FINANCIAL STRATEGIES
For estate planning and planned giving.
• Legislation
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UNIVERSITY OF ROCHESTER

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IS THAT YOUR FINAL ANSWER? A TALE OF THREE RULINGS

It was the best of rulings; it was the worst of rulings. Okay, maybe it wasn't so bad after all.

It took three tries, but the Internal Revenue Service finally seems to have settled on approval of early termination of a charitable remainder unitrust (CRUT) with the trust corpus divided among the income and remainder beneficiaries (**Ltr. Rul. 200616035**).

In October of 2005 the IRS issued a private letter ruling granting the request of a trustee to terminate a CRUT prior to the death of the life-income beneficiaries (**Ltr. Rul. 200525014**). Under the proposed termination, the income beneficiary and the charitable remainder beneficiary would each receive an amount equal to the present value of their respective interests in the trust.

The IRS determined • that such distributions were appropriate and did not constitute self-dealing since all the relevant parties agreed to the termination, • that the income beneficiaries claimed —and affidavits from their physician confirmed—they had no medical condition that would result in a life expectancy shorter than would normally be predicted, • and that the distribution would not be to the detriment of the charitable remainderman.

Early in 2006, though, the IRS abruptly rescinded the earlier approval without explanation (**Ltr. Rul. 200614032**). That ruling proved quite unsettling to a number of taxpayers and advisors since **Ltr. Rul. 200525014** had been consistent with previous rulings the Service had made concerning early termination. That gave rise to speculation as to whether the IRS was rethinking its position or if there was something in the fact situation of **Ltr. Rul. 200525014** that distinguished it.

Sentiment shifted again recently when the IRS again reversed itself and issued yet another favorable ruling on this situation in **Ltr. Rul. 200616035**. Better still, the latest ruling gives some insight into the facts of the case that may have been the source of the IRS's discomfort. The ruling starts out by noting that the IRS has reconsidered "based on the additional information you have submitted."

The facts presented in **Ltr. Rul. 200616035** vary somewhat from those presented in **Ltr. Rul. 200525014**. This most recent ruling refers to a single grantor and income beneficiary of the trust who also served as trustee and points out that the original charitable remainderman of the CRUT was a private foundation.

Pursuant to a power to change the charitable remainderman, the grantor substituted six publicly supported organizations under **Internal Revenue Code §509(a)** for the private foundation as the charitable remainder beneficiaries of the trust. The ruling also states that the grantor wished to terminate the trust by selling his income interest to the charitable remaindermen. Such a transaction would result in a merger of the income and remainder interests and cause the trust to terminate. Reciting again its rationale for why the trust should be allowed to be terminated, the IRS reinstated its approval.

The ruling did not specifically identify what new information had prompted it to reverse its position. It is possible that the change of the remainderman from the private foundation to the publicly supported charities could have been key.

Although the facts do not state whether or not the grantor of the CRUT had any relationship to the private foundation that was the original charitable beneficiary,

there could be problems if the grantor also created the private foundation, was a substantial contributor, or held any other role that would cause him to be a disqualified person within the meaning of IRC §4946(a)(1). If so, certain acts—including a sale of an income interest as described in Ltr. Rul. 200616035—would constitute self-dealing.

If the private foundation had been the designated charitable remainderman at the time the first letter ruling was issued, that could have been the basis for the IRS rethinking its position and rescinding the favorable ruling. The IRS, of course, does not disclose any information about private letter rulings beyond what is included in the ruling itself.

ACGA RATES UNCHANGED FOR CURRENT ANNUITIES, INCREASED FOR DEFERRED ANNUITIES

The American Council on Gift Annuities (ACGA) has issued its annual recommendations for maximum charitable gift annuity rates effective July 1, 2006. The latest recommendations reflect no change in the rates for current gift annuities from the schedule that has been in effect since July 1, 2003. However, ACGA has recommended a slight modification for the rates for deferred gift annuities.

Even though the final recommendations for rates for current gift annuities are unchanged, there were several changes in the assumptions underlying the rates. Interestingly, the changes in these assumptions had the net effect of offsetting each other in arriving at the final recommendations.

Specifically, the life-expectancy assumptions were changed by using a two-year instead of a one-and-a-half year setback to the female mortality expectations under the Annuity 2000 Mortality Tables. In addition, the assumed total return on the investment of gift annuity reserves increased from 6% to 6.25%. This change in the assumed total return—along with an assumption that the same return will be achieved throughout the total deferral period rather than decreasing after 20 years—is responsible for the change in the deferred gift annuity rates.

Following are recommended current gift annuity rates at representative ages:

One Life		*Two Lives*	
AGE	RATE	AGES	RATE
55	5.5%	55-55	5.0%
60	5.7%	60-60	5.4%
65	6.0%	65-65	5.6%
70	6.5%	70-70	5.9%
75	7.1%	75-75	6.3%
80	8.0%	80-80	6.9%
85	9.5%	85-85	7.9%
90	11.3%	90-90	9.3%

For more information about charitable gift annuities, visit the ACGA Web site at www.acga-web.org.

DIRECTING IRD TO CHARITY: A PAIR OF POSITIVE RULINGS

Many taxpayers and their advisors are aware of the benefits of funding testamentary charitable gifts with items constituting income in respect of a decedent (IRD). ***Reason:*** The recipient of IRD has to include it in gross income. If noncharitable beneficiaries receive other assets, they will face no income-tax liability; and the IRD will generate no tax for a tax-exempt charity.

While this concept is straightforward, it is not always completely clear who or what entity should be treated as the recipient of the IRD. This is particularly true if items of IRD first pass to a decedent's estate. A pair of recent private letter rulings found that the decedents' estates were not liable for income tax on the IRD even though the path of the IRD to charitable beneficiaries was less than crystal clear. In both of these situations, the decision ultimately turned on an interpretation of whether there had been a "transfer" of IRD by the decedent's estate.

IRC §691(a)(1) provides, generally, that IRD that is not properly includible in the decedent's final income-tax return should be included in the gross income of

The Tax Relief Act of 2001
Impact on Estate and Gift Planning

Fewer and fewer estates will be affected by the federal estate tax for the rest of this decade as the exemption-equivalent amount climbs to $3.5 million in 2009 (see chart at right). The tax is repealed for the year 2010. But unless repeal or higher exemption amounts are **re-enacted** into law at that time, the estate tax of 2001 will be back in full force in 2011 with a $1 million exemption.

Rate and Exemption Schedule

Calendar Year	Exemption	Highest Tax Rate
2006	$2 Million	46%
2007	$2 Million	45%
2008	$2 Million	45%
2009	$3.5 Million	45%
2010	Estate Tax Repealed	
2011	$1 Million	55%

the estate of the decedent if the right to receive the amount is acquired by the decedent's estate from the decedent. In addition, IRC §691(a)(2) provides, generally, that if an estate transfers the right to receive the IRD, the estate must include in gross income the fair-market value of the item transferred.

However, "transfer" does not include "transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent."

In Ltr. Rul. 200617020, a decedent's executor proposed to use the decedent's IRA—which named the estate as beneficiary—to satisfy the amount due a charity as a residuary beneficiary under the decedent's will. The will expressly provided that the executor would have the power "to make payment, division, or distribution required by this will, either in cash or in kind, or partly in each, in such manner and such proportions as they shall deem appropriate, either with or without regard to the income-tax consequences of any such sale to my estate or the income-tax consequences of any such distribution to the beneficiary or beneficiaries receiving such property."

The IRS concluded that the executor had the power to satisfy the interest of the charity with the IRA assets and that the assignment of the IRA to charity would not be a transfer within the meaning of IRC §691(a)(2). As such only the charity would be required to include the amounts of IRD in the IRA in its gross income when the distribution is received by the charity.

The connection between IRD and a charity was even more elusive in Ltr. Rul. 200618023. In that case, the decedent died owning a nonqualified deferred annuity contract that had not yet reached its annuity starting date. Since the decedent did not name a beneficiary of the annuity, the executor contended that the annuity passed to the estate.

The executor also proposed to assign the annuity to named charitable beneficiaries. The will did not specifically provide that the executor had the power to make in-kind or non pro rata distributions, but the executor represented that applicable state law grants such power.

The ruling noted that the amount received by a beneficiary of a deferred annuity contract is, indeed, IRD under Rev. Rul. 2005-30, 2005-20 I.R.B. 1015. Accepting the executor's representation that state law grants the authority to make in-kind and non pro rata distributions, the ruling follows the logic of Ltr. Rul. 200617020 to conclude that assigning the annuity contract to the charities does not constitute a transfer within the meaning of IRC §691(a)(2). Accordingly, the IRD will be includable only in the gross income of the charities.

BRIEFLY…

Trust Is Split-Interest; Deduction Denied. Despite vigorous arguments to the contrary by a trustee, the U.S. District Court for the Western District of Pennsylvania has determined that a decedent's trust does constitute a split-interest trust that fails to meet the requirements for a charitable estate-tax deduction (Edmond C. Galloway v. United States; No. 05-50). IRC §2055(e)(2) is quite clear that in order for an estate to receive a deduction for a charitable interest in a split-interest trust, it must be in the form of a charitable remainder annuity trust, charitable remainder unitrust, or pooled income fund in the case of a remainder interest or in the case of any other interest, in the form of a guaranteed annuity or fixed percentage of the fair-market value of the property, determined yearly.

Rather than trying to argue that the trust in question constitutes one of these exceptions, the plaintiff instead chose to argue that the trust was not really a split-interest trust. It provided

E-Mail Discussion Lists for Gift Planners

- **ABA-TAX** A tax-law Internet discussion group sponsored by the American Bar Association Tax Section. Participation is limited to practitioners, law professors, and law students. http://www.abanet.org/tax/lsinfo.html
- **ABA-PTL** Sponsored by the Probate Division of the Real Property, Probate & Trust Law Section of the American Bar Association, intended primarily for the use of Section members and related professionals so they can discuss estate-planning and administration issues by e-mail. http://mail.abanet.org/scripts/wa.exe?SUBED1=aba-ptl&A=1
- **FUNDSVCS** Fund-raising services technical discussion list. http://lists.duke.edu/archives/fundsvcs.html
- **Yahoo PLANNED GIVING** An open list for discussion of gift-planning topics. http://groups.yahoo.com/group/plannedgiving/
- **GIFT-PL** National Committee on Planned Giving members-only discussion list for all issues and queries related to gift planning. http://www.ncpg.org/members/gift_pl.asp?section=4

that upon the death of the decedent—which occurred in 1998—the residue would pass in four equal shares, including two for a child and a grandchild and two for charities. Each beneficiary would get 50% of the anticipated distribution in 2006 and the balance in 2016.

According to the plaintiff, this constituted two separate trusts for all practical purposes, instead of a single trust with both charitable and noncharitable beneficiaries. The plaintiff went on to argue that IRC §2055(e)(2) is ambiguous in that it does not clearly delineate what constitutes a split-interest and suggested that a remainderman is a necessary element of a split-interest trust. To deny the deduction, according to the plaintiff, would be allowing the IRS to elevate form over substance to the extent that the charitable intent of the trust is defeated. The court expressed some sympathy for the plaintiff's arguments but noted that it is the role of Congress "to clarify or amend the plain language of §2055(e) to prevent such results, not this Court."

Disclaimer Saves Deduction. A beneficiary proposes to disclaim his interest in a provision under his father's will that will result in the interest passing to a private foundation of which he is director and president. The beneficiary represents that he has not accepted any interest in or benefit from the interest.

In addition, the private foundation proposed to amend its bylaws to allow the disclaimed interest to be held in a separate fund. The foundation will also create two classes of directors, general directors and special directors, and only the special directors will have any authority over the use and distribution of the assets in the separate fund. The disclaimant will not be allowed to serve as a special director or to participate in the selection of special directors.

The IRS found that the child's disclaimer will be a qualifying disclaimer under IRC §2518 since he has not accepted any benefits of the property and since the foundation has taken steps to prevent him from directing the future use or enjoyment of the property in keeping with §25.2528-2(a)(2) and 25.2518-2(e)(1)(i) of the Gift Tax Regulations. As such, the decedent's estate will be entitled to a charitable estate-tax deduction in the amount of the disclaimed interest. (Ltr. Rul. 200616026).

CRT Can Pay Legal Fees for Division. Over the last several years, the IRS has issued several private letter rulings allowing a single charitable remainder trust with a husband and wife as beneficiaries to be divided into two equal trusts pursuant to divorce. A recent private letter ruling request poses an interesting corollary question: Can the legal fees to accomplish such a division be paid out of trust assets (Ltr. Rul. 200616008)?

The answer, according to this ruling, is yes. In addition to the typical findings approving the division, absolving all entities from any liability for self-dealing, and confirming there is no income-tax liability as a result of the division, the ruling went on to state, "Under §53.49456(b)(2) [of the Foundation and Similar Excise Taxes Regulations], legal and other expenses incurred by Trust to implement the division of the assets of Trust, assuming such expenses are incurred in the good faith belief that they are reasonable and consistent with ordinary care and prudence, will not constitute taxable expenditures under §4945."

__Financial Strategies__ is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep philanthropic planners up to date on developments in estate planning as they relate to testamentary and lifetime plans of support of qualified charities.

UNIVERSITY OF
ROCHESTER
590 Mt. Hope Avenue
Rochester, New York 14620
(585) 273-5930
toll free (800) 635-4672

Edited by André R. Donikian, J.D., and Robert L. Coffman, J.D.
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