Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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We received a letter dated September 16, 1998, from your authorized representative requesting rulings regarding the proposed reformation of Trust pursuant to § 2055(e)(3) of the Internal Revenue Code. This letter responds to that request.

Decedent died testate in 1997. The Second Codicil to Decedent's will, executed on August 2, 1997, amends Article IV, Section 8 of Decedent's will to provide for the creation of Trust, a charitable lead annuity trust. Taxpayer proposes to reform Trust in accordance with § 2055(e)(3), in the manner described below.

Article II of Trust as reformed provides that an annuity amount equal to 9.612% of the initial net fair market value of the assets of Trust is to be paid to Charity, a charitable foundation to be established by Decedent's family, for a term of 18 years. On termination of the annuity, the assets in Trust are to be distributed to a trust as provided under Article VI of Decedent's will.

Article IV, ¶ B. provides that the annuity amount is to be paid in equal quarterly installments on the last day of each quarter. The annuity amount is to be paid from trust income and, to the extent income is insufficient, from principal. Any trust income in excess of the annuity amount is to be added to principal.

Article IV, ¶ C. provides that, if the initial net fair market value of the assets in Trust is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the Trustee is to pay to Charity (in the case of an undervaluation) or Charity is to pay to the Trustee (in the case of an overvaluation) an amount equal to the difference between the annuity amount properly payable and the annuity amount actually paid.

Article IV, ¶ D. provides that the Trustee must prorate the annuity amount on a daily basis for a short taxable year.

Article IV, ¶ E. provides that the trust income for each taxable year is to be distributed at such time and in such manner as not to subject Trust to tax under § 4942. The Trustee cannot (1) engage in any act of self-dealing, as defined in § 4941, (2) make any taxable expenditures, as defined in § 4945(d), (3) make any investments that jeopardize the charitable purpose of any charitable lead trust, within the meaning of § 4944, or (4) retain any excess business holdings, within the meaning of § 4943.

Article IV, ¶ F. provides that the annuity amount is to be paid first from ordinary taxable income of Trust (including short-term capital gains) that is not unrelated business income. If such ordinary taxable income is insufficient to satisfy the annuity amount, it is to be paid from long-term capital gains, unrelated business income, tax-exempt income, and trust principal, in that order.

Article IV, ¶ G. provides that Trust's taxable year is the calendar year.

Article IV, ¶ H. provides that nothing in the instrument is to be construed to restrict the Trustee from investing Trust's assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of Trust's assets.

Article IV, ¶ J. provides that, if any charity designated to receive any distribution from Trust is not an organization described in §§ 170(c), 2055(a), and 2522(a), at a time when any principal or income of Trust is to be distributed to it, then the trustee is to distribute such principal and income to one or more organizations,

selected at the trustee's sole discretion, that are then organizations described in such sections.

The following rulings have been requested:

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

2. As reformed, the bequest to Trust will qualify for the estate tax charitable deduction under § 2055.

Section 2055(a) provides that, for purposes of the Federal estate tax, the value of the taxable estate is determined by deducting from the value of the gross estate all bequests to or for the use of certain governmental entities, certain corporations organized and operated exclusively for religious, charitable, scientific, literary, or education purposes, and certain other fraternal and veterans organizations.

Section 2055(e)(2) provides that, 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 that 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), no deduction is allowed under § 2055(a) for the interest that passes to the person, or for the use, described in § 2055(a) unless, in the case of interests other than charitable remainder interests described in § 664 or pooled income funds described in § 642(c)(5), 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) provides that a deduction is allowed under § 2055(a) for any qualified reformation. The term "qualified reformation" means a change of a governing instrument by reformation, amendment, construction, or otherwise that 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 5 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) the reformable interest and the qualified interest are for the same period, and

(iii) such change is effective as of the decedent's death.

Section 2055(e)(3)(C)(i) provides that the term "reformable interest" means any interest for which a deduction would be allowable under § 2055(a) at the time of the decedent's death but for the provisions of § 2055(e)(2).

Section 2055(e)(3)(C)(ii) provides that 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) provides, however, that the restriction in § 2055(e)(3)(C)(ii) does not apply if a judicial proceeding is commenced to change the charitable interest into a qualified interest not later than the 90th day after the last date (including extensions) for filing the estate tax return, if one is required to be filed.

Under § 2055(e)(3)(D), the term "qualified interest" means an interest for which a deduction is allowable under § 2055(a).

Section 20.2055-2(e)(2)(vi)(a) of the Estate Tax Regulations provides that a charitable interest is a guaranteed annuity interest, whether or not the interest is in trust. The term "guaranteed annuity interest" means the right pursuant to the instrument of transfer to receive a guaranteed annuity. A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of death of the decedent and can be ascertained as of such date. For example, the annuity may be paid for the life of A

plus a term of years. An amount is determinable if the exact amount that must be paid under the conditions specified in the instrument of transfer can be ascertained as of the appropriate valuation date. Paragraph (b) provides that a charitable interest is a guaranteed annuity interest only if it is a guaranteed annuity interest in every respect.

Section 20.2055-2(e)(2)(vi)(e) provides that where a charitable interest in the form of a guaranteed annuity interest is in trust and the present value, on the appropriate valuation date, of all the income interests for a charitable purpose exceeds 60 percent of the aggregate fair market value of all amounts in such trust (after the payment of estate taxes and all other liabilities), the charitable interest will not be considered a guaranteed annuity interest unless the governing instrument of the trust prohibits both the acquisition and the retention of assets that would give rise to a tax under § 4944 if the trustee had acquired such assets.

Under the provisions of Decedent's codicil, the charitable interest was a reformable interest because an estate tax deduction would have been allowable under § 2055(a) for the charitable interest but for the requirements of § 2055(e)(2). According to the information submitted, the reformation is effective as of the date of Decedent's death and the reformable interest and the qualified interest are for the same period. The difference between the actuarial value of the qualified interest and the actuarial value of the reformable interest does not exceed five percent of the actuarial value of the reformable interest.

Based on the above, we conclude that the proposed reformation will be a qualified reformation within the meaning of § 2055(e)(3). The charitable interest qualifies as a guaranteed annuity interest for Federal estate purposes, for any years in which it continues to meet the definition of and functions exclusively as a charitable lead annuity trust. Because the charitable interest qualifies as a guaranteed annuity interest, an estate tax charitable deduction is allowed under § 2055(a).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code. We note that Article IV, ¶ F. provides certain ordering rules for the distribution of income from Trust. This ordering of the income distributions will not be given effect for Federal income tax purposes because the ordering provisions have no economic effect independent of the tax consequences. Trust is required to pay annually a stated annuity amount to Charity, regardless of the amount or character of income that Trust earns. Accordingly, income distributed to Charity shall consist of the same proportion of each class of items of income of Trust as the total of each class bears to the total of all classes. See § 1.642(c)-3(b)(2).

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

In accordance with a power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By George Mashik
George Mashik
Chief, Branch 4

Enclosure
Copy for § 6110 purposes