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Federal Estate Tax Formula Clauses: Draft Ohio Legislation

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As all readers of this publication know, the United States estate tax and the United States generation-skipping transfer tax both became inapplicable for persons dying and generation-skipping transfers made after December 31, 2009, and before January 1, 2011. Because the federal estate tax law has been in effect continuously since 1914, and is a significant factor in estate planning for wealthy people, many existing trust agreements and Wills contain formulas that refer to federal estate tax concepts to define the division and allocation of assets. For example, an estate plan may provide for a gift of the amount exempt from federal estate tax to the children of the decedent, and a gift of the amount that would otherwise be subject to federal estate tax to the spouse of the decedent. For persons dying in 2009, such a formula would have allocated 3.5 million dollars to the children of the decedent and the balance to the spouse. If the person dies in 2010, such a formula might allocate the entire estate to the children and nothing to the spouse, apart from whatever share the spouse could receive by election against the Will. The spouse's right-of-election does not extend to assets in revocable trusts at the time of the death of the first spouse to die. Smyth v. Cleveland Trust Co., 172 Ohio St. 489 (1961); 179 N.E. 2d 60. Similarly, the formula might provide for a gift to an Ohio charity of the amount that would be subject to federal estate tax and to nieces and nephews of the decedent of the amount that passes free from federal estate tax. For person dying in 2010, that formula might allocate all of the assets to the nieces and nephews and nothing to the Ohio charity, absent some language in the instrument that covers the current situation. Many charitable bequests that do not involve formulas are conditioned on the charity qualifying under Internal Revenue Code Section 2055, which is not applicable to persons who die in 2010.

We all recognize that there are many variants of formula clauses. Some of those clauses address the situation we find ourselves in with respect to persons dying in 2010. Many formulas do not. It seems likely that many of the formulas that do not address the current situation will be interpreted in ways that continue to work for the intended beneficiaries and for Ohio estate tax planning. However, many of us have already dealt with formulas that seem ambiguous in light of the current state of the law. Early in this calendar year, when it became clear that Congressional action with respect to the estate tax was not occurring, officers of the Estate Planning, Trust and Probate Law Section of the Ohio State Bar Association consulted on the subject of whether state legislation, in the form of a rule of construction, should be proposed to address the confusion. A committee was formed consisting of Roy Krall, Bob Brucken, Don Cairns and Mike Cooney to consider possible legislation. While the committee and the section recognized that the best way to deal with the confusion in formulas caused by the inapplicability of the estate tax and generation-skipping tax to persons dying in the year 2010 is for affected clients to specifically consider the impact of repeal on their personal circumstances and make appropriate changes in their trust agreements and Wills, experience with past federal tax changes tells us that many clients will ignore a recommendation to review their plans. Further, many of us have experiences with clients who have already died in January of 2010, without a change in estate planning documents. Because the repeal is scheduled to last for only one year, it seems more likely than average that many people will ignore the need to consider the repeal in their planning.

A number of states have proposed legislation in the form of rules of construction to address the confusion and ambiguity in formula clauses, and the committee recommended such an approach for Ohio. The proposed legislation generally is designed to put people who die in 2010 in the position they would have been in if they had died on December 31, 2009, in terms of formula allocation of assets. The committee believes that this puts most testators and most settlors in the position they expected to be in the last time they seriously thought about their estate plans. It should be noted that this chooses predictability, and an assumption regarding settlor's intent, over optimum tax planning, which would usually allocate all the assets to a bypass trust in a year in which there is no federal estate tax. Disadvantages associated with this approach can be ameliorated through the Private Settlement Agreement procedure discussed below, through disclaimers, and using the other post-mortem planning tools available to us.

Overview of Proposal

The proposed legislation has three parts:

1. Expand existing authority regarding Private Settlement Agreements to allow the interested parties to reach agreement on the application of estate tax based or generation-skipping tax based formulas, provided all trustees and all beneficiaries agree.
2. Expand existing authority for courts to modify a trust to specifically address authority with respect to estate tax based or generation-skipping tax based formula issues.
3. Add a rule of construction interpreting federal estate or generation-skipping tax formulas as if the person died on December 31, 2009, unless (i) the Will or trust specifically addresses the application of the formula; or (ii) all necessary parties agree otherwise through a Private Settlement Agreement (1 above); or (iii) a court directs otherwise (2 above).

Summary of Proposed Changes

1. Private Settlement Agreements. Existing O.R.C. Section 5801.10 permits the settlor, if living, all trustees, and all beneficiaries of a trust, as well as creditors, if their interests are affected, to make certain modifications to the terms of the trust by entering into a Private Settlement Agreement. The current statute limits the ability of the parties to change the interests of the beneficiaries in the trust. The committee's proposed change to this statute would add an additional exception to the limitation on changing the interests of the beneficiaries. The change would allow the beneficiaries and trustees to address the application of the federal estate tax based, or federal generation-skipping transfer tax based formulas to give effect to settlors' intent. Further, the proposed change would permit changing beneficial interest in trust provisions for charities affected by such a tax formula, provided the Ohio Attorney General agrees to the Private Settlement Agreement.
2. Court Modification. O.R.C. Section 5804.12 currently contains a grant of authority to courts to modify or terminate a trust because of circumstances not anticipated by the settlor, with the direction that the court is to make the modification in accordance with the settlor's probable intent. The committee proposes adding Section 5804.12(D) to specifically authorize court modification to apply the terms of a federal estate tax or federal generation-skipping transfer tax formula, which did not address the temporary inapplicability of those taxes.
3. Rule of Construction. The committee proposed a new section of the Ohio Trust Code. The new section would define the terms "federal estate tax term" and "federal generation-skipping transfer tax term". The proposed statute provides a rule of construction, which would interpret such terms as if the settlor, testator, or beneficiary, whose death triggers the division, had died on December 31, 2009, unless (i) the Will or trust instrument specifically addresses the application of the formula in the context of inapplicability of the tax, or (ii) in the case of a trust, all necessary parties agree otherwise through a Private Settlement Agreement, or (iii) a court directs otherwise. The statute further provides that a retroactive change by Congress would not alter the operation of the division statute.

Status

At the time of this writing, the proposal has been submitted to the Ohio State Bar Association, but has not been endorsed by the Ohio State Bar Association or introduced in the legislature.