the Grantor's estate, taking into account prior taxable gifts (if any) and all other available credits and deductions that may be allowed in determining such tax, and using valuation methods, tables, factors, and applicable rates prescribed by the appropriate provisions of the Internal Revenue Code and the United States Treasury regulations, Rulings, Procedures, and guidelines promulgated pursuant thereto. When determining the term of the Charitable Lead Trust, the trustee shall follow the procedures below using values as finally determined for federal estate tax purposes in the grantor's estate:

1. The trustee shall determine or obtain from the personal representative of the grantor's estate the value of the grantor's taxable estate for federal estate tax purposes, exclusive of the charitable deduction that may be allowable for this Charitable Lead Trust. From this amount, the trustee shall deduct the amount that can pass free of tax by reason of the allowable unified credit and any other credits available in determining the federal estate tax payable in the Grantor's estate.

2. The trustee or personal representative of the Grantor's estate shall determine the amount passing to this Charitable Lead Trust, valued at the date of the decedent's death, or alternate valuation date if applicable.

3. The trustee shall determine the annuity amount by multiplying the amount determined in step 2 above by the annual percentage payout rate of 8% set forth in subparagraph 2(a) of the Charitable Lead Trust.

4. The trustee shall then divide the result of Step 1 by the appropriate adjustment factor to reflect the quarterly frequency of payment of the annuity amount. The trustee shall determine the appropriate adjustment

factor from tables prescribed by the appropriate provisions of the applicable United States Treasury Regulations and publications issued by the Internal Revenue Service.

5. The trustee shall then divide the amount determined in step 4 above by the annuity amount determined in step 3 above.

6. The trustee shall then determine the two term-of-years annuity factors between which fall the result determined in Step 5. The trustee shall determine these factors based on the applicable Treasury regulations or publications issued by the Internal Revenue Service using the applicable assumed rate of return prescribed by Section 7520 of the Internal Revenue Code (or comparable provisions of any subsequent tax statute).

7. The number of whole years for which the Charitable Lead Trust must be in effect in order to produce a charitable deduction in an amount that will reduce the federal estate tax liability on the Grantor's estate to zero will be that number of years which corresponds to the lesser of the two annuity factors determined in step 6. The trustee shall then interpolate between this annuity factor and the other annuity factor determined in step 6 in order to determine the total number of whole years and whole months the Charitable Lead Trust must last in order for the amount of the charitable deduction allowable with respect to this Charitable Lead Trust to be the smallest amount necessary to reduce the federal estate tax liability on the Grantor's estate to zero.

8. The duration of the Charitable Lead Trust shall be the lesser of that number of whole years and whole months as determined in Step 7 or 20 years.

If the values used by the trustee in determining the trust term are incorrectly determined or if the trust term is not initially correctly determined, then, within a reasonable time after the correct determination is made, the trustee shall lengthen or shorten the term of the Charitable Lead Trust to the correct duration.

For purposes of this request it is assumed that, except for the term of the Charitable Lead Trust, the Charitable Lead Trust satisfies all other governing instrument requirements which must be met in order to qualify the interests of the charitable beneficiaries as guaranteed annuity interests under section 2055(e)(2)(8) of the Internal Revenue Code.

You request that we rule that Subparagraph 2(e) of the Charitable Lead Trust may be reformed through an amendment signed by the trustee of the Trust and that the amended subparagraph 2(e), as provided above, defining the duration of the charitable interest, satisfies the requirements under section 20.2055-2(e)(2)(vi)(a) of the Estate

Tax Regulations which requires that a guaranteed annuity interest be payable for a specified term.

ISSUE 1 (Reformation of the Trust)

Section 2055(a) of the Internal Revenue Code allows a deduction from the gross estate for bequests or transfers to certain entities. These include the United States or other political subdivisions where the funds must be used for public purposes, certain charitable organizations, a trust or fraternal organization that is to use the funds for charitable purposes, and certain veterans organizations.

Section 2055(e)(2), in part, disallows the deduction under section 2055(a) where a lead interest in property passes to a charitable or other organization described in section 2055(a) and a remainder interest in the same property passes to a noncharitable beneficiary, unless the former interest is in the form of a guaranteed annuity or is a fixed percentage of the fair market value of the property determined on a yearly basis and this percentage is distributed annually.

Section 2055(e)(3) provides that a charitable interest that fails to satisfy the requirements of section 2055(e)(2) may be reformed to qualify under that section. Section 2055(e)(3)(B) provides that a "qualified reformation" is a change in a governing instrument by reformation, amendment, construction or otherwise which changes a reformable interest into a qualified interest. This is allowed only if any difference between the actuarial value at the date of the decedent's death of the qualified interest and the actuarial value of the reformable interest at the date of the decedent's death does not exceed 5% of the actuarial value of the reformable interest at the date of the decedent's death. Section 2055(e)(3)(B)(ii) requires that the reformable interest and the qualified interest have the same term and that the change be effective as of the date of the decedent's death.

Section 2055(e)(3)(C) provides that a reformable interest is any interest for which a deduction would be allowable under section 2055(a) at the time of the decedent's death, but for the disallowance provisions contained in section 2055(e)(2) (see Issue 2 below). This subparagraph also requires that, in the case of charitable remainder trusts, prior to the remainder vesting in possession, all payments to persons other than the charitable organization must be expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property.

Section 2055(e)(3)(D) provides that a qualified interest is an interest for which a deduction is allowable under section 2055(a).

Under the terms of the Charitable Lead Trust, the organizations to whom distributions are to be made during the term of the trust will qualify for the charitable deduction allowed under section 2055(a).

The charitable interest in the Trust as it exists prior to the proposed reformation is a reformable interest since it would qualify for the charitable deduction under section 2055(a), but for the provisions of section 2055(e)(2). (See Issue 2 below.) While all payments prior to the remainder vesting in possession are to be made to charitable organizations and, consequently, do not fall within section 2055(e)(3)(C), these payments are expressed as a fixed percentage (8%) of the fair market value of the property.

The charitable interest as determined after the proposed reformation is a qualified interest, since it is an interest for which a deduction is allowable under section 2055(a) (see Issue 2 below).

The actuarial value at the date of the decedent's death of the qualified interest would be the same as the actuarial value of the reformable interest at the date of the decedent's death. Thus, the difference between the two actuarial values does not exceed 5% of the reformable interest at the date of the decedent's death. The period or duration of the reformable interest and the qualified interest are also the same and the reformation is proposed to take effect at the date of the decedent's death.

Section 2055(e)(3) was added as a permanent reformation rule by the Tax Reform Act of 1984. The Senate Finance Committee Print relating to this Act stated that, in order for a governing instrument of a charitable split-interest contribution to be reformable, either, 1) the creator had to make a bona fide attempt to comply with the rules, of the Tax Reform Act of 1969, or 2) the taxpayer must initiate reformation proceedings before the Internal Revenue Service could reasonably be expected to begin an audit. S. Prt. No. 98-169, Vol. 1, 98th Cong., 2d Sess., 731. The Print states that the governing instrument evidences an attempt to comply with the 1969 Act rules if all current payouts from the trust are expressed solely as a fixed dollar amount or a fixed percentage of the value of the trust assets. The current payouts from the trust, in the instant case, are expressed as a fixed percentage of the value of the trust assets.

The Committee Print also notes that a qualified reformation "can be achieved in any method permitted under applicable local law as long as that change is binding on all relevant parties under applicable local law." S. Prt. No. 98-169, supra at 734. Section 109.232 of the Ohio Revised Code provides that if a charitable split-interest trust sets forth a method for amendment, the trust may be amended by the method prescribed in the trust instrument without resort to judicial reformation. Paragraph 7 of the Charitable Lead Trust provides that the trustee shall have the power to amend the trust agreement for the purpose of qualifying the interests of the charitable beneficiaries as guaranteed annuity interests under section 2055(e) of the Code.

We conclude that the proposed amendment to the Charitable Lead Trust will be a qualified reformation under section 2055(e)(3) of the Code.

ISSUE 2 (Qualification As Payable For A Specific Term)

Section 20.2055-2(e)(2)(vi)(a) of the regulations describes a guaranteed annuity as an arrangement under which a determinable amount is paid at least annually for a specified term or for the life or lives of an individual(s) who is living at the date of death of the decedent. An amount is determinable if the exact amount to be paid under the terms of the instrument can be ascertained as of the date of death or alternate valuation date, if applicable.

An analogous determination involving charitable remainder trusts, is provided in Rev. Proc. 90-32, 1990-1 C.B. 545. The Revenue Procedure sets out five sample forms of declarations of trust that meet the requirements for a charitable remainder annuity trust. The payout percentage under Section 6 (sample testamentary charitable remainder annuity trust: one life) provides that the percentage which is to be paid out annually to the noncharitable beneficiary, may be adjusted at the date of death so that the payout percentage does not exceed the percentage that would result in a five percent probability that the trust corpus would be exhausted before the death of the noncharitable beneficiary. This computation of the payout percentage is based on the initial net fair

market value of the assets passing in trust as finally determined for federal estate tax purposes. Thus, the payout percentage term of the charitable trust may not be determined until the date of death or alternate valuation date if applicable. Nonetheless, the adjustment clause is permissible because the payout percentage, although not expressly stated in the instrument, is determinable as of the date of death, or alternate valuation date, based on a formula or directive in the instrument.

We conclude that the use of a formula as set out in the proposed amendment to subparagraph 2(e) of the Charitable Lead Trust satisfies the requirement that a guaranteed annuity must be for a specified term. In this case the annuity term, although not expressly stated is determinable as of the date of the decedent's death based on the formula contained in the instrument. Since the term of the trust is ascertainable as of the date of the decedent's death (or alternate valuation date), under the terms of the instrument, we conclude that the instrument satisfies the "specified term" requirement. In order for the trust to be eligible for an estate tax charitable deduction, the trust must also meet the other requirements of section 2055 and the corresponding regulations.

This ruling is based on the facts and applicable law in effect on the date of this letter. If there is a change in material fact or law (local or Federal) before the transactions considered in the ruling take effect, the ruling will have no force or effect. If the taxpayer is in doubt whether there has been a change in material fact or law, a request for reconsideration of this ruling should be submitted to this office.

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

Sincerely,

Assistant Chief Counsel

(Passthroughs and Special

Industries)

By: George Masnik

Assistant to the Branch Chief

Branch 4

Enclosure

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