Notwithstanding Savings Clause, Judicial Reformation Required to Correct Defects in Charitable Remainder Annuity Trust

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A recent tax court case serves as a stern reminder to practitioners that (1) in order for a trust to qualify as a charitable remainder annuity trust (CRAT), the trust's governing instrument must unambiguously provide for a sum-certain annuity to be paid to the income beneficiaries,[1] and (2) the **only** way to reform a trust that fails to **unambiguously** provide for a sum-certain annuity is to commence a judicial reformation proceeding within ninety (90) days after the due date for the estate tax return.

In *Estate of Block v. Commissioner*, T.C. Memo 2023-30, the court denied an estate's claim for a deduction under § 2055(a) attributable to the present value of the charitable remainder interest of a testamentary trust intended to be a CRAT. In providing for the annuity to be paid to the trust's individual income beneficiaries, the trust at issue directed that an annuity in an amount "equal to the greater of: (a) all net income, or (b) the sum of Fifty Thousand Dollars ($50,000), at least annually" be paid. The court held that this provision violated the plain language of § 664(d)(1)(A), which requires a CRAT annuity to be a "sum certain." Treasury Regulations § 1.664-2(a)(1)(ii) defines "sum certain" as follows: "A sum certain is a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of such period." Because the trust provided for an annuity in an amount equal to the greater of net income or $50,000, the trust failed to qualify as a CRAT under § 664(d)(1).

After the IRS initiated the estate tax return audit and upon recognizing this fatal flaw in the trust's governing instrument, the co-trustees attempted to reform the trust (with retroactive effect to the decedent's date of death) by executing a trust amendment to remove "all net income" from the determination of the annuity amount and specifying that the trustees shall pay to the income beneficiaries "an annuity amount equal to the sum of Fifty Thousand Dollars ($50,000), at least annually." In doing so, the trustees relied upon a savings clause contained in the trust instrument, which provided as follows:

Following [Ms. Block's] death this entire Trust, including THE HARRIET KATZ TRUST, shall be irrevocable. However, the Trustee shall have the power, acting alone, to amend THE HARRIET KATZ TRUST from time to time in any manner required for the sole purpose of ensuring that THE HARRIET KATZ TRUST qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of § 664(d)(1) of the Code. The Trustee may not, however, change the annuity period, the annuity amount, or the identity of the Recipient [of the annuity amount].

Because the terms of the original trust document did not meet the requirement set forth in § 2055(e)(3)(C)(i) and (ii) that all payments to non-charitable beneficiaries be "expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property," the court held that the only means of effecting a qualified reformation was by judicial proceeding pursuant to § 2055(e)(3)(C)(iii). It appears that the estate did not attempt to seek a judicial reformation of the trust, and the court rejected the estate's argument that there had been substantial compliance with the qualified reformation rules. First, the purported reformation was not effected within ninety (90) days of the due date for the estate tax return. Second, the purported reformation was not instituted by a court as required by § 2055(e)(3)(C)(iii).

The court also rejected the estate's argument that Rev. Proc. 2003-57 and Rev. Proc. 2003-59 (both of which contain sample language for similar savings clauses to the one at issue in *Block* and provide for non-judicial reformation) permitted the trustees to act without court involvement to amend the trust at any time for the purposes of ensuring the trust qualified as a CRAT and preserving the estate tax deduction. Citing public policy against incentivizing settlors and trustees to "favor the income beneficiary over the remainder beneficiary by means of manipulating the trust's investments," the court unequivocally held that the non-judicial reformation contemplated by such savings clauses do not

involve corrections for "major, obvious defects," such as a provision that allows annual payments to the income beneficiary in the amount equal to the greater of all net income or $50,000. Major defects, "such as where the 'income' interest is not expressed as an annuity interest," require a judicial proceeding to be commenced before an IRS audit might begin.

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[1] The sum-certain annuity must be an amount equal to at least five percent (5%) (but not more than fifty percent (50%)) of the initial fair market value of all property placed in the trust and must be required to be paid at least annually. *See* I.R.C. § 664(d)(1)(A).