

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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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 \$3.5 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:

Jurisdictions with Bills Pending (As of December 15, 2010)
New Jersey
Ohio

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

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

Most States Provide Statutory Construction Rules

States have generally¹ 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 \$3.5 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 (\$3.5 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 \$3.5 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.²

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).

Jurisdictions With Currently Enacted Laws (As of December 15, 2010)	Time for Bringing Judicial Proceeding
Delaware	<p>Within the later of 6 months of (1) death or (2) July 12, 2010 (the effective date of the Delaware legislation)</p> <p>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</p>
District of Columbia	Within 12 months of death
Florida	<p>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)</p>
Georgia	Within 1 year of death
Idaho	Within 12 months of death

Jurisdictions With Currently Enacted Laws (As of December 1, 2010)	Time for Bringing Judicial Proceeding
Indiana	Within 9 months of death
Maryland	Within 1 year of death
Michigan	Within the earlier of (a) two years after the decedent's death, or (b) six months after the fiduciary sends notice to the beneficiary
Minnesota	By December 31, 2011
Nebraska	Within 12 months of death
New York	Within 12 months of death
North Carolina	Within 12 months of death
Pennsylvania	Within 12 months of death
South Carolina	Within 12 months of death
South Dakota	Within 12 months of death
Tennessee	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
Utah	Within 12 months of death
Virginia	Within 12 months of death
Washington State	Within 12 months of death
Wisconsin	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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¹ Florida and South Carolina have taken a different approach (discussed separately). Other states provide for additional exceptions from the statutory construction rules.

² 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.