
Construction of Tax Formula Clauses

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

- A. The U.S. estate tax and the U.S. 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 2010, the estate tax was retroactively reenacted, subject to a \$5 million exemption, and made elective, for 2010 decedents. The generation-skipping tax was retroactively reenacted with a zero rate for 2010.
- B. 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 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 out of estate tax 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.

C. There are many variants of formula clauses.

1. 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 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 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.

2. 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 that 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 settlors in the position that they expected to be in the last time they seriously thought about their estate plans. This approach chooses predictability and an assumption regarding settlors' intent, over optimum tax planning, which would usually allocate all of the assets to a bypass 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.

D. Overview of initial proposed formula statute.

1. The original proposed legislation had three parts:
 - a. 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;
 - b. 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; and
 - c. 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 (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. below); or (iii) a court directs otherwise (2. below).

E. Original proposed changes.

1. Private settlement agreements.

Existing Ohio Rev. Code § 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 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 settlor's 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.

Ohio Rev. Code § 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 proposed 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, § 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 statute as originally proposed provided a rule of construction, applicable if a person dies when those taxes are not applicable, which interpret such terms as if the settlor, testator, or beneficiary, whose death triggers a division, had died on December 31, 2009, unless (a) the will or trust instrument specifically addresses the application of the formula in the context of inapplicability of the tax; (b) in the case of a trust, all necessary parties agree otherwise through a private settlement agreement; (c) a court directs otherwise. The statute further provided that a retroactive change by Congress would not alter the operation of the statute.

F. 2011 revision: S.B. 117.

1. 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.
2. Our committee was divided on the right course of action. The following is a summary of our discussion
 - a. 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 settlor's intent, which could give rise to a gift tax issue.

b. 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.

c. 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. A copy of the statute, now incorporated into S.B. 117, is attached.

Excerpt from S.B. 117

TAXABLE INCOME (TRUSTS)

OR

**OHIO TAXABLE INCOME
(ESTATES)**

TAX

\$5,000 or less	.587%
More than \$5,000 but not more than \$10,000	\$29.35 plus 1.174% of the amount in excess of \$5,000
More than \$10,000 but not more than \$15,000	\$88.05 plus 2.348% of the amount in excess of \$10,000
More than \$15,000 but not more than \$20,000	\$205.45 plus 2.935% of the amount in excess of \$15,000
More than \$20,000 but not more than \$40,000	\$352.20 plus 3.521% of the amount in excess of \$20,000
More than \$40,000 but not more than \$80,000	\$1,056.40 plus 4.109% of the amount in excess of \$40,000
More than \$80,000 but not more than \$100,000	\$2,700.00 plus 4.695% of the amount in excess of \$80,000
More than \$100,000 but not more than \$200,000	\$3,639.00 plus 5.451% of the amount in excess of \$100,000
More than \$200,000	\$9,090.00 plus 5.925% of the amount in excess of \$200,000

In July of each year, beginning in 2010, the tax commissioner shall adjust the income amounts prescribed in this division by multiplying the percentage increase in the gross domestic product deflator computed that year under section 5747.025 of the Revised Code by each of the income amounts resulting from the adjustment under this division in the preceding year, adding the resulting product to the corresponding income amount resulting from the adjustment in the preceding year, and rounding the resulting sum to the nearest multiple of fifty dollars. The tax commissioner also shall recompute each of the tax dollar amounts to the extent necessary to reflect the adjustment of the income amounts. The rates of taxation shall not be adjusted.

The adjusted amounts apply to taxable years beginning in the calendar year in which the adjustments are made. The tax commissioner shall not make such adjustments in any year in which the amount resulting from the adjustment would be less than the amount resulting from the adjustment in the preceding year.

(B) If the director of budget and management makes a certification to the tax commissioner under division (B) of section 131.44 of the Revised Code, the amount of tax as determined under division (A) of this section shall be reduced by the percentage prescribed in that certification for taxable years beginning in the calendar year in which that certification is made.

(C) The levy of this tax on income does not prevent a municipal corporation, a joint economic development zone created under section 715.691, or a joint economic development district created under section 715.70 or 715.71 or sections 715.72 to 715.81 of the Revised Code from levying a tax on income.

(D) This division applies only to taxable years of a trust beginning in 2002 or thereafter.

(1) The tax imposed by this section on a trust shall be computed by multiplying the Ohio modified taxable income of the trust by the rates prescribed by division (A) of this section.

(2) A ~~nonresident~~ resident trust may claim a credit against the tax computed under division (D) of this section equal to the lesser of (1) the tax paid to another state or the District of Columbia on the ~~nonresident-resident~~ trust's modified nonbusiness income, other than the portion of the ~~nonresident~~ resident trust's nonbusiness income that is qualifying investment income as defined in section 5747.012 of the Revised Code, or (2) the effective tax rate, based on modified Ohio taxable income, multiplied by the ~~nonresident~~ resident trust's modified nonbusiness income other than the portion of the ~~nonresident~~ resident trust's nonbusiness income that is qualifying investment income. The credit applies before any other applicable credits.

(3) The credits enumerated in divisions (A)(1) to (13) of section 5747.98 of the Revised Code do not apply to a trust subject to division (D) of this section. Any credits enumerated in other divisions of section 5747.98 of the Revised Code apply to a trust subject to division (D) of this section. To the extent that the trust distributes income for the taxable year for which a credit is available to the trust, the credit shall be shared by the trust and its beneficiaries. The tax commissioner and the trust shall be guided by applicable regulations of the United States treasury regarding the sharing of credits.

(E) For the purposes of this section, "trust" means any trust described in Subchapter J of Chapter 1 of the Internal Revenue Code, excluding trusts that are not irrevocable as defined in division (I)(3)(b) of section 5747.01 of the Revised Code and that have no modified Ohio taxable income for the taxable year, charitable remainder trusts, qualified funeral trusts and preneed funeral contract trusts established pursuant to sections 4717.31 to 4717.38 of the Revised Code that are not qualified funeral trusts, endowment and perpetual care trusts, qualified settlement trusts and funds, designated settlement trusts and funds, and trusts exempted from taxation under section 501(a) of the Internal Revenue Code.

Sec. 5801.10. (A) As used in this section, "creditor" means any of the following:

(1) A person holding a debt or security for a debt entered into by a trustee on behalf of the trust;

(2) A person holding a debt secured by one or more assets of the trust;

(3) A person having a claim against the trustee or the assets of the trust under section 5805.06 of the Revised Code;

(4) A person who has attached through legal process a beneficiary's interest in the trust.

(B) The (1) Subject to division (B)(2) of this section, the parties to an agreement under this section shall be all any two or more of the following, or their representatives under the representation provisions of Chapter 5803. of the Revised Code, except that only the settlor and any trustee are required to be parties to an amendment of any revocable trust:

~~(1)(a)~~ The settlor if living and if no adverse income or transfer tax results would arise from the settlor's participation;

~~(2) All (b)~~ The beneficiaries;

~~(3) All (c)~~ The currently serving trustees;

~~(4)(d)~~ Creditors, if their interest is to be affected by the agreement.

(2) In addition to the parties to an agreement under division (B)(1) of this section, the parties shall include the attorney general if an agreement described in division (C)(7) of this section is being made and either of the following applies:

(a) An organization with one or more purposes that are described in division (A) of section 5804.05 of the Revised Code is a beneficiary.

(b) The trust is a charitable trust.

(C) The persons specified in division (B) of this section may by written instrument enter into an agreement with respect to any matter concerning the construction of, administration of, or distributions under the terms of the trust, the investment of income or principal held by the trustee, or other matters. The agreement may not effect a termination of the trust before the date specified for the trust's termination in the terms of the trust, change the interests of the beneficiaries in the trust except as necessary to effect a modification described in division (C)(5) ~~or~~, (6), or (7) of this section, or include terms and conditions that could not be properly approved by the court under Chapters 5801. to 5811. of the Revised Code or other applicable law. The invalidity of any provision of the agreement does not affect the validity of other provisions of the agreement. Matters that may be resolved by a private settlement agreement include, but are not limited to, all of the following:

(1) Determining classes of creditors, beneficiaries, heirs, next of kin, or other persons;

(2) Resolving disputes arising out of the administration or distribution under the terms of the trust, including disputes over the construction of the language of the trust instrument or construction of the language of other writings that affect the terms of the trust;

(3) Granting to the trustee necessary or desirable powers not granted in the terms of the trust or otherwise provided by law, to the extent that those powers either are not inconsistent with the express provisions or purposes of the terms of the trust or, if inconsistent with the express provisions or purposes of the terms of the trust, are necessary for the due administration of the terms of the trust;

(4) Modifying the terms of the trust, if the modification is not inconsistent with any ~~dominant~~ material purpose or objective of the trust;

(5) Modifying the terms of the trust in the manner required to qualify the gift under the terms of the trust for the charitable estate or gift tax deduction permitted by federal law, including the addition of mandatory governing instrument requirements for a charitable remainder trust as required by the Internal Revenue Code and regulations promulgated under it in any case in which ~~all the~~ parties interested in the trust have submitted written agreements to the proposed changes or written disclaimer of interest;

(6) Modifying the terms of the trust in the manner required to qualify any gift under the terms of the trust for the estate tax marital deduction available to noncitizen spouses, including the addition of mandatory governing instrument requirements for a qualified domestic trust under section 2056A of the Internal Revenue Code and regulations promulgated under it in any case in which ~~all the~~ parties interested in the trust have submitted written agreements to the proposed changes or written disclaimer of interest;

(7) Construing or modifying the terms of a trust that refer to the federal estate tax, federal generation-skipping transfer tax, or Ohio estate tax, or that contain a division of property based on the imposition or amount of one or more of those taxes, to give effect to the intent of the settlor;

(8) Resolving any other matter that arises under Chapters 5801. to 5811. of the Revised Code.

(D) No agreement shall be entered into under this section affecting the rights of a creditor without the creditor's consent or affecting the collection rights of federal, state, or local taxing authorities.

(E) Any agreement entered into under this section that complies with the requirements of division (C) of this section shall be final and binding on the ~~trustee, the settlor if living, all beneficiaries, creditors who are parties to the agreement or persons represented by the parties to the agreement whether by reason of Chapter 5803. of the Revised Code or otherwise,~~ and their heirs, successors, and assigns, but shall have no effect on any trustee, settlor, beneficiary, or creditor who is not a party to the agreement or is not represented by a party to the agreement.

(F) Notwithstanding anything in this section, in division (D) of section 5803.03 of the Revised Code, or in any other rule of law to the contrary, a trustee serving under the terms of the trust shall only represent its own individual or corporate interests in negotiating or entering into an agreement subject to this

section. No trustee serving under the terms of the trust shall be considered to represent any settlor, beneficiary, or the interests of any settlor or beneficiary in negotiating or entering into an agreement subject to this section.

(G) Any party to a private settlement agreement entered into under this section may request the court to approve the agreement, to determine whether the representation as provided in Chapter 5803. of the Revised Code was adequate, and to determine whether the agreement contains terms and conditions the court could have properly approved.

(H) If an agreement entered into under this section contains a provision requiring binding arbitration of any disputes arising under the agreement, the provision is enforceable.

(I) Nothing in this section affects any of the following:

(1) The right of a beneficiary to disclaim under section 5815.36 of the Revised Code;

(2) The termination or modification of a trust under section 5804.10, 5804.11, 5804.12, 5804.13, 5804.14, 5804.15, or 5804.16 of the Revised Code;

(3) The ability of a trustee to divide or consolidate a trust under section 5804.17 of the Revised Code;

(4) The power of the trustee to make distributions pursuant to section 5808.18 of the Revised Code.

(J) Nothing in this section restricts or limits the jurisdiction of any court to dispose of matters not covered by agreements under this section or to supervise the acts of trustees appointed by that court.

(K) This section shall be liberally construed to favor the validity and enforceability of agreements entered into under it.

(L) A trustee serving under the trust instrument is not liable to any third person arising from any loss due to that trustee's actions or inactions taken or omitted in good faith reliance on the terms of an agreement entered into under this section.

(M) This Subject to divisions (B)(2) and (C)(7) of this section, this section does not apply to any of the following:

(1) A charitable trust that has one or more charitable organizations as qualified beneficiaries;

(2) A charitable trust the terms of which authorize or direct the trustee to distribute trust income or principal to one or more charitable organizations to be selected by the trustee, or for one or more charitable purposes described in division (A) of section 5804.05 of the Revised Code, if any of the following apply:

(a) The distributions may be made on the date that an agreement under this section would be entered into.

(b) The distributions could be made on the date that an agreement under this section would be entered into if the interests of the current beneficiaries of the trust terminated on that date, but the termination of those interests would not cause the trust to terminate.

(c) The distributions could be made on the date that an agreement under this section would be entered into if the trust terminated on that date.

(N) This section does not prohibit some or all of the persons who could enter into an agreement under this section from entering into agreements that are not described in this section and are governed by other law, including the common law. Nothing in this section limits or negates any consents, releases, or ratifications, whether under section 5810.09 of the Revised Code or otherwise, relating to any agreement described in this section or governed by other law.

Sec. 5804.11. (A) If upon petition the court finds that the settlor and all beneficiaries consent to the modification or termination of a noncharitable irrevocable trust, that all consents, including any given by representatives under Chapter 5803. of the Revised Code, are valid, and that all parties giving consent are competent to do so, the court shall enter an order approving the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust. An agent under a power of attorney may exercise a settlor's power to consent to a trust's modification or termination only to the extent expressly authorized by both the power of attorney and the terms of the trust. The settlor's guardian of the estate may exercise a settlor's power to consent to a trust's modification or termination with the approval of the court supervising the guardianship if an agent is not so authorized. The guardian of the settlor's person may exercise a settlor's power to consent to a trust's modification or termination with the approval of the court supervising the guardianship if an agent is not so authorized and a guardian of the estate has not been appointed. This division does not apply to a noncharitable irrevocable trust described in 42 U.S.C. 1396p(d)(4).

(B) A noncharitable irrevocable trust may be terminated upon consent of all of the beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust. A noncharitable irrevocable trust may be modified, but not to remove or replace the trustee, upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust. A spendthrift provision in the terms of the trust may, but is not presumed to, constitute a material purpose of the trust. In determining what constitutes a material purpose of a trust, a court may but is not required to consider extrinsic evidence indicating a settlor's intent at the time the instrument was executed.

(C) Upon termination of a trust under division (A) or (B) of this section, the trustee shall distribute the trust property as agreed by the beneficiaries.

(D) If not all of the beneficiaries consent to a proposed modification or termination of the trust under division (A) or (B) of this section, the court may approve the modification or termination if the court is satisfied of both of the following:

(1) That if all of the beneficiaries had consented, the trust could have been modified or terminated under this section;

(2) That the interests of a beneficiary who does not consent will be adequately protected.

Sec. 5804.12. (A) The court may modify the administrative or dispositive terms of a trust or terminate the trust if because of circumstances not anticipated by the settlor modification or termination will further the purposes of the trust. To the extent practicable, the court shall make the modification in accordance with the settlor's probable intention.

(B) The court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or impair the trust's administration.

(C) Upon termination of a trust under this section, the trustee shall distribute the trust property in a manner consistent with the purposes of the trust.

(D) The court may modify or interpret the terms of a trust, including, but not limited to, a charitable trust or a trust having as a beneficiary an organization with one or more purposes that are described in division (A) of section 5804.05 of the Revised Code, that refer to the federal estate tax, federal generation-skipping transfer tax, or Ohio estate tax, or that contain a division of property based on the imposition or amount of one or more of those taxes, to give effect to the intent of the settlor.

Sec. 5808.02. (A) A trustee shall administer the trust solely in the interests of the beneficiaries.

(B) Subject to the rights of persons dealing with or assisting the trustee as provided in section 5810.12 of the Revised Code, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or that is otherwise affected by a conflict between the trustee's fiduciary and personal interests is voidable by a beneficiary affected by the transaction unless one of the following applies:

(1) The transaction was authorized by the terms of the trust or by other provisions of the Revised Code.

(2) The transaction was approved by the court.

(3) The beneficiary did not commence a judicial proceeding within the time allowed by section 5810.05 of the Revised Code.

(4) The beneficiary or the beneficiary's representative consented to the trustee's conduct, ratified the transaction, or released the trustee in compliance with section 5810.09 of the Revised Code.

(5) The transaction involves a contract entered into or claim acquired by the trustee before the person became or contemplated becoming trustee.

(C) A sale, encumbrance, or other transaction involving the investment or management of trust property is presumed to be affected by a conflict between personal and fiduciary interests if it is entered into by the trustee with one of the following:

(1) The trustee's spouse;

(2) The trustee's descendant, sibling, or parent or the spouse of a trustee's descendant, sibling, or parent;

(3) An agent or attorney of the trustee;

(4) A corporation or other person or enterprise in which the trustee, or a person that owns a significant interest in the trustee, has an interest that might affect the trustee's best judgment.

(D) A transaction not concerning trust property in which the trustee engages in the trustee's individual capacity involves a conflict between personal and fiduciary interests if the transaction concerns an opportunity properly belonging to the trust.

(E) An investment by a trustee that is permitted by other provisions of the Revised Code is not presumed to be affected by a conflict between personal and fiduciary interests if the investment otherwise complies with the prudent investor rule of Chapter 5809. of the Revised Code.
