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## WHEN WHAT YOU SAY IS NOT WHAT YOU MEAN: IRS Rulings Allow Reformation

The Internal Revenue Service has demonstrated that it can be sympathetic to genuinely unintended provisions contained in charitable remainder trusts (CRTs). Recently it issued private letter rulings that granted a pair of taxpayers a “do over” when the original documents they executed missed the mark of their intentions by a wide margin.

### You say CRAT, I say CRUT, let's call the whole thing off.

In **Ltr. Rul. 200251010**, the taxpayers, husband and wife, intended to create a charitable remainder unitrust (CRUT) that would pay them a fixed percentage of the trust's annual value and conveyed that intention to their attorney. Rather than drafting a CRUT, the attorney drafted a charitable remainder annuity trust (CRAT) that provided for fixed payments for life. In an effort to simplify review of the document, the attorney presented the taxpayers with a computer software-generated synopsis of the trust.

Even though the synopsis used the term “Charitable Remainder Annuity Trust” in the title, it went on to describe the provisions of a CRUT—exactly what the taxpayers

wanted. Based on that synopsis, and without reviewing the full document, the husband approved and subsequently executed the draft document.

The fact that the trust that purported to be a CRUT was in fact a CRAT was not discovered until the tax preparer was working on the trust's first income-tax return. After reviewing the document, the tax preparer realized the document described an annuity trust. The parties immediately took corrective action to put the trust in the position it would have been had the trust been administered as a CRUT from its inception, and they sought an order for judicial reformation.

The state court granted reformation *ab initio* by removing the provisions of the trust that characterized it as a CRAT and replacing them with provisions consistent with a CRUT. The taxpayers then asked the IRS to rule that the judicial reformation of the trust from its inception would not violate any provisions under **IRC §664** and the regulations thereunder or be an act of self-dealing under **IRC §4941**.

In issuing its ruling, the IRS made it clear that it relied heavily on the original intent of the taxpayers. The actions of the taxpayers, both before the trust was executed and after the errors were

discovered, were strong evidence that their true intent was to create a CRUT, the IRS reasoned. Both the attorney and the trustee submitted affidavits that supported the taxpayers' contention that they intended to create a CRUT and believed they had. Once the errors were discovered, they took swift action to reform the trust to be consistent with their original intentions. Accordingly, correction of these scrivener's errors would not cause the trust to fail to qualify under **IRC §664**.

In regard to the self-dealing issues, the ruling noted that the husband and wife are both disqualified persons for purposes of the self-dealing rules. Because a judicial reformation could have the effect of increasing the annual amount payable to them, the judicial reformation could be a transfer to, or use by or for the benefit of, disqualified persons. Here again, the IRS focused on original intent in concluding there was no self-dealing.

Particularly compelling was the fact that a reformation might not have been in the taxpayers' best financial interests. The ruling noted that “there is no evidence that A [the husband] is reducing his and his wife's own taxes, or using the benefit of hindsight in making the change to the charitable remainder unitrust.

In fact, the Trust represents that the assets of the Trust have decreased in value since the Trust was funded. Therefore, for the foreseeable future, A and B [the wife] will actually receive smaller payments over the course of a year from the reformed Trust (as a unitrust) than they would have received under the original trust (as an annuity trust).”

**Time to reform and not make up.** A similar type of situation was involved in **Ltr. Rul. 200244011**, although the mistakes were not quite as drastic. The taxpayers represented that they had intended to create a charitable remainder trust that would pay them a fixed percentage of the trust’s annual value—a **CRUT**. What their attorney drafted instead was a **CRT** that would pay them the lesser of the stated unitrust percentage or the trust’s actual income for the year, with any deficiencies from prior years made up in years in which there is excess income—a so-called net income with make-up unitrust, or **NIMCRUT**. The taxpayers had concluded they did not want a **NIMCRUT** since they did not believe it could generate income sufficient to produce the payments they wanted.

Again, the trust was executed by the donor under the belief that it was consistent with the stated intentions, naming the donor and the donor’s spouse as trustees. The trust was administered by the trustee’s agent as a **CRUT** throughout the trust’s first year before the agent discovered that

the terms of the trust described a **NIMCRUT**. At that time, the trustees petitioned the state court for judicial reformation.

The **IRS** followed much the same reasoning in this case as in **Ltr. Rul. 200251010** and determined that the reformation does not violate **IRC §664** and would not cause the trust to fail to qualify as a **CRT**. The ruling also concluded that even though the spouses were both disqualified persons, there was no self-dealing since the parties never intended to create a **NIMCRUT**.

The agent administering the trust submitted an affidavit attesting to the fact that the couple had never intended to have a net-income limitation in the trust language. In light of all the circumstances, the **IRS** determined that there was no evidence that the couple were reducing their own taxes or “using the benefit of hindsight in making the change to the fixed percentage payment method.”

#### **Caution is still in order.**

These rulings add to the growing list of situations in which the **IRS** has proven to be sympathetic to cases of “scrivener’s error”—especially when the taxpayers can convincingly demonstrate that language in a trust document does not represent their original intention or understanding of what they actually executed. Nevertheless, there is no guarantee that the **IRS** will always interpret every variance as a reformable scrivener’s error.

Taxpayers and advisors should continue to take great care to be sure trust language accurately reflects the taxpayer’s intentions.

## **COUPLE SPLITS, CRT FOLLOWS SUIT**

Charitable remainder trusts are required to be irrevocable but marriages are not. So what happens when a husband and wife go their separate ways if they happen to be co-beneficiaries of a **CRT**? According to a recent private letter ruling, it is okay to split the existing trust into two new trusts (**Ltr. Rul. 200301020**).

The couple had created a charitable remainder unitrust (**CRUT**) and named themselves co-trustees and life-income beneficiaries. In the event of the death, resignation, or incapacity of one of the spouses, the other would become the sole trustee. Upon the death, resignation, or incapacity of the survivor, a bank would become the successor trustee. The couple also retained the right to change the remainder beneficiaries jointly as long as both were living and then individually by the survivor.

Now that they are divorcing, the couple is seeking approval of a plan to divide the Original Trust into two substantially similar trusts. Each of the two new trusts will get half of the trust assets, divided on a pro rata basis; and each trust will retain the same unitrust payout percentage as the Original Trust.

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The husband will be the sole income beneficiary of **CRUT 1** during his lifetime; the wife, if she survives him, will be the successor beneficiary. The second trust (**CRUT 2**) will be just the opposite—the wife will be the initial beneficiary and the husband will be the successor. Both trusts will terminate on the death of the survivor of the couple.

The husband will have the right, acting alone, to designate the charitable remainder beneficiary or beneficiaries of **CRUT 1**, and the wife will have the same rights in **CRUT 2**. With regard to trustee provisions, each will be the initial trustee of the **CRUT** of which he or she is the initial income beneficiary. If the initial trustee resigns or becomes incapacitated during his or her lifetime, the bank will become the successor trustee and will continue in that capacity even after the initial beneficiary's death.

If, on the other hand, either is serving as the trustee of the trust of which he or she is the initial income beneficiary at his or her death, the other spouse, if he or she survives, will become the successor trustee. If the surviving successor beneficiary spouse resigns or becomes incapacitated, the bank will step in as trustee.

The taxpayers have sought guidance from the **IRS** on a number of issues related to this plan, foremost among which is whether the two new trusts will qualify as charitable remainder trusts under **IRC §664**. The ruling

concluded that the two new trusts will retain all of the required characteristics of qualified **CRTs**.

The taxpayers were also concerned about possible recognition of gain as a result of these transactions by the Original Trust, **CRUT 1**, **CRUT 2**, or the beneficiaries. **Reg. §1.1001-1(a)** states that, except as otherwise provided in subtitle A of the Code, a taxpayer's income includes gain realized from the exchange of property differing materially either in kind or in extent. The ruling determined that dividing the assets of the trust did not produce property "materially different" from the Original Trust assets and no gain would be attributable to any party or entity. Similarly, the **IRS** concluded pursuant to **IRC §1015(b)** that the basis of trust assets in the hands of the two new trusts would be the same as that of the Original Trust.

Another concern for the taxpayers was whether or not the division of the trust would be treated as a termination subject to tax under **IRC §507(c)**. No, said the **IRS**, citing **Reg. §1.507-1(b)(6)** that provides, in part, that if a private foundation transfers all or part of its assets to one or more other private foundations pursuant to a transfer described in **§507(b)(2)**, such transferor foundation will not have terminated its private foundation status under **IRC §507(a)(1)**.

For these purposes, the trusts are treated as subject to these private foundation provisions.

By the same token, the two new entities will not be treated as "newly created" but will retain the aggregate tax benefit of the Original Trust within the meaning of **IRC §507(d)**.

The **IRS** also determined that, since the only interest the husband and wife had in the Original Trust was the payment of the unitrust amount and that was not changed by the division of the trust, those amounts are not subject to self-dealing provisions of **IRC §4941** (or **§507** or **§4945**). By the same analysis, it determined that no taxable expenditures had occurred under **IRC §4945**.

Finally, the ruling found payment of reasonable attorney fees by the Original Trust was appropriate and did not constitute self-dealing. The ruling said, "Any expenses paid pursuant to the division of Original Trust, assuming such expenses are reasonable, are justified as necessary to carry out the trust purpose to facilitate the smooth functioning and operation of the trust which was not possible under the prevailing divorce proceedings."

## **GIFT TO SUPPORT WORK OF COMPOSER DOES NOT HIT SOUR NOTE**

It is well-established in case law and revenue rulings that a donor is not entitled to a charitable contribution deduction if the donor is allowed to designate the gift for the benefit of a particular

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individual, even if that individual is a member of the class the donee charity is intended to benefit. However, a donor can express his or her desire as to how he or she would like to see the funds used as long as the charity retains the ultimate control over the use of the gift.

Sometimes it is hard to ascertain a distinct line between those two scenarios. In a recent private letter ruling, the IRS determined that the donors did not cross the line and were entitled to a charitable deduction (Ltr. Rul. 200250029).

Early in the year, the taxpayers expressed interest in making a gift to a charitable organization to support the composition of a work by a specific composer. That summer, the donors actually made the gift. Although the charity was fully aware of how the donors hoped they would use the funds, the charity represented, in writing, to the donors that there could be no assurance that the funds would be used to support the work of the composer. They emphasized that the funds would be used at the discretion of the charity's officers, in furtherance of the organization's charitable purposes; and the taxpayers represented that they understood the charity's position in accepting the gift.

Late that year, the organization entered into an agreement with

the composer and an orchestra that the organization would pay the composer a commissioning fee and copying costs and would reimburse the composer for reasonable expenses associated with the composer's appearance at the premiere of the work. The donors' contribution was sufficient to pay the commissioning fee and the copying cost.

The ruling cited, among other authority, Rev. Rul. 62-113, 1962-2 C.B. 10, as setting out the appropriate test for deductibility. In that case, a father made contributions to a missionary organization in which his son served as a missionary and would, therefore, be eligible to receive reimbursements for expenses. The revenue ruling states that the test in each case is whether the organization has full control of the donated funds, and discretion as to their use, so as to ensure that they will be used to carry out its functions and purposes. Here, even though the father had in fact provided most of his son's support in the past, the circumstances supported the conclusion that his gift was for the benefit of the organization and not restricted for the benefit of his son.

Typically, however, that determination is a question of fact. Rev. Rul. 79-81, 1979-1 C.B. 107, concluded that gifts to an educational institution were

simply tuition payments for designated students. "Sponsors" signed a commitment form that set the contribution amount, the payment schedule, and indicated the names of the sponsor and the student. The sponsors received payment envelopes that had a space for the names of the students. Even though the commitment form stated that the use of the money was "solely at the discretion" of the organization, the ruling concluded that the commitment forms and payment envelopes made it clear that the funds really were designated for particular students.

In the present situation, the fact that the donors had expressed interest in supporting the work of the composer raises the question of whether the gift was improperly designated. Based on the facts, the IRS felt that the answer was no.

The ruling determined that this situation was more similar to that in Rev. Rul. 62-113. In reaching that conclusion, the ruling said, "Although the Donors expressed an interest in the selection of a particular individual to compose a work for Organization, the common understanding was the contribution would become part of the general funds of Organization, and would be distributed in the manner chosen by Organization's officers."

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