

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:4/PLR-116243-00

Date:

February 04, 2002

Re:

Legend:

- Donors -
- Charitable Trust -
- Charity 1 -
- Charity 2 -
- Foundation -
- Co-trustee 1 -
- Co-trustee 2 -
  
- Custodian 1 -
- Custodian 2 -
- Corporation -
- Date 1 -
- Date 2 -
- Date 3 -
- Date 4 -
- Date 5 -
- Date 6 -
- \$A -
- \$B -
- \$C -
- \$D -

Dear :

This is in response to your letter dated December 18, 2000, and subsequent submissions, in which you requested rulings under § 664 of the Internal Revenue Code regarding the rescission of a charitable remainder trust.

The facts are represented to be as follows:

Prior to Date 1, Charity 1, a qualified charitable organization described in §§ 170(b)(1)(A), 170(c), 2055(a), and 2522(a) of the Internal Revenue Code, solicited Donors to participate in extensive charitable giving, primarily for the benefit of Charity 1.

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The solicitation by Charity 1 included representations concerning the income tax consequences for Donors of the proposed transfer to Charity 1. Pursuant to the solicitation and under the guidance of Charity 1's estate design office, Donors executed an intervivos irrevocable trust (Charitable Trust) on Date 1. At the time it was executed, Charitable Trust satisfied the requirements for a charitable remainder unitrust under § 664(d)(2). Charity 1 is the primary charitable remainder beneficiary and Charity 2 is the other charitable remainder beneficiary. The initial co-trustees of Charitable Trust (Co-trustee 1) were Charity 1 and an individual who was not related to Donors. Because Charity 1 was both the charitable beneficiary and co-trustee of Charitable Trust, Custodian 1 was hired to manage the account for Charitable Trust. Charitable Trust is governed by the laws of the State of California.

Article I(2) of Charitable Trust sets forth the provisions for payment of the unitrust amount, as follows:

In each taxable year of the Trust, the Trustee shall pay to [the Donors] (hereinafter collectively referred to as "the Recipients"), in equal shares during their lifetimes, a unitrust amount equal to eight (8%) percent of the net fair market value of the assets of the Trust valued as of the first day of each taxable year of the Trust (the "Valuation Date"). Each Recipient reserves the right to revoke the income interest due from the first Recipient's share to the other Recipient by notifying all trustees in writing of said intention prior to the death of the first Recipient. Upon the death of the first Recipient to die, and unless the first Recipient has revoked the survivor Recipient's right to receive the first Recipient's income share, the survivor Recipient shall be entitled to receive the entire unitrust amount. The unitrust amount shall be paid in equal quarterly amounts from income and, to the extent that income is not sufficient, from principal. Any income of the Trust for a taxable year in excess of the unitrust amount shall be added to principal. . . . The obligation to pay the unitrust amount in the trust's first taxable year shall begin on the commencement date of this trust.

Article I(5) provides that, upon the death of the surviving donor, the trustee shall distribute 75 percent of the principal and accumulated income to Charity 1 and the remaining 25 percent to Charity 2, provided such organizations satisfy the requirements as qualified charitable organizations described in §§ 170(b)(1)(A), 170(c), 2055(a), and 2522(a). If those organizations are not qualified charitable organizations described in §§ 170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time the distributions are to be made, the trustee will distribute the principal and accumulated income to charitable organizations that are described in §§ 170(b)(1)(A), 170(c), 2055(a), and 2522(a).

Donors funded Charitable Trust with 75 percent of the issued and outstanding stock in Corporation, all of the shares of which were owned by Donors at the time of funding. Corporation stock was the only asset of Charitable Trust.

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On Date 2, Donors timely filed their United States Individual Income Tax Return, Form 1040, for the year of the creation and funding of Charitable Trust, reporting adjusted gross income of \$A and claiming a charitable deduction of \$B for the present value of the remainder interest in stock of Corporation transferred to Charitable Trust. Because of the charitable deduction limitation on the value of the stock in the year of the transfer, on Date 3, Donors timely filed their United States Individual Income Tax Return, Form 1040, for the year following the year of the creation and funding of Charitable Trust, reporting adjusted gross income of \$C and claiming a charitable deduction of \$D for the present value of the remainder interest in stock of Corporation transferred to Charitable Trust that was not reported on the prior year's return.

Donors represent that, at the time Charitable Trust was created, they were informed by Charity 1 that distributions, deemed or otherwise, were not required to be made from the Charitable Trust until the stock in Corporation was sold. Charitable Trust was unable to sell the stock in Corporation. Accordingly, the annual unitrust amount was never paid to Donors. It is further represented that Corporation never paid dividends and Charitable Trust had no income, capital gain or otherwise, from any source. After the transfer to Charitable Trust, the shares lost value and were never sold by Charitable Trust.

The Donors contend that, prior to and subsequent to formation of Charitable Trust, they were informed by Charity 1, serving in the capacity as the co-trustee, that no income tax would be imposed on Donors if the stock contributed to Charitable Trust by Donors was sold. The Donors also contend that Custodian 1 informed Donors after creation of Charitable Trust that, if there was to be a distribution of the stock to Donors, such distribution would not be "a taxable event." No stock was ever distributed to Donors.

After the creation of Charitable Trust, Foundation, which is a charitable organization described in § 501(c)(3) contributions to which are deductible under §§ 170(b)(1)(A), 170(c), 2055(a), and 2522(a), became the successor-in-interest to Charity 1. As the successor-in-interest to Charity 1, Foundation and an individual unrelated to Donors became the successor co-trustees (Co-trustee 2) and Foundation became the primary charitable remainder beneficiary of Charitable Trust.

On Date 4, Co-trustees 2 designated Custodian 2 as successor custodian to Charitable Trust. Under the custodian agreement, Custodian 2 was to hold cash, securities, and other property transferred to Charitable Trust by Donors, maintain the records of Charitable Trust, and serve as Charitable Trust's Investment Manager. Custodian 2 and Foundation subsequently determined that Charitable Trust should have made distributions, in kind or otherwise, to Donors in satisfaction of the unitrust amount and that such distributions, if made in kind, would have been characterized as distributions of capital gain includible in Donors' gross income. See, § 1.664-1(d)(5). Although no distributions had been made, Form K-1s were sent to Donors for the years dating from the creation of Charitable Trust reporting "deemed" taxable distributions to

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Donors. The position taken by Foundation and Custodian 2 regarding the income tax treatment of distributions from Charitable Trust conflicted with the prior advice that Donors had received from Charity 1 and Custodian 1 and, prior to receiving the Form K-1s, Donors were unaware of the different position.

Pursuant to several discussions among the interested parties to resolve their positions, Donors filed a Petition for Rescission in the appropriate local court based on a substantial mistake of law and fact in the execution of Charitable Trust. Donors and Foundation were represented at the hearing. The Attorney General's Office for the State of California was notified of the hearing and, by its absence, elected not to oppose the hearing. Although Charity 2 did not appear at the hearing, it consented to the hearing and filed its consent with the local court.

In the pleading, Donors alleged, *inter alia*, that, prior to creating Charitable Trust, Donors were incorrectly advised that: (a) no distribution from Charitable Trust was required to be made until the stock in Corporation was sold by Charitable Trust; and (b) neither the transfer of Corporation stock to Charitable Trust nor the actual distribution of stock to Donors in satisfaction of the unitrust payment would generate capital gain includible in Donors' gross income. Donors also alleged that they were unaware of any requirement that a "deemed" distribution of stock to them would generate capital gain includible in their gross income. Donors also alleged that, if they had been fully informed that distributions from Charitable Trust had to commence immediately and that in-kind distributions of Corporation stock to them would result in recognition of capital gain income, they would not have created Charitable Trust.

On Date 5, the court issued an order rescinding Charitable Trust and directing that the remaining assets of Charitable Trust be returned to Donors and that the trustees be discharged from any further administrative duties.

On Date 6, Donors subsequently filed amended income tax returns for the years in which they claimed charitable deductions for the transfer of the Corporation stock to the Charitable Trust. The amended returns reversed the income tax charitable deductions claimed by the Donors on the original returns. The resulting additional tax was paid with these returns. However, because the amended income tax return for the year in which Charitable Trust was created and funded was filed and the additional tax was paid more than three years after Date 2, the date that the original return was timely filed, the Donors made a statutory overpayment for that year. The Donors are entitled to a refund for the additional tax paid for that year if they file a timely claim. The amended income tax return filed for the year following the year of the transfer, in which the excess charitable deduction was claimed and additional tax was paid, was filed within three years after Date 3, the date of the original return.

You request a ruling that the court order issued on Date 5 will be effective for tax purposes such that:

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(1) the court order rescinding Charitable Trust will be effective for tax purposes as of Date 1, the date Charitable Trust was created; and

(2) Charitable Trust is not required to report taxable distributions to Donors for years 1995 through 2000 and Donors are not required to include any such amounts in gross income because either:

(a) no distributions were actually made by Charitable Trust, and Charitable Trust did not realize any capital gain, dividend or other income during that period; or

(b) as a result of the court order, the trust is deemed not to have existed during the period for tax purposes.

Law and analysis:

Section 2501(a)(1) imposes for each calendar year a tax on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2522(a) provides, in part, that in computing taxable gifts for the calendar year, there is allowed a deduction for all gifts to or for the use of a corporation or trust operated exclusively for religious, charitable, scientific, literary, or educational purposes and for certain other purposes.

Section 2522(c)(2)(A) provides in part that, where a donor transfers an interest in property (other than an interest described in § 170(f)(3)(B)) to a person or for a use described in § 2522(a) above and an interest in the same property is retained by the donor or transferred by the donor to another person or for a use not described in § 2522(a), no deduction is allowed unless -

(A) in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (described in § 664) or a pooled income fund (described in § 642(c)(5)), or

(B) in the case of any other interest, such interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).

Section 664 provides definitions, general rules governing the creation and administration of a charitable remainder trust, and rules governing the taxation of the trust and its beneficiaries.

Section 664(d)(2) defines a charitable remainder unitrust, generally, as a trust -

(A) from which a fixed percentage (which is not less than 5 percent) of the

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net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in § 170(c),

Section 664(d)(3) provides an exception to paragraphs (2)(A) and (B) for a trust that provides for payment to the income beneficiary for any year of -

(A) the amount of the trust income, if such income is less than the amount required to be distributed under paragraph (2)(A), and

(B) any amount of the trust income which is in excess of the amount required to be distributed under paragraph (2)(A), to the extent that (by reason of subparagraph(A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required payments.

The law of California governing contracts between parties provides at Cal. Civ. Code § 1566 (West 2000):

A consent which is not free is nevertheless not absolutely void, but may be rescinded by the parties, in the manner prescribed by the Chapter on Rescission.

Cal. Civ. Code § 1567 (West 2000) states that an apparent consent is not real or free when obtained through duress; menace; fraud; undue influence; or mistake.

Cal. Civ. Code § 1578 states that mistake of law constitutes a mistake only when it arises from: 1. A misapprehension of the law by all parties, all supposing that they knew and understood it, and all making substantially the same mistake as to the law; or 2. A misapprehension of the law by one party, of which the others are aware at the time of contracting, but which they do not rectify.

In Walton v. Bank of California, National Association, 218 Cal. App. 2d 527, 32 Cal. Rptr. 856 (1963), trustor attempted to rescind an irrevocable trust on the basis of mistake of fact as to the irrevocability of the trust and the gift tax liability of the transfer. The court found that there was substantial evidence that the trustor was informed of the gift tax liability resulting from the transfer and, thus, a mistake did not occur that would be sufficient to rescind the contract. The court noted that where a trust is created solely

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or principally for a tax purpose, the mistake as to the tax consequences is a material one, indicating that such a material mistake would be sufficient to rescind the contract. In taking this position, the court, at 32 Cal. Rptr. 868, cited Reid v. Landon, 333 P.2d 423, 437 (Cal. App. 1958) and Stone v. Stone, 29 N.W.2d 271 (Mich. 1947).

Under California law, the rescission of a contract means the annulling or abrogation of it and the placing of the parties to it in status quo. Sessions v. Meadows, 57 P.2d 548, 549 (Cal. 4<sup>th</sup> Dist. Ct. App. 1936).

In the instant case, based on the representations made and statements contained in the pleadings submitted to the court, the Donors were misinformed regarding the operation of Charitable Trust as drafted and the requirement that the unitrust amount became payable immediately upon execution of Charitable Trust. In view of the nature of the assets transferred to Charitable Trust (non-income producing stock) and Donor's understanding that no unitrust payment would be made until the stock was sold, it appears that the scrivener intended to draft and the Donors intended to execute a charitable remainder trust described in § 664(d)(3), rather than one described in § 664(d)(2). Further, Donors were incorrectly informed regarding the tax consequences if Charitable Trust distributed assets in kind in satisfaction of the unitrust amount.

As noted above, in an attempt to reverse the income tax charitable deductions claimed by the Donors on the original income tax returns, Donors filed amended income tax returns on Date 6 and paid the additional tax due. However, also as noted above, because the period of limitations on assessment for Donors' income tax return filed on Date 2 has expired, the Donors made a statutory overpayment for the year in which Charitable Trust was created and funded and the Donors may make a claim for a refund of the additional tax paid for that year. The remaining assets of Charitable Trust were returned to Donors pursuant to the court order issued on Date 5. Traditionally, the tax benefit rule requires taxpayers to recognize income when the taxpayers "recover" an item or amount deducted in a previous tax year. Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983). The rule is also applicable in cases involving charitable deductions and provides that if a taxpayer receives a deduction for a charitable contribution in one taxable year and recoups that donation in a later year, the value of the contribution, up to the amount of the charitable contribution previously taken, is treated as income in the year in which it was recouped. Rosen v. Commissioner, 611 F.2d 942 (1<sup>st</sup> Cir. 1980), aff'g 71 T.C. 226 (1978). It is irrelevant that the deduction taken in the prior year may have been improper or that the period of limitations on assessment has expired for the year in which the deduction was claimed. Unvert v. Commissioner, 656 F.2d 483 (9<sup>th</sup> Cir. 1981). Thus, the amount of the charitable deduction, \$B, claimed by Donors on their income tax return filed on Date 2, for the present value of the remainder interest in the stock of Corporation transferred to Charitable Trust, will be includible in the Donors income for the year in which the remaining assets of Charitable Trust were returned to the Donors. Donors have represented that they will timely file an amended United States Individual Income Tax

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Return, Form 1040X, for that year reporting the value of the stock up to \$B, the value of the contribution claimed by Donors on their income tax return filed on Date 2.

However, the amended income tax return filed for the year following the year of the transfer, in which the excess charitable deduction was claimed and the additional tax was paid, was filed within three years after Date 3, the date of the original return. Thus, the additional tax was paid for that year, which negated the charitable deduction claimed in that year for the transfer to Charitable Trust and, as to that year, the parties are in the same position that they would have been in if Charitable Trust had never been created.

Because of the application of the tax benefit rule for the year in which the transfer was made to Charitable Trust, the filing of the amended tax income return and payment of additional tax for the year following the transfer to Charitable Trust and the fact that Charitable Trust had no income, either ordinary or capital gains, and the Corporation paid no dividends from Date 1 until the date of the court order granting rescission, all parties are in the same position that they would have been in if Charitable Trust had never been created. Further, the court order rescinding Charitable Trust is consistent with applicable state law.

Accordingly, we conclude that the rescission will be recognized for federal tax purposes as effective as of the date Charitable Trust was created.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by the appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. Except as specifically ruled above, no opinion is expressed or implied as to the federal tax consequences of this transaction described above under the cited provisions or any other provisions of the Code or regulations.

A copy of this letter should be attached to any tax returns that you may file relating to these matters.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,  
George Masnik  
Chief, Branch 4  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure  
Copy for section 6110 purposes