Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

199917068

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:Br.7-PLR-105629-98
Date:
JANUARY 7, 1999

Re:

Legend

Taxpayer:

Trust A:

Trust B:

Charitable Lead Trust 1:

Charitable Lead Trust 2:

Charitable Beneficiaries:

Charitable Beneficiary 1:

Date 1:

Date 2:

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We received your letter dated , , requesting rulings on behalf of Taxpayer concerning the application of §§ 2055 and 2631 of the Internal Revenue Code. This letter is in reply to your requests.

Taxpayer is the grantor of Trust A. Taxpayer created Trust A on Date 1 and amended and restated Trust A on Date 2. Trust A is a pourover trust that provides for Taxpayer during Taxpayer's life. Taxpayer may alter, revoke, or terminate Trust A during Taxpayer's life.

On Taxpayer's death, Trust A becomes irrevocable. Sections 1.4 and 1.5 of Trust A agreement provide that, upon the death of Taxpayer, the assets in Trust A shall be administered and distributed as provided in Trust A agreement.

Section 3.2 of Trust A agreement provides that after various distributions and specific bequests described in Trust A agreement, Trustee is to distribute an amount of property equal to the largest amount that can pass to Trustee and have a zero inclusion ratio under § 2642 to be held in Charitable Lead Trust 1. Further, Trust A agreement provides that Trustee is to distribute the balance of the property after the specific bequests and the transfer to Charitable Lead Trust 1 to Trustee of Charitable Lead Trust 2 to be held, administered and distributed as provided in Article V of Trust A agreement.

Article IV of Trust A agreement establishes Charitable Lead Trust 1. Section 4.1 provides that Taxpayer intends that Charitable Lead Trust 1 be construed to qualify as a charitable lead trust described in § 2055(e)(2) and any provision in Article IV that conflicts with Taxpayer's intention shall be disregarded or reconciled to accomplish Taxpayer's intent.

Under § 4.2 of Trust A agreement, Charitable Lead Trust 1 begins on Taxpayer's death and terminates fifteen years later. The obligation to pay the unitrust amount begins on the date of Taxpayer's death, but payment may be deferred from that date to the end of the tax year of Charitable Lead Trust 1 in which it is funded.

Sections 4.3 through 4.5 of Trust A agreement provide that the unitrust amount for each tax year of Charitable Lead Trust 1 is six percent of the net fair market value of the trust assets determined as of the first business day of the tax year. Payments of the unitrust amount for each tax year shall be made annually at the end of the trust's tax year. The payments are to be made first from the ordinary income of the trust that is not unrelated business income. If the ordinary income of the trust that is not

unrelated business income is insufficient to satisfy the unitrust amount, the unitrust amount is to be paid from the following sources of funds in the order listed: long-term capital gains of the trust, the unrelated business income, the tax-exempt income, any accumulated income and finally the principal of the trust. Any net income for a tax year in excess of the unitrust amount may, in the discretion of the Trustee, be added to principal or paid to Charitable Beneficiaries. Trustee fees are to be taken as a deduction in computing taxable income of the trust and not charged against the unitrust amount. The Trustee may, in its sole discretion, allocate capital gains to income or to principal, or part to both. All depreciation, amortization, and depletion deductions are to be allocated to the Trust.

For any short tax year and for the tax year in which the payments of the unitrust amount terminate, the Trustee must prorate the unitrust amount on a daily basis.

If the net fair market value of trust assets as of the first business day of any tax year is incorrectly determined, and, as a result, payments to Charitable Beneficiaries are less than the payments required to be made, the Trustee must pay to Charitable Beneficiaries the difference between the amount that the Trustee should have paid if correct valuation had been used and the amount which the Trustee actually paid. If the net fair market value of the trust assets as of the first business day of any tax year is incorrectly determined, and, as a result, payments to Charitable Beneficiaries exceed the payments required to be made, Charitable Beneficiaries must repay to the Trustee the difference between the amount which the Trustee actually paid and the amount that the Trustee should have paid if correct valuation had been.

During the term of Charitable Lead Trust 1, the unitrust payments must be paid at least annually. Fifty percent of the unitrust amount is to be paid to Charitable Beneficiary 1 and the remaining fifty percent of the unitrust amount is to be paid to qualifying charities described in §§ 170(c), 2055(a), and 2522(a). Further, the Trustee may not prepay the unitrust amount.

Section 4.6 of Trust A agreement provides that the Trustee of Charitable Lead Trust 1 shall not engage in any act of self-dealing as defined in § 4941 nor make any taxable expenditures as defined in § 4945(d). Further, except to the extent provided in § 4947(b)(3), the Trustee shall not retain any excess holdings as defined in § 4943(c), nor shall the Trustee acquire or retain any assets which would subject Charitable Lead Trust 1 to tax under § 4944. If § 4942 is applicable to Charitable Lead Trust 1, the Trustee is to make the appropriate distributions so that the trust is not subject to tax under § 4942.

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Section 4.7 of Trust A agreement provides that Charitable Lead Trust 1 is irrevocable and cannot be altered or amended, except that the Trustee may amend in writing the trust instrument at any time to enable the trust to continue to qualify as a charitable lead unitrust.

Under § 4.8 of Trust A agreement, upon the termination of Charitable Lead Trust 1, the remaining trust assets are to be distributed per stirpes to the then living grandchildren of Taxpayer. If a grandchild of Taxpayer is not alive when Charitable Lead Trust 1 terminates but has descendants living, the deceased grandchild's share shall be distributed per stirpes to such deceased grandchild's descendants. If no descendant of such deceased grandchild of Taxpayer is then living, the share of the deceased grandchild shall be distributed per stirpes to the then living descendants of the one among Taxpayer's children who was the ancestor of such grandchild. If no such descendant of Taxpayer is then living, the deceased grandchild's share shall be distributed per stirpes to Taxpayer's descendants then living. If Taxpayer has no living descendants, all of such remaining trust property shall be distributed to Charitable Beneficiary 1. Further, Article IV of Trust A agreement provides that any distribution under Charitable Lead Trust 1 to a descendant of Taxpayer for whom assets are held in trust under Trust B shall be added to the principal of the trust that such descendant of Taxpayer is a beneficiary and administered as part of Trust B.

Article V of Trust A agreement establishes Charitable Lead Trust 2. Charitable Lead Trust 2, also, begins on Taxpayer's death and terminates fifteen years later. Except for the distribution provisions on termination of the trust, the terms of Charitable Lead Trust 2 are the same as Charitable Lead Trust 1.

Under § 5.9 of Trust A agreement, if a child of Taxpayer predeceases the termination of Charitable Lead Trust 2, the child is granted a testamentary general power of appointment to appoint his or her share (discussed below) of Charitable Lead Trust 2 to any person, or persons or charity, including without limitation, his or her creditors, his or her estate or the creditors of his or her estate. This power is effective only upon the subsequent termination of Charitable Lead Trust 2.

Under § 5.8 of Trust A agreement, if a child (or children) of Taxpayer survive the termination date, then on termination of Charitable Lead Trust 2, the assets in Charitable Lead Trust 2 shall be divided and distributed as follows:

(a) Any child of Taxpayer that is living and has no descendants living at the termination of Charitable Lead Trust 1 shall receive a distribution from Charitable Lead Trust 2 equal to the share of trust assets distributed per stirpes to the descendants of each child of Taxpayer under § 4.8 of Trust A agreement.

If the then remaining assets of Charitable Lead Trust 2 are insufficient to fund such distributions in full, any distributions made under § 5.8 of Trust A agreement are to be reduced equally. If no child of Taxpayer is entitled to receive distributions from Charitable Lead Trust 2 described above, or if there are funds in Charitable Lead Trust 2 in excess of the amounts needed to make these distributions, the remaining assets of Charitable Lead Trust 2 shall be distributed as provided in § 5.8(b).

(b) All of the remaining assets of Charitable Lead Trust 2 shall be distributed in equal shares to the then living children of Taxpayer; provided, however, if a child of Taxpayer is not then living, but has descendants then living, the deceased child's unappointed share shall be distributed per stirpes to such deceased child's descendants; or if no descendant of such deceased child of Taxpayer is then living, such deceased child's unappointed share shall be distributed per stirpes to Taxpayer's descendants then living, and if Taxpayer no descendants then living, all of the then remaining unappointed trust property shall be distributed to Charitable Beneficiary 1.

Further, § 5.8 of Trust A agreement provides that any distribution under Charitable Lead Trust 2 to a descendant of Taxpayer for whom assets are held in trust under Trust B shall be added to the principal of the trust that such descendant of Taxpayer is a beneficiary and administered as part of Trust B.

You have requested the following rulings:

(1) The charitable lead interests created under Articles IV and V of Trust A agreement are unitrust interests within the meaning of § 20.2055-2(e)(2)(vii) of the Estate Tax Regulations, the present value of which, determined under § 20.2055-2(f)(2)(v), will be deductible for federal estate tax purposes under § 2055, and

(2) The amounts transferred to Taxpayer's grandchildren and great-grandchildren upon the termination of Charitable Lead Trust 1 created under Article IV of Trust A agreement will not be subject to the generation-skipping transfer tax provided that the executor of Taxpayer's estate allocates sufficient generation-skipping transfer tax exemption under § 2631 to the trust.

RULING REQUEST 1

Section 2055(a) provides that, for purposes of the tax imposed by § 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate all bequests, legacies, devises, or transfers to or for the use of certain

governmental entities, certain corporations organized and operated exclusively for religious, charitable, scientific, literary, or educational 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 shall be allowed under § 2055 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).

Under § 20.2055-2(a), the amount passing to charity must be ascertainable and determinable as of the date of death. Similarly, under § 20.2055-2(b)(1), if the trustee is empowered to divert the property or fund, in whole or in part, to a noncharitable purpose, the deduction is limited to that portion, if any of the property which is exempt from the exercise of the power.

Under § 20.2055-2(e)(1)(i), in the case of decedents dying after December 31, 1969, where an interest in property passes from the decedent for charitable purposes and an interest in the same property passes from the decedent for private purposes, no deduction is allowed under § 2055(a) for the value of the interest passing for charitable purposes unless the interest is a "deductible interest."

Under § 20.2055-2(e)(2)(vii)(a), the term "deductible interest" includes a unitrust interest. Under § 20.2055-2(e)(2)(vii)(a), a "unitrust interest" means the right pursuant to the instrument of transfer to receive payment, not less often than annually, of a fixed percentage of the net fair market value, determined annually, of the property that funds the unitrust interest. In computing the net fair market value of the property that funds the unitrust interest, all assets and liabilities shall be taken into account without regard to whether particular items are taken into account in determining the income from the property. The net fair market value of the property that funds the unitrust interest may be determined on any one date during the year or by taking the average of valuations made on more than one date during the year, provided that the same valuation date or dates and valuation methods are used each year. Payments under a unitrust interest may be paid 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 the gift and can be ascertained at the date.

In the instant case, the charitable unitrust interests provided for in Articles IV and V of Trust A agreement give the charitable beneficiaries rights to receive annually a payment of a fixed percentage of the net fair market value, determined annually, of the property that will fund the trusts. Articles IV and V of Trust A agreement provide that the term of the unitrust interests will be fifteen years. Also, the trustees are prohibited by the terms of Trust A agreement from making any unitrust payments to an organization that is not described in § 2055(a). Based on the facts submitted and the representations made, we conclude that the unitrust amounts provided for in Articles IV and V of Trust A agreement will constitute unitrust interests within the meaning of § 2055(e)(2)(B) and § 20.2055-2(e)(2)(vii). Therefore, on the death of Taxpayer, an estate tax charitable deduction will be allowed under § 2055(a) for the present value of the unitrust interests in Charitable Lead Trust 1 and Charitable Lead Trust 2 as established in Articles IV and V of Trust A agreement and payable to charity, determined under § 20.2055-2(f)(2)(v).

We note that Trust A agreement provides that the unitrust amounts shall be paid first from ordinary taxable income that is not unrelated business income. If such ordinary taxable income is insufficient to satisfy the unitrust amounts, the unitrust amount shall be paid from short term capital gain, long term capital gain, unrelated business income, tax-exempt income, and trust corpus, in that order. This ordering of income distributions will not be given effect for federal income tax purposes because the ordering provision has no economic effect independent of the tax consequences. Charitable lead trusts are required to pay annually a stated unitrust amount to organizations described in §§ 170(c) and 2055(a), regardless of the amount or character of income earned by the trusts. Accordingly, income distributed to organizations described in §§ 170(c) and 2055(a) shall consist of the same proportion of each class of items of income of the charitable lead unitrusts as the total of each class bears to the total of all classes. See § 1.642(c)-3(b)(2).

RULING REQUEST 2

Section 2601 imposes a tax on every generation-skipping transfer (within the meaning of subchapter B of chapter 13. Under §2602, the amount of the tax imposed by § 2601 is the taxable amount (defined in §§ 2621 through 2624) multiplied by the applicable rate.

Section 2641 provides that the applicable rate means, with respect to any generation-skipping transfer, the product of the maximum federal estate tax rate, and the inclusion ratio with respect to the transfer.

Section 2631(a) provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of $1,000,000 which may be

allocated by such individual (or his executor) to any property with respect to which the individual is the transferor. Under § 2631(b), any allocation under § 2631(a), once made, is irrevocable.

Section 2632(a) provides that any allocation by any individual of the GST exemption may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2632(b)(1) provides that, if any individual makes a direct skip during his lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for the property zero. If the amount of the direct skip exceeds such unused portion, the entire unused portion shall be allocated to the property transferred. Section 2632(b)(2) provides that, for purposes of § 2632(b)(1), the unused portion of an individual's GST exemption is that portion of such exemption that has not previously been allocated by such individual (or treated as allocated under § 2632(b)(1) with respect to a direct skip).

Section 2632(c) provides that any portion of an individual's GST exemption that has not been allocated within the time prescribed by § 2632(a) shall be deemed to be allocated as follows--first, to property which is the subject of a direct skip occurring at the individual's death, and second, to trusts with respect to which the individual is the transferor and from which a taxable distribution or taxable termination might occur at or after such individual's death. In general, this allocation is made among the direct skips and trusts in proportion to the respective amounts (at the time of allocation) of the nonexempt portions of the properties and trusts.

Section 2642(a)(1) provides that, in general, the inclusion ratio with respect to any property transferred in a generation-skipping transfer shall be the excess (if any) of one over the applicable fraction determined for the trust from which such transfer is made. In the case of a direct skip, the inclusion ratio shall be the excess (if any) of one over the applicable fraction for such skip.

Section 2642(a)(2) provides that the applicable fraction is a fraction --

(A) the numerator of which is the amount of the GST exemption allocated to the trust (or in the case of a direct skip, allocated to the property transferred in such skip), and

(B) the denominator of which is --

(i) the value of the property transferred to the trust (or involved in the direct skip), reduced by

(ii) the sum of --

(I) any Federal estate tax or State death tax actually recovered from the trust attributable to such property, and

(II) any charitable deduction allowed under § 2055 or § 2522 with respect to such property.

Section 2642(b)(2)(A) provides that if property is transferred as a result of the death of the transferor, the value of such property for purposes of § 2642(a) shall be its value for purposes of chapter 11; except that, if the requirements prescribed by the Secretary respecting allocation of post-death changes in value are not met, the value of such property shall be determined as of the time of the distribution concerned.

Section 2642(b)(2)(B) provides that any allocation of GST exemption to property transferred as a result of the death of the transferor shall be effective on and after the date of the death of the transferor.

Based on the information submitted and the representations made, Charitable Lead Trust 1 will be funded on Taxpayer's death. Trust A agreement provides that Charitable Lead Trust 1 is to be funded with an amount of property equal to the largest amount that can pass to Trustee and have a zero inclusion ratio under § 2642. Further, Trust A agreement provides that any estate taxes imposed on Taxpayer's estate are not to be paid out of Charitable Lead Trust 1. Accordingly, the numerator of the applicable fraction for Charitable Lead Trust 1 will be the GST exemption allocated to that trust. The denominator of the applicable fraction for Charitable Lead Trust 1 will be value of the property passing to that trust less the present value of the charitable lead unitrust. Assuming each trust is funded timely, based on the formula provided, and sufficient GST exemption is timely allocated, Charitable Lead Trust 1 will have an inclusion ratio of zero. Thus, we conclude that Charitable Lead Trust 1 will not be subject to the generation skipping transfer tax on termination of the charitable lead interest if timely funded, based on the formula provided in Trust A agreement and sufficient GST exemption is allocated.

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.

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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. If there is a change in material fact or law (local or federal) before the transactions considered in this ruling take effect, the ruling will have no force or effect.

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

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

Sincerely,

Christine E. Ellison
Chief, Branch 7
Associate Chief Counsel (P&SI)