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Trusts & Estates Special Feature

Available options for fixing defective trusts

By Robert J. Morrill

Trusts often provide for the division of assets between beneficiaries following formulas tied to the tax code. More often than not, such formulas are an efficient way to capture the grantor's intent.

However, due to changes in the tax laws or a lack of understanding by the draftsperson of the trust, there are times when the formulas lead to results wholly inconsistent with the grantor's intent. Two typical scenarios are set forth below.

In one scenario, the grantor's intent is defeated by changes in the tax code after the trust is created.

For example, a client comes into your office for the probate of his father's estate. The estate is worth about $3.4 million. The client's mother predeceased his father by several years.

The client brings in a copy of his father's funded revocable trust, which was created in 1999. The trust calls for an amount equal to the exemption from the generation-skipping transfer tax imposed under I.R.C. §2601 (GST tax) to be set aside in a grandchildren's fund, with the excess passing to the client and his siblings.

Unfortunately for the client, the GST exemption has increased from $1.010 million in 1999 when the trust was created to its current level of $3.5 million. As a result, the client and his siblings will receive nothing, and the entire estate will be allocated to the fund for the benefit of the decedent's grandchildren.

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In another scenario, a drafting attorney's misunderstanding of the tax clause in his master documents can defeat the grantor's intent.

For example, a client comes into your office for the probate of his father's estate, which is valued at about $4 million. The father divorced the client's mother and remarried. The father's estate plan utilized a standard credit shelter trust.

It is critical that trusts be reviewed to ensure the tax formula clauses do not produce results that, while tax efficient, are contrary to the grantor's intent.

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The client explains that his father set up the trust last year, and the lawyer who drafted the trust told him that most of his assets would be held in a credit shelter trust, available to the entire family, because the funding of the credit shelter trust was tied to the federal estate tax exemption.

According to the attorney, any excess, which he predicted to be a small portion of the estate, would be held in a marital trust for the widow.

Unfortunately for the client, the terms of the trust provide for funding of the credit shelter trust with only $1 million, due to the Massachusetts estate tax exemption, with the balance held in a marital trust for which a partial QTIP election will be made for estate tax purposes.

Given the stepmother's age and health, it is probable that the client and his siblings will have a long wait before anything beyond $1 million is available to them.

In each case, unintended results occur when the terms of the trust are applied using the tax laws in effect at the time of the grantor's death.

In the first case, changes in the tax laws after the trust was created caused the problem. In the second case, the drafting attorney's lack of understanding of the tax formula clause in his master form creates the problem. The fluid nature of the estate tax laws in recent years has made it more

critical than ever to pay close attention to trust provisions tied to the tax laws.

Potential fixes

In 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act into law, which, among other things, provided for the gradual increase in the federal estate tax and generation-skipping transfer tax exemptions to their current levels.

Until recently, whether these changes to the estate tax system would become permanent was uncertain. However, President Obama has signaled his intent to freeze the exemptions, including the generation-skipping transfer tax exemption, at their current levels.

Now it is critical that trusts be reviewed to ensure the tax formula clauses do not produce results that, while tax efficient, are contrary to the grantor's intent.

For trusts that are revocable, the fix can take the simple form of an amendment. For trusts that are irrevocable, other options to fix the problem will need to be explored, including various forms of judicial actions.

To fix an irrevocable trust, an equity complaint seeking reformation can be filed in the Supreme Judicial Court, Probate & Family Court or Superior Court. G.L.c. 215, §6.

Unilateral mistake by the grantor, including the grantor mistakenly signing a trust that, due to scrivener's error, fails to capture his or her intent, is valid grounds for reformation. *Berman v. Sandler*, 379 Mass. 506, 510 (1980). The plaintiff bears the burden of showing by clear and decisive proof that the trust contains an error. *Reynolds v. Reynolds*, 443 Mass. 1001, 1002 (2004).

If the grantor is alive, his or her own testimony can be presented. See, e.g., *Putnam v. Putnam*, 425 Mass. 770 (1997).

Often, however, the mistake is not discovered until after the grantor has passed away. In such cases an affidavit of the drafting attorney can be very helpful. See, e.g., *Walker v. Walker*, 433 Mass. 581 (2001). If the drafting attorney is not available, the plaintiff will need to exercise some creativity to build the requisite evidentiary record to meet the burden of presenting "full, clear and decisive proof" of the mistake. Frequently, the wording of the trust itself will provide this proof, such as where it evidences a clear intent to minimize taxes. See, e.g., *Fleet National Bank v. Mackey*, 433 Mass. 1009, 1010 (2001).

All interested individuals must be made party to the action. Service is made upon the parties by summons. If there are minor or unborn or unascertained beneficiaries, a guardian ad litem will likely need to be appointed.

However, in certain circumstances, the plaintiffs can seek to waive the appointment of the GAL. See, e.g., *Reynolds v. Reynolds*, 443 Mass. 1001 (2004) (waiver of guardian ad litem appropriate where there is no conflict between the interests of the minor, unborn and unascertained beneficiaries and where their interests benefit from the relief sought).

If the trust names a charity as a beneficiary, the attorney general must be made a party. It is always preferable to obtain the agreement of the interested parties to the relief sought in advance of the filing of the complaint. Those interested parties can then file answers and assents to the complaints. Obviously, this will make success more likely.

If the reformation impacts federal tax liability and the parties want the Internal Revenue Service bound, a ruling from the SJC should be sought. *Commissioner of Internal Revenue v. Bosch*, 387 U.S. 456 (1967). The plaintiff needs to make the IRS aware of the action and typically notifies the IRS of the action by mailing a copy of the complaint via certified mail. Often the IRS takes no position.

If there are Massachusetts tax implications, the commissioner of revenue should be served and the attorney general's Government Bureau should also be notified of the action and provided with a copy of the complaint.

If a ruling by the SJC is desired, there are different procedural avenues available. The action can be filed in the Probate Court and then reserved and reported to the Appeals Court. G.L.c. 215, §13. From the Appeals Court, the plaintiffs can seek direct appellate review by the SJC. G.L.c. 211A, §10.

Alternatively, the complaint can be filed in the SJC for Suffolk County (the so-called "single justice" or "county court" side of the court) with a request that the single justice reserve and report the matter to the full court. G.L.c. 231, §112.

Parties should beware, however, that the SJC has recently signaled an unwillingness to rule on such actions absent an actual dispute between the parties and/or an actual challenge by the IRS. See, e.g., *Fierst v. Laird*, 453 Mass. 1016 (2009); *Linehan v. Linehan*, 453 Mass. 1017 (2009).

Other alternatives

When faced with poorly drafted and ambiguous language in a trust, other alternatives can be explored. The trustees can seek instructions pursuant to the general equity jurisdiction of the Probate Court. G.L.c. 215, §6. In seeking instructions, the fiduciary is supposed to remain neutral.

The trustees can also assert what they believe to be the correct interpretation of the ambiguous language and seek confirmation from the court by means of a complaint for declaratory judgment. G.L.c. 231A. And the parties can enter into a compromise agreement and seek judicial approval of same. G.L.c. 204, §14.

If there are no tax or real estate title ramifications, the parties can enter into a private compromise agreement. In certain limited circumstances, the parties could also seek to "decant" the defective trust by a transfer of the assets to a properly drafted instrument.

Of course, the procedures discussed above can also be utilized to cure defects in trusts that have nothing to do with a tax clause. While it is never a welcome discovery to find a trust works contrary to the grantor's intentions, there are many options to fix the problem. Which approach to adopt requires careful consideration of the desired result as well as the law and facts of the particular case. MLW

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