Trust Reformation Is Not Always a Good Solution

Estate planning practitioners have, for many years, found relief from many errors by a trust reformation. The Uniform Trust Code makes reformations of trusts quite easy to accomplish, even without a court order, upon a showing by clear and convincing evidence of the settlor's intention and that the terms of the trust "were affected by a mistake of fact or law, whether in expression or inducement."[1] The IRS has been quite generous in recent years, allowing retroactive reformations to correct scrivner's errors, even when the reformation would dramatically improve the income, estate, gift, and generation-skipping transfer (GST) tax consequences of the transaction or instrument.[2] Unfortunately, the IRS does not always recognize the retroactivity of state law reformations for federal tax purposes, as demonstrated in Ltr. Rul. 201243001.

Background

Spouse died survived by Decedent. The couple's joint revocable trust was, at Spouse's death, to be divided into a credit shelter trust and a revocable marital trust for Decedent's lifetime benefit. The marital trust leaves the remaining trust assets to a trust on the same terms as the credit shelter trust, when Decedent dies. The credit shelter trust provides that upon the death of the latter of the grantors to die, x% of the trust fund will be paid outright to Son.

Decedent hired Attorney to prepare an amendment to the marital trust, providing that, upon Decedent's death, x% of the marital trust will be paid outright "to [Son], if surviving, but he shall have the right to disclaim all or any part of his share of said assets." Any disclaimed assets would be held in another trust, Trust 3, which would then be irrevocable. Son would be trustee of Trust 3, and he and his descendants would be the beneficiaries. The beneficiaries of Trust 3 would receive net income and principal for their health, education, maintenance, and support in reasonable comfort. Upon Son's death, Trust 3 will be distributed to Son's lineal descendants.

After Decedent's death, Attorney became aware that the requirements of a qualified disclaimer cannot be satisfied by a person who is not the spouse of the grantor if the disclaimed property passes to a trust for the benefit of the person making the disclaimer. More than one year after Decedent's death, Son, as trustee of the credit shelter trust and of Trust 3, petitioned the court to reform the provisions of the Marital Trust, *nunc pro tunc*, as of Decedent's death. The reformed instrument would delete the outright distribution to Son, and leave the trust assets in trust for Son and his descendants.

The court issued the requested order, citing a state statute as authority for reforming the trust. The state statute provides that "[n]othing in this section shall prohibit modification or termination of any trust pursuant to its terms or limit general equitable power of a court to modify a trust in whole or in part." Son submitted evidence, including an affidavit by Attorney, stating that Attorney met with Decedent and Son to discuss Decedent's estate plan, and Son provided Attorney with a letter from Son's attorney suggesting an amendment to Decedent's trust.

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Decedent indicated to Attorney that she wanted to amend the trust so that, upon her death, certain assets passing to Son would be retained in an irrevocable trust in which Son would have a beneficial interest, but that these assets would pass free of estate and GST taxes at Son's death. Attorney stated that this could be achieved through a disclaimer by Son, and Son and Decedent agreed to proceed with the disclaimer approach, if it would allow the assets to be retained in a GST exempt trust for Son. Attorney prepared an amendment to the trust to incorporate this disclaimer planning. Apparently, Attorney had no documents or notes with respect to Decedent's intent, and there were no express references to GST planning in Decedent's estate planning documents.

IRS rejects state court reformation

The IRS ruled that the state court order reforming the trust would not be recognized as a retroactive reformation for gift, estate, and GST tax purposes. The taxpayer took the position that the amendment created an ambiguity or a scrivener's error due to a mistake of law or fact and, accordingly, the reformation should be recognized retroactively for federal tax purposes.

The IRS explained that, generally, a state court reformation of a trust instrument has retroactive effect as between the parties to the instrument, but not as to third parties who may have already acquired rights under the instrument. Furthermore, retroactive changes to the legal effects of a transaction through judicial nullification or reformation are not given retroactive effect for federal tax purposes.[3]

The IRS also explained that, under *Estate of Bosch*,[4] the decision of a state trial court on an underlying issue of state law does not control the federal courts and agencies; they are bound by a decision of the highest court of the state, and absent that, they must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

Applicable state law provides that a unilateral mistake by the settlor of a trust may be sufficient grounds to reform it, and the party advocating reformation must establish the mistake by clear and convincing evidence. The state supreme court also may reform a document whether there is a mistake of fact or a mistake of law.

In this case, the highest court and the appellate courts in the state have not considered the issue in this case, but the IRS stated that it would give "proper regard" to the state court order to determine whether to recognize the retroactive reformation. The IRS noted that the amendment was not ambiguous on its face, and the petition for the state court order did not allege ambiguity, but rather that Attorney made a drafting error and that the reformation proceeding was needed to carry out Decedent's intent.

The IRS concluded that the documentation did not provide clear and convincing evidence that Decedent intended for Son's share in the marital trust to be distributed to Trust 3, as reformed by the state court. The amendment gave Son the right to disclaim part of the assets left outright to him, in which case they would be held in Trust 3. Son determined not to disclaim his interest in the trusts. The IRS stated that the reformation was not consistent with applicable state law, as applied by the highest court of state, and that they would not recognize it as retroactive for federal tax law purposes.

Reformations are great, but not a panacea

Estate planners should never be reluctant to seek a trust reformation, particularly to correct a true scrivener's error. Ltr. Rul. 201243001 should remind us, however, that merely obtaining a judicial reformation does not assure favorable tax treatment. Practitioners who seek a retroactive reformation that is not expressly authorized by the Code,[5] should take pains to establish that the settlor had expressly desired that the trust instrument provide something specific, and that the attorney inadvertently omitted that provision. It is not entirely clear when the IRS will accept such reformations as retroactively valid, but practitioners should attempt to establish that the error was one of drafting, rather than one of planning, as the IRS appears to be more inclined to allow retroactive reformation in cases where the errors are directly tied to drafting. ■

[1] Uniform Trust Code sections 411 and 415. See discussion of trust reformations generally in Boyle, "When It's Broke—Fix It: Reforming Irrevocable Trusts to Change Tax Consequences," 53 Tax Law. 821 (Summer 2000); Hodgman and Blickenstaff, "Judicial Reformation of Trusts—the Drafting Tool of Last Resort," 28 ETPL 287 (June 2001); Schindel, "How to Modify or Terminate an Irrevocable Trust," 22 ETPL 323 (November/December 1995).

[2] See, e.g., Ltr. Ruls. 201147010 (reformation to correct scrivener's error that omitted authority for trust to make distributions to lineal descendants during settlor's lifetime); 201132017, 201002013 (reformation corrects an inadvertent general power of appointment); 200919003 (reformation saves defective QTIP); and 200848017 (reformation converts nongrantor trust into grantor trust).

[3] Van Den Wymelenberg, 397 F.2d 443, 22 AFTR2d 6008 (CA-7, 1968), *aff'g* 272 F. Supp. 571, 20 AFTR2d 5994 (DC Wis., 1967); M.T. Straight Trust, 245 F.2d 327 (CA-8, 1957), *aff'g* 24 TC 69 (1955); Sinopoulo v. Jones, 154 F.2d 648, 34 AFTR 1124 (CA-10, 1946); American Nurseryman Publishing Co., 75 TC 271 (1980), *aff'd without published opinion* 673 F.2d 133 (CA-7, 1981); Estate of Hill, 64 TC 867 (1975), *aff'd without published opinion* 568 F.2d 1365 (CA-5, 1978).

[4] 387 U.S. 456, 19 AFTR2d 1891 (1967).

[5] See, e.g., Section 2055(e).