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Federal Estate Tax Formula Legislative Proposal

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I. EFFECT OF REPEAL OF FEDERAL ESTATE TAX AND FEDERAL GENERATION-SKIPPING TRANSFER TAX ON WILL AND TRUST FORMULA CLAUSES

The United States Estate Tax and the United States Generation-Skipping Transfer Tax became inapplicable for persons dying and generation-skipping transfers made after December 31, 2009 and before January 1, 2011. In December of 2010, the estate tax was retroactively re-enacted, subject to a $5,000.00 exemption, and made elective, for 2010 decedents. The Generation-Skipping Tax was retroactively re-enacted with a zero rate for 2010.

Because the federal estate tax law had been in effect continuously since 1914, and federal estate taxes are 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, intending to qualify for the estate tax marital deduction. For a person who died in 2009, such a formula would have allocated 3.5 million dollars to the children of the decedent, and the remaining assets to the spouse. If the person died 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 electing against the Will, and any joint assets. It is unclear how the election might affect the allocations. 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 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 persons 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.

There are many variants of formula clauses. Some such clauses address the situation with respect to persons dying in 2010. Some formulas do not. It seems likely that, in the event of litigation, many of the formulas that do not address the 2010 situation will be interpreted in ways that continue to work for the intended beneficiaries and for Ohio estate tax planning. However, many of us now have experience dealing with formulas that seem ambiguous in light of the state of the law in 2010. Early in 2010, when it became clear that Congressional action with respect to the estate tax was not occurring, officers of the Estate Planning, Trust & 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 to consider possible legislation. While the committee and the Section Council 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 made it certain that many clients would ignore a recommendation to review and update their plans. Further, many of us had experiences with clients who had already died in 2010, without a change in estate planning documents. Because the repeal was expected to last for only one year, it seemed more likely than average that many people would ignore the need to consider the repeal in their planning.

A number of states enacted legislation in the form of rules of construction to address the confusion and ambiguity in formula clauses. The OSBA Section Council Committee recommended such an approach for Ohio. The proposed legislation generally was designed to put people who died in 2010 in a position they would have been in if they had died on December 31, 2009, in terms of formula allocation of assets. The Committee believed that this would put most testators and most settlers in the position they expected to be in the last time they seriously thought about their estate plans. This approach chooses predictability, and an assumption regarding settlers' intent, over optimum tax planning, which would usually allocate all of the assets to a by-pass trust in a year in which there is no federal estate

tax. Disadvantages associated with this approach could be ameliorated through the Private Settlement Agreement procedure discussed below, through disclaimers and through use of the other post-mortem planning tools available.

Overview of Proposed Formula Statute

The original proposed legislation had three parts
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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 tax or federal generation-skipping tax formulas as if the person died on December 31, 2009, unless a) the will or trust specifically addresses the application of the formula, or b) all necessary parties agree otherwise through a Private Settlement Agreement (1 above), or c) a court directs otherwise (2 above).

Proposed Changes

1. Private Settlement Agreements. Existing O.R.C. §5801.10 permits the settler, 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 interest of the beneficiaries in the trust. The Committee's proposed change to the 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 formula to give effect to settlers' 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. §5804.12 currently contains a grant of authority to courts to modify or terminate a trust because of circumstances not anticipated by the settler, with the direction that the court is make the modification in accordance with the settlers' probable intent. The Committee proposes adding §5804.12(D) to specifically authorize court modification to apply the terms of a federal estate tax formula, or a federal generation-skipping transfer tax formula, which did not address the temporary inapplicability of those taxes.

3. Rule of Construction. The Committee initially proposed a new Section of the Ohio Trust Code, Section 5815.49, Construction of Will or Trust Containing Tax Terms. 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, until a person dies when those taxes are not applicable, which interpret such terms as if the settler, testator, or beneficiary, whose death triggers a division, had died on December 31, 2009, unless 1) the Will or trust instrument specifically addresses the application of the formula in the context of inapplicability of the tax, or 2) in the case of a trust, all necessary parties agree otherwise through a Private Settlement Agreement, or 3) a court directs otherwise. The statute further provides that a retroactive change by Congress would not alter the operation of the division statute.

2011 Revision

There were a number of views represented in the Committee in light of the December, 2010 estate tax law. After discussion, the Committee recommended not providing any rule of construction to cover the situation in which an estate elects out of application of the 2010 federal estate tax, but continuing the effort to expand private settlement agreement authority and to clarify the authority for court modification.

Our Committee was divided on the right course of action. The following is a summary of our discussion:

1. Private Settlement Agreement Expansion. The opposition to this within the Committee was based on the view that because of potential federal gift tax consequences, this may be a trap for the unwary, as compared with a judicial decision on the meaning of the terms. A majority of the Committee believes that it is, nevertheless, desirable. If intent can be discerned from the document, broadening authority for private settlement agreements may allow deviation from settlers' intent, which could give rise to a gift tax issue.

2. Judicial Authority. With respect to judicial authority, the Committee ultimately was unanimous in support of retaining that language, although a concern was expressed regarding the danger of being too specific with respect to the authority.

3. Rule on Effect of Election on Allocation. With respect to a rule regarding the effect of an election out of estate tax on allocation of assets under a formula using federal estate tax terms, there was significant support within the Committee for a rule of construction to the effect that an election out of estate tax and into carry-over basis would have no effect on the division of assets pursuant to a formula using federal estate tax terms. However, the Committee decided to drop any such provision. Experience over the previous 12 months had made us realize more fully that there are a multitude of formulas in use, some of which are clear and some of which are not. The view of those who felt that trying to address all situations, no matter what the formula, by a clear and simple rule could lead to more problems than it solved, carried the day within the Committee. The Section Council endorsed the Committee recommendation. The draft statute is now incorporated into S.B. 117, which has been approved by the Senate Judiciary-Civil Justice Committee and is now awaiting a Senate vote.