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Don't Try This at Home:
Reforming the Non-Qualified Split-Interest Trust

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[Prefatory note: throughout these materials, I have used the phrase "testamentary trust" to describe not only a trust that is literally created by the terms of a decedent's will, but also a trust that is revocable during the settlor's lifetime and becomes irrevocable at her death. I recognize that this usage is inaccurate, but in the present context the distinction is for the most part without a difference, and the usage serves to identify what is for our present purposes the salient point, *i.e.*, whether there is an estate tax return to be filed versus when the first trust income tax return would be due.]

1. The death of the sixties

A lot of stuff happened in 1969, forty years ago. Nixon launched Operation Breakfast, a secret expansion of the Vietnam war into Cambodia. Warren Burger replaced Earl Warren as Chief Justice. John and Yoko went to bed for peace. The Stonewall Riots. Chappaquiddick. Apollo 11. The Manson family. Woodstock. Hurricane Camille. Monty Python's Flying Circus. The Weather Underground. The "miracle" New York Mets. Altamont. And . . .

. . . the Tax Reform Act of 1969, Pub. L. 91-172 (TRA '69), signed into law on December 30, 1969, which among many, many other things -- the alternative minimum tax was introduced here -- completely changed the landscape for tax planning with charitable lead and remainder trusts.

Stated simply, TRA '69 required that a split interest trust be in the form of an annuity or unitrust with (in the case of a remainder trust) a five pct. minimum payout in order to be eligible for a charitable contributions deduction for income or transfer tax purposes.

2. Background on Section 2055(e)(3)

As with many other amendments to the tax Code, the provisions dealing with split interest trusts were an attempt to combat perceived abuses. TRA '69 was also the bill that introduced the five pct. minimum payout requirement for private foundations and imposed excise taxes on net investment income, self-dealing transactions, excess business holdings, jeopardizing investments, and taxable expenditures. People take advantage, IRS responds within the limits of its regulatory authority, and eventually you get legislation.

The perceived abuse here was that the trustee of a split interest trust might manage investments in such a way as to favor the non-charitable beneficiaries. And IRS had attempted to deal with this.

In Rev. Rul. 60-385, 1960-2 C.B. 77, the Service ruled that a charitable deduction would not be allowed for income or transfer tax purposes for a remainder interest where the trust instrument permitted the trustee to invest in mutual funds and to treat gains distributions as income. In Rev. Rul. 67-33, 1967-1 C.B. 62, this principle was extended to the case in which state law, rather than the trust instrument itself, permitted the trustee to treat gains distributions as income. And in Rev. Rul. 65-144, 1965 C.B. 442, the Service ruled that a deduction would not be allowed where the trust instrument gave the trustee absolute discretion to allocate stock dividends and other extraordinary or liquidating dividends, and taxes and other expenses, between income and principal. A "savings" clause was treated as a condition subsequent and disregarded.

A deduction would also be denied pre- TRA '69 where the trustee was given discretion to invade principal for a non-charitable beneficiary, unless that discretion was limited to an ascertainable standard and the likelihood that it would be exercised was so remote as to be negligible. Similarly, a deduction would be denied if the charitable remainder was subject to a contingency -- again, unless the contingency was so remote as to be negligible.

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In the end, Congress stepped in and codified a fixed payout requirement. Pooled income funds were excepted because it was assumed the charity acting as trustee would look out for its own interests -- though in valuing the remainder gift in a pooled income fund, TRA '69 did impose some rate of return assumptions. Remainder gifts in farms and residences were also excepted. TRA '69 also enacted the four-tier, "worst in first out" method of allocating trust income to annuity or unitrust distributions. Landscape completely changed.

The question is often asked, why a five pct. minimum payout, and the answer is sometimes given, no particular reason, it just happens to correspond with the minimum payout for a private foundation. But the actual answer is a bit more subtle. According to the Joint Committee report accompanying the legislation, the five pct. minimum payout requirement was imposed so that a remainder trust with a very low payout could not be used as a device for evading the minimum payout requirement for a private foundation.

There was of course the problem of transition. The new requirements were made effective as to *inter vivos* transfers made after July 31, 1969 or testamentary transfers occurring after December 31, 1969. A will or trust instrument executed on or before October 9, 1969 (the date the new requirements were voted out of the Senate Finance Committee) was grandfathered if the transferor either died on or before October 9, 1972 or was incapacitated on and after October 10, 1969 from amending the instrument to bring it into compliance.

Rev. Proc. 74-6, 1974-1 C.B. 417, superseding Rev. Proc. 73-9, 1973-1 C.B. 758, provided a mechanism for settling a limited class of cases governed by the provisions of Section 2055 in effect prior to the enactment of TRA '69. Where the trustee of a split interest trust had investment powers that might render the value of the income or remainder interest unascertainable, *e.g.*, a power to allocate capital gains to income, a charitable contributions deduction would be denied unless all interested parties entered into an agreement with the Service that the trustee would exercise the subject powers impartially as between the income and remainder interests. Any unascertainable charitable beneficiaries were to be represented by the state attorney general. The agreement was to be executed within thirty days after the Service notified the estate that there appeared to be grounds for denying the deduction (though the Service could extend this period), or before the expiration of the limitations on credits or refunds under Section 6511, whichever occurred earlier.

But at first there was no mechanism at all for reforming a nonqualified split interest trust instrument that was executed after the effective date of TRA '69. Legislation in 1974, 1976, 1978, and 1980 permitted reformation under repeatedly extended deadlines, but these stopgap measures did not address the question of deductibility for income or gift tax purposes. It was not until the enactment of the Deficit Reduction Act of 1984, Pub. L. 98-369 (DEFRA), that a permanent reformation mechanism, Section 2055(e)(3) in roughly its present form, was enacted, together with Sections 170(f)(7) and 2522(c)(4), allowing deductions for income and gift tax purposes for a trust reformed in compliance with Section 2055(e)(3).

The intricacies of 2055(e)(3) are the primary focus of this paper.

3. A description of the problem

In its "plain vanilla" form, what we are talking about here is a remainder trust in what you could call a pre- TRA '69 configuration. The typical case might involve a testamentary trust paying income to a child for life, then maybe to a grandchild for life or a term of years, with perhaps discretionary distributions of principal, and then the remainder over to charity. But there are any number of variations -- a fixed payout of less than five pct., a term of years longer than twenty, a remainder with a present value of less than ten pct. -- each of which entails its particular complexities. And the situation can be complicated further by, for example, the surviving spouse electing to take against the will, or a will contest, or nonprobate transfers generating estate tax, and so on and on.

Section 2055(e)(2) also disallows a deduction for a lead trust that is not structured as an annuity or unitrust, and the reformation mechanism of Section 2055(e)(3) applies here as well.

In the case of a remainder trust, if the payout to noncharitable beneficiaries is not in the form of an annuity or unitrust, the deadline for initiating a reformation proceeding is quite short.

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4. The statutory framework

Section 2055(e)(3) provides a mechanism for reforming a split-interest trust that does not qualify under Section 644 (in the case of a remainder trust) or under Section 642(c)(5) (in the case of a pooled income fund) or as a lead trust.

The basic rule

A reformation will be "qualified" only if

(a) any difference in the actuarial value of the "reformable" interest and the resulting "qualified" interest does not exceed five pct., and

(b) the nonremainder interests, before and after reformation, "terminate at the same time," in the case of a remainder trust, or "are for the same period," in the case of a lead trust, and

(c) the reformation is retroactive to the date of the decedent's death (or the date the trust became irrevocable).

Section 2055(e)(3)(B). In Rev. Rul. 74-283, 1974-1 C.B. 157, the Service acknowledged that this is an exception to the general rule, *Commissioner v. Bosch*, 387 U.S. 456 (1967), that a federal agency is not bound by a retroactive determination of a state trial court.

Note: while the statute provides that the requirement that the nonremainder interests in a remainder trust "terminate at the same time" before and after reformation is satisfied if a term interest in excess of twenty years is reformed to a twenty year term, this does not address the separate requirement that the difference in values before and after not exceed five pct.

The ninety-day rule

In the case of a remainder trust, if the nonremainder interest is not already in the form of an annuity or unitrust (including a net income unitrust, with or without makeup),

(a) a judicial reformation proceeding must be brought within ninety days after the estate tax return is due (with extensions), or

(b) if no estate tax return is due, within ninety days after the income tax return for the first taxable year of the trust is due (with extensions), unless

(c) the interest passes under a will executed before January 1, 1979.

The accelerated CRT rules

The Taxpayer Relief Act of 1997, Pub. L. 105-34 (TRA '97), added language to Section 664(d)(1) and (d)(2) requiring that the annuity or unitrust payout from a remainder trust created after June 18, 1997 be no more than fifty pct. of its initial fair market value, and that the present value of the remainder of a trust created after July 28, 1997 be at least ten pct. Again, addressing an abuse.

One might think that a proceeding to reform a trust that violates one or the other of these requirements would not be subject to the ninety-day limit, because the payout is in the form of a fixed annuity or unitrust. And this appears to be true as to the fifty pct. payout limitation.

However, Section 2055(e)(3)(J), also enacted as part of TRA '97, provides that a proceeding either to declare void *ab initio* or to reform a trust that does not meet the ten pct. minimum remainder requirement of Section 664(d)(1)(D) or (d)(2)(D), must be brought within the ninety-day limit. If the trust is declared void *ab initio*, obviously no

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deduction is allowed for the initial transfer, and transactions entered into by the trustee prior to the declaratory judgment are treated as having been entered into by the transferor.

Obviously, a reformation proceeding to bring a trust into compliance with the ten pct. minimum remainder rule is an exception to the five pct. variance rule.

A side note: TD 8923

Similar rules were adopted by the Treasury as part of T.D. 8923, finalized on December 20, 2000, requiring that measuring lives for a lead trust are limited to the transferor's spouse or an individual who is either a lineal ancestor or the spouse of a lineal ancestor of any noncharitable remainderman. Again, an anti-abuse rule, combating the so-called "ghoul" lead trust, which used as a measuring life an unrelated individual with a known shortened life expectancy. The limitation on measuring lives is effective for transfers occurring on or after April 4, 2000, with a transitional rule for decedents dying on or before July 5, 2001.

A lead trust that does not meet the requirement may be declared void *ab initio* or reformed to a term of years trust, using the table factor that most closely corresponds (rounding up) to the annuity or unitrust factor for the age of the disqualified measuring life.

In either case, the Reg requires that a proceeding be brought, in the case of an *inter vivos* transfer, prior to October 15th of the year following the year in which the transfer is made, and in the case of a testamentary transfer, "prior to the date prescribed by Section 2055(e)(3)(C)(iii)," *i.e.*, the ninety-day rule. A nonjudicial reformation, if permitted by state law, must be completed within those limits. The Regs provide that if the trust is declared void *ab initio*, the Service will treat the transfer "in a manner similar to that described in" Section 2055(e)(3)(J), presumably meaning the trust would be disregarded for income tax purposes.

See, Reg. 20.2055-2(e)(3) and 25.2522(c)-3(e).

Reformation by death

Finally, Section 2055(e)(3)(F) provides that if the death of an individual distributee results in a direct distribution to the charitable remainderman, the reformation is, in effect, automatic.

To be more precise: if prior to the due date of the estate tax return, either as a result of the death of an individual or as a result of the distribution or termination of the trust according to its terms, the "reformable" interest passes outright to charity or to a trust that would be described in Section 4947(a)(1) if the deduction were allowed . . . then the deduction will be allowed.

No regulations interpreting this (or actually, any) portion of Section 2055(e)(3) have been finalized.

5. A watched clock never boils: two recent cases

In *Estate of Tamulis*, 509 F.3d 343 (7th Cir. 11/29/07), the decedent, a Catholic priest, had left an estate of $3.4 million in trust for the benefit of his brother and the brother's wife and certain of their descendants, with the remainder after ten years outright to a Catholic diocese. Several of the beneficiaries were to receive fixed annuities in varying amounts, and the remaining income, after payment of real estate taxes on a house in which the brother and his wife were given a life estate, was to be distributed to two grandnieces, who were also the remaindermen after the life estate in the house. A fixed stipend was to be paid to the decedent's niece "so long as she [was] making reasonable progress in pursuit of a Ph.D. in education," and a letter which the parties agreed to treat as an amendment to the trust provided that a another stipend was to be paid to a third grandniece "until she graduate[d] from medical school." The trust was to continue for the longer of ten years or the joint lives of the brother and his wife.

In this form, of course, the trust did not qualify as a charitable remainder annuity or unitrust. The executor did not file a petition to reform the trust pursuant to Code Section 2055(e)(3). Well outside the period required for filing

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such a petition (ninety days after the estate tax return was due) the executor did circulate among the individual beneficiaries a draft document that would arguably have constituted a nonjudicial reformation, but the third grandniece declined to sign it. Controlling state law (Illinois) apparently would have required unanimous consent of the beneficiaries to accomplish a judicial reformation.

Nonetheless, the executor (in her capacity as trustee of the trust) claimed to be administering the trust as a five pct. unitrust for a ten year term certain, having reported her intention to do so on the estate tax return. Both the Tax Court and the appeals court ruled that this attempted "substantial compliance" was not sufficient to secure the estate a charitable deduction under Section 2055(e)(3), which requires literal compliance.

In *ESB Financial*, No. 07-1059 (D. Kan. 09/22/08), the decedent's revocable trust instrument provided that after her death the income was to be paid to her daughter for life, with the remainder over to a charitable entity to be selected by the trustee. Plain vanilla. It was only after the IRS opened an examination of the estate tax return that the trustee filed a petition in state court to reform the trust to a straight unitrust in order to conform to the requirements of Section 2055(e)(2). The petition was filed well beyond ninety days after the last date (with extensions) for filing the return, as required by Section 2055(e)(3).

The trial court entered an order reforming the trust as requested, but the order stated that the reformation was "effective immediately," rather than retroactive to the date of the decedent's death. The Kansas supreme court, in an unpublished opinion, affirmed this decision without expressly addressing the question of retroactivity.

The Service disallowed the charitable deduction, and the estate paid the additional tax and filed a refund claim in the federal district court for Kansas. Both parties filed motions for summary judgment on stipulated facts.

Citing *Tamulis*, the court ruled for the Commissioner, holding that the time limit prescribed by Section 2055(e)(3) for filing reformation petition is to be strictly applied, and that in any event the state court order granting the reformation was insufficient because it was not made effective retroactive to the date of the decedent's death.

We will return to *Tamulis* later in these materials, but for the moment, the point these two decisions forcefully illustrate is that the ninety-day deadline in Section 2055(e)(3)(C)(iii) is critical.

In PLR 200548019, the Service ruled that it did not have discretion under Reg. 301.9100-3 to extend the time for commencing a judicial reformation proceeding under Section 2055(e)(3)(C)(iii), because the deadline is statutory rather than regulatory.

In this connection, note also PLR 200414011, in which an *inter vivos* CRUT paying eight pct. over two lives failed the ten pct. remainder test, but the problem was not discovered until after the settlor's death. A proposed reformation not commenced within ninety days after the due date (with extensions) of the first trust income tax return was disapproved.

6. Plain vanilla

The simplest situations can be addressed simply. A straight income trust with no provision for distribution of principal to a noncharitable beneficiary can readily be reformed to a qualifying remainder trust. Several letter rulings illustrate the point.

PLR 200105059. Testamentary trust paying income in unequal proportions to six individuals for a term of ten years, with income otherwise payable to an individual who died during the term added to principal, remainder over to a Section 4947(a)(1) trust. Reformed to a CRAT paying 6.8 of initial fair market value, apportioned among the six individuals, for the ten-year term.

Oddly, the ruling approves reapportioning the annuity among the surviving individuals rather than distributing the portion otherwise payable to a deceased annuitant over to the remainderman.

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PLR 200201026. Testamentary trust paying income only to the decedent's son for life, remainder to a Section 4947(a)(1) trust. Reformed to a straight CRUT at 7.6 pct. (the then-current 7520 rate). Plain vanilla.

PLR 200227015. Testamentary trust paying income only to the decedent's brother for life, then a fixed annuity to the brother's wife for life, remainder to a Section 4947(a)(1) trust. Reformed to a CRAT at 6.9579 pct. of initial fair market value. Not clear what relationship 6.9579 pct. might bear to the stated amount of the fixed annuity to the brother's wife, but remainder values within five pct.

PLR 200234038. Testamentary trust paying income to two charities and two individuals or the survivor until the death of the survivor, remainder to the two charities, could be reformed by dividing the trust into four trusts, two distributing income to the charities, and two seven pct. unitrusts, one for each of the two individuals, with the unitrust payout to be divided after the first death equally among the survivor and the two charities.

Compare *Galloway*, discussed below.

PLR 200632013. Testamentary trust paying income only in equal shares to two individuals or the survivor, remainder to a Section 4947(a)(1) trust. Reformed to a five pct. CRUT.

PLR 200832003. Testamentary trust paying the decedent's sister a fixed annuity for life, with any excess income to be paid to the decedent's brother for his life, remainder in equal shares to three named charities. Reformed to a NIMCRUT paying the fixed annuity to the sister from the unitrust payout, and any excess to the brother. If the brother predeceased the sister, that portion of the unitrust payout in excess of her fixed annuity would be distributed in equal shares among the three charities.

Note: the will was silent with respect to income in excess of the annuity to the sister should she survive the brother, but the ruling seems to proceed on the assumption that (prior to reformation) the excess was to be accumulated and added to principal.

7. Disclaimers

Where the nonqualifying trust instrument provides for discretionary distributions of principal, it may be necessary to include disclaimers in the reformation strategy.

In order for a disclaimer not to constitute a taxable gift, it must conform to the requirements of Section 2518(b) and (c). Specifically, for our present purposes,

> (a) the disclaimer must be made within nine months after the later of the date of the transfer or the date the disclaimant attains age 21,
>
> [Note: this is usually a much shorter deadline than the ninety-day rule for initiating a reformation proceeding.]
>
> (b) the disclaimant must not have accepted the subject property interest or any of its benefits,
>
> [Note: this includes any *quid pro quo*.]
>
> (c) as a result of the refusal, the interest must pass without any direction on the part of the disclaimant either to a third person or to the decedent's spouse, and
>
> (d) while the disclaimant may disclaim less than her entire interest in the subject property, the interests must be "severable."

What does and does not constitute a "severable" interest in a trust for purposes of a partial disclaimer is itself a subject for a thirty-page paper and an hour and a half lecture. The relevant regulations are at Reg. 25.2518-3(a)(1)(ii), which speaks in terms of "property which can be divided into separate parts each of which, after severance,

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maintains a complete and independent existence," and Reg. 25.2518-3(a)(2) which in effect requires, in the case of a disclaimer of anything other than a fractional share of all interests in a trust, that the disclaimed interests be segregated.

But let me just mention in passing that a divided Tax Court recently ruled in *Estate of Christiansen*, 130 T.C. No. 1 (2008), that a disclaimer by a decedent's daughter to a testamentary CLAT in which the daughter herself had a remainder interest, albeit contingent on her surviving the term, did not qualify under Section 2518(b)(4) because she did not also disclaim the remainder. The case is pending appeal in the Eighth Circuit federal appeals court, which decided *Walshire*, 288 F.3d 342 (8th Cir. 2002), on which the majority relied, but which the two dissenting judges credibly distinguished . . . but the appeal does not involve this issue.

The Service has had a number of occasions to rule privately on reformations involving disclaimers, and what is noteworthy about these rulings is their treatment of the severable interest question.

In TAM 9610005, the Chief Counsel advised that two testamentary trusts, each paying income to an individual (neither identified as a surviving spouse) for life, with discretionary distributions of principal, remainder to charity, could be reformed -- after disclaimer by each individual of the discretionary principal distributions -- to two 7.4 pct. CRUTs.

Note: we are talking here about a disclaimer by a non-spouse of discretionary distributions of principal, but reserving a unitrust payout, which of course might include distributions of principal. The memo cites Reg. 25.2518-3(d), Example 11, which says that the remainderman of a testamentary trust may disclaim a right to discretionary distributions of principal during the life of the income beneficiary without the necessity of also disclaiming the remainder gift. The example is not exactly on all fours, but it does arguably establish that the right to discretionary distributions of principal is a severable interest.

In PLR 9827008, a factually somewhat similar scenario, the Service expressly reserved ruling whether the disclaimers were qualified under Section 2518, though the question of severability was not specifically mentioned.

In PLR 9827010, the Service ruled that a testamentary trust that was to pay a fixed annuity to an individual for life, subject to upward adjustment based on the consumer price index, remainder to two named charities, could be reformed, after disclaimer by the annuitant of the CPI adjustments, to a CRAT at five pct. of the initial fair market value, from which the stated annuity amount would be paid to the individual and the excess -- also a fixed annuity, which qualified under Reg. 20.2055-2(e)(2)(vi) -- to the charities. The ruling states without analysis that the disclaimed interest "is a separate interest in property under Section 25.2518-3(a)(1)(i)."

To similar effect, PLRs 200010019, 200230022, 200232015, 200302029, and 200840030, each of which cites Reg. 25.2518-3(d), Example 11. In both PLRs 200330028 and 200535006 the income beneficiary disclaimed discretionary principal distributions but did not seek a ruling whether the disclaimer was valid. PLR 200340001 does not expressly mention that a disclaimer was made, suggesting that the formality may not even be necessary . . .

8. Breaking it apart

Sometimes it is necessary to divide a nonqualified trust into several components in order to bring parts or all of it into compliance with the requirements of Section 2055(e)(3).

Noncharitable remaindermen

In PLR 9407024, the Service ruled that a testamentary trust that was to pay income to the decedent's sister for life, with pecuniary distributions from the remainder at her death to four named individuals and the balance to a university, could be reformed by dividing the trust into two trusts:

a unitrust with a payout at the then-current 7520 rate of 7.4 pct., remainder to the university, and

a noncharitable trust paying income only, funded in the amount of the pecuniary remainder gifts.

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In PLR 199935041, the Service ruled that a testamentary trust that was to pay fixed annuities to two individuals for life and in perpetuity to four named entities, one of which was not an eligible recipient under Section 2055(a), with any excess income to another named charity, could be reformed by dividing it into two trusts:

> a CRAT paying five pct. of initial fair market value, allocated among the two individuals and the charities, with the remainder after the second death to be held in a Section 4947(a)(1) trust, and
>
> a noncharitable trust paying a fixed annuity to the other entity in perpetuity.

Note that the fixed annuity to the charities itself qualified under Reg. 20.2055-2(e)(2)(vi). Compare *Estate of Jackson*, noted under "settlement of controversies," below.

In PLR 200535006, the Service approved the proposed reformation of a testamentary trust that was to have paid half the income and discretionary amounts of principal to the testator's son, half the principal to him after ten years, and the remainder at his death to a sibling and several charities. The son disclaimed the discretionary principal distributions and a petition was timely filed in state court to divide the trust into two, one paying income to the son, remainder to the sibling, and the other reformed to a five pct. CRUT.

Citing *Cottage Savings Association*, 499 U.S. 554 (1991), the Service also ruled that the transaction would not constitute a sale or exchange, triggering recognition of income or gain.

In PLR 200605001, the Service ruled that a testamentary trust that was to pay income to a separate trust for the benefit of the decedent's son, remainder over at the son's death in shares to various charities and individuals, could be reformed by dividing it into two trusts:

> one for the ultimate benefit of the individual remaindermen, paying income over to the son's trust, and
>
> the other for the ultimate benefit of the charitable remaindermen, a CRAT paying a fixed annuity of five pct. of initial fair market value to the son's trust.

Note: the ruling does not discuss the point, but this would appear to be a "stacked" trust, paying the annuity to a discretionary trust for a disabled beneficiary. See Rev. Rul. 2002-20, 2002-1 C.B. 794, amplifying and superseding Rev. Rul. 76-270, 1976-2 C.B. 194.

Burning down the house

In PLR 8912027, a husband and wife had created reciprocal trusts, funded in part by their respective interests in their residence. Each trust was to pay income to the other. After the first death, the survivor was to be permitted to live in the residence rent-free, while forty pct. of the trust income was to be distributed to various family members and sixty pct. to a named charity. At the second death, the residence was to be sold, and the trust remainder was to be distributed, again forty pct. to the various family members and sixty pct. to the named charity.

Both spouses died within a few months of one another, with the result that each trust terminated before the due date (with extensions) of either estate tax return, bringing the case within Section 2055(e)(3)(F).

The ruling notes Rev. Rul. 77-169, 1977-1 C.B. 286, disallowing a deduction under Section 2055(a) where the remainder to charity is in the proceeds of the sale of a residence, rather than in the residence itself, and Rev. Rul. 83-158, 1983-2 C.B. 159, allowing the deduction where state law permits the remainder charity to elect distribution of the residence despite the terms of the decedent's will under a doctrine of "equitable reconversion."

In PLR 200024014, the Service ruled that a testamentary trust granting an individual rent free use of a house for life, remainder to a perpetual charitable trust, could be reformed by dividing it into two trusts:

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a CRAT paying 7.1 pct. of initial fair market value, from which the individual might pay rent, maintenance, repairs, property taxes, insurance, etc., on the house (which was assigned to the second trust), with the remainder to

the second trust, a perpetual Section 4947(a)(1) trust.

The CRAT was to be funded in a stated amount that would suffice to pass the "five pct. probability of exhaustion" test set forth in Rev. Rul. 70-452, 1970-2 C.B. 199, and Rev. Rul. 77-374, 1977-2 C.B. 329.

Note: the charitable trust was to hold certain farmland in perpetuity, to be leased at reasonable rates, subject to a proviso that two named individuals be given priority to lease. These provisions were not altered in the reformation proceeding.

To similar effect, PLR 200428013. Testamentary trust holding various parcels of real property for conservation purposes, but holding a residence for the surviving spouse rent free and paying her income for life. Proposed reformation would remove the residence from the trust, giving the spouse a legal life estate, remainder to a newly created private foundation holding the other properties. Cash and securities to be held in a CRAT. Service rules favorably.

The vertical slice

PLR 200027014. Testamentary trust paying twenty pct. of current income to each of the decedent's three surviving siblings, remaining income accumulated to principal. After the death of the second sibling, forty pct. of current income in unequal shares among ten named charities, and after the death of the remaining sibling, eighty pct. of income to the charities, with the remaining twenty pct. accumulated in perpetuity.

Timely reformation proceeding dividing the trust into three CRATs, each paying five pct. of initial fair market value to one of the siblings, remainder over to a Section 4947(a)(1) trust paying eighty pct. of current income to the charities.

Service approves the arrangement, noting that the actuarial value of the reformed remainder interests, collectively, is within five pct. of the actuarial value of the reformable remainder interest.

PLR 200401012. Testamentary trust paying a fixed annuity to the surviving spouse for life, and granting her a life estate in a residence on which the trustees were to pay taxes, insurance, and association fees. Also a fixed annuity to the decedent's son for his life, and a smaller annuity to the daughter-in-law if she survived the son. Also a pecuniary amount set aside for a granddaughter's education, to be paid to her as a fixed annuity starting at age twenty if not used for that purpose. And similar amounts set aside for the education of other grandchildren, including afterborns, albeit without the annuity payout option. Remainder in equal shares to five named charities. Quite a puzzle.

Solution: divide into two trusts,

one reformed to five pct. CRAT from which (a) annuity to spouse for life, (b) annuity to son for life, then smaller annuity to daughter-in-law, and (c) balance to charities, remainder to charities, and

the other to fund education for grandchildren, remainder to charities, not qualified.

Service approves.

In PLR 200430012, a testamentary trust implementing the terms of an antenuptial agreement provided a stipend to the surviving spouse, plus separate allowances for maintenance and medical expenses, until her death or remarriage, remainder to a private foundation. Under the terms of the antenuptial agreement, however, the stipend was to terminate upon remarriage, but the allowances were to continue for life.

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In reforming the trust to conform to the terms of the agreement, the parties agreed to fix the amount of the stipend and the allowances. The trust was then divided into three CRATs,

> one paying the agreed amount for the allowances for life,
>
> one paying the agreed amount for the stipend until death or remarriage -- a qualified contingency under Section 664(f)(3) that did not disqualify the CRAT under Section 2056(b)(8) --, and
>
> one paying a fixed annuity to be divided in stated proportions between the spouse and the remainder foundation -- again, the fixed annuity to the foundation qualified under Reg. 20.2055-2(e)(2)(vi).

The Service approved the arrangement.

In PLR 200541038, the surviving spouse had elected to take her statutory share against the will. Under applicable state law, a portion of this share was to be held in trust, paying her income for life, remainder to the residuary legatees under the will, in this case fourteen named charities. Included in the elective share were a painting which had been left in the will to a museum, and certain real property which had been left to a conservancy. The spouse agreed with the museum to share possession the painting in proportion to their respective interests, and agreed with the conservancy to sell the real property. These assets were segregated from the statutory trust.

The parties then agreed to reform the statutory trust to a five pct. CRUT, and the Service approved the reformation, reserving comment on any other aspect of the transaction.

The ten percent solution

In PLR 200022014, the Service ruled that an addition after July 28, 1997 to an existing *inter vivos* CRUT at five pct. paying the settlor for life and then multiple successor beneficiaries, with the remainder after the death of the last survivor to charity, could be severed, per Section 664(d)(4), into four separate trusts, each paying (after the death of the settlor) a smaller number of the successor benefiaries, in order to meet the ten pct. remainder requirement of Section 664(d)(2)(D).

9. Technical compliance

The reformation mechanism at Section 2055(e)(3) is also available to correct technical deficiencies in the trust instrument that would result in disqualification under Section 664. While the ninety-day rule does not apply where the payout to noncharitable, nonremainder beneficiaries is in the form of an annuity or unitrust, the better part of discretion is to identify and correct these problems earlier than later. Sometimes the noncompliance issue falls into a grey space.

Less than five, why drive

Where a trust does provide a fixed annuity or unitrust payout, but in an amount less than the required five pct. minimum, it is usually a simple matter to reform the trust to provide for the five pct. payout, with the excess paid over to the remainder charities. Because the excess amount is also a fixed annuity or unitrust amount, it should also qualify under Reg. 20.2055-2(e)(2)(vi).

PLR 8927057 does not quite fit the above description. Testamentary trust paying a fixed annuity of less than five pct. to an individual for life, with the remainder to eleven named charities and ten named individuals. Reformed by setting aside twenty times the annuity amount in a separate trust, with any excess income to be paid currently to the remainder charity. Citing Rev. Rul. 89-31, 1989-1 C.B. 277, the Service also approved the acceleration of the remainders as to the balance of the trust not required to fund the annuity trust. But compare *Galloway*, below. Useful to remember letter rulings are not binding precedent.

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PLR 200020034. Testamentary trust paying annuities to two individuals totaling less than five pct. of initial net fair market value, remainder after each death to charity. Reformed to provide an annuity payout of five pct., with the excess over the fixed annuities to be distributed to the remainderman. No ruling on deductibility of annuity payout to charity.

TAM 200224006. Testamentary trust paying annuities to the decedent's two sisters totaling less than five pct. of initial net fair market value, remainder after the death of the survivor to charity. Reformed to provide an annuity payout of five pct., with the excess over the fixed annuities to the sisters to be distributed to the remainderman. Lead and remainder interests aggregated for purposes of the five pct. variance calculation.

To similar effect, PLRs 200306008 and 200306009. Testamentary trust paying a fixed annuity to the decedent's son in an amount less than five pct. of initial net fair market value, remainder over to a qualified charity. Reformed to provide an annuity payout of five pct., with the excess over the fixed annuity to the son to be distributed to the remainderman -- also ruled deductible.

See discussion of PLR 200350012 under "settlement of controversies," below. See also PLRs 200622005 (four pct. unitrust) and 200726005 (annuity less than five pct.).

Life plus twenty

PLR 200122045. An *inter vivos* NICRUT (without makeup) for the joint lives of the settlors, plus twenty years for the benefit of nieces and nephews, could not be reformed by limiting the term to the greater of the joint lives or twenty years, to comply with the requirement of Section 664(d)(2)(A), where

(a) the reformation proceeding was not begun within ninety days after the due date (with extensions) of the first 1041,

(b) the actuarial values of the "reformed" and "reformable" interests would differ by more than five pct., and

(c) the nonremainder interests before and after reformation would not terminate at the same date.

Because of powers reserved to the settlors to revoke the term interest to nieces and nephews and to add or delete remainder beneficiaries, the transfer of these interests were ruled to be "incomplete." Somewhat less than half a loaf.

Note: the argument could be made that the flush language at Section 2055(e)(3)(B) saying a term of years in excess of twenty reformed to twenty will be treated as terminating "at the same time" should apply here.

Devil in the details

In PLR 200305023, the decedent's revocable trust was to become a NIMCRUT at his death, paying the lesser of income or five pct. (with makeup) to two individuals or the survivor, remainder to four qualified charities. The interim trust was liable for administration expenses and estate taxes, and there were insufficient assets to pay these amounts from sources other than the trust. Also, no provision had been made for deferral of the unitrust payout pending administration.

The Service ruled that a judicial reformation authorizing payment of administration expenses and estate taxes and deferral of the unitrust payout would qualify, provided the interim distributees made timely repayment of any overpayments, per Rev. Rul. 92-57, 1992-2 C.B. 123, construing Reg. 1.664-1(a)(5).

PLR 200927013 involved a testamentary trust creating two CRATs, one to be funded with a stated dollar amount and paying an annuity of five pct. of its initial fair market value to a named individual for life, the other to be funded with the residue and paying six pct. of its initial fair market value in equal shares to two named individuals or all to the survivor. The remainder of each CRAT was designated to a named charity.

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The trust instrument failed to include a number provisions required to qualify the CRATs under Section 664, and the trustees brought a reformation action in state court. The petition was filed prior to the due date for filing an estate tax return (in other words, within the ninety-day limit), and the court entered an order reforming the trust instrument, contingent on a favorable IRS ruling.

The reformation added provisions to the trust instrument (a) allowing the trustees to defer annuity payments until after probate administration was concluded and each trust was fully funded, (b) prorating the final payment at the death of the annuitant, (c) allowing the trustee to adjust the annuity payout in the event of an over- or under-valuation of initial trust assets, (d) forbidding additions to either trust, and (e) forbidding the trustees from engaging in acts of self-dealing, making taxable expenditures, making any payment other than the annuity amount for less than full and adequate consideration (except to a qualified charity), retaining excess business holdings, or making jeopardizing investments.

In addition, the reformation "clarified" that the direction to pay transfer taxes from the trust residue had the effect of allocating taxes entirely to the second CRAT.

In concluding that the reformation qualified under Section 2055(e)(3), the Service was of course required to determine, pursuant to Section 2055(e)(3)(B)(i), that the difference between the actuarial value of the charitable remainder after reformation differed by no more than five pct. from the value of the remainder before reformation. The court order purported merely to clarify that transfer taxes were payable entirely from the second (residuary) CRAT. While this is the necessary result as a practical matter, since the first CRAT was to be funded with a pecuniary amount, it is not entirely clear whether the Service here determined that the "before" and "after" values for the remainder of the second CRAT were both premised on this reading of the trust instrument.

10. Settlement of controversies

Rev. Rul. 77-491

In Rev. Rul. 77-491, 1977-2 C.B. 332, the Service took the position that no charitable deduction was allowable where the remainder of a nonqualified trust was accelerated as a result of the settlement of a will contest in which the income beneficiary was paid a lump sum in lieu of his income interest in the trust.

A year later, in Rev. Rul. 78-152, 1978-1 C.B. 296, the Service allowed a deduction where the remainder of a nonqualified trust was accelerated as a result of the decedent's spouse electing to take against the will. The earlier ruling was distinguished on the grounds

> (a) that because of the election, the spouse's foregone income interest in the trust was treated as not having passed from the decedent to her, Reg. 20.2056(c)-2(c), so that a nonqualified split interest was not created in the first instance, and
>
> (b) that in the earlier case, the outright payment to the remainder charity was traceable to either the contested will or the prior will that would have replaced it in a successful contest, and neither will created a qualified split interest trust for which a deduction would have been allowed, absent a reformation proceeding.

***Northern Trust* and its progeny**

Several adverse court decisions caused the Service to rethink this position.

In *Northern Trust Co.*, 78-1 USTC para. 13,229, 41 AFTR 2d 78-1523 (N.D. Ill. 1977), a trust under the decedent's will was to pay income to his two sisters for their lives, with the remainder over to several named charities. The trustee was given discretion to invade principal for their "care, comfort, support[,] and general welfare." The estate tax return as filed did not claim a deduction for the remainder interest in this trust. However, the sisters contested the will, and under the terms of a settlement agreement, each of them received a lump sum in lieu of her interest in

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the trust and the remainder was accelerated. The executors then sought a refund based on a claimed deduction for the amount paid over to the charities.

The court concluded that the amount paid to the charities under the settlement agreement "passed by inheritance" from the decedent, rather than under a split interest trust, so that the policy concerns expressed in Section 2055(e) did not apply. In a footnote, the court also rejected the government's argument that the invasion power would have rendered the value of the remainder unascertainable under pre- TRA '69 law.

Northern Trust was cited favorably by the Eighth Circuit federal appeals court in two decisions, *Oetting*, 712 F.2d 358 (8th Cir. 1983), and *First National Bank of Fayetteville*, 727 F.2d 741 (8th Cir. 1984).

In *Oetting*, the decedent had left the residue of her estate, after several specific bequests, in trust to pay a fixed annuity to each of three friends (referred to throughout the opinion as "elderly ladies"), with income in excess of the amount required to fund the annuities to be paid in equal shares to four named charities and another individual, who were also the remaindermen after the death of the last of the three annuitants.

The annuitants were in their eighties, and the estate was an order of magnitude larger than the lawyer who drafted the will had understood it to be. The trustees were concerned not only about estate taxes, but also about burdening the remainder with what might be perceived as excessive trust administration fees. With the approval of a state court, they purchased annuity contracts for each of the three annuitants, distributed four-fifths of the remaining trust corpus outright to the charities, and held one-fifth for the benefit of the individual remainderman and her descendants.

The federal district court denied a refund claim, but the appeals court reversed, finding the situation analogous to a revenue ruling that had been issued after the appeal had already been briefed.

In Rev. Rul. 83-20, 1983-1 C.B. 231, the Service had ruled that a widow's election to take a statutory allowance did not create a split interest with respect to that portion of the residuary estate that it was nearly certain, given the size of the allowance and the likely duration of the administration of the decedent's estate, the residuary charitable legatee would receive.

That ruling in turn "clarified" an earlier ruling, Rev. Rul. 74-97, 1974-1 C.B. 281, in which the Service had ruled that a similar allowance, payable under the terms of the decedent's will, also did not create a split interest with respect to a residuary charitable bequest. Both rulings were premised on the idea that the amount of the allowance and, conversely, the amount payable to the charity could be measured with near certainty and "severed" one from the other.

At oral argument, the government suggested that yet another ruling, issued even more recently, had in effect eviscerated the earlier rulings. In Rev. Rul. 83-45, 1983-1 C.B. 233, the Service ruled that a direction in the decedent's will to pay out the dividends on certain corporate stock to a named individual during the period of probate administration, though the stock itself was bequeathed to a charity, created a nondeductible split interest. But the *Oetting* court was not having any of it, and distinguished that ruling on the ground that the amount of the dividends and the duration of probate administration were uncertain.

In *Fayetteville*, the appeals court reached a similar conclusion, citing *Oetting* and Rev. Rul. 78-152, where the decedent's widow elected to take against the will and under the terms of a settlement agreement was paid a lump sum plus a fixed annuity for life, in lieu of a much smaller annuity that had been provided for her in the will, with the remainder to a scholarship fund at a university. The court treated the amount required to fund the lifetime annuity as severable, and allowed a charitable deduction in the amount of the lump sum paid outright to the scholarship fund.

These decisions in turn were cited in *Flanagan*, 810 F.2d 930 (10th Cir. 1987), and *Estate of Strock*, 655 F.Supp. 1334 (W.D. Pa. 1987), both cases in which a charity received an accelerated payment in lieu of a nondeductible remainder interest as the result of the settlement of a will contest.

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Rev. Rul. 89-31

Finally, in Rev. Rul. 89-31, 1989-1 C.B. 277, the Service revoked Rev. Rul 77-491, stating that in view of the "adverse" decisions in *Flanagan*, *Strock*, and *Northern Trust*, it would no longer challenge the deductibility of an immediate payment to a charity in settlement of a "bona fide" will contest "solely" on the ground that the payment was made in lieu of a nonqualified split interest under the challenged will. The ruling also modified Rev. Rule 78-152, which had explained the result in the revoked ruling under a theory of "tracing" the proceeds of a will contest settlement to the litigant's rights under the will or by intestate inheritance.

It should be noted

> (a) that Rev. Rul. 89-31 does not formally acquiesce in any of the cited decisions, and that in each of them the grounds on which the will was contested are unclear and/or of questionable *bona fides*, and
>
> (b) that the *Oetting* and *Fayetteville* decisions (which did not involve will contests) are not mentioned at all.

Subsequent letter rulings

PLR 8945004. Testamentary trust paying a fixed annuity to two named charities for twelve years, remainder in equal shares to the decedent's three grandchildren. Grandchildren threatened will contest, asserting decedent had intended to sign a codicil under which they would have received immediate benefit, also threatened to sue lawyer for failing to get codicil executed. Under settlement agreement, charities would receive lump sum payment roughly equal to present value of the annuity stream, residue to grandchildren.

Service says:

> Rev. Rul. 89-31, 1989-1 C.B. 277, permits immediate payment to charity in settlement of "bona fide" will contest. Contest here not bona fide, as purported codicil was not executed.
>
> Rev. Rul. 88-27, 1988-1 C.B. 331, says lead trust giving trustee discretion to commute annuity does not qualify under Section 2522(c)(2)(B).

In PLR 200127038, the Service ruled that the settlement of a controversy over the widow's elective share, modifying a nonqualified CRAT to increase the payout to the minimum five pct. of initial fair market value, was a qualified reformation, and that the widow's annuity interest would qualify for a marital deduction under Section 2056(b)(8). The ruling does not mention Rev. Rul. 89-31, but instead cites *Ahmanson Foundation*, 674 F.2d 761 (9th Cir. 1981), for the analogous proposition that

> property distributed to a spouse pursuant to a compromise settlement will be treated as passing from the decedent for marital deduction purposes, only if the distribution represents a good faith settlement of an enforceable claim.

In TAM 200128005, the Chief Counsel, citing Rev. Rul. 89-31 and the *Flanagan*, *Strock*, and *Northern Trust* decisions, advised that an outright distribution to a municipal cemetery association as part of the settlement of a "bona fide" controversy over the funding and construction of a testamentary trust would qualify for a charitable deduction. As drafted, the trust was to have paid income to the decedent's widow for her life, then to his cousin for her life, then to the cousin's descendants for a term of twenty years, remainder to the cemetery association. Note: it is not stated in the memo that a will contest petition was actually filed.

In PLR 200252077, the Service ruled that the settlement of a will contest, resulting in the outright distribution of assets that would otherwise have funded a nonqualifying "income" trust for the benefit of ten individuals and a church, was not entered into collusively to circumvent Section 2055(e)(2), and that a deduction would therefore be allowed. The ruling quotes at length from TAM 200128005.

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In TAM 200306002, the Chief Counsel advised that a deduction should not be allowed for an outright distribution to a charity in settlement of a will contest, where there was "little possibility" that a state court would have admitted to probate the earlier will naming the charity, there having been seven intervening wills and codicils over a period of thirty-five years. Oddly, the memo does not mention Rev. Rul. 89-31 or the *Flanagan*, *Strock*, and *Northern Trust* decisions, but instead cites *Ahmanson*, this time for the proposition that

> an amount paid to a surviving spouse pursuant to a good faith settlement does not qualify for the estate tax marital deduction to the extent the spouse receives more than could have been obtained if the spouse had litigated the claim to conclusion,

and to similar effect, *Terre Haute First National Bank*, 67 AFTR2d 91-1217, 91-1 USTC para. 60,070 (S.D. Ind. 1991), in which the court had ruled that where the settlement of a will contest, albeit *bona fide*, resulted in an outright distribution to a charity greatly in excess of the present actuarial value of its remainder interest in the pooled income fund that was to have been created under the contested will, the charitable deduction would be limited to the smaller amount.

In PLR 200350012, the Service ruled that a deduction would not be allowed for an outright distribution to a charity or for its remainder interest in a CRAT to be created as part of the proposed compromise of a controversy arising in the settlement of a decedent's estate.

The decedent's will provided for payment of a fixed annuity to each of three grandsons for their respective lives, with the remainder after the death of the survivor to a named charity. An apparent scrivener's error had made the payment of these annuities contingent on the decedent's daughter (the grandsons' mother) surviving him. She had in fact predeceased, and left her estate to her father, the decedent. The grandsons contended that their mother had intended her estate to pass to them.

Under an agreement among the parties, submitted to the state court, (a) a CRAT would be funded in an amount twenty times the stated annuities, with one third of the then corpus to be distributed to the remainder charity at the death of each grandson, (b) a fractional share of residue of the decedent's estate equal to his unused credit equivalent would be distributed outright to the grandsons, and (c) the balance would be distributed outright to the charity.

The Service ruled that the proposed CRAT did not qualify under Section 664(d)(1) -- after the death of the first grandson, the annuity payout to the others would be less than five pct. of the initial fair market value --, and that in any event the proposed transaction would not comply with the requirement of Section 2055(e)(3)(B)(i) that there be no more than a five pct. difference in the actuarial value of the remainder interest before and after reformation, nor the requirement of Section 2055(e)(3)(B)(ii) that the nonremainder interests, before and after reformation, terminate at the same time.

The ruling goes on to suggest an alternative path that would comply: assuming the dispute over the daughter's estate was *bona fide*, an outright distribution might be made to the grandchildren in the disputed amount, and the entire residue of the decedent's estate could then fund a CRAT paying five pct. of initial fair market value, with a portion going to pay the fixed annuities provided under the terms of the decedent's will and the balance distributed currently to the remainder charity. See "less than five," below.

Note: by filing a petition with the state court to approve the proposed settlement, the parties may have preserved their position under the ninety-day rule of Section 2055(e)(3)(C)(iii), so that they could now amend the petition to conform to the suggested alternative.

Stretching the point

In *Harbison*, 87 AFTR 2d para. 2001-734 (N.D. Ga. 2001), the decedent's left her entire estate in trust to pay income to her brother for life, with discretionary distributions of principal, remainder to eight charities after satisfaction of several pecuniary gifts. The brother died a few weeks after the decedent, but not before a discretionary distribution had been made to him.

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Two granddaughters, who had been given only nominal benefits under the will, brought a will contest. The settlement agreement restructured the distribution to the brother, after the fact, as a pecuniary bequest, accelerating the remainder to the charities. The granddaughters were assigned the refund claim.

The trial court initially ruled that the situation fell within the "reformation by death" rule of Section 2055(e)(3)(F), citing *Shriners Hospitals*, 14 Ct. Cl. 51 (1987), *rev'd on other grounds*, 862 F.2d 1561 (Fed. Cir. 1988), and two letter rulings decided on very similar facts, and upheld the refund claim.

However, on a motion for rehearing, the court vacated its earlier decision and instead ruled that the provision for discretionary distributions of principal to the brother rendered the remainder gift to the charities unascertainable. The court noted Section 2055(a), which treats the termination of a power to invade by reason of the death of the person for whom the power might be exercised prior to the due date of the estate tax return as a qualified disclaimer, but only if the power has not yet been exercised.

The court accepted the government's argument that although the will contest itself may not have been "collusive," the fact that the granddaughters received nothing in settlement apart from the refund claim made it a "nuisance" action, "brought only for the purposes [sic] of avoiding estate taxes." See the discussion of *Burdick* and *Estate of La Meres*, below.

11. Be careful with that axe

In TAM 200840008, the decedent's will had provided that income was to be distributed 25 pct. each to two individuals for their respective lives, and the balance annually to charities selected by the trustees. After the death of both individuals, the trustees were given discretion to terminate the trust, distributing the remainder to charities of their selection.

In an effort to qualify some portion of the trust for a charitable deduction, the trustees divided the trust in two, with the income from one half payable in equal shares to the two individuals and the income from the other half distributable to charities. The division of the trust was done in conformance with a state statute permitting nonjudicial severances, and the state attorney general was notified.

That transaction did not meet the requirement that the resulting trust be in the form of an annuity or unitrust for the same term, nor the requirement that there be no more than a five pct. difference in the actuarial value of the charitable interest before and after reformation.

However, the trustees argued that the value of the share set aside in a separate trust for the exclusive benefit of charities should qualify without reference to Section 2055(e)(3), citing *Estate of Jackson*, 96 AFTR2d 2005-7279 (D. W.Va. 2005), in which the court had held that where an "intervening event destroys the [non-qualifying] split interest and causes a direct transfer of property to a charitable organization," the deduction will be allowed. The "intervening event" in *Jackson* was an early termination of the trust to avert possible litigation arising from perceived conflicts of interest. Compare *Oetting*, under "settlement of controversies," below.

Although the Commissioner had filed an appeal from the *Jackson* decision to the 4th Circuit federal appeals court, the appeal was voluntarily dismissed. The Service has not published a formal nonacquiescence from the decision.

In response to the taxpayer's argument here, without conceding that *Jackson* (or *Oetting*) was correctly decided, the Chief Counsel rejected the analogy and argued that the situation more closely resembled *Estate of Burdick*, 979 F.2d 1369, 70 AFTR2d 92-6287, 92-2 USTC para. 60,122 (9th Cir. 1992), *aff'g* 96 T.C. 168 (1991), and *Estate of La Meres*, 98 T.C. 294 (1992), both cases in which the court disallowed a deduction where the parties terminated the trust early solely for the purpose of claiming the deduction.

The Chief Counsel also disputed the analogy to Rev. Rul. 89-31. In the present case, the Chief Counsel argued, unlike a will contest, the trustee was not faced with "the untenable choice" of either terminating the trust and forgoing the charitable deduction or facing "protracted litigation."

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Note: it would have been possible to reform this trust within the requirements of Section 2055(e)(3) by restructuring it as a five pct. unitrust paying 25 pct. of the unitrust payout to each of the two individuals and the remaining fifty pct. to charities. In what appears to have been an attempt to secure a larger deduction, the trustees unfortunately pursued another, failed course of action, which extended beyond the ninety-day deadline for initiating a judicial reformation proceeding.

In *Burdick*, cited in the Chief Counsel memo, the decedent had left his entire estate in trust to pay income to his brother for life, remainder in equal shares to a nephew and to the Church of Christ, Scientist. The estate claimed a charitable deduction, and it was only after a deficiency notice was issued that the executor contacted the church and offered a lump sum payment in lieu of its remainder interest, which the church accepted. The Tax Court denied the deduction on the ground that the transaction was motivated solely by tax considerations, and the appeals court affirmed.

The scenario in *La Meres* was substantially more complicated, but again the key point is that the court would not recognize an attempted nonjudicial reformation outside the ninety-day limit where the "only apparent reason" for the reformation was to evade the requirements of Section 2055(e)(2).

To similar effect, see *Estate of Johnson*, 941 F.2d 1318 (5th Cir. 1991).

12. What is a split interest, anyway

In *Galloway*, 492 F.3d 219 (3d Cir. 2007), the residue of the decedent's estate was to be held in trust for his son, his granddaughter, and two charities in equal shares, with income accumulated to principal and outright distribution in two stages, half in 2006 and the remainder in 2016. If either of the individuals died before receiving a distribution, his or her share would be redistributed among the remaining beneficiaries.

The executor calculated the present value of the staged distributions to the charities and claimed a deduction in that amount on the 706. The IRS disallowed the deduction, asserting that this was a split interest, not in the form of an annuity or unitrust.

In his refund claim, the executor argued that the situation did not lend itself to the abuses that Section 2055(e)(2) was intended to address, *i.e.*, that there was no conflict of interest between the charitable and noncharitable beneficiaries, and that the amount that would be distributed to charity was readily ascertainable. In effect, the executor argued, the interests of the charitable and noncharitable beneficiaries were not "in the same property" -- that as a practical matter, these were two (or four) separate trusts -- and that Section 2055(e)(2) did not apply. {Note, however, that the executor did not seek a reformation making an actual division into separate trusts.]

The appeals court, affirming a district court decision denying the refund claim, acknowledged that "the abuses Congress sought to protect against are not present here" and called the result "unfortunate," but found that Section 2055(e)(2) unambiguously did apply.

The court cited *Zabel*, 995 F.Supp. 1036 (D. Neb. 1998), denying a deduction for a trust paying income in equal shares charitable and noncharitable beneficiaries, and *Estate of Edgar*, 74 T.C. 983 (1980), *aff'd*, 676 F.2d 685 (3rd Cir. 1982), denying a deduction though there was almost no possibility, given the size of the trust, that the fixed annuities payable to various individuals could begin to encroach on principal. *Oetting* and *Fayetteville*, and *Strock* and *Northern Trust*, were distinguished on the ground that in those cases the charities had actually received their distributions by the time the deduction was claimed.

13. More than one way to skin a cat

Sometimes the post-mortem planning required to reform a nonqualified split interest trust can be strikingly elegant.

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As drafted, the testamentary trust at issue in PLR 200746010 provided for the payment of a fixed annuity among three individuals until the death of the survivor, with any excess income to be distributed currently to named charities. In no event was the annual payout to be less than five pct. of the initial fair market value.

In that form, the trust did not qualify either as a charitable remainder annuity or unitrust, because the payout was not fixed and because the possibility that the remainder might fail was not so remote as to be negligible. Nor did it qualify as a charitable lead trust, again because the payout was not fixed. Evidently it was not possible to bring the remainder up to ten pct., so the advisors had to get creative.

The executor filed a petition in state court to reform the trust to fix the current payout at five pct. of initial trust corpus and to limit the term of the trust to the lesser of the three measuring lives or the number of years indicated by the 7520 rate to yield a non-zero remainder (see Reg. 25.7520-3(b)(2)(v), Example 5).

Thus, as reformed, the trust would be a CLAT, with both charitable and noncharitable annuitants and a remainder to charity. Note: although Reg. 20.2055-2(e)(2)(vi)(f) provides that a lead annuity trust will not qualify if any amount may be paid for a private purpose prior to the expiration of all charitable annuity interests, there is an exception for a fixed annuity payout where there is no preference as between the charitable and noncharitable annuitants.

The Service determined that the annuity interest was reformable, and that the actuarial difference between the reformable interest and the reformed interest did not exceed five pct.

Summary

It may not always be possible to restructure a nonqualified split-interest trust in such a way as to bring the actuarial values of the "reformed" and "reformable" interests within five pct., but on the other hand it is sometimes possible to accomplish this in situations in which it is not immediately obvious, through a combination of disclaimers of discretionary principal distributions and payouts to the charitable remainderman during the non-charitable beneficiary's lifetime.

The deadlines for implementing this post-mortem planning (nine months for disclaimers, ninety days after the due date, with extensions, of the 706 for filing a petition for judicial reformation) are tight, and it is sometimes necessary to get quite a number of people with divergent interests on board quickly. The fact that their interests diverge does not imply that a compromise among the parties can be structured as a "bona fide" will contest settlement.

So what about *Tamulis*. What might have been done differently. And here it can be useful to keep in mind that the decedent might not have cared much about tax consequences. But a useful starting point is to imagine how the thing might have been structured if there had been an effort to qualify the trust.

Life estate in the house to the brother and his wife, remainder to two of the grandnieces, real estate taxes to be paid from the trust. Probably should think about segregating the house from the rest of the trust. Fixed annuities to various people, including the brother and his wife, in various amounts, with excess income (after paying the real estate taxes) to the two grandnieces, remainder to the diocese. Possibly a unitrust from which the various annuities could be paid, excess to the two grandnieces.

Trust to continue for the longer of ten years or the joint lives of the brother and his wife. A more difficult problem. Maybe split this into two trusts, one for the brother and his wife for their lives, one for everyone else for ten years, with possibly the earlier death of the brother and his wife as a qualifying contingency, terminating early. Some serious math here, but remember that TAM 200224006 aggregated separate interests for purposes of calculating the five pct. variance.

And then you have to either close the deal on a nonjudicial reformation or file a petition for a judicial reformation before the extended filing date for the 706. If Illinois law requires the consent of all beneficiaries, and the one grandniece is holding out, the executor or her sisters might take the position that the letter purportedly creating her stipend is not a valid amendment to the trust, creating at least some semblance of a *bona fide* dispute. Bring her to the table, maybe settle her out with a lump sum payment.

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We are talking about well over $700k in tax liability here, some of which will end up benefiting the diocese. There ought to be room to negotiate a deal with the disfavored grandniece.

A final note

Omitted entirely from this discussion has been the possibility of seeking a judicial reformation outside the ninety-day limit and/or outside the five pct. variance limit or the identical term requirement on the ground of scrivener error. See, for example, PLRs 200930048, 200850046, 200825017, 200818002, and 200811003, each reforming a NIMCRUT to a straight CRUT, and PLR 200850046, tacking on a twenty-year term after the joint lives of the settlors, for the benefit of descendants. Where the object is to reform a nonqualifying trust, it may be necessary to frame the proceeding as a "bona fide" controversy.

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