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Guest Article

Scrivener's Error: Lessons Learned From The Mistakes Of Others

By Jeffrey A. Baskies

A recent private letter ruling (PLR 200425027) offers some insights into the Internal Revenue Service's liberal position on reformation of charitable trusts, and provides planners with two key lessons. The insight is fairly simple: The IRS is willing to be liberal in allowing reformations of charitable trusts that are poorly drafted.

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The lessons are also fairly simple (yet very important). The first lesson is that even a poorly crafted estate plan can sometimes be successfully reformed. So if you run across one involving a difficult charitable bequest and/or split-interest charitable trust (those with charitable and non-charitable beneficiaries) in your practice, don't despair. You may be able to obtain a court reformation and then a positive PLR from the IRS.

The second lesson is to be very careful when drafting charitable bequests (directly or in split-interest trusts). As the PLR reminds us, not every charitable bequest meets the IRS' requirements.

Background

In PLR 200425027, the IRS ruled that a reformed trust would qualify for a charitable deduction. That ruling saved the day, because prior to reformation the trust would not have met the rules for a deduction and the estate would have incurred significant, unnecessary taxes.

Article five of the decedent's will provided that the residue of the estate was to be held in trust to benefit a foundation - which was a qualified charity under sections 501(c)(3) and 2055 of the Internal Revenue Code.

The trust created under article five provided that starting one year after the decedent's death and annually thereafter, a payment should be made from the trust to the foundation if certain circumstances were met. The restrictions limited the distributions to years when the principal has

grown and also limited them to set percentages of the principal as of the first anniversary date.

To the extent there is income earned in excess of the annual distribution, such income is to be added to principal.

In addition to receiving the residue of the decedent's estate, the trust was also directed to receive distributions from two retirement funds and a tax-deferred annuity of the decedent.

Ultimately, the foundation is directed to use the distributed assets from the trust to establish a memorial fund in the memory of the decedent.

The attorney for the decedent, the scrivener, admitted that he "inadvertently failed to include the appropriate language in Trust to qualify it for the charitable estate tax deduction and ensure that the receipt for the Plans and the Annuity by Trust would not be subject to income tax because Trust would be a tax-exempt organization."

That's a fairly significant scrivener's error - it's not just a missed comma. Indeed, the error wasn't so much in the drafting as it was in the planning - you can't make the trust qualify as a tax-exempt entity if it is allowed to accumulate income and perhaps use it for non-charitable beneficiaries.

The Reformation

The scrivener worked with the trustee and obtained a court-approved reformation of the trust.

The trust was modified to stipulate that the income must be paid to foundation. Also, any successor beneficiary to foundation must also be a 501(c)(3) entity. Further provisions were added to allow the trust to qualify under section 509 as a supporting organization, all of the activities of which are investing the donations and then distributing the funds to a 501(c)(3) charity - the foundation.

To accomplish the reformation, the scrivener asked the court to modify the terms of the trust to add language to make it qualify under section 501(c)(3) and also section 509 (private foundations, if so elected), including:

- That the trust operates exclusively for exempt purposes.
- That no part of the trust shall inure to the trustee or any non-charitable persons or entities.
- That the trust shall not be involved with political activities including propaganda, lobbying, etc.
- That the trustee shall not exercise any power not permitted under section 501(a) of the Internal Revenue Code.
- That the trust shall be managed in all respects to qualify as a tax-exempt entity.

The Ruling

Essentially, the IRS ruled that after reforming the trust into a supporting organization that the transfer of assets from the estate would not be subject to estate tax. Further, the disbursements from the two retirement plans and the annuity would not be subject to estate tax.

The ruling also examined the 2 percent excise tax on private foundation income imposed by section 4940 of the code. And the IRS also found that there would be no excise tax triggered by the disbursements to the trust.

Thus, the reformation was successful and the charitable intent of the decedent was carried out - with some liberal support from the IRS. The IRS has consistently applied a liberal review to modified charitable bequests.

Conclusion

As noted, there are two primary lessons for practitioners to be gleaned from this PLR.

The first is that a poor estate plan can sometimes be reformed. If you are reviewing an estate plan as part of your representation of a trustee or executor, and you notice a failure or mistake in a charitable bequest, do not despair. There may be an opportunity to fix the mistake. It will not necessarily be cheap or easy, but there may be a way.

The prudent practice would be to alert the draftsman and try to find out as much as possible about the decedent's intent. As in this case, the scrivener may admit that the intent existed and the failure was in the drafting. Then a court petition must be prepared and attempts made to convince a trial judge that the document should be reformed.

But as seen in this PLR, some "scrivener's errors" are pretty substantial. In this case, there was a lot more than a word or two omitted. The scrivener's error was in failing to make a charitable trust at all! Nevertheless, with the support of the scrivener's testimony and the demonstrated charitable intent in the document, a court accepted the petition and reformed the document.

Next, you will need to confirm with the IRS that as modified the reformed document will satisfy the charitable deduction requirements. Again, the IRS has been fairly liberal in this regard.

The second lesson is to be careful when drafting split-interest trusts and charitable bequests. In this case, the scrivener failed to recognize that the estate plan he was creating required qualifying the trust as a supporting organization. Thus, he drafted an estate plan with a charitable bequest that totally failed.

Whether asked to prepare a split-interest trust (like a charitable remainder trust) or a public charity or private foundation, or even a substantial outright charitable bequest, be careful in your drafting. The rules are complex and any mistake can be potentially disastrous.

If this trust was not reformed and/or the IRS did not accept the reformation, there would have been a great deal of unnecessary taxes created. I can assume that the scrivener would have been liable.

And the fact of the matter is that charitable planning can be like a malpractice minefield. There are so many ways that a charitable plan can be drafted incorrectly. And usually the consequences of such are very high - usually these issues only come up with our higher net-worth clients.

So be careful when drafting charitable plans and avoid this malpractice minefield.

[EDITOR'S NOTE: The full text of the Private Letter Ruling discussed in this article can be found in the Important Documents section of Lawyers Weekly USA's website:

www.lawyersweeklyusa.com/subscriber/usa/treas.cfm]

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