

[Jen Wickham](#) - Tue, 3/10/2015 - 11:43

PG Calc summary This revenue ruling imposes the 5% probability test for charitable remainder annuity trusts. IRS Headnote Charitable transfer; trust remainder; reformed to protect corpus. No deduction is allowable under section 2055 of the Code for a charitable remainder trust that, pursuant to the provisions of section 2055(e)(3), was amended and reformed to meet the conditions of section 20.2055-2(b)(1) of the regulations requiring that only a negligible chance exist that the charitable transfer will not become effective. Full Text Rev. Rul. 77-374 Advice has been requested whether a charitable deduction is allowable under section 2055 of the Internal Revenue Code of 1954 with respect to a remainder interest in a trust that was amended, pursuant to the order of a local court, under the circumstances described below. The decedent died testate on June 15, 1973. Under the terms of the will, executed on September 15, 1972, the decedent bequeathed the residue of the probate estate, valued at \$400,000, in trust. The trustee was directed to pay to W, a female aged 61 years, \$40,000 each year during W's lifetime. The trust was to have terminated upon the death of W, at which time the principal and any accumulated income would be paid to an organization considered charitable under sections 170(c), 2055(a), and 2522(a) of the Code. On March 15, 1974, the executor of the decedent's estate filed the Federal estate tax return in which a charitable deduction was claimed in respect of the trust. Six months thereafter, the Internal Revenue Service disallowed the charitable deduction because, in view of W's age and the size of W's annuity, a distinct possibility existed that no trust assets would remain available to charity at W's death. The possibility that W's annuity might entirely consume the trust assets was not so remote as to be a negligible possibility. Section 2055(e)(3) of the Code was enacted on October 26, 1974, to provide for amendment of certain governing instruments in order to qualify charitable remainder interests passing thereunder for a charitable deduction for Federal estate tax purposes. Shortly thereafter, on December 5, 1974, the executor of the estate, the trustee of the trust, and W obtained from the local probate court an order amending and reforming the trust to provide that W shall receive a reduced annuity of only \$28,000 each year during W's lifetime. After the trust was amended, W repaid to the trustee the excess of the amount of the annuity that W had received during the prior year over the amount receivable under the amended trust. Section 2055(a) of the Code provides that for purposes of the estate tax, the value of the taxable estate shall be determined by deducting from the value of the gross estate

the amount of all bequests, devises, or transfers to or for the use of charity. Any property interest which increases a charitable bequest as the result of an irrevocable disclaimer of a noncharitable bequest, legacy, devise, transfer, or power will qualify for the charitable deduction "if the disclaimer is made before the date prescribed for the filing of the estate tax return." Section 2055(e) of the Code provides, with certain exceptions, that where interests in the same property pass from the decedent to charity and to persons or for uses not qualified as charitable, the charitable deduction is disallowed unless, in the case of a charitable remainder interest, that interest is in a charitable remainder annuity trust or charitable remainder unitrust (described in section 664), or in a pooled income fund (described in section 642(c)(5)). The above requirement with respect to charitable remainder interests is set forth in section 2055(e)(2)(A). If however, a deduction is not allowable because of the requirements of section 2055(e)(2)(A), a deduction may nevertheless be allowable in certain cases pursuant to section 2055(e)(3). Section 2055(e)(3) of the Code provides, in pertinent part, as follows: In the case of a will executed before December 31, 1977, or a trust created before such date, if a deduction is not allowable at the time of the decedent's death because of the failure * * * to meet the requirements of subparagraph (A) of paragraph (2) of this subsection, and if the governing instrument is amended or conformed on or before December 31, 1977, or, if later, on or before the 30th day after the date on which judicial proceedings begun on or before December 31, 1977 * * * become final, so that the interest is in a trust which is a charitable remainder annuity trust * * * a deduction shall nevertheless be allowed. * * *. Section 20.2055-2(a) of the Estate Tax Regulations provides that if a trust is created or property is transferred for both a charitable and a private purpose, deduction may be taken of the value of the charitable beneficial interest only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest. Section 20.2055-2(b) of the regulations provides that in the case of a charitable transfer subject to a condition, no deduction is allowable "unless the possibility that the charitable transfer will not become effective is so remote as to be negligible." Section 24.1(c) of the Temporary Estate Tax Regulations describes those situations where a charitable deduction may be obtained by amending a governing instrument pursuant to section 2055(c)(3) of the Code. Section 24.1(c) states, however, that "a governing instrument may not be amended pursuant to this section unless, at the time of the decedent's death, the interest is an irrevocable remainder interest for which a deduction, but for section 2055(e)(2)(A), would be allowable under section 2055(a) and the regulations thereunder." Under section 2031 of the Code and section 20.2031-10 of the regulations, an interest rate of six

percent per annum is used for valuation purposes with respect to decedents dying after December 31, 1970. See also section 1.664-4(a)(1)(ii) of the Income Tax Regulations. A fund of \$400,000, invested at 6 percent per annum, yields \$24,000 each year. Therefore, the trustee of the charitable remainder annuity trust would have been required to invade trust principal each year in order to provide W with the \$40,000 annual payment originally provided in the decedent's will. The principal of the trust must also be invaded, but to a lesser extent, to provide W with the reduced annuity of \$28,000 that she is now entitled to receive under the amended trust. The mathematical formula used to determine the number of years it will take to completely exhaust a fund with an initial value of \$400,000, invested at 6 percent per annum, that is subject to fixed annual payments of \$40,000 out of both income and principal is: $1.06 \times \$400,000$ (initial value of corpus) - \$40,000 (fixed annual payment) = \$384,00 (value of corpus at end of year after first invasion). By a series of similar successive computations (that is: $1.06 \times \$384,000$ (value of corpus at end of first year) - \$40,000 (fixed annual payment) = \$367,040 (value of corpus after second invasion), it was determined that the original fund of \$400,000 would be completely exhausted in less than sixteen years. Based on Table LN, which is found in section 20.2031-10(e) of the regulations, the probability that a female aged 61 will be alive sixteen years hence--or stated otherwise, the probability that a female aged 61 will survive to age 77, is greater than 63 percent. See example 12 contained in I.R.S. Publication 723A (12-70), "Actuarial Values II: Factors at 6 Percent Involving One and Two Lives." As set forth in Rev. Rul. 70-452, 1970-2 C.B. 199, the charitable deduction is not allowable where the probability exceeds 5 percent that a noncharitable beneficiary will survive the exhaustion of a fund in which charity has a remainder interest. Any possibility in excess of 5 percent that the contingency will occur and defeat charity's interest is not considered so remote as to be negligible within the meaning of section 20.2055-2(b) of the regulations. In this connection, see sections 2037 and 2042 of the Code which specify that 5 percent is the value at which a reversionary interest will be considered significant. The charitable deduction was disallowed in *Moffett v. Commissioner*, 269 F. 2d 738 (4th Cir. 1959), where the probability that the fund would be exhausted was 19 percent, and *United States v. Dean*, 224 F.2d 26 (1st Cir. 1955), where the probability was 9 percent. Section 2055(e)(3) of the Code states only that a trust instrument can be amended if no deduction is allowed because the instrument fails to meet the requirements of section 2055(e)(2)(A), which states that a charitable remainder trust must be in the form of an annuity trust, a unitrust or a pooled income fund. In neither an annuity trust, a unitrust nor a pooled income fund must the noncharitable beneficiary

receive an amount less than the amount that would deplete the trust prior to the death of the noncharitable beneficiary. Sections 1.664-2, 1.664-3, and 1.642(c)-5 of the Income Tax Regulations. Thus, an amendment of a trust to meet the requirement of section 20.2055-2(b)(1) of the Estate Tax Regulations requirement that only a negligible chance exist that the charity will receive nothing is not a change within the purview of section 2055(e)(3) since the purpose of such a change is not compliance with the section 2055(e)(2)(A) requirements. Additionally, the Senate Finance Committee Report states that the purpose of section 2055(e)(3) of the Code was merely to extend the cut-off date of the Treasury Regulation transitional rules that allow trusts to be amended to comply with the new requirements added by the Tax Reform Act of 1969. S. Rep. No. 93-1063, 93d Cong., 2d Sess. 3 (1974). The Conference Committee report contains a similar statement. H.R. Rep. No. 73-1405, 93 Cong., 2d Sess. 3 (1974). Therefore, to interpret section 2055(e)(3) as affording trusts an opportunity to achieve compliance with the long-standing requirement of section 20.2055-2(b)(1) of the regulations would be inconsistent with its legislative history. Accordingly, no deduction is allowable under section 2055 of the Code for the amended charitable remainder annuity trust in this case.

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