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Subject: **General Estate and Gift Tax Developments: February 2006**

1. **Unexercised Spousal Elective Share Rights Will Not Disqualify Charitable Remainder Trust Pending Further IRS Guidance**

Major References: ***Notice 2006-15, 2006-8 IRB 1.***

Prior AALU Washington Reports: *05-74*

2. **Charitable Trust May be Reformed to Meet Requirements for Estate Tax Charitable Deduction**

Major References: ***PLR 200605001***

Prior AALU Washington Reports: *06-09; 04-120; 02-109; 99-23*

3. **Fund Created by Tax-Exempt Organization to Finance Construction Qualifies as a "Pooled Income Fund"**

Major References: ***PLR 200608002*** ***and*** ***PLR 200608003***

This Washington Report summarizes a few of the more important cases and rulings in the estate and gift tax areas which were decided or reported by the courts and the IRS in February of 2006, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

Notice

1. *Notice 2006-15*

The Internal Revenue Service has stated that, until it completes its review and issues further guidance, an unexercised spousal elective share right against a charitable remainder trust will not disqualify the trust. Notice 2006-15 modifies Revenue Procedure 2005-24 (see our Bulletin No. 05-74), in which the IRS stated that such unexercised elective share rights disqualified a charitable remainder trust created on or after June 28, 2005.

Revenue Code Section 664 sets forth the requirements for a qualified charitable remainder trust (CRT), including the requirement that, generally, no amount other than the annuity or unitrust payments, as the case may be, may be paid to or for the use of any person other than a qualified charity. This requirement may be violated, according to the Revenue Service, where state law grants the spouse of a trusts' deceased grantor a right of election against the trust assets. The IRS is currently considering whether the mere existence of the right of election under applicable state law, even if it is not exercised, and the resulting possibility that the CRT may be invaded for the benefit of the surviving spouse may cause the trust to fail to qualify.

Last year, the IRS issued Rev. Proc. 2005-24 in which it provided a "safe harbor" against disqualification for charitable remainder trusts created on or after June 28, 2005. Under the safe harbor, a surviving spouse's right of election would be disregarded, provided that the spouse waived that right**.** For any CRT created prior to June 28, 2005, the IRS stated it would disregard the right of election, even without a waiver, but only if the surviving spouse did not in fact exercise the right of election. *See, e.g.*, discussion of Rev. Proc. 2005-24 in our *Bulletin No. 05-74*.

In response to vociferous comments that the approach of Rev. Proc. 2005-24 placed an undue burden on both taxpayers and trustees, the IRS announced in Notice 2006-15 that it is reconsidering the approach of Rev. Proc. 2005-24. As a result, until the Service publishes further guidance on this matter, it will disregard the existence of such a right of election for all trusts <u>regardless</u> of the date of creation, even without a waiver, but only if the surviving spouse does not in fact exercise the right of election.

Private Letter Rulings

2. *PLR 200605001*

A charitable remainder trust that fails to meet the requirements of IRC Section 664 because interests pass to both charitable and non-charitable beneficiaries may be reformed to qualify for the estate tax charitable deduction.

Under the facts of PLR 200605001, the decedent created a lifetime revocable trust (the "Trust"), the net income of which is payable after decedent's death to the trustee of a trust for the benefit of the testator's son for his life. Under the son's trust, his trustee has the discretion to pay as much of its income or principal to the son as the trustee in the trustee's sole discretion determines is required for his health and welfare. Upon the son's death, the trust property is distributable as follows: (i) Parcel A to named individuals and charities; (ii) Parcel B to named individuals and charities; (iii) Parcel C to named individuals and charities; and (iv) the balance to named individuals. Each of the named charities is a qualified charity within the meaning of Sections 170(c) and 2055(a).

Section 2055(a) allows a deduction from the gross estate for federal estate tax purposes for the value of certain charitable bequests. However, Section 2055(e)(2) disallows the charitable deduction where an interest in the same property passes to both charitable and non-charitable beneficiaries unless, in the case of a

remainder interest to charity, such interest is in the form of a charitable remainder trust (CRT) or a pooled income fund.

A split-interest bequest that is not in one of the required forms may nevertheless be reformed in certain circumstances so that a deduction may be allowed if: (i) any difference between the actuarial value of the qualified (reformed) interest and the actuarial value of the reformable interest does not exceed five percent of the actuarial value of the reformable interest; (ii) in the case of a charitable remainder interest, the non-remainder interest, both before and after the qualified reformation, terminates at the same time; and (iii) such change is effective as of the date of the decedent's death. An interest in a trust is a "reformable" interest only if all payments to non-charitable beneficiaries are "fixed" (*i.e.,* a specified dollar amount or as a fixed percentage of the fair market value of the trust property).

An interest in a split-interest trust that is not otherwise "reformable" may be reformed if a judicial proceeding is commenced to reform the interest not later than the 90th day after the last date (including extensions) for filing the federal estate tax return. *See, e.g.*, PLR 200541038, discussed in our *Bulletin No. 06-09*, TAM 200224006, discussed in our *Bulletin No. 02-109*, PLR 200428013, discussed in our *Bulletin No. 04-120* and PLRs 9851023 and 9852034, discussed in our *Bulletin No. 99-23*.

Since the remainder interests in the Trust passed to both charitable and non-charitable beneficiaries and did not qualify as a CRT or pooled income fund, the personal representative of the decedent's estate commenced a timely judicial proceeding to sever the Trust effective as of the decedent's date of death into two trusts, a charitable trust (the "Charitable Trust") and a non-charitable trust (the "Non-charitable Trust") as follows:

1. Non-Charitable Trust. The Non-charitable Trust will distribute its net income annually to the trustee of son's trust. Upon the death of the decedent's son, if Parcels A, B and C have not previously been sold, the trustee must sell any remaining interests in each property and then must distribute all the remaining trust income and principal (including the proceeds of any sale) to the individuals named in the Trust.

2. Charitable Trust. Each year until the death of the decedent's son, the Charitable Trust will pay an aggregate annuity of five percent of the fair market value of the Trust's assets determined as of decedent's date of death from three separate accounts corresponding to each of the three parcels. The portion of the annuity amount payable from each of these accounts each year will be based on the initial fair market value of each parcel. The annuity amounts will be payable in set percentages to the son and to the respective charities. Upon the death of the decedent's son, if Parcels A, B and C have not previously been sold, the trustee must sell any remaining interests in each property and then must distribute all the remaining trust income and principal (other than any amount due to the son or his estate and the other designated annuity recipients) held in the accounts, including the proceeds of any sale, to the charities as remaindermen.

The Charitable Trust contains language that satisfies the requirements of applicable Treasury regulations under Section 664. In addition, the trustee is precluded from: (i) engaging in any act of self-dealing; (ii) failing to make required annual distributions; (iii) retaining excess business holdings; (iv) triggering the tax on jeopardizing investments ; or (v) making taxable expenditures.

The IRS held that the severance of the Trust into the Charitable Trust and Non-charitable Trust is a qualified reformation because the Trust was a "reformable" trust. The IRS further held as follows:

1. The annuity amount to be paid to the named charities under the Charitable Trust will constitute a guaranteed annuity. Therefore, an estate tax charitable deduction is allowed for the present value of the guaranteed annuity interest in the Charitable Trust.

2. Assuming that the value of the remainder interest is a least ten percent of the initial fair market value of the trust asset, the Charitable Trust will qualify as a charitable remainder annuity trust (CRAT) effective as of the date of decedent's death. Accordingly, an estate tax charitable deduction is allowed for the present value of the remainder interest in the Charitable Trust.

3. *PLR 200608002 and PLR 200608003*

A fund created by a tax-exempt hospital in order to accept donations to facilitate the purchase and renovation of buildings may qualify as a "pooled income fund" under Section 642(c)(5). Additionally, the rental of the buildings and the underlying land by the fund to such organization for a term of years on a net-net basis will be a passive activity under Section 469(c). Finally, the building is tax-exempt use property under Section 168(h)(1)(B) and must be depreciated using a straight-line method.

PLRs 200608002 and 200608003 are identical letter rulings wherein a hospital that is tax-exempt (the "Hospital") creates a pooled income fund (the "Fund") in order to accept donations to facilitate the purchase and renovation of buildings. The Fund will liquidate contributed property and use the proceeds thereof to purchase and renovate the buildings and to lease the underlying land (together, the "property") from the Hospital for a term of 25 years. Each income beneficiary of the Fund will share in the net rental income according to his or her *pro rata* participation in the Fund.

Section 642(c)(5) and applicable Treasury regulations define a "pooled income fund" as a trust set up by a tax-exempt organization to which a donor contributes property and retains an income interest for the life of one or more beneficiaries living at the time of the transfer, with an irrevocable remainder interest given to the tax-exempt organization. Although the Internal Revenue Service will generally decline to rule on the transfer tax consequences of pooled income funds, it will rule where, as in PLRs 200608002 and 200608003, the provisions of the pooled income fund differ substantially from the sample provisions provided in Rev. Proc. 88-50.

The IRS held that the following provisions of the declaration of trust for the Fund will not adversely affect the qualification of the Fund as a pooled income fund assuming it otherwise qualifies as such:

1. Income for a quarter in which an income beneficiary dies that is attributable to the interest of decedent-beneficiary must be prorated to the date of death;

2. Any depletion and depreciation in excess of the reserves established and maintained for any Fund property by setting trust income aside must be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each;

3. Donor may, by Will, revoke or terminate the income interest of any designated beneficiary other than the Hospital; and

4. Hospital may amend, in whole or in part, any provision of the declaration of trust, other than an amendment that would jeopardize the Fund's status as a pooled income fund.

The Service determined that the rental of the buildings and underlying land by the Fund to the Hospital will be a passive activity as defined under Section 469(c). That Code section disallows the current use of "passive activity losses" (*i.e.*, excess of a taxpayer's losses from passive activities over income from such passive) and "passive activity credits" (*i.e.*, the excess of a taxpayer's credits from passive activities over the taxpayer's tax liability allocable to such activities) during a taxable year. A “passive activity is defined as (1) an activity that involves the conduct of a trade or business in which a taxpayer does not

materially participate and (2) all rental activities, regardless of whether the taxpayer materially participates therein. A disallowed passive activity loss or credit may be carried forward to the next taxable year and used to offset the taxpayer's income and taxes from passive activities. The disallowed losses and credits may also be used to offset compensation, active business and portfolio income if the taxpayer subsequently disposes of his or her entire passive activity interest in a fully taxable transaction.

As a result, if in any taxable year the Fund's has a passive activity credit, the amounts distributed from the Fund that are includable in the gross income of the Fund's income beneficiaries for that year will be income from a passive activity to each beneficiary in the same proportion as to the Fund.

The IRS also concluded that the buildings in PLRs 200608002 and 200608003 is "tax-exempt use property," and thus must be depreciated using a straight-line method, a mid-month convention and a recovery period of 40 years. The IRS noted that the depreciation deductions will be allocated to the Fund's income beneficiaries to the extent that such depreciation deductions exceed the Fund's depreciation reserve.

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