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SAVING THE CHARITABLE DEDUCTION IN SPLIT INTERESTS TRUSTS

Once in a while a case comes along that causes genuine unhappiness at the outcome and reminds us to be vigilant in drafting.

James Galloway's revocable trust provided that the residue was to be paid in equal, one-fourth shares, to his son, Edmund, his granddaughter, and two charities. Each beneficiary was to receive one-half of its one-quarter share on January 1, 2006 and the balance on January 1, 2016. In the event either of the natural persons is not living at the time of distribution, his or her share is to be distributed to the remaining beneficiaries in equal parts.

Upon the decedent's death, and at the request of his attorney, the Commonwealth of Pennsylvania Department of Revenue calculated the value of the remainder interest under the Trust. Upon being furnished with a valuation, the Estate claimed a charitable deduction of $399,079.33 on the estate tax return for the portion to be distributed to the charities and computed the estate tax to be $168,637.09; a sum paid in three installments. In October 2000, the IRS, acting under the authority of IRC § 2055(e), disallowed the charitable deduction.

The Estate timely filed a refund claim under IRC § 6511(a), which was denied. The Estate sued in the US District Court for the Western District of Pennsylvania. The Court held that the plain language of § 2055(e), dealing with split interests between charities and

natural persons, dictated that the charitable deduction be disallowed. This holding was affirmed on appeal.[1]

Something had gone terribly wrong. IRC § 2055(a) allows a deduction from a decedent's estate for the amount of "all bequests, legacies, devises or transfers" to a qualifying charitable organization.[2] The Court did not dispute that the named charities were charitable organizations for purposes of the statute. Where then lay the Estate's error? In fact, the decedent had created a so-called "split-interest" in charities and natural persons.

The statute permits a charitable deduction for an interest shared between a charity and natural persons (a "split-interest" bequest) only if, in the case of a remainder, the charity's interest is in the form of a charitable remainder annuity trust, a charitable remainder unitrust or a pooled income fund.[3] In the case at bar, the charities did not receive an interest that squarely fell within the above set forth categories.

The charities did not receive a guaranteed annuity, or a fixed percentage distributed yearly of the annually determined fair market value of the property. In fact, charitable and non-charitable parties had contemporaneous interests in a single property. Was the statute therefore applicable? Doesn't the statute only apply where a non-charitable beneficiary has a life interest and the charity a remainder interest?

The Court of Appeals commenced its decision by a review of the statute and its purpose, noting that prior to its enactment, the Trustee was able to manipulate the charities' interest to the advantage of the natural beneficiaries by investing the corpus in "high risk, high yield" investments leaving a substantially reduced corpus for the charities.[4]

The Court concluded that, notwithstanding the unfortunate results in the Galloway

case, the plain language of the statute supported its finding that the statute applied, and did not only refer to charitable remainders, as 26 U.S.C. §2055(e)(2)(B) refers clearly to "any other interest."[5]

Let us look at the New York application of this set of facts. Could the Galloway result have been avoided? The decedent, in Galloway, had, in fact, created a kind of unitrust interest. Both the natural beneficiaries and the charities shared equally in appreciation or depreciation of income and principal. The equal division in four shares, although over time, is eminently fair to the charities.

Requests for reformation or amendment of true testamentary charitable remainder trusts have been routinely granted, based on the presumption that the decedent intended to take advantage of all the ways authorized by law to reduce estates taxes.[6] At times, several infirmities need to be cured to bring the proposed reformation into compliance. In *Estate of Scudder*,[7] the income interest was not in the form of an annuity; the trustees had the power to invade the corpus for the income beneficiary and the charitable remainder was contingent upon the predecease of an additional, natural person. The individual beneficiaries renounced their impermissible interests; the lead income interest was restructured into an annuity interest. Concluding that "the dispositive provisions of decedent's will thereby will not be altered to the detriment of any beneficiary," the Court permitted reformation to save the charitable deduction.

A Court may condition its reformation order upon the petitioner's obtaining a favorable ruling from the IRS.[8] At times petitioners are faced with too many shortcomings in the dispositive instrument. In *Estate of Relkin*,[9] the residuary trust provided for an 8% annuity to be paid in equal shares to three individuals, or the surviving of them; remainder

to three charities. The trust, as drafted, failed to satisfy two criteria of a charitable Remainder Trust:(1) the ten percent (10%) minimum remainder interest requirement; and (2) the five percent (5%) probability of exhaustion requirement under Treasury Regulation §20.2055-2(b)(1). Under the circumstances of the case, even if the Court were to grant the requested reformation, it was not clear if the trust would qualify for a charitable estate tax deduction, as the proposed reformation would still leave a likelihood of non-compliance with the highly technical requirements[10] of a CRAT: "[A]bsent proof the requested reformation could enable petitioner to achieve its objective of a charitable estate tax deduction, petitioner's application is denied."[11]

As a Galloway type trust was not amenable to reformation into a qualified Charitable Remainder Trust, was the Executor/Trustee precluded from seeking relief? E.P.T.L. §7-1.13 authorizes a trustee (executor or administrator) of an express trust without prior Court approval or consent of the persons interested to establish two or more separate trusts in order to segregate, for a variety of named purposes, inter alia, to secure a marital deduction under I.R.C. §§ 2056 or 2523; a charitable deduction under I.R.C. §§ 2055 or 2522; to insulate against Generation Skipping Transfer taxes; to establish subchapter S trusts for individual beneficiaries; to create separate trusts, with the consent of all interested persons, for any reason not contrary to the trust's primary purpose, or for any reason not directly contrary to the trust's primary purpose, if the trustee or a person interested has petitioned for it and all persons have received notice. A related statute is E.P.T.L. §11-1.11 which gives trustees certain powers to achieve tax benefits.[12]

As the practice commentaries to E.P.T.L. §7-1.13 point out, the statute will aid in avoidance of IRS refusal to honor lower court decisions under *Commissioner v. Bosch.*[13]

Although petitioner in *Estate of Olga v. Hargis*,[14] did not bring his prayer for relief under the statute, the relief sought by petitioner, to wit the creation of four equal shares of decedent's revocable trust upon his death to segregate the charitable interests from the individual ones is conceptually similar to the case at bar. Rather than paying the individual beneficiaries of two equal trust shares created by decedent for a period of ten years and thereafter paying charities chosen by the Trustee, the court sanctioned reformation allowed for the creation of four trusts, two of which would be payable upon termination to the named individual beneficiaries and two of which would qualify as charitable remainder unitrusts.

Under the factual circumstance of *Galloway*, a petition for proposed reformation under E.P.T.L. §7-1.13 could request that, upon decedent's death, the trust be split into four equal shares; three of which intended for the named individuals and one for the charities. At no time would individuals and charities be enjoying an interest in the same property, thereby avoiding the application of 26 USC §2055(e). How best to proceed? One would wish to avoid the Trustees acting without Court approval, given the importance of the issue. All interested parties should be cited, including the IRS and Attorney General, the latter representing the charities and the petition must be timely commenced.[15]

In conclusion, *Galloway* serves as a painful reminder to draft with the utmost care where charities and individual beneficiaries are to have an interest in the same property and, when faced with a fait a compli, to seek a permissible cure.

1. *Galloway v. United States,* 492 F.3d 219, 220-22 (3d Cir. 2007).

2. I.R.C. § 2055(a).

3. I.R.C. § 2055(e)(2)(A). A charitable remainder annuity trust requires the payment of a "sum certain," that is, either a "stated dollar amount" or a "percentage of the initial net fair market value of the property irrevocably passing in trust", at least once a year. 26 C.F.R. § 1.664-2. A unitrust requires the yearly payment of a fixed percentage of the corpus, as revalued each year. 26 C.F.R. § 1.664-3. A pooled income fund is a trust which grants an irrevocable interest in property to a charity while the donor retains a life interest. 26 C.F.R. § 1.642(c)-5(b).

4. *Galloway,* 492 F.3d at 222 (citing *Oetting v. United States,* 712 F.2d 358, 360 (8th Cir.1983).

5. *Id.* at 224.

6. *Matter of Tedeschi*, N.Y.L.J. Apr. 29, 2002, p. 31, col. 5 (Surr. Ct. Suffolk Cty.) (citing *Matter of Brown*, N.Y.L.J., Dec. 8, 1995, p. 32, col. 4) ; see, e.g., *Estate of Conlin*, N.Y.L.J. Sept. 3, 1996, p. 34, col. 2 [citing *Estate of McComas*, 165 Misc. 2d 947 (Surr. Ct. N.Y. Cty 1995); *Matter of Martin*, 146 Misc 2d 144 (Surr. Ct. N.Y. Cty. 1989); *Matter of Lepore*. 128 Misc. 2d 250 (Surr. Ct. Kings Cty. 1985)]; c.f. *Estate of Pollock*, Jan. 10, 2001, p. 31, col. 6 (Surr. Ct. Richmond Cty); *Matter of Balletta*, Feb. 23, 1998, N.Y.L.J., p. 33, col. 5 (Surr. Ct. Westchester Cty). For an interesting application of the principal *see Estate of Cataldo*, N.Y.L.J. May 11, 2005, p. 29, col. 4 (Surr. Ct. Kings Cty.), where the decedent had provided that the trust's principal could be invaded for the maintenance and support of the individual beneficiary, but the trustee was directed that "under no circumstances are funds from either trust to be used in lieu of any form of public assistance."

7. *Estate of Scudder,* N.Y.L.J. Dec. 12, 1990, p. 26, col. 3 (Surr. Ct. Nassau Cty.).

8. *Matter of Tedeschi*, N.Y.L.J. April 29, 2002, p. 31, col.5, supra.

9. *Estate of Relkin*, N.Y.L.J., Dec. 14, 2005, p. 27, col. 4 (Surr. Ct. N.Y Cty.).

10. *See* IRC § 664.

11. *Estate of Relkin*, N.Y.L.J., Dec. 14, 2005, at 27, col. 4, supra.

12. For a case employing that statute to save GST taxes, see *Matter of Sadie Wachtel*, N.Y.L.J. September 4, 1992, p. 26, col. 3 (Surr. Ct. Westchester Cty.).

13. Margaret Valentine Turano, Practice Commentaries to EPTL § 7-1.13 (McKinney 2002); *Commissioner v. Bosch*, 387 U.S. 456, 563 (1967).

14. *Olga v. Hargis*, N.Y.L.J. Jan. 14, 2004, p. 31, col. 4 (Surr. Ct. Suffolk Cty.)

15. I.R.C §2055(e).