Exiting the Underproductive CRT

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When I gave a similar talk at the national conference in Cincinnati in October of 2003, we were just coming out of a rather brief recession that had followed the "irrational exuberance" of the 1990s and the peak of the so-called dot.com bubble in Y2K.

While the equities markets had begun to recover some of the ground they had lost, the federal funds rate had dropped to 1.0 pct. from a high of 6.5 pct. in May of 2000, and the section 7520 rate, on which annuity and unitrust interests are valued for tax purposes, had fallen to a then-historic low of 3.0 pct. from a high of 8.2 pct. in March of 2000, and was only beginning to climb back, eventually peaking at 6.2 pct. in August of 2006.

Today, more than four years after the financial collapse of 2008, while the equities markets, again, have recovered almost all of their lost ground, the federal funds rate, which had climbed back to 5.25 pct. in June of 2006, is now expressed as a "target range" somewhere around or even below 0.25 pct., and the Federal Reserve has entered at least its third round of "quantitative easing," buying up longer term and selling off shorter term Treasuries to put downward pressure on long term interest rates.

The section 7520 rate hit yet another historic low at 1.0 pct. in August of 2012, and as this paper goes to press, the announced rate for September is again 1.0 pct.

Net asset values in charitable remainder trusts have also fallen, although the available data are incomplete. According to IRS statistics of income reports, the decline in 2009 was about 1.7 pct. in unitrusts and about 5.6 pct. in annuity trusts. In 2010, unitrust net asset values fell another 2.5 pct., for an aggregate loss since 2008 of 4.18 pct.

Net asset values in annuity trusts actually increased marginally in 2010, but the absolute number of annuity trusts fell by nearly twelve pct. over those two years, so it is possible these figures reflect the fact that some number of CRATs simply crashed.

As net asset values fall, of course, unitrust payouts will suffer corresponding declines. And the damage a fixed annuity payout can do to a trust in a falling market may be irreparable.

Meanwhile, the recession has also taken a toll on charities themselves. A study published earlier this year by the National Association of College and University Business Officers (NACUBO) showed that endowments within that sector had returned minus 18.7 pct., net of fees, in fiscal 2009, and while net returns over the next two fiscal years were 11.9 pct. and 19.2 pct.,

> "returns were still below the average inflation-adjusted spending rates of educational institutions, indicating that the damage inflicted by the downturn is still being felt."

And although 2011 saw a slight rebound from two years of sharp declines, total contributions were still down nearly four pct. from 2007 in current dollars, and more than eleven pct. after adjusting for inflation. The Indiana University Center on Philanthropy predicted it might take "more than a decade to get back to where we were" before the financial collapse.

Our conversation today about "exiting the underproductive CRT" takes place in this context.

What we are talking about

In 2003, I introduced my talk with a little story, to frame the discussion. I tried to keep it simple, even naming the characters Richard and Jane.

I had Richard in an eight pct. NIMCRUT funded with an illiquid property. Post-contribution gains were defined as income, so when the property sold not long after the trust was set up, the modest accumulated arrearage, or make-up amount, was distributed.

But then the proceeds were invested in a balanced portfolio yielding only about 1.5 pct. currently, the payout to Richard dropped, and the arrearage began to accumulate in earnest.

Fortunately, when the Treasury adopted regulations in 1998 permitting a NIMCRUT to be "flipped" to a straight CRUT, Richard took advantage of the opportunity, and he began receiving a straight unitrust payout of eight pct. of corpus, most of it taxed as pre-contribution gain.

"But," the story continued, "with the recent decline in the stock market, the amount of the unitrust payout has been trending downward dramatically."

And this was where Jane, the planned giving director in the development office at the university that was designated to receive the trust remainder, came in. The story portrayed her engagement as a matter of stewardship and of networking with advisors.

Jane suggested three possibilities, and these are again the subject of our conversation today:

one, a commutation, in which Richard and the university would each receive the present value of their respective interests in the trust, or

two, a surrender of his unitrust interest, either as an outright gift to the university, or

three, in exchange for a gift annuity.

Typical scenarios in which this conversation might arise include not only those suggested in the story, *i.e.*,

- a relatively high stated unitrust or annuity payout,
- principal balances trending down,

but also

- a NIMCRUT with no "flip" provision or with the triggering event unlikely to occur,

- the reduced life expectancy of a contingent successor income beneficiary (albeit not the current beneficiary, for reasons we will explore shortly),

and of course

- the immediate needs of the charitable remainderman superseding those of the income beneficiary.

An aside

Our conversation in 2003 was to some extent focused on this latter transaction, *i.e.*, the surrender in exchange for a gift annuity, which had then been the subject of a recent letter ruling. We put some numbers to it, and we will put some numbers to it today, but let me just mention at the outset that a couple of things have changed.

In the continuing aftermath of the financial meltdown of 2008, the American Council on Gift Annuities has lowered its recommended gift annuity rates several times. But much more significantly, in April of 2011 the ACGA adopted a policy that the present value of the residuum at the time the contract is issued should be not just ten pct., as required by the acquisition indebtedness rule of section 514(c)(5), but at least twenty pct. of the amount transferred.

With the section 7520 rate down at, say, 1.4 pct., where it has been for most of the past year, an annuity paid at the lowered ACGA recommended rates at most ages would meet the ten pct. requirement, but would fail the twenty pct. requirement for anyone aged 59 or younger. And with the section 7520 rate falling to 1.0 pct., where it was when I was writing this paper, an annuity paid at the ACGA recommended rate of 4.4 pct. to an annuitant aged 61 would fail the twenty pct. requirement, and an annuity paid at the recommended rate of 3.9 pct. to an annuitant aged 53 would fail even the 10 pct. requirement.

Another aside

Not so very long ago, it was not uncommon to see unitrusts with rather high payout rates. Many of these had been "oversold" by aggressive investment managers, often in conjunction with "replacement" life insurance trusts. In a down market, the settlors or other life or term beneficiaries may have become disillusioned with these, particularly if there is a net income limitation and not much prospect of ever recovering the accumulated arrearage.

To put this in perspective, fully 13.5 pct. of unitrusts filing returns for tax year 2009 had stated payout rates of 10 pct. or higher. A small handful of filers, 4.8 pct., were net income trusts without makeup, while just over one-sixth, 17.3 pct., were NIMCRUTs.

More than two-thirds of all unitrusts, 69.4 pct., reported net assets under $500k, while about 3.9 pct. reported net assets of $3 million or more. And more than a quarter of these very large unitrusts, 26.9 pct., were NIMCRUTs.

A brief overview

Back in 2003, there were about a dozen private letter rulings dealing with various forms of this transaction, from which we drew the following tentative conclusions:

(a) assuming Richard had not created the split interest trust for the purpose of evading the partial interest rule of section 170(f)(3)(A), and

(b) assuming there is no reason to believe Richard's life expectancy at the time of the transaction is less than would be indicated for a person of the same age under the tables set forth at Reg. 1.72-9, then

[in the case of a surrender]

(c) if Richard were to surrender a portion or all of his unitrust interest to the remainder charity outright, then

(d) he could claim a charitable contributions deduction, both for income tax purposes and for gift tax purposes, in the amount of the present value of the surrendered interest, determined using the "section 7520" rate in effect at the time of the surrender, and

(e) he would not recognize undistributed gains accumulated in prior years, or

[in the case of a commutation]

(f) if instead Richard took distribution of the present value of his unitrust interest, determined using the "section 7520" rate in effect at the time of the transfer, or of a portion of that interest, and the remainder charity took distribution of the present value of the remainder, or of a corresponding portion of the remainder,

(g) he would recognize long-term capital gain in the full amount he received, treating his basis in the unitrust interest as zero, or

[in the case of a surrender in exchange for a gift annuity]

(h) if instead Richard surrendered his unitrust interest to the remainder charity in exchange for a gift annuity,

(i) he would recognize long-term capital gain under the "bargain sale" rules of section 1101(b) in the amount of the present value of the gift annuity, ratably over the period of years measured by the expected return multiple, from that portion of the annuity payout that was treated as a return of his investment in the contract, *i.e.*, the present value of the unitrust interest, determined using the "section 7520" rate in effect at the time of the transfer.

In addition, although the point was not covered in any of the rulings, we speculated that

(j) if the interest Richard was surrendering was in an annuity trust rather than a unitrust, his deduction probably would be limited to the lesser of the present value of the unexpired annuity or the current principal balance of the trust,

cf. Reg. 25.7520-3T(b)(2)(v), example 5, illustrating the calculation of the value of an annuity where the payout expressed as a percentage of corpus exceeds the then-current section 7520 rate.

[in the case of a partial surrender or commutation]

In the case of a partial surrender or commutation, several rulings cited Reg. 1.664-3(a)(4) as in effect requiring that

> (k) the assets surrendered or distributed be "fairly representative" of the adjusted basis of all assets in the trust.

The regulation permits the trust instrument to provide for current distributions, apart from the unitrust payout, to an exempt entity, provided that if the distribution is made in kind, "the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment." There is a similar provision at Reg. 1.664-2(a)(4) with respect to annuity trusts.

The net income limitation

At the time, there was exactly one ruling, PLR 200205008 (10/23/01), suggesting that

> (l) if the NIMCRUT had not flipped to a straight CRUT, Richard's deduction on a surrender of his interest to the remainder charity might have been limited to the lesser of the present value of the specified eight pct. unitrust payout or of a straight income interest, determined using the "section 7520" rate in effect at the time of the surrender or transfer.

There were at least two earlier rulings in which this "lesser of" limitation had not been mentioned -- PLR 9550026 (09/18/95), a partial surrender of a nine pct. net income trust without makeup, and PLR 9721014 (02/19/97), a full surrender of a five pct. net income trust with makeup -- but then, at the time each of these rulings was requested, the section 7520 rate was higher than the stated unitrust payout rate.

So it was perhaps premature to speculate. And over the next few years, there were several rulings concerning net income trusts that did not expressly impose such a limitation -- even in the context of a commutation, where the question, as we shall see, becomes one of self-dealing. Specifically,

e. in PLR 200208039 (11/29/01), the Service ruled that the proposed judicial commutation of an eight pct. NICRUT (without makeup), with actuarial values calculated "using the methodology under section 1.664-4 of the regulations," would not be an act of self-dealing. "The critical question," the ruling said,

> is whether early termination may be expected to result in a greater allocation of the trust assets to the income beneficiary, to the detriment of the charitable beneficiary, than a non-early termination. The possibility of gamesmanship by the income beneficiary and whipsawing of the Service exists here.

Nonetheless, the ruling concluded that this concern was sufficiently addressed by affidavits from both the beneficiary and his physician that he had no medical condition that would suggest a shorter life expectancy than set forth in the Reg. 1.72-9 tables.

To put the references to "gamesmanship" and "whipsawing" in some context:

- when the ruling was requested in June of 2000, the section 7520 rate was still at eight pct., but
- it fell to 7.6 pct. two months later, and it was down to five pct. when the letter was finally issued in November of 2001,
- the taxpayer was the last survivor of several successive income beneficiaries, and most significantly,
- the trust was invested for total return and was yielding less than three pct. current income.

Similarly,

f. in PLR 200304025 (10/23/02), the joint settlors of a five pct. NIMCRUT (with makeup) had partitioned the trust into two trusts, allocating assets equally between them in a manner that was represented to be "fairly representative of adjusted basis," and they proposed to commute their unitrust interests in one of these trusts, with actuarial values calculated "using the methodology under section 1.664-4 of the regulations."

When the ruling was requested in January of 2002, the section 7520 rate was 5.4 pct., but by the time the ruling was issued in October it had fallen to 4.2 pct. The Service ruled the commutation would not be an act of self-dealing. Nothing was said about "gamesmanship" or "whipsawing."

However, although the taxpayers had apparently not asked, the Service did also rule that the transaction would be treated as a sale of their unitrust interests to the remainderman, that their basis was zero, and that they therefore would recognize long-term capital gain in the full amount that they were to receive in the transaction.

No formal authority was cited for these conclusions. See the discussion of "commutation as a capital transaction," below.

In the context of outright surrenders,

g. in PLR 200524014 (03/15/05), the settlor of ten pct. NIMCRUT (with makeup) proposed to divide the trust into two trusts, allocating assets proportionately between them in a manner that was represented to be "fairly representative of the aggregate adjusted bases of [the trust's] assets and their overall appreciation or depreciation," and to accelerate the remainder of one of the trusts to a private operating foundation of which he was both a manager and a substantial contributor.

The Service ruled:

(1) that the reformation of the trust instrument necessary to accomplish the transaction would not disqualify the trust under 664(d)(2),
(2) that the taxpayer could claim charitable contributions deductions for both income and gift tax purposes in the amount of the present value of his unitrust interest,
(3) that the taxpayer would not recognize undistributed gains accumulated in prior years, and

(4) that the transaction would not be treated as a direct or indirect act of self-dealing.

Nothing was said about the taxpayer's life expectancy, and nothing was said about the spread between the stated unitrust payout rate and the section 7520 rate, which was considerably lower than ten pct. Instead, the ruling concluded simply:

> we express no opinion as to the method of determining the present value of the unitrust interest [ ] for purposes of calculating the amount of the income and gift tax charitable deductions[.]

h. an essentially identical ruling, PLR 200525008 (03/15/05), substituted the gender of the personal pronouns throughout.

Similarly,

i. in PLR 200808018 (11/07/07), the taxpayer had created a seven pct. flipCRUT (with makeup), apparently for a term of years, with a contingent payout at his death to a "family trust." The triggering event had apparently not yet occurred. Again, the taxpayer proposed to partition the trust and to accelerate one of the trusts to the remainderman, in this case a public charity. The "family trust" was to seek approval of a state court to renounce its interest.

Again, the Service ruled the taxpayer would be entitled to claim income and gift tax deductions in the amount of the present value of the unitrust interest, but again it expressly withheld comment on how that value was to be calculated, concluding nonetheless that the transaction would not constitute an act of self-dealing.

Self-dealing of the third kind

A series of three related rulings brought the question of self-dealing into sharper relief.

The facts as recited in PLR 200525014 (03/30/05) involved a fifteen pct. NICRUT (without makeup) payable to the settlors for their joint lives, with the remainder to a private nonoperating foundation of which they were substantial contributors, subject to a reserved power to redesignate.

The taxpayers proposed to effect a judicial commutation, with the consent of the state attorney general, "using the methodology under [Reg.] 1.664-4" to value the income and remainder interests. The closely held stock with which the trust had been funded had been sold, and "the purpose of [the trust,] to provide management over the trust assets, no longer exist[ed]."

The taxpayers conceded that the transaction was to be treated as a sale of their unitrust interests to the remainder charity, and that the entire proceeds would be recognized as long term gain, with no offsetting basis.

Nothing was said about the trust not having been created for the purpose of evading the partial interest rule. Both settlors and their physicians submitted affidavits that neither had a medical condition that would suggest a shorter life expectancy than set forth in the Reg. 1.72-9 tables.

The Service ruled that the proposed commutation would not constitute an act of self-dealing by the trustee, by either settlor with respect to either the trust or the foundation, or by any foundation manager, and that no foundation termination tax would be incurred.

Nine months later, the ruling was revoked by PLR 200614032 (01/09/06), with no explanation given, and replaced by PLR 200616035 (01/25/06), reciting somewhat confusingly altered facts -- there was now only one settlor and a single life payout, and the reserved power to redesignate the remainder beneficiary had been exercised in favor of a number of public charities. Apparently it was this latter change that allowed favorable rulings on the self-dealing issues.

This series of rulings might have been understood to imply a determination that a deemed sale to a private nonoperating foundation with respect to which the remainder trust beneficiary is a disqualified person is *per se* self-dealing, for which purpose it is "immaterial whether the transaction results in a benefit or a detriment to the private foundation," per Reg. 53.4941(d)-1, despite the exception at Reg. 53.4947-1(c)(2) for amounts payable under the terms of a split interest trust to the noncharitable beneficiary.

But in retrospect, at least, a more likely interpretation is that these rulings were the last straw, forcing IRS to rethink the question of how to value the interests in a net income unitrust, at least in the context of a commutation.

A steep learning curve

The turning point seems to have come with PLR 200725044 (03/27/07).

The case was factually very similar to PLR 200616035 (01/25/06), above -- a ten pct. NIMCRUT (with makeup), remainder to a private nonoperating foundation, subject to a reserved power to redesignate. The settlor had proposed a nonjudicial commutation, again "using the methodology under section 1.664-4 of the regulations" to value the income and remainder interests.

But before the IRS would issue a favorable ruling, the taxpayer was called upon not only to exercise his reserved power to redesignate the remainder to one or more public charities, but also to concede that

> contrary to the formula assumed in [the ruling request], the payout rate to be used in calculating the respective interests [in the unitrust] will be the lesser of the [section] 7520 rate in effect at the time or termination of the trust and the stated interest rate of [ten pct.]

In the legal "analysis" section of the ruling, the author explained that in order to bring the distribution to the noncharitable beneficiary within the exception at Reg. 53.4947-1(c)(2)(i) from self-dealing, it would be necessary to use a "reasonable method" of calculating the actuarial value of his interest that "does not inappropriately inflate" that value "to the detriment of the charitable remaindermen." And "[o]ne reasonable method" would be to use a "special factor," modifying the methodology of Reg. 1.664-4(a)(3) to assume that the stated payout was

> a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the section 7520 rate for the month of termination.

At the time, the section 7520 rate was 5.8 pct.

The use of this "special factor," the author suggested, was "indicated" by Reg. 1.7520-3(b)(1)(ii), which says the standard section 7520 rate may not be used to value a "restricted beneficial interest," defined as

> an annuity, income, remainder, or reversionary interest that is subject to a contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances.

Yet another aside

It might be observed that the author stopped somewhat short of saying the net income limitation was in fact a "restriction" for purposes of Reg. 1.7520-3(b)(1)(ii), or that a deviation from the standard section 7520 rate was in fact required. What he said was that an advance ruling would not be issued except on the assumption the "special factor" would be used.

The example given at Reg. 1.7520-3(b)(4), example 2, is the shortened life expectancy of an individual who has been diagnosed with a terminal illness "and there is at least a 50 percent probability of the individual dying within 1 year." This formulation reflects the substantive provision at Reg. 1.7520-3(b)(3), which, however, makes an exception if the individual in fact survives the transfer by at least eighteen months.

These provisions were added to the regulation in 1995 by TD 8630, after the IRS found itself on the wrong end of a valuation dispute.

In Estate of McLendon v. Commissioner, 135 F.3d 1017 (5th Cir. 1998), the decedent had transferred his interest in various partnerships to his son and an irrevocable trust in exchange for annuity contracts valued using the table rates, which projected a life expectancy of fifteen years, despite the fact he was dying of esophogeal cancer.

At the time, the controlling authority was Rev. Rul. 80-80, 1980-1 C.B. 194, which said you had to use the tables unless death was "clearly imminent," and death was not "clearly imminent" if there was "a reasonable possibility of survival for more than a very brief period," and specifically death was not "clearly imminent" if the possibility you might survive a year or more was "not so remote as to be negligible."

This in itself was a retreat, in the face of adverse court rulings, from Rev. Rul. 66-307, 1966-2 C.B. 429, which had said you could not use the tables in valuing a life estate if you knew the life tenant had a terminal illness and could not survive "for more than a brief period of time."

At the time the decedent in Estate of McLendon made the transfer, he was in "complete remission," and his doctors were giving him a ten pct. chance of surviving at least a year. In fact he died within a few months after the transfer.

The Tax Court agreed with the Commissioner that it was not appropriate to use the tables to value the annuities. The 5th Circuit reversed, saying a ten pct. chance of survival was not "negligible" and the taxpayer was entitled to rely on the published revenue ruling.

Shortly after the regulations were revised in 1995, the two earlier revenue rulings were obsoleted by Rev. Rul. 96-3, 1996-1 C.B. 348, which simply refers to the revised regulations.

With one exception, discussed below, in each of the letter rulings we are looking at today the taxpayer represented that there was no reason to believe her life expectancy at the time of the transaction was less than would be indicated for a person of the same age under the tables set forth at Reg. 1.72-9. But on its face, Reg. 1.7520-3(b)(1)(ii) does not require this.

Note also that while section 7520(b) requires that exceptions from the application of the standard discount rates be prescribed by regulation, Reg. 1.7520-3(b)(5) purports to allow for "additional exceptions" from those enumerated in that regulation. But these are to be provided through formal guidance, which has not yet been forthcoming.

Returning to the subject at hand

The key language of PLR 200725044 (03/27/07), above, was pasted verbatim into several subsequent rulings, including

p. PLR 200733014 (04/26/07), which was conditioned on the taxpayers using the "special factor" methodology. Although the stated unitrust payout rate, the ages of the beneficiaries, and the applicable section 7520 rate were redacted, the text disclosed that even using the "special factor" the taxpayers would still receive distribution of 90.573 pct. of the trust corpus.

q. PLR 200809044 (12/06/07), an eleven pct. NICRUT (without makeup) created by a limited partnership, payable for the shorter of twenty years or the joint lives of the two partners. The taxpayers had conceded the "special factor" methodology. The transaction was treated as having closed in December of 2006, when the section 7520 rate was 5.8 pct., yielding a distribution to the taxpayers, aged 77 and 78, of 44.517 pct. of the trust corpus (versus roughly 72.336 pct.).

r. PLR 200816032 (01/23/08), a ten pct. NIMCRUT (with makeup) for the joint lives of the settlors. Again, the taxpayers had conceded the "special factor" methodology. The transaction was treated as having closed in December of 2006, when the section 7520 rate was 5.8 pct., yielding a distribution to the taxpayers, aged 57 and 70, of 73.380 pct. of the trust corpus (versus roughly 88.513 pct.).

s. PLR 200816033 (01/22/08), a companion ruling to PLR 200816032 (01/23/08).

t. PLR 200817039 (01/31/08), a ten pct. NIMCRUT (with makeup) for the shorter of the joint lives of the settlors or twenty years. Again, the taxpayers had conceded the "special factor" methodology. The transaction was treated as having closed in February of 2008, when the section 7520 rate was 4.2 pct., yielding a distribution to the taxpayers, aged 48 and 52, of 36.348 pct. of the trust corpus (versus roughly 86.637 pct.).

u. PLR 200827009 (04/03/08), which was conditioned on the taxpayers using the "special factor" methodology. Although the stated unitrust payout rate, the ages of the beneficiaries, and the applicable section 7520 rate were redacted, the text disclosed that even using the "special factor" the taxpayers would still receive distribution of 83.336 pct. of the trust corpus.

and

v. PLR 200833012 (05/09/08), which was conditioned on the taxpayers using the "special factor" methodology. Although the stated unitrust payout rate, the ages of the beneficiaries, and the applicable section 7520 rate were redacted, the text disclosed that even using the "special factor" the taxpayers would receive distribution of 68.638 pct. of the trust corpus.

Somewhat gratuitously, in PLR 200912036 (12/22/08), approving the commutation of a five pct. NIMCRUT, the author mentioned this series of rulings, but then noted that the "special valuation methodology" was not required in the particular case "because the unitrust payout rate is not in excess of the section 7520 rate for the month of the transaction." Oddly, the author then calculated the present value of the unitrust interest using the 5.6 pct. section 7520 rate for April, 2006 rather than the stated payout rate of five pct. That ruling is interesting for other reasons, which we will explore under "contingent or defeasible successive interests," below.

Shortly after the first of these letters were released, the Committee on Estate and Gift Taxation of the New York State Bar wrote to the Associate Chief Counsel, Passthroughs and Special Industries, and the Director of the Exempt Organizations division, pointing out that these represented a departure from earlier rulings and asking IRS to publish formal guidance confirming

> that the proper method for valuing the income interest and the remainder interest of a NIMCRUT that is being terminated early is the same method that is used to value those interests when a NIMCRUT is created[.]

To date, of course, the agency has not acted on this request.

What about an outright surrender

It might be noted that this series of rulings dealt only with commutations, and that the logic of these rulings, which centers on the question of self-dealing, might not readily extend to outright surrenders.

But then recall that we began this discussion by mentioning PLR 200205008 (10/23/01), which did limit the deduction on the surrender of the settlor's interest in a NIMCRUT to the lesser of the present value of the specified unitrust payout or of a straight income interest.

That ruling cited as authority Reg. 20.2031-7(d), which has since been replaced by temporary Reg. 20.2031-7T(d), which in turn expired on May 1, 2012. Subparagraph (d)(2)(i) of the temporary regulation refers to temporary Reg. 1.664-4T(e)(2), also expired, which deals only with the valuation of a straight unitrust.

The letter ruling also cited Reg. 25.2522(c)-3(d)(2)(v), which says the present value of a straight unitrust payout is to be determined

> by subtracting the present value of all interests in the transferred property other than the unitrust interest [*i.e.*, the remainder] from the fair market value of the transferred property.

In turn, Reg. 25.2522(c)-3(d)(2)(ii) says the remainder value is to be determined under Reg. 1.664-4, presumably subparagraph (e)(2), which again has been replaced by temporary Reg. 1.664-4T(e)(2), again, expired.

None of these regulations deal specifically with valuing interests in a net income unitrust. In short, the conclusion drawn in PLR 200205008 (10/23/01) is simply an assertion, albeit a superficially reasonable assertion.

Again, the question may come down to whether the net income limitation is a "restriction" for purposes of Reg. 1.7520-3(b)(1)(ii). But as noted above, the Service has been reluctant to pick up this thread in connection with outright surrenders.

Commutation as a capital transaction

For at least ten years, the IRS has consistently ruled that the commutation of an annuity or unitrust interest in a remainder trust is to be treated as a sale or exchange of a capital asset, with the remainderman in effect purchasing the income interest, and that under section 1001(e)(1) the beneficiary has a zero basis, so that the entire amount received in the commutation is taxable as capital gain.

One of the earliest such rulings, if not the earliest, is PLR 200127023 (04/04/01), which involved a twenty-year unitrust, payable in the event the settlor predeceased the term to whomever he might appoint under a reserved testamentary power, or in default of the exercise of that power to his estate.

The four tier mechanism of section 664(b) for characterizing distributions from a remainder trust did not apply to a commutation, the ruling said. Instead, the taxpayer was "disposing of [his] interest in [the trust] in exchange for money and property in a transaction that is governed by [section] 1001." The ruling cited Rev. Rul. 72-243, 1972-1 C.B. 233, for this proposition.

A similar result was reached in PLR 200314021 (12/24/02), again citing Rev. Rul. 72-243. The trust had been reformed, after the closely held stock with which it was funded was sold, to a straight twelve pct. unitrust. The settlor had retained a power to redesignate the remaindermen, which he exercised in favor of a private nonoperating foundation with respect to which he and his spouse were disqualified persons.

The taxpayer proposed to seek a judicial commutation of the trust, with notice to the state attorney general. At the time of the ruling request, the trust still held patents it had received as part of the proceeds of the sale of the closely held stock. The ruling does not mention how the settlor proposed to handle the distribution of these patents.

See also

- PLR 200304025 (10/23/02), noted above under "net income limitation,

- PLR 200324035 (03/04/03), a judicial commutation of a straight CRUT for the life of the settlor, since deceased, plus twenty years or the earlier death of two successor beneficiaries,

- PLR 200403051 (09/30/03), a judicial commutation of a straight seven pct. CRUT for the joint lives of the settlors, husband and wife,

- PLR 200441024 (06/10/04), a judicial commutation of a straight ten pct. CRUT for a twenty year term,

- PLR 200727013 (04/05/07), a nonjudicial commutation of two straight CRUTs for the joint lives of the settlors, husband and wife, and

- PLR 200739004 (06/21/07), a judicial commutation of a straight CRUT for several beneficiaries in separate shares, each share terminating at the death of the beneficiary, remainder to a donor advised fund.

Of some interest here also is PLR 200846037 (08/20/08), a nonjudicial commutation of a six pct. NIMCRUT for the joint lives of the settlors, husband and wife, which had been converted to a straight CRUT.

Although the text of the letter characterized the transaction as a sale, citing Rev. Rul. 69-486, 1969-2 C.B. 159, the ruling itself was limited to the question of self-dealing. And in that connection, the ruling was made expressly subject to the continued qualification of the remainderman as a supporting organization.

A critique of these rulings requires an examination of the two revenue rulings cited, and of the legislative history of section 1001(e).

Rev. Rul. 72-243, 1972-1 C.B. 233

It is certainly the case that Rev. Rul. 72-243 recites that a life tenant's sale of her entire interest in a testamentary trust to the remainderman is the sale of a capital asset. The ruling is in effect a belated acquiescence in Beulah Eaton McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), cert. den., 330 U.S. 826 (1946), to that effect.

The appeals court ruling was a defeat for the Commissioner, who had argued that the transaction was an anticipatory assignment of income, and that the proceeds should be taxed as ordinary income. The Second Circuit rejected this argument, citing Blair v. Commissioner, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465 (1937), in which the Supreme Court had ruled that gifts by a trust beneficiary to his children of specified amounts of the net income of the trust in future years were effective to shift to them the liability for tax on that income.

The logic of the Blair decision was that the taxpayer had in effect transferred to his children a portion of his life income interest in the trust, substituting them as direct beneficiaries. The majority in McAllister reasoned that the transfer was therefore of a capital asset.

The situation in McAllister was somewhat complicated by the fact that the tax code did not then include a mechanism for adjusting the life tenant's basis, so that when she sold her interest to the remainderman she reported a capital loss. Had she sold her interest to a third party, the purchaser would have been able to amortize the purchase price against income.

The enactment of section 1001(e) as part of the Tax Reform Act of 1969 was intended to address these anomalies.

Section 1001(e)

What the statute literally says is

> In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

Disregarded, entirely.

The legislative history indicates that this provision was specifically intended to address a situation in which "a life estate or similar interest [was] acquired by gift, bequest, or inheritance [and] the life tenant sold his interest." As stated in the "general explanation" of the 1969 act prepared by the Joint Committee on Taxation, JSC-16-70, under then-existing law,

> [t]he life tenant was not taxed on the income to the extent of the basis which he was treated as having in the life estate when he sold it [, and] the purchaser of the life estate was not taxed on most of the income because he was allowed to reduce that income by amortizing his basis (the purchase price) in the life estate. In some cases [for example, McAllister] the seller's basis even exceeded the amount he received upon its sale, and, as a result, he was permitted to take a deductible loss.

There is an exception at section 1001(e)(3) for a disposition that includes both the income and remainder interests, but we will postpone that discussion for a moment.

The cross references are to sections determining the basis of property acquired from a decedent (section 1014), by gift (section 1015), and in a transfer incident to a divorce (section 1041). The logic of the letter rulings centers on section 1015, titled "basis of property acquired by gifts and transfers in trust."

Several of the rulings begin by mentioning section 1015(b), which somewhat incongruously provides that if property was acquired by a transfer in trust "other than by a transfer in trust by a gift, bequest, or devise," basis is to be "increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer."

The argument would appear to be that the settlor "acquired" her annuity or unitrust interest "other than by gift" and that her basis in that interest is determined "pursuant to" section 1015(b).

Reg. 1.1015-1(b) allocates basis in property transferred by gift to a trust between the income and remainder interests. The "uniform" basis of the entire trust corpus remains fixed, subject to the usual adjustments, but

> the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman are adjustable to reflect the change in the relative values of such interest on account of the lapse of time.

There is a cross reference to Reg. 1.1014-5(a), which says the "uniform" basis is to be allocated between the income and remainder interests using the actuarial factors prescribed by Reg. 20.2031-7. So far, so good.

Reg. 1.1015-1(b) then goes on to say that in determining gain or loss from the sale or other disposition of a term interest, including a life estate, term or years, or income interest, "the adjusted basis of which is determined pursuant, or by reference, to section 1015,"

> that part of the adjusted uniform basis assignable under the rules of [Reg.] 1.1014- 5(a) to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and [Reg.] 1.1001-1(f).

These are the references that are quoted repeatedly in the letter rulings.

So what this all comes down to is whether the settlor's annuity or unitrust interest in a charitable remainder trust was "acquired by gift" for purposes of section 1015(a), or whether her basis in that interest is to be determined "pursuant to" section 1051(b).

It does seem reasonably clear that a successive annuity or unitrust interest would be "acquired by gift," and that an annuity or unitrust interest in a testamentary remainder trust would be "acquired from a decedent." But it is not at all clear that the settlor's retained annuity or unitrust interest in an inter vivos remainder trust is within the letter or the intention of the statute.

Rev. Rul. 69-486, 1969-2 C.B. 159

The literal holding of Rev. Rul. 69-486 is that a non-pro rata distribution of trust property by a trustee who does not have authority to make such a distribution, but does so as a result of an agreement among the beneficiaries, is to be treated as a pro rata distribution, followed by an exchange among the distributees.

In the particular case contemplated by the revenue ruling, one of the distributees was an individual and the other was an exempt entity, and the strategy the ruling was intended to defeat was the distribution of higher basis assets to the individual and lower basis assets to the exempt entity, in whose hands realized gains would not be taxed.

The ruling was cited in PLR 200727013 (04/05/07), in PLR 200739004 (06/21/07) and, as noted above, in PLR 200846037 (08/20/08), as supporting the conclusion that the commutation was to be treated as a sale to the remaindermen, though clearly it does not apply, unless the distributions were to be non-pro rata, which was not stated..

Rev. Proc. 2008-3, 2008-1 I.R.B. 110

In Rev. Proc. 2008-3, the IRS announced that effective immediately, that is, January 7, 2008, it would no longer "ordinarily" give advance rulings on whether the termination of a CRT in which each of the parties received its actuarial share of the value of the trust assets is to be treated as a sale or other disposition for purposes of section 1001(a), or as a sale or exchange of a capital asset under section 1221(a).

"Not ordinarily" means in the absence of "unique and compelling reasons" to justify the issuance of a ruling. There are no clear criteria for what might be "unique and compelling reasons."

In that same revenue procedure, the question whether the transaction would cause the trust no longer to qualify under section 664(d) was identified as an "area under study," in which rulings would not be issued until the issue was resolved through the publication of formal guidance.

These three items have been carried forward in succeeding annual revenue procedure updates, and starting with Rev. Proc. 2010-3, 2009-1 C.B. 107 the question whether the transaction would disqualify the trust under section 664(d) was moved to the "not ordinarily" category, suggesting that formal guidance may not be immediately forthcoming, after all.

And in fact there have been no letter rulings on commutations of remainder trusts since 2008. The handful that were issued that year were in response to requests that had been made several years earlier.

Notice 2008-99, 2008-47 I.R.B. 1194

However, at least one other shoe did drop in October of 2008, when the IRS issued Notice 2008-99, identifying as a "transaction of interest" the "coordinated" sale of the income and remainder interests in a charitable remainder trust to an unrelated third party, where appreciated assets contributed to the trust had been sold and the proceeds reinvested.

As noted above, under section 1001(e)(1), the holder of a term interest in a trust is treated as having a zero basis for purposes of calculating gain or loss on disposition of the interest. But there is an exception at section 1001(e)(3) where the disposition is "a part of a transaction in which the entire interest in property is transferred," that is, in which both the income and remainder interests are sold to a third party.

In that case, the holder of the term interest determines her basis with reference to Reg. 1.1014-5(a) and Reg. 1.1015-1(b), and would thus report modest if any gain.

By identifying this as a "transaction of interest" under Reg. 1.6011-4(b)(6), the Notice imposes a reporting requirement both on the term holder and on the charitable remainderman, but not the third party purchaser. Any "material advisor" who was paid more than $5,000 for providing assistance or advice with respect to the transaction must also report, a substantial reduction from the threshold amount otherwise applicable under Reg. 301.6111-3(b)(3)(i)(B).

The Notice applies to transactions entered into on or after November 2, 2006, except that a charitable remainderman is not required to report a transaction in which it sold or otherwise disposed of its interest in a trust on or before October 31, 2008, the date of publication of the Notice.

In describing the transaction, the Notice first presents the scenario in which the holder of the term interest is the trust settlor. The remainder charity "may, but need not" be controlled by the settlor, who "may, but need not" have reserved a power to redesignate.

But then the Notice goes on to mention other variations that expand the scope of the "transaction of interest" rather considerably:

- the trust "may have been in existence for some time prior to the sale,"
- the appreciated assets might already be in the trust "prior to the commencement of the transaction,"
- the settlor might have contributed the appreciated assets to a passthrough entity and then contributed an interest in that entity to the remainder trust, and
- the holder of the term interest might be someone other than the settlor.

The Notice does not make clear what criteria the Service would apply in determining that the transaction is a "coordinated" sale or disposition.

The publication of Notice 2008-99 drew at least three public comments.

Conrad Teitell, writing on behalf of the American Council on Gift Annuities, suggested that in the event of either a commutation or a sale to a third party the income beneficiary's basis should be calculated with reference to the "uniform" basis rules, adjusted by undistributed gains under Reg. Sec. 1.664-1.

A similar argument was advanced by Dan T. Hastings, a lawyer from West Orange, New Jersey, expanding on an article he had written some years previously for U.S. Trust's "Practical Drafting" commentaries.

Mr. Teitell urged the agency to move quickly to resolve the difficulties that had led it to suspend the issuance of advance rulings on early terminations, and to issue formal guidance that would make letter rulings necessary "only in unusual cases."

Noting the line of letter rulings valuing a net income interest with reference to the "lesser of" the stated payout rate or the then-current section 7520 rate, Mr. Teitell suggested that formal guidance might allow a taxpayer the opportunity to establish a fair market value for a net income interest, using a qualified appraiser.

James W. Lintott, the chairman of Sterling Foundation Management, LLC, which describes itself as "a provider of backoffice administration for private foundations," and which is actively engaged in facilitating section 1001(e)(3) transactions, urged the Service to frame any formal guidance "in as narrow a manner as possible" to address the "clearly abusive" transaction described in the Notice, while "preserving liquidity" in what he called "the market for lead interests."

Somewhat unexpectedly, Mr. Lintott suggested that simply

> prohibiting the use of basis would have very little to no effect on the salability of CRT interests, because few if any transactions would be affected.

Contingent or defeasible successive interests

An early ruling, PLR 8805024 (11/05/87), allowed a deduction for the partial surrender of the settlor's interest in a straight five pct. unitrust, but disallowed a deduction for the partial surrender of the spouse's successive interest, because it was defeasible by the settlor's exercise of a reserved testamentary power to revoke.

This meant not only that the surrender of the spouse's defeasible interest did not generate an income tax deduction, but also that the present value of that interest was reportable as a taxable gift.

Where the holder of the successive interest is someone other than a spouse, of course, the idea behind reserving the testamentary power to revoke is to make the transfer incomplete for gift tax purposes. This approach was explicitly validated by Rev. Rul. 79-243, 1979-2 C.B. 343.

But where the holder of the successive interest is a spouse, it is not necessary to reserve a testamentary power to revoke, because section 2523(g), enacted in 1981 as part of the Economic Recovery Tax Act, Pub. L. 97-34, renders the transfer eligible for a gift tax marital deduction, despite the fact that the spouse's interest is contingent, and despite the fact that others may possess or enjoy a part of her interest if the contingency fails.

In each of two later rulings, PLR 9550026 (09/18/95) a nine pct. NICRUT (without makeup), and PLR 9721014 (02/19/97), a five pct. NIMCRUT (with makeup), the taxpayers attempted to address the problem by having the holder of the defeasible successive interest disclaim. Those two rulings were silent on the question whether this strategy was effective.

In PLR 200802024 (09/14/07), the settlor proposed to release his reserved testamentary power to revoke the spouse's successive interest in each of two straight five pct. CRUTs, as part of a complete surrender, and instead of disclaiming, the spouse then participated in the surrender. The ruling explicitly acknowledged that the release completed a gift to the spouse that qualified for a marital deduction under section 2523(g).

In this connection, note Rev. Rul. 79-295, 1979-2 C.B. 349, to the effect that where a trust remainderman transferred an undivided one-half interest in the remainder (which apparently had not yet vested in possession) to a charity, a charitable deduction would be allowable under section 2522(c)(2), because

(a) the transfer was not made in further trust and

(b) the transferor had no other interest in the property at or before the time of the transfer.

The ruling was subject to the proviso that the trust had not been created for the purpose of evading the partial interest rule of section 170(f)(3)(A).

Some rather awkward maneuvering was in evidence in PLR 200912036 (12/22/08), which as noted above approved the commutation of a five pct. NIMCRUT (with makeup) without requiring the use of the "special valuation factor" because the section 7520 rate was then higher than the stated unitrust payout rate.

The trust had been established by a husband and wife, payable to them jointly, and after the death of the survivor in equal shares to their two sons. Neither settlor had reserved a testamentary power to revoke the successive interests to the sons, so presumably those were completed, taxable gifts.

At the time of the ruling request, the husband had a shortened life expectancy, albeit not a terminal illness. Both he and the two sons had assigned their interests to the wife, who then proposed to sell the combined interests to the remainder charity. The letter expressly reserved ruling on the possible income or gift tax consequences of these transfers, or on whether these transfers might have disqualified the trust under section 664(d).

The only rulings actually requested were that this transfer would not constitute an act of self-dealing and that it would not trigger a foundation termination tax. A favorable ruling on these points depended on whether the amount the wife would receive in the commutation was limited to the present value of the income interest, per Reg. 53.4947-1(c)(2).

The letter recites that the taxpayer (*i.e.*, the wife) had requested that the calculation "not reflect survival" for the husband. Thus, in making the calculation, the Service disregarded the husband's life, noting that

> [t]he factor for the remainder interest following the remaining three measuring lives is the same as the factor for the remainder interest following all four lives assuming the fourth is terminally ill[,]

though again, the husband's illness was not terminal. In this connection it bears noting, as stated in Rev. Rul. 80-80, that the actuarial tables under Reg. 20.2031-7 and Reg. 20.2031-7T are not

> [t]he actuarial tables are not based on data that exclusively involve persons of 'good' or 'normal' health. They reflect the incidence of death by disease and illness as well as by accident. The actuarial tables are properly applicable to the vast majority of individual life interests, even though the health of a particular individual is obviously better or worse than that of the 'average' person of the same age and sex.

Only occasionally, the revenue ruling went on to say, are the actual facts of an individual's condition "so exceptional as to justify departure from the actuarial tables." Although Rev. Rul. 80-80 was obsoleted by Rev. Rul. 96-3, the fact remains that the tables include everyone except the terminally ill.

Though these four rulings do not directly illustrate the point, we should note that where circumstances have emerged to shorten the life expectancy of the spouse or a child of the settlor whose successive interest in the annuity or unitrust is contingent and/or defeasible, it may be desirable for the settlor to accelerate all or part of the remainder gift and claim an additional income tax charitable contributions deduction.

Surrender in exchange for a gift annuity

To date, there has been exactly one ruling, PLR 200152018 (09/26/01), dealing with a surrender in exchange for a gift annuity. There, the Service ruled:

(a) the taxpayer would be entitled to claim a charitable contributions deduction for both income and gift tax purposes in the amount by which the present value of the unitrust interest he would be surrendering exceeded the present value of the gift annuity he would be receiving in exchange,

(b) because a sale of the unitrust interest would have resulted in long-term capital gain, there would be no reduction in the amount allowable as a charitable contributions deduction per section 170(e)(1), and the amount of the deduction that he could take in a given year would be subject to a limitation of thirty pct. of his adjusted gross income,

(c) the taxpayer would not recognize undistributed capital gains accumulated in prior years as a consequence of the transfer, per Reg. 1.664-3, and

(d) the transaction would be treated as a bargain sale under section 1011(b), *i.e.*, the taxpayer would recognize long-term capital gain in the amount of the present value of the gift annuity ratably over the period of years measured by the expected return multiple under the annuity contract, but only from that portion of the annuity payout that was treated as a return of his investment in the contract.

Again, for purposes of calculating gain, the taxpayer's basis in his unitrust interest was to be treated as zero, ostensibly pursuant to section 1001(e).

Let us take a look at what this transaction might look like today, with the section 7520 rates at record lows, and with the ACGA recommended gift annuity rates having been reduced several times.

First, using a section 7520 rate of 1.4 pct., roughly the average rate over the last twelve months, an annuity at the recommended rate, paid quarterly at the end of the quarter, would not meet the additional requirement ACGA has recently imposed, that the present value of the residuum of the gift annuity be at least twenty pct., for an annuitant younger than 60. The recommended rate for an annuitant aged 60 is 4.4 pct.

With the section 7520 rate all the way down to 1.0 pct., the youngest age that would meet the twenty pct. residuum requirement is age 62, with an annuity rate of 4.5 pct. So for convenience, let's say Richard is now 62 years old.

And this time we will put Richard in a five pct. straight unitrust, rather than eight. Again, payable quarterly at the end of the quarter. If the section 7520 rate is 1.4 pct., the present value of his unitrust interest is 59.402 pct. If the section 7520 rate is 1.0 pct., the present value of his unitrust interest is 59.483 pct. This is as good a place as any to note that depressed section 7520 rates have not all that much effect on the valuation of interests in a unitrust.

If the unitrust is holding $1 million, Richard is receiving a payout of $50k, and the present value of his unitrust interest is somewhere north of $594k. If he were to surrender his unitrust interest in exchange for a gift annuity paying 4.5 pct., we are looking at a payout of something less than $27k per year, of which not quite $20k would be taxed as long-term gain and a little over $6k would be taxed as ordinary income for the next twenty-three years, after which the entire payout would be taxed as ordinary income.

If Richard has reserved a power to redesignate the remainderman, he might be able to persuade the issuing charity to treat the entire $1 million, or at least some larger portion of it, as funding the annuity, or otherwise to deviate from the ACGA recommended rate.

Keeping in mind, of course, that if the issuance of annuity contracts constituted a "substantial part" of the activities of an otherwise exempt organization, this would be treated as an unrelated trade or business, were is not for the exception at section 501(m)(5) for gift annuities. That exception applies only if the annuity contacts conform to the requirements of section 514(c)(5) regarding "unrelated debt-financed income" in the form of "acquisition indebtedness."

For this purpose, the present value of the annuity cannot be more than 90 pct. of the value of the property received by the charity in the exchange. Reg. 1.514(c)-1 defines this limitation in terms of "the value of the prior owner's equity" in the property received (an embellishment of the statute, which does not use the word "equity"). And for income tax purposes, Richard not only has no basis in the remainder, he has no property interest in it at all (unless some value were to be ascribed to his reserved power to redesignate the remainder charity).

But after all, Richard is accelerating the remainder, reducing by nearly half the amount of his current payout, and accepting almost a quarter of that as ordinary income rather than long-term gain, so maybe some accommodation could be made

A similar, possibly more attractive result might be achieved by having Richard surrender his unexpired unitrust interest in exchange for a unitrust interest in a freshly created trust with a somewhat lower payout rate. The question of deviating from ACGA rates would not come into play. While this transaction has not yet been the subject of any letter rulings, the same principles would seem to apply.

This technique might be particularly attractive in a situation in which the settlor is locked into a net income trust that has accumulated a considerable deficiency and which continues to make payouts below the stated percentage.

Concluding remarks

Keeping in mind that letter rulings may not be relied on as precedent, what these rulings actually teach us is how we might need to structure the transaction if we wanted a favorable advance ruling. They do not necessarily tell us how we might survive a challenge if we structured the transaction differently or if we reported the tax consequences differently.

But for the moment, at least, IRS is not issuing advance rulings on the question of recognizing gain on a commutation, or on whether a commutation will disqualify the trust under section 664(d).

The legal mechanics of how this transaction is to be closed are very state law specific. In general, whether the transaction is to be accomplished by private agreement or through a "friendly" judicial proceeding to modify or terminate the trust, all interested parties, including the holders of contingent interests (albeit perhaps not the holders of interests defeasible through the exercise of a power reserved by the settlor) must be represented.

Where the identities or shares of the charitable remaindermen are indefinite, either because the settlor has reserved a power to designate the remaindermen or because a similar power has been granted to the trustee or to one or more individual beneficiaries, it will almost certainly be necessary to join the state attorney general in a judicial modification or termination proceeding.

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Postscript

The seminal ruling underlying everything we have talked about here is Rev. Rul. 86-60, 1986-1 C.B. 302.

The ruling considered two related situations.

In the first ("situation 1"), the taxpayer had created the trust, reserving a lifetime annuity for herself, with the remainder over to a designated charity, and then four years later she assigned the unexpired annuity to the remainderman. It was assumed that the taxpayer had not initially created the trust (thereby dividing her interest in the trust corpus) for the purpose of evading the partial interest rule of section 170(f)(3)(A) —- and this was key to the ruling, in that the taxpayer was treated as having transferred her entire interest in the trust to the charity, without regard to the fact that she had earlier owned other interests in the property comprising the trust corpus. Therefore, the Service ruled, the transfer qualified for a charitable contributions deduction for both income and gift tax purposes. The method of calculating the amount of the deduction was not discussed.

In the second situation ("situation 2"), the annuity was to have continued for the life of the taxpayer's spouse, if he survived her. Both the taxpayer and her spouse transferred their respective interests in the trust to the remainderman. Again, the fact that the taxpayer had not (it was assumed) initially created the trust for the purpose of evading the partial interest rule was key, because in this circumstance the transfer of the taxpayer's annuity interest, standing alone, would not otherwise have qualified for the charitable contributions deduction, in that she had also made a transfer for private (*i.e.*, noncharitable) purposes: the annuity to her spouse, if he survived her.

The ruling also concluded that the transfer by the spouse of his annuity interest to the remainderman qualified, though it was not in the form of a charitable lead annuity trust, because it was the only interest in the property he had ever had.