

# TAXWISE GIVING®

Editor: Conrad Teitell, LL.B., LL.M.

Sydney Prerau, Editor 1962-1967

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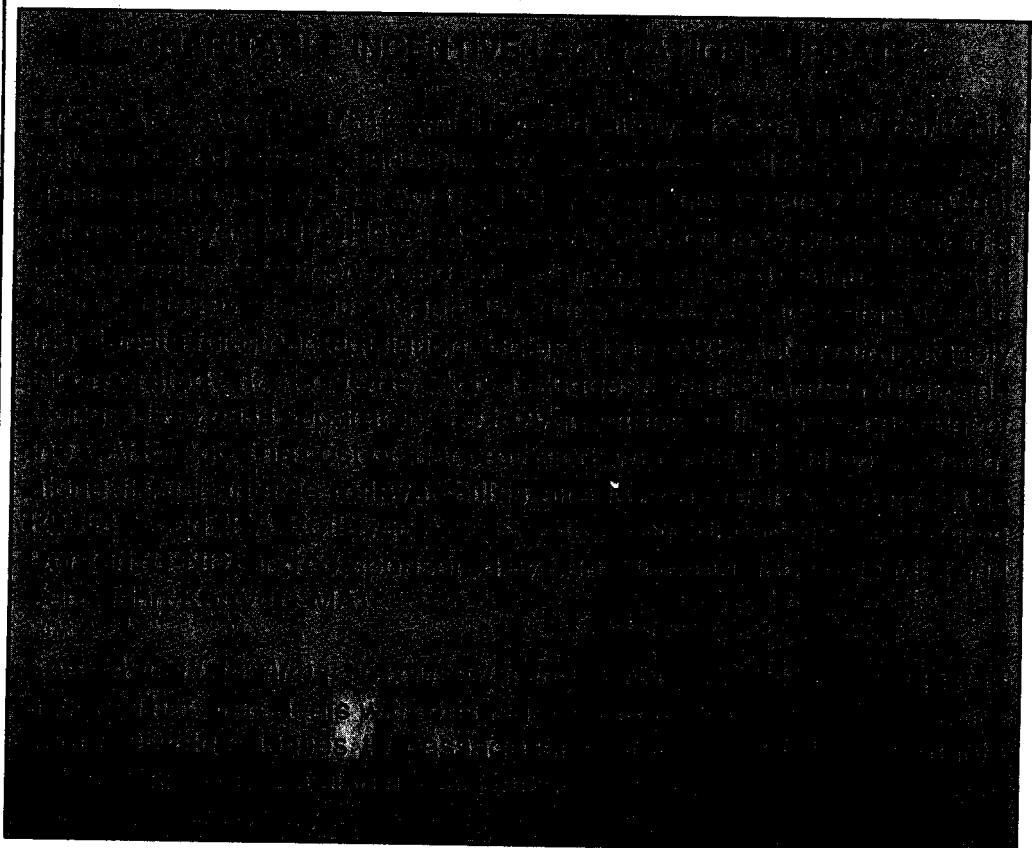
## **CRT 10%-MINIMUM-REMAINDER-INTEREST REQUIREMENT ... You Could Have a Ticking Tax Bomb**

"So we beat on, boats against the current, borne back ceaselessly into the past."—*The Great Gatsby*, F. Scott Fitzgerald

**IRS Letter Ruling—in brief.** The IRS looked to the past in determining whether an inter vivos charitable remainder unitrust qualified for the estate tax charitable deduction for the value of the remainder interest. The Service held that the 10%-minimum-remainder-interest (10%-MRI) requirement had to have been satisfied when the inter vivos trust was created—years earlier during the donor's lifetime. And, sad to say, the short period for reforming the trust to qualify had expired.

Congress enacted the 10%-MRI requirement in response to the abuses of accelerated charitable remainder trusts and multi-beneficiary trusts with remainder interests under 1%. With current low IRC §7520 rates—3.8% this month and next—the 10%-MRI test is easily flunked.

*(continued on page 2)*



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After giving you the details of the letter ruling, I'll give you a primer on the 10%-MRI requirement. Some of what you need to know isn't in the Code, but is deeply buried in the legislative history.

**Puzzler.** Abandon all hope of salvaging income, gift and estate tax charitable deductions, gift and estate tax marital deductions and tax exemption for CRUTs and CRATs, ye who flunk the 10%-MRI requirement and miss the deadline to reform those trusts.

A ray of hope—when all else fails—is on page 12. If you see the light before you get there, let me know. I'll award rubber chickens to the first 10 respondents. Standing by: [Conrad@taxwisegiving.com](mailto:Conrad@taxwisegiving.com).

**Situation in Letter Ruling.** Xavier created an inter vivos charitable remainder unitrust that made payments to him for life and if he is survived by Henry, the unitrust amount is to be divided into two equal shares. The payments from one share are to be paid to Henry for life; the payments from the other share are to be paid equally to Able, Baker and Charlie, or the survivor of them, during Henry's lifetime.

At the death of the survivor of Xavier and Henry, the CRUT's assets are to be distributed to charity. Xavier died and was survived by Henry. The estate's executor told IRS that the value of the remainder interest when Xavier created the trust was less than 10% of the net fair market value of the property funding the trust.

IRS said that a provision providing for the termination of the unitrust payments to Able, Baker and Charlie upon Henry's death was a qualified contingency and that contingency didn't cause the trust to fail to qualify as a unitrust. However, the value of the charitable remainder interest had to be calculated at the time the trust was created without regard to the qualified contingency. (The ruling doesn't discuss it, but apparently the estate maintained that the CRUT would have met the 10%-MRI requirement if the potential interests of Able, Baker and Charlie were disregarded.)

**IRS rules.** The value of the remainder interest at the inception of the trust (during Xavier's lifetime) was less than 10% and thus the estate tax charitable deduction was denied. We aren't told whether the 10%-MRI requirement would have been met had it been calculated at Henry's death, but even if it had, the result would be the same. As already stated, the 10%-MRI requirement must be met at the CRUT's

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creation. IRC §664(d)(2)(D). Further, the short deadline for reforming the trust had expired.

*Letter Ruling 200414011\**

**The deadline for reforming trusts that fail the 10%-MRI test.** A trust is treated as meeting the 10% requirement if the trust's governing instrument is changed by reformation (amendment, construction, or otherwise) to meet that requirement by reducing the payout rate, duration, or both, of any noncharitable beneficiary's interest to the extent necessary to satisfy that requirement. The reformation, according to the Conference Report, must be commenced within the period permitted for reformations to charitable remainder trusts under IRC §2055(e)(3).

**A technical but important point:** What a difference "(C)(iii)" can make. Under the rules of IRC §2055(e)(3) specified in the Conference Report, a charitable remainder trust that is clearly, but defectively, an attempt to qualify as a CRAT or CRUT is not subject to the "90-days-after-the-tax-return-is-due" deadline to be reformed or amended. Only trusts that don't show an attempt to be a CRAT or CRUT are subject to that short deadline. However, the Code provision on reforming trusts failing the 10%-MRI requirement (IRC §2055(e)(3)(J)) says the deadline for reformation is spelled out in IRC §2055(e)(3)(C)(iii). [emphasis added.] So the "90-days-after-the-tax-return-is-due" deadline applies to a trust not meeting the 10%-MRI requirement.

When the Code and a conference report are at odds, the Code wins. IRC §2055(e)(3)(C)(iii) provides that a "proceeding" must begin within 90 days after the filing date (including extensions) of the estate tax return. If no estate tax return is required (the estate isn't large enough to require the filing of a return, **or the trust is created during the donor's lifetime**), reformation must begin within 90 days after the due date (including extensions) for the trust's first income tax return. IRC §2055(e)(3)(C)(iii)(II). *Note.* In Xavier's case, the CRUT was created during his lifetime so the deadline for reforming or amending to meet the 10%-MRI requirement expired 90 days after the due date (including extensions) for his trust's first *income* tax return.

**A word to worry warts.** Because of the short deadline for correcting a 10%-MRI infraction, check existing inter vivos and testamentary charitable remainder unitrusts and annuity trusts for compliance. And executors will want to have 10%-MRI compliance on their checklists. Waiting until a testamentary CRT is funded to check for compliance could be too late.

**Comment.** Suppose at Xavier's death, he wasn't survived by Henry. In that case, unitrust payments obviously wouldn't be made to Henry, nor would they be made to Able, Baker and Charlie. Instead, the en-

\*A letter ruling is not a precedent. See page 12.

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tire trust principal would go to the charity on Xavier's death. Xavier's estate would get no estate tax charitable deduction even though the charity receives the property right away (and at his death the remainder interest is worth 100%). And the estate taxes would not come out of the payment to the charity but out of his estate because trusts that are drawn to be qualified CRUTs and CRATs must provide that no death taxes are to come out of the trust. The result would have been the same had the inter vivos trust flunked the 10%-MRI test and the payments were to be made to Xavier for life, with remainder to charity (with no successor beneficiaries)

**PRIMER ON THE 10%-MRI REQUIREMENT AND ADDITIONAL  
COMMENTS ON XAVIER'S SITUATION**

**The basic rules.** For each contribution to a CRUT, the value of the remainder interest (determined under IRC §7520) must be at least 10% of the net fair market value of the property as of the date the property is contributed. IRC §664(d)(2)(D). Charitable remainder annuity trusts must also meet the 10%-MRI requirement. IRC §664(d)(1)(D). Additional contributions can't be made to CRATs.

**Valuing CRUT and CRAT remainder interests—the details.** IRC §7520 calls for using tables prescribed by the Treasury having an interest rate (rounded to the nearest 2/10ths of one percent) equal to 120% of the federal midterm rate in effect under IRC §1274(d)(1) for the month in which the valuation date falls. The rate so determined is the applicable federal rate (AFR). IRC §7520 provides that if an income, estate or gift tax charitable contribution deduction is allowed for any part of the property, the taxpayer, instead of valuing the interest for the month of the creation of the interest, may elect to use the AFR for either of the two preceding months.

**Can the 10%-MRI requirement be met by using the AFR for either of the two months preceding the month the CRAT or CRUT is created, or must the valuation be made using the AFR for the month the trust is created?** IRC §7520 says you can use either of the two preceding months for computing any income, estate or gift tax charitable deduction. It doesn't say you can use either of those two months for determining whether the 10%-MRI requirement is met. Yet IRC §664(d)(1)(D) and IRC §664(d)(2)(D) say the values for meeting the 10%-MRI requirement shall be "determined under section 7520," and those Code sections don't carve out the "either-of-the-two-preceding months" election. **Another yet.** IRC §664(d)(2)(D) provides: "with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10% of the net fair market value of such property *as of the date such property is contributed to the trust.*" [emphasis added.]

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A splendid argument can be made that for purposes of meeting the 10% MRI requirement, the remainder can be valued using the AFR for either of the two preceding months or the month of the transfer. *But do you want to have to make that argument to the IRS, or to a court?* The words of Justice Oliver Wendell Holmes, Jr., in *U.S. v. Wurzbach*, 280 U.S. 396, 399 (1930) are instructive: "Whenever the law draws a line there will be cases very near each other on opposite sides. The precise course of the line may be uncertain, but no one can come near it without knowing that he does so, if he thinks." So, unless clarification comes from IRS, I'd make sure the 10%-MRI requirement is met for the month of the transfer.

**How to correct CRUTs and CRATs that flunk the 10%-MRI requirement.** An otherwise qualified CRUT or CRAT (or one that could be reformed to qualify) that fails to meet the 10%-MRI requirement may be declared null and void *ab initio* (from the beginning), or changed by "reformation, amendment, or otherwise" to meet the 10%-MRI requirement by reducing the payout rate and/or the duration of any noncharitable beneficiary's interest to the extent necessary to satisfy that requirement. IRC §2055(e)(3).

**Consequence of declaring a trust void *ab initio*.** A charitable deduction is not allowable for any transfer to the trust, and any transactions entered into by the trust before being declared void will be treated as entered into by the donor. IRC §2055(e)(3)(J).

**Statute of limitations extended.** The period for IRS's assessing any deficiency of tax regarding a reformed interest CRUT or CRAT doesn't expire until one year after the Treasury is notified of the reformation. IRC §2055(e)(3)(G).

**Issues and practice pointers.** If the 10%-MRI requirement isn't met, who decides whether the trust is declared void from the beginning or is to be reformed or amended to comply? That the Code states those two options doesn't necessarily give the grantor, the trustee, the beneficiary or the charitable remainder organization the power to choose. State law and a state of uncertainty govern unless the trust instrument gives direction. A trip to the courthouse would be likely.

Many CRUT and CRAT governing instruments traditionally have given the trustee the power to amend the trust for the sole purpose of complying with the requirements of IRC §664, Treasury regulations under that section, and any other Treasury or Internal Revenue Service requirements for charitable remainder [unitrusts] [annuity trusts]. Does that language give the trustee the power to fix up the trust (reduce the payout rate and/or the duration of any noncharitable beneficiary's interest) to meet the 10%-MRI requirement?

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Is that a "proceeding" under IRC §2055(e)(3)(C)(iii)? Does the trustee's power to amend give the trustee the power to declare the trust void?

*Some considerations.* Suppose the trust had sold highly appreciated property before being declared void. The capital gain would be taxable to the donor. Had the trust been amended or reformed to meet the 10%-MRI requirement, the gain would not be taxable. The charitable remainder organization won't be enthusiastic about a trust being declared void. But the donor might not have wanted the trust to be created if the payout has to be lower or the term shorter (or both).

*What to do.* Ah, that, of course, depends on the facts of each situation. Consider giving the trustee the power to declare the trust void *ab initio* or to amend it to qualify. Will a donor-trustee retaining that power create any tax problems?

*For CRUTs and CRATs that are in wills of living individuals.* Consider giving the executor the power to decide whether to declare the trust void *ab initio*, or to amend or reform it to comply with the 10%-MRI requirement. Also consider giving the power to the trustee alone or together with the executor. Explore, however, whether giving the fiduciaries this power could endanger the estate tax charitable deduction. Alternatively, the testator might direct that if the trust didn't meet the 10%-MRI requirement it shall not be created, or he or she could direct that it be amended to comply. In all cases, if the trust is declared void or is not to be funded, provide for an alternative disposition. Take into account whether the trustee and executor are family members, trust beneficiaries or both.

**Additional contributions made to an existing qualified charitable remainder unitrust (meeting the 10%-MRI requirement from its creation).** If the remainder value of the additional contribution is not at least 10%, that addition would result in the trust ceasing to be a qualified CRUT except for this rule: The additional contribution "shall be treated as a transfer to a separate trust under regulations [to be] prescribed by the Secretary [of the Treasury]." IRC §664(d)(4). Can that separate trust then be amended or reformed to qualify as a CRUT? The Code and the Conference Report are silent. And Treasury doesn't seem to be in a hurry to prescribe regulations. See letter ruling discussed on page 8.

**Another practice pointer and issue.** Naturally, you'll want to be sure that the 10%-MRI requirement will be met before making additional transfers to CRUTs. But suppose there's a SNAFU. The Code says that the transfer "shall be treated as a transfer to a separate trust." That the Code says so doesn't necessarily mean that the CRUT's

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trustee has the power to put the additional contribution in a separate trust. So consider providing in the trust instrument for such a contingency.

**Effective dates.** The 10%-MRI requirement applies for transfers to trusts after July 28, 1997. But there is a bonkers rule for some decedents. The 10%-MRI requirement doesn't apply to transfers in trust under a will (or other testamentary instrument) executed before July 29, 1997 if the decedent was on July 28, 1997, under a mental disability to change the disposition of his or her property and didn't regain competence to dispose of the property before he or she died.

*Caution.* An individual who executed a will (or other testamentary instrument) before July 29, 1997 that created a trust not meeting the 10%-MRI requirement and who was bonkers on July 28, 1997 can die having a CRUT or CRAT that doesn't meet the 10%-MRI requirement. But if that previously lucky devil regains competence, even for one second, he'd better amend his trust pronto because the 10%-MRI requirement will apply.

### The Legislative History

**History of the 10%-MRI legislative history.** Bismarck supposedly said that the two things one should not see being made are sausages and a nation's laws. Well, hardly anyone saw the 10%-MRI requirement being made. It was added to the Code at the very last minute in a House-Senate conference committee.

The Conference Report deals with some important concerns that are not covered in the Code. When the Code and a conference report are at odds, the Code governs. When a conference report clarifies an ambiguity in the Code or covers a topic not included in the Code, IRS and the courts are often, but not always, guided by the report.

Here now, with much editing, shortening, and my comments along the way is the Conference Report on the TRA '97 10%-MRI requirement.

**Trusts that meet the 10%-MRI requirement on creation but not down the road.** The 10% MRI requirement is measured on each transfer to the charitable remainder trust and, consequently, a charitable remainder trust that meets the 10%-MRI test on the date of transfer will not subsequently fail to meet that test if interest rates have declined between the trust's creation and the death of a measuring life. [So, if Xavier's trust, for example, had met the 10%-MRI requirement when he created it, the requirement wouldn't have had to be met again at his death when the estate tax charitable deduction was claimed. Pass it once, and you pass it for the life of the

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trust. Conversely, Xavier's letter ruling holds that if you flunk it once (at the outset on the trust's creation) the test is deemed flunked for all time.

**"Relaxed" rule for reforming trusts to meet the 10%-MRI requirement.** Letter rulings often recite all or many of the Code sections dealing with the topic ruled on. And that's so even if a particular Code section is not the subject of the letter ruling. The above letter ruling given to Xavier's estate recited IRC §2055(e)(3)(B) that provides that a remainder interest before and after a trust's reformation can't vary by more than 5%.

IRS, however, didn't discuss the "relaxed" rule in the Conference Report. It would have been academic, because the deadline for reforming Xavier's trust had passed. But it is important to know about if the time to reform hasn't expired. "In substance," says the Conference Report, the reformation requirements of section §2055(e)(3)(B) are relaxed "to the extent necessary for the reformation for the trust to meet the 10% requirement." **Translation.** The long-existing rules of IRC §2055(e)(3)(B) require that the value of an interest before and after reformation can't vary by more than 5% for there to be a qualified reformation of a defective CRAT or CRUT. The Conference Report says the "5% variance rule" is relaxed to the extent necessary to reform a trust to meet the 10% MRI requirement.

The 10%-MRI Code provision doesn't deal with this. Presumably, IRS will go along with the Conference Report. Otherwise, the ability to reform a trust to meet the 10%-MRI requirement would be illusory.

*Note.* The "5% variance rule" is not relaxed, however, so that a trust can be reformed to meet the 50%-maximum-annual payout requirement and the 5%-minimum-payout requirement for CRATs and CRUTs. Nor is it relaxed so that a trust can be amended to comply with the "not-so-remote-as-to-be-negligible-5%-probability test of Rev. Rul. 77-374. (How beautiful upon the mountain are the feet of him that bringeth all these percentage requirements.)

**CRUT flunked the 10%-MRI test but it turned out okay—Letter Ruling 200022014.** A created a 5% CRUT before the 10%-MRI requirement took effect, paying him for life, then to B, C, D, and E, and the survivor of them; the remainder was to go to charity. In 1999, A made an additional contribution to the CRUT and the remainder interest flunked the 10%-MRI test. The trustee, before the deadline for reformation, petitioned a state court to sever an amount representing the additional contribution from the trust and transfer it equally to four separate trusts. Each new trust was to make unitrust payments to A for life, and then to only one beneficiary for life, with remainder to charity. Thus, Trust 1 would pay A for life and then B for life, with re-

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mainder to charity. C, D, and E were each successor beneficiaries to A in Trusts 2, 3, and 4, respectively. Each of the new trusts passed the 10% MRI test.

**IRS ruled.** An amount representing the additional contribution to the initial trust may be severed without disqualifying that trust. By creating four new trusts (each with only one successor beneficiary), the duration of the non-charity beneficiaries' interests would be reduced (as authorized by the Code) and, thus, the 10% MRI requirement would be met. In all other respects (other than the number of non-charity beneficiaries), the four separate trusts were identical to the original trust. Each of the four trusts were qualified CRUTs and contributions to them qualified for the income tax charitable deduction.

**To sum up.** If the 10%-MRI test is flunked on the creation of a CRUT or CRAT, these deductions will be lost: income, gift and estate tax charitable deductions; and gift and estate tax marital deductions. Further, the trust won't be exempt and all income and capital gains will be taxable (not just the income and capital gains payable to the trust beneficiaries). To qualify as a unitrust or annuity trust, the governing instrument must provide that no death taxes are to be paid from the trust. So, if the 10%-MRI requirement is not met, the estate tax payable on the full value of the trust at the donor's death will likely be paid from the estate—not the property passing to the charity.

If the 10%-MRI requirement is met at the outset, it is deemed met for all time. But if it is flunked at the outset, it is flunked for all time.

**Parthian shot: It's not enough to meet the 10%-MRI, the 5%-minimum, the 50%-maximum, the 5%-probability requirements.** A trust can pass all those requirements when created during a donor's lifetime and have all the other required bells and whistles; nevertheless, it can lose the charitable deduction for the remainder interest. In *Atkinson*, the donor funded a 5% charitable remainder annuity trust with almost \$4 million to make annuity payments to her for life. On her death, the annuity payments were to be paid equally to four secondary beneficiaries with an eventual remainder to charity. The CRAT didn't make any payments to donor during her lifetime (missing seven quarterly payments totaling just under \$350,000). A circuit court (affirming the Tax Court) held that a charitable remainder annuity trust's failure to make the required annual payments during the donor's lifetime resulted in the complete loss of the estate tax charitable deduction. And that's so even though substantial sums would go to charity. The loss of the charitable deduction cost the estate \$2,654,976.

*Atkinson*, CA-11 (No. 01-16530, 10/16/02)  
The U.S. Supreme Court  
declined to take the case on appeal.

**S CORP/CHARITY  
SCHEME—  
IRS WARNING**

**In short.** S Corp shareholders attempt to transfer the incidence of taxation on S Corp income by purportedly donating S Corp nonvoting stock to a charity, while retaining the economic benefits associated with that stock. IRS says the purported tax benefits won't be achieved, the S Corp could lose its S Corp status and penalties will apply.

**The typical transaction.** S Corp, its shareholders, and an IRC §501(c)(3) charity take the following steps:

- S Corp issues, pro rata to each of its shareholders (the original shareholders), nonvoting stock and warrants that are exercisable into nonvoting stock. The warrants may be exercised at any time over a period of years.
- The strike price on the warrants is set at a price that is at least equal to 90% of the purported fair market value of the newly issued nonvoting stock on the date the warrants are granted. For this purpose, the fair market value of the nonvoting stock is claimed to be substantially reduced because of the existence of the warrants.
- Shortly after the issuance of the nonvoting stock and the warrants, the original shareholders donate the nonvoting stock to the charity. The parties to the transaction claim that after the donation of the nonvoting stock, charity owns 90% of the stock of the S Corp and that any taxable income allocated to the nonvoting stock to the charity is not subject to tax on unrelated business income (or the charity has offsetting UBIT net operating losses). The original shareholders might also claim a charitable contribution deduction under IRC §170 for the donation of the nonvoting stock to the charity.
- Under one or more agreements (typically redemption agreements, rights of first refusal, put agreements, or pledge agreements) entered into as part of the transaction, the charity can require the S Corp or the original shareholders to purchase the charity's nonvoting stock for an amount equal to the fair market value of the stock as of the date the shares are presented for repurchase.
- Because the original shareholders own 100% of the voting stock of the S Corp, they have the power to determine the amount and timing of any distributions made with respect to the voting and nonvoting stock.
- The original shareholders exercise that power to cause the S Corp to limit or suspend distributions to its shareholders while the charity purportedly owns the nonvoting stock. For tax purposes, however, during that period, 90% of the S Corp's income is allocated to the charity and 10% of the S Corp's income is allocated to the original shareholders.
- The transaction is structured for the original shareholders to exercise the warrants and dilute the shares of nonvoting stock held by the charity, or for the S Corp or the original shareholders to purchase the nonvoting stock from the charity at a value that is substantially reduced by reason of the existence of the warrants. In either event, the charity will receive a share of the total economic benefit of stock ownership that is substantially lower than the share of the S Corp income allocated to the charity.

**S CORP/CHARITY  
SCHEME—  
IRS WARNING  
(Cont.)**

**IRS takes this view.** This scheme (my word) is designed to artificially shift the incidence of taxation on S Corp income away from taxable shareholders to the charity. Thus the original shareholders attempt to avoid paying income tax on most of the S Corp's income over a period of time.

**What IRS plans to do about this.** "The Service intends to challenge the purported tax benefits from this transaction based on the application of various theories, including judicial doctrines such as substance over form. . . . [T]he Service also may argue that the existence of the warrants results in a violation of the single class of stock requirement of IRC §1361(b)(1)(D), thus terminating the corporation's status as an S Corp. See, e.g., Reg. §§1.1361-1(l)(4)(ii) and (iii)."

**IRS will throw the book (the regs too) at the participants:**

Transactions that are the same as, or substantially similar to, the transaction just described are identified as "listed transactions" for purposes of Reg. §§1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2) effective April 1, 2004, the date this notice was released to the public. Independent of their classification as listed transactions, transactions that are the same as, or substantially similar to, the above transaction may already be subject to the disclosure requirements of IRC §6011 (Reg. §1.6011-4), the tax shelter registration requirements of IRC §6111 (Reg. §301.6111-1T and Reg. §301.6111-2), or the list maintenance requirements of IRC §6112 (Reg. §301.6112-1).

Under the authority of Reg. §1.6011-4(c)(3)(i)(A), the exempt party in the listed transaction described in this notice will also be treated as a participant in the transaction (whether or not otherwise a participant). The charity will be treated as participating in the transaction for the taxable year of the purported donation, the taxable year of the reacquisition, and all intervening taxable years.

Persons who are required to register these tax shelters under IRC §6111 but have failed to do so may be subject to the penalty under IRC §6707(a). Persons who are required to maintain lists of investors under IRC §6112 but have failed to do so (or who fail to provide those lists when requested by the Service) may be subject to the penalty under IRC §6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under IRC §6662.

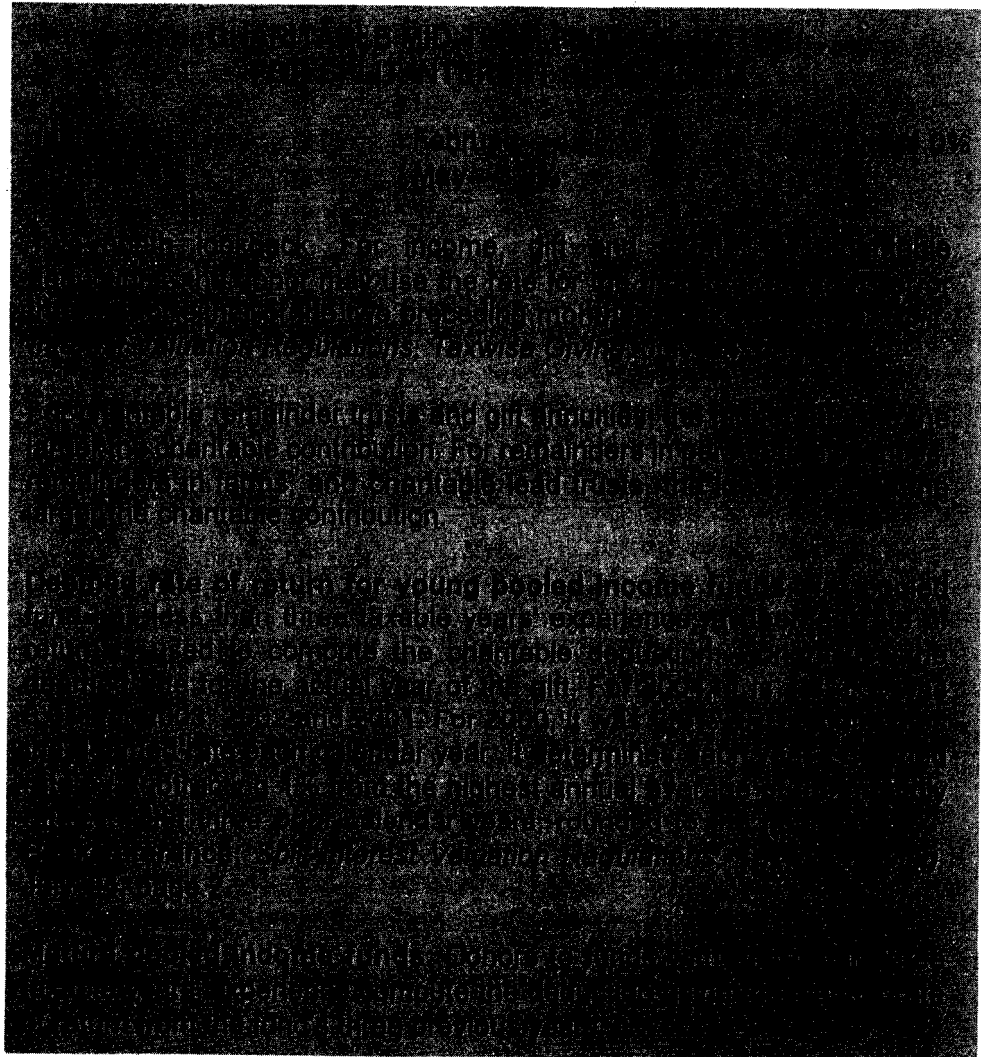
**Turn yourself in.** "The Service and the Treasury Department recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should take appropriate corrective action and ensure that their transactions are disclosed properly."

*Notice 2004-30*

**Comment.** At a time when charities are seeking additional tax incentives for charitable gifts—the CARE Act—these schemes make the row even tougher to hoe.

Answer to Puzzler on Page 2

Now for the Hail Mary Pass. Ask a state court to reform the trust *ab initio* (from the beginning) based on a scrivener's error.



\*PRIVATE LETTER RULINGS

Private letter rulings may be relied upon only by the recipients and are not precedents. Knowing about them, however, can be helpful. If a ruling is favorable, it gives some indication of IRS's position. But do not rely on them; seek your own. If a private letter ruling is unfavorable, it alerts you to a problem—so tread most carefully.

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