

**The Ultimate Irony: Part II**  
**States Begin to Tackle Construction Issue Dilemmas in Their Own  
Formulaic Construction Statutes**

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**Sharon L. Klein**  
**Head of Wealth Advisory**  
**Lazard Wealth Management LLC**  
**30 Rockefeller Plaza**  
**New York, New York 10020**  
**Phone Number: 212-332-4504**  
**Fax Number: 212-830-5023**  
**E-Mail: [sharon.klein@lazard.com](mailto:sharon.klein@lazard.com)**

## States React to Unintended Estate Plan Distortions Caused by Lapse of Federal Estate Tax Regime

When the federal estate and generation-skipping transfer (“GST”) tax regimes initially lapsed on January 1, 2010, that had a significant trickle-down effect at the state level. Estate planning documents frequently contain dispositive provisions tied to formulas that are linked to federal tax concepts – like the federal estate tax or GST tax exemption amounts. The lapse of the federal estate and GST tax regimes caused much uncertainty in the construction of formulaic dispositive provisions when the tax concepts to which they were tied simply disappeared.

On the federal front, it was not until the waning weeks of 2010 that Congress enacted the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act"). In the interim, in order to prevent unintended distortion to estate plans during a period of federal estate tax lapse, 20 jurisdictions enacted legislation in 2010 regarding formulaic dispositions in dispositive instruments of decedents dying in 2010.

Eighteen<sup>1</sup> of those jurisdictions generally provide for the construction of formula clauses with reference to the law as it existed on December 31, 2009 (when the federal estate and GST exemption amounts were \$3,500,000 million). In the other two jurisdictions<sup>2</sup>, a court is authorized to construe a dispositive instrument in order to determine a decedent's intent.

A detailed discussion of the formulaic construction issues, and the reaction of the various jurisdictions, is included in Part I of this article, annexed below.

## Election to Opt Out of Estate Tax Treatment Causes State Construction Dilemmas

The 2010 Act, signed into law on December 17, includes a retroactive imposition of the federal estate tax regime for 2010, with a \$5,000,000 federal estate tax exemption amount and 35% estate tax rate. The 2010 Act also includes an election to opt out of estate tax treatment and be subject instead to a modified carry-over basis regime.

When formula construction statutes were enacted as a response to the uncertainty created by the initial lapse of the federal estate and GST tax regimes, a possible retroactive enactment of those regimes was apparently anticipated. Accordingly, most

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<sup>1</sup> Delaware, Georgia, Idaho, Indiana, Maryland, Michigan, Minnesota, Nebraska, New York, North Carolina, Pennsylvania, South Dakota, Tennessee, Utah, Virginia, Washington State, Washington D.C., and Wisconsin

<sup>2</sup> Florida and South Carolina

states provide that their formulaic construction provisions will not apply if the federal estate tax "becomes applicable" or "becomes effective" before January 1, 2011.

Presumably, if an estate is subject to estate tax under the 2010 Act, the statutory rules of construction should not apply, and formulaic provisions will be tied to the \$5,000,000 exemption amount.

But what if an estate elects to opt out of the estate tax regime? Does the estate tax have to "become applicable" or "become effective" for the particular case at hand, or is it sufficient that the estate tax regime is potentially applicable or effective in 2010 (even though a carry-over basis election is made)?

If the estate tax has to be applicable to the case at hand in order for the statutory construction rules not to apply, there may be an anomalous result if carry-over basis treatment is elected: in the estate tax default treatment scenario, a \$5,000,000 exemption would presumably apply in the interpretation of formula clauses. However, if carry-over basis treatment is chosen and the statutory construction rules are applicable, formulaic clauses may be interpreted with a \$3,500,000 exemption (because state statutory construction rules typically refer to the law as of December 31, 2009). This potentially creates a very difficult dilemma for a fiduciary, typically subject to duties of impartiality, if the fiduciary's election might determine the size of a funding amount.

While formulaic legislation generally seems to have been drafted to anticipate a possible retroactive estate tax, an election about whether to have the estate tax apply does not seem to have been anticipated.

### **And Time May be Running Out to Bring a Construction Proceeding**

Add to this uncertainty that fact that time may be running out to bring a judicial proceeding to construe a formula clause.

In all the state formula clause construction legislation that passed in 2010, there is some provision to enable certain interested parties to bring a judicial proceeding to construe a formula disposition.

Generally, the time frame for commencing a judicial proceeding is within 12 months of death...so time may be running out, or may indeed have run.

### **Virginia: First State to Introduce Clarifying Legislation on January 20, 2011, Law Enacted March 26, 2011**

In an attempt to remedy these issues, clarifying legislation was enacted in Virginia on March 26. The legislation provides that a formula clause in an instrument of a decedent

dying in 2010 is deemed to refer to federal laws applicable to decedents dying in 2010, regardless of any election to opt out of estate tax treatment. Accordingly, formula clauses should be construed to refer to a \$5,000,000 exemption amount, irrespective of whether an estate is subject to an estate tax regime or a modified carry-over basis regime.

The time for bringing a construction proceeding is extended until December 31, 2011. Extrinsic evidence that contradicts the plain meaning of an instrument is admissible in such a proceeding to determine whether the decedent intended that the instrument be construed otherwise than as provided in the statute; and the burden of proof, by clear and convincing evidence, is on the person seeking to establish that result. The court is authorized to modify a document to conform to the decedent's intention or achieve the decedent's tax objectives.

There is also provision for interested persons to enter into a binding agreement regarding the decedent's intent, without court approval.

#### **South Dakota: Legislation Introduced on February 14, 2011, Law Enacted March 11, 2011**

Like the Virginia approach, the South Dakota legislation clarifies that a formula clause in an instrument of a decedent dying in 2010 is deemed to refer to federal laws applicable to decedents dying in 2010, regardless of any election to opt out of estate tax treatment. Accordingly, formula clauses should be construed to refer to a \$5,000,000 exemption amount, irrespective of whether an estate is subject to an estate tax regime or a modified carry-over basis regime.

The time for bringing a construction proceeding is extended until December 31, 2011. Extrinsic evidence that contradicts the plain meaning of an instrument is admissible in such a proceeding to determine whether the decedent intended that the instrument be construed otherwise than as provided in the statute; and the burden of proof, by clear and convincing evidence, is on the person seeking to establish that result. The court is authorized to modify a document to conform to the decedent's intention or achieve the decedent's tax objectives.

There is also provision for interested persons to enter into a binding agreement regarding the decedent's intent, without court approval.

#### **Mississippi: Legislation Introduced February 1, 2011, But Dies in Committee**

Interestingly, Mississippi had not enacted construction legislation to aid in the interpretation of formula clauses when the federal estate and GST tax regimes initially lapsed in 2010.

For decedents dying in 2010, the Mississippi bill provided for the construction of formula clauses with reference to federal laws as they applied to estates of decedents dying on December 31, 2010. The statutory construction rule did not apply if a personal representative elected out of estate tax treatment and into the carry-over basis regime.

Accordingly, instead of formula clauses being interpreted consistently (whether an estate is subject to an estate tax or a modified carry-over basis regime), it appears that the statutory construction rule in Mississippi would have applied only to those estates subject to the estate tax regime.

A construction proceeding could have been commenced within 24 months of death.

The Mississippi bill died in committee on February 10, 2011.

#### **Idaho: Legislation Introduced February 17, 2011, Law Enacted April 11, 2011**

The Idaho law is substantially similar to the Virginia law.

#### **Washington State: Legislation Introduced February 22, 2011, Bill Delivered to Governor For Signature April 12, 2011**

The bill makes changes to the construction proceeding provision. The proposed amendments include the ability to introduce extrinsic evidence, and extend the time for commencing a proceeding from within 12 months of death to within 2 years of death.

The Washington bill passed the Senate on March 4, 2011, passed the House on April 6, 2011, and was presented to the Governor for signature on April 12, 2011.

#### **South Carolina: Legislation Introduced April 12, 2011**

The South Carolina law enacted in 2010 did not provide for the construction of formula clauses with reference to the law as it existed on December 31, 2009. In South Carolina, a court is authorized to construe a trust or will that contains a formula disposition in order to determine the decedent's intent. Accordingly, in the absence of a statutory rule of construction, a court proceeding is required.

The proposed amendments to the law concern only the time for bringing a proceeding. In the existing law, a court proceeding has to be commenced within 12 months of death. In the bill introduced, the time to commence the proceeding is extended to December 31, 2012.

**Status of State Formulaic Clause Construction Legislation as of April 14, 2011**

<b>Jurisdictions That Enacted Laws in 2010 Regarding Construction of Formula Bequests</b>		<b>States That Enacted Clarifying Legislation in Light of 2010 Act (as of April 14, 2011)</b>	<b>States with Pending Clarifying Legislation In Light of 2010 Act (as of April 14, 2011)</b>
Delaware <b>12 Del. C. § 3335</b>	New York <b>NY EPTL § 2-1.13</b>	South Dakota <b>Amends Chapter 10-40A of the S.D. Codified Laws</b>	South Carolina <b>2011 SC H.B. 4061</b>
District of Columbia <b>D.C. Code § 20-1108</b>	North Carolina <b>N.C. Gen. Stat. § 31-46.1</b>	Idaho <b>Amends Idaho Code § 15-1-501</b>	Washington State <b>2011 WA S.B. 5849</b>
Florida <b>Fla. Stat. § 736.04114; Fla. Stat. § 733.1051</b>	Pennsylvania <b>20 Pa.C.S. § 2801 to § 2803</b>	Virginia <b>Amends § 64.1-62.4 of the Virginia Code</b>	
Georgia <b>O.C.G.A. § 53-4-75</b>	South Carolina <b>S.C. Code Ann. § 62-2-612</b>		
Idaho <b>Idaho Code § 15-1-501</b>	South Dakota <b>S.D. Codified Laws § 10-40A-11, 10-40A-12, 10-40A-13</b>		
Indiana <b>Burns Ind. Code Ann. § 29-1-6-1(n)-(r)</b>	Tennessee <b>Tenn. Code Ann. § 32-3-113</b>		
Maryland <b>Md. ESTATES AND TRUSTS Code Ann. § 11-110</b>	Utah <b>Utah Code Ann. § 75-3-917</b>		
Michigan <b>MCLS § 700.2723</b>	Virginia <b>Va. Code Ann. § 64.1-62.4</b>		
Minnesota <b>Minn. Stat. § 524.2-712</b>	Washington State <b>ARCW § 11.108.080 to § 11.108.090</b>		
Nebraska <b>R.R.S. Neb. § 30-2342.02</b>	Wisconsin <b>Wis. Stat. § 854.30</b>		

## 20 Jurisdictions Enacted Formulaic Construction Legislation in 2010 - How Will the Other 15 React?

The reaction of the other 15 jurisdictions that enacted legislation in 2010 regarding formulaic dispositive provisions (Florida, Delaware, Georgia, Indiana, Maryland, Michigan, Minnesota, Nebraska, New York, North Carolina, Pennsylvania, Tennessee, Utah, Washington D.C., and Wisconsin) remains to be seen. Some states, including New York, have proposals circulating that have not yet been formally introduced as legislation.

Certainly, these issues are ripe for legislative change, both to effect consistency in the interpretation of formula clauses (whether an estate is subject to an estate tax or a modified carry-over basis regime), and to extend deadlines (which may have already run) to commence a construction proceeding.

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**The Ultimate Irony: In Light of the Passage of President Obama's Tax Proposal, State Formulaic Construction Statutes May Face Their Own Construction Issues**

**...And Time For a Construction Proceeding May Be Running Out**

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**Sharon L. Klein  
Head of Wealth Advisory  
Lazard Wealth Management LLC  
30 Rockefeller Plaza  
New York, New York 10020  
Phone Number: 212-332-4504  
Fax Number: 212-830-5023  
E-Mail: [sharon.klein@lazard.com](mailto:sharon.klein@lazard.com)**

## Problems with Distorted Formulaic Dispositions May Continue to Persist

When the federal estate and generation-skipping transfer (“GST”) tax regimes lapsed on January 1, 2010, that had a significant trickle-down effect at the state level. When state taxation regimes are entwined with federal tax concepts, what happens when those federal tax concepts disappear?

President Obama’s proposal, passed on December 15 by the Senate and December 16 by the House, includes a \$5,000,000 estate tax exemption amount and 35% estate tax rate for 2010, with an option to elect out of estate tax treatment and be subject to a carry-over basis regime. Accordingly, the effect of an election to be subject to an estate tax or carry-over basis regime should also be factored into the analysis of formulaic provisions (discussed further below).

A federal estate and GST tax lapse can cause particularly acute problems regarding the construction of formula provisions in dispositive instruments. Many dispositive instruments contain formulaic terminology tied to federal tax concepts, like the federal estate tax exemption amount or GST tax exemption amount. Formula provisions can become distorted if their conceptual underpinnings have been removed from the law.

Before 2010, a disposition in a will of the “federal estate tax exemption amount” or a disposition of the “largest amount that can pass free of federal estate taxes” would have accomplished the same result - a disposition of the largest amount that could pass without the imposition of federal tax. In 2009, that amount would have been \$3,500,000 million.

However, if an estate is not subject to estate tax in 2010, a disposition of the “federal estate tax exemption amount” could be interpreted to mean no disposition at all: if there is no federal estate tax, there can be no federal estate tax exemption amount. On the other hand, a disposition of the “largest amount that can pass free of federal estate taxes” could be interpreted to mean a disposition of the whole estate: if there is no federal estate tax, the whole estate is the largest amount that can pass free of federal taxes.

How ironic that a disposition of the same amount was intended in both scenarios. Yet, depending on terminology used, the whole estate or nothing could be construed to pass - and neither of those results was intended.

## States React

To prevent unintended distortion to estate plans, many states introduced legislation in 2010 regarding formulaic dispositions:

<b>Jurisdictions with Bills Pending (As of December 15, 2010)</b>
<b>New Jersey</b>
<b>Ohio</b>

<b>Jurisdictions With Currently Enacted Laws (As of December 15, 2010)</b>
<b>Delaware</b> - 12 Del. C. § 3335 (2010)
<b>District of Columbia</b> - D.C. Code § 20-1108 (2010)
<b>Florida</b> - Fla. Stat. § 736.04114 (2010), Fla. Stat. § 733.1051 (2010)
<b>Georgia</b> - O.C.G.A. § 53-4-75 (2010)
<b>Idaho</b> - Idaho Code § 15-1-501 (2010)
<b>Indiana</b> - Burns Ind. Code Ann. § 29-1-6-1(n)-(r) (2010)
<b>Maryland</b> - Md. ESTATES AND TRUSTS Code Ann. § 11-110 (2010)
<b>Minnesota</b> - Minn. Stat. § 524.2-712 (2010)
<b>Michigan</b> – To be inserted into Chapter 700, Article I of the Michigan Compiled Laws
<b>Nebraska</b> - R.R.S. Neb. § 30-2342.02 (2010)
<b>New York</b> - NY EPTL § 2-1.13 (2010)
<b>North Carolina</b> - N.C. Gen. Stat. § 31-46.1 (2010)
<b>Pennsylvania</b> – To be inserted into Title 20 of the Consolidated Statutes of Pennsylvania
<b>South Carolina</b> – To be inserted into Title 12, Chapter 16 of the South Carolina Code of Laws
<b>South Dakota</b> - S.D. Codified Laws § 10-40A-11, 10-40A-12, 10-40A-13 (2010)
<b>Tennessee</b> - Tenn. Code Ann. § 32-3-113 (2010)

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)
<b>Utah</b> - Utah Code Ann. § 75-3-917 (2010)
<b>Virginia</b> - Va. Code Ann. § 64.1-62.4 (2010)
<b>Washington State</b> – To be inserted into chapter 11.108 of the Revised Code of Washington
<b>Wisconsin</b> - Wis. Stat. § 854.30 (2010)

**Most States Provide Statutory Construction Rules**

States have generally<sup>1</sup> taken the approach of construing formula clauses during a period of federal estate tax lapse with reference to the law as it existed on December 31, 2009 (when the federal estate tax exemption amount was \$3.5 million). Accordingly, in the absence of an applicable federal estate tax in 2010, a disposition of the “federal estate tax exemption amount” or the “largest amount that can pass free of federal estate taxes” would both be interpreted to mean a \$3,500,000 million disposition. These rules of construction apply not only to formulaic dispositions of the federal estate tax exemption amount, but also to formulaic dispositions of the GST tax exemption amount (\$3,500,000 million in 2009).

**Judicial Construction Alternative**

In Florida and South Carolina, a court is authorized to construe a trust or will that contains a formula disposition in order to determine the decedent's intent. Accordingly, in the absence of a statutory rule of construction, a court proceeding is required.

**How Does An Election To Opt Out Of Estate Tax Treatment Effect Statutory Construction Legislation?**

Most states provide that their statutory rules of construction will not apply if the federal estate tax or GST tax "becomes applicable" or "becomes effective" before January 1, 2011. Presumably, if an estate is subject to estate tax under the bill that is poised to be signed by the president, the statutory rules of construction will not apply, and formulaic provisions will be keyed to the \$5,000,000 exemption amount.

But will the statutory construction rules also fall away if an estate tax/modified carry-over basis election exists and the estate tax option is not chosen? In other words, does the estate tax have to "become applicable" or "become effective" for the particular case at hand, or is it sufficient that the estate tax regime is potentially applicable or effective in 2010 (even though a carry-over basis election is made)?

If the estate tax has to be applicable to the case at hand in order for the statutory construction rules not to apply, there may be an anomalous result if carry-over basis treatment is elected: In the estate tax default treatment scenario, a \$5,000,000 exemption would presumably apply in the interpretation of formula clauses. However, if carry-over basis treatment is chosen and the statutory construction rules are applicable, formulaic clauses may be interpreted with a \$3,500,000 exemption (because state statutory construction rules typically refer to the law as of December 31, 2009). This election option could present a very difficult dilemma for a fiduciary, typically subject to duties of impartiality, if the fiduciary's election might determine a funding amount.

While formulaic legislation generally seems to have been drafted to anticipate a possible retroactive estate/GST tax, an election about whether to have the estate tax apply does not seem to have been anticipated.

### **And if State Statutory Construction Rules Do Apply, Do They Always Produce the Best Result?**

In many acrimonious situations, if the statutory rules of construction apply, they might prevent an unintended disinheritance. However, query whether those rules of statutory construction always produce the most tax-efficient result.

Take, for example, a will which provides for the largest amount that can pass free of federal estate taxes to fund a trust for the benefit of a surviving spouse and children. If there were no construction rules and that disposition was interpreted in 2010 to mean that the whole estate passed to that trust (a so-called "credit shelter trust"), no federal estate taxes would be due at the death of the surviving spouse. If, however, such a clause was interpreted with reference to the law as of December 31, 2009, the amount passing to the trust would be limited to \$3,500,000 million. If the remainder of the estate passed outright to the surviving spouse, that entire balance would be subject to federal estate tax at the death of the surviving spouse (after 2010).

In a harmonious family situation, it may have been a much more efficient tax result for the entire estate to pass to a trust which would not be subject to federal taxation on the death of the surviving spouse.<sup>2</sup>

## Time May be Running Out to Bring a Judicial Proceeding

In all the state formula clause "fix" legislation that has passed so far, there is some provision to enable certain interested parties to bring a judicial proceeding to construe a formula disposition.

Typically, states permit either a general construction proceeding, or a proceeding to determine if a formulaic disposition should be construed without reference to a state's statutory rules of construction.

In Florida, the ability to bring a judicial proceeding is tied to whether a disposition occurred within a defined period. Generally, however, the time frame for commencing a judicial proceeding is within 12 months of death, but can be shorter (in Indiana, for example, the proceeding must be commenced within 9 months of death). Accordingly, if a decedent died early in 2010, time is running out to bring a proceeding (or, in Indiana, may have already run out).

<b>Jurisdictions With Currently Enacted Laws (As of December 15, 2010)</b>	<b>Time for Bringing Judicial Proceeding</b>
<b>Delaware</b>	Within the later of 6 months of (1) death or (2) July 12, 2010 (the effective date of the Delaware legislation)  Note, statutory presumption will not apply if a disinterested fiduciary elects to opt out of its application, and no beneficiary objects within 30 days of receipt of written notice of the election
<b>District of Columbia</b>	Within 12 months of death
<b>Florida</b>	Proceeding can be brought if disposition occurred in "applicable period" (Beginning January 1, 2010 until the earlier of (1) December 31, 2010 or (2) the day before the date on which federal estate and GST tax sunset is repealed or modified)
<b>Georgia</b>	Within 1 year of death
<b>Idaho</b>	Within 12 months of death

<b>Jurisdictions With Currently Enacted Laws (As of December 15, 2010)</b>	<b>Time for Bringing Judicial Proceeding</b>
<b>Indiana</b>	Within 9 months of death
<b>Maryland</b>	Within 1 year of death
<b>Michigan</b>	Within the earlier of (a) two years after the decedent's death, or (b) six months after the fiduciary sends notice to the beneficiary
<b>Minnesota</b>	By December 31, 2011
<b>Nebraska</b>	Within 12 months of death
<b>New York</b>	Within 12 months of death
<b>North Carolina</b>	Within 12 months of death
<b>Pennsylvania</b>	Within 12 months of death
<b>South Carolina</b>	Within 12 months of death
<b>South Dakota</b>	Within 12 months of death
<b>Tennessee</b>	Within 12 months of death  Note, general rule of construction will not apply if a personal representative elects to opt out of its application with beneficiary consent within 9 months of death
<b>Utah</b>	Within 12 months of death
<b>Virginia</b>	Within 12 months of death
<b>Washington State</b>	Within 12 months of death
<b>Wisconsin</b>	Within 1 year of death

## Time Generally Runs From the Commencement of a Proceeding

As practitioners apparently still continue to grapple with uncertainty, the clock is ticking on the ability to bring such a proceeding, which generally must be *commenced* within the applicable time frame.

Accordingly, practitioners may wish to consider at least commencing a proceeding in order to keep their options open.

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<sup>1</sup> Florida and South Carolina have taken a different approach (discussed separately). Other states provide for additional exceptions from the statutory construction rules.

<sup>2</sup> Note that state-level taxes may have to be factored into the analysis, and potentially the loss of a spousal basis adjustment for capital gains tax purposes.