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TRUSTS AND ESTATES

No Federal Estate Tax Creates Planning Opportunities, Potential Confusion and Litigation

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There is currently no federal estate tax or Generation-Skipping Transfer ("GST") tax for persons dying in 2010. Additionally, only a limited income tax basis step-up of assets held at death exists, resulting in possible unexpected capital gains tax and a need for professional decision-making. Thereafter, in 2011, the federal estate tax reapplies with a $1-million exemption and a 55 percent marginal tax rate. The basis of assets is then stepped up to fair market value. Retroactive legislation in 2010 could re-enact the tax this year, and the $1-million exemption scheduled in 2011 will likely be increased, creating difficulties in planning and administering estates.

This article contains advice for clients, drafting considerations, and a discussion of the limited basis step-up ($1.3 million in all estates, plus an addition $3 million to certain spousal dispositions). Litigation issues involving interpretation of wills with common pre-existing formula clauses are discussed. The application of New Jersey law when representing beneficiaries in will construction proceedings is also discussed.

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Drafting Wills in 2010

Prior will formulas in larger estates used terms like "marital deduction," "Credit Shelter Trust" and "least amount of federal estate tax" to divide assets between spouse's portions and exemption portions. None of these concepts apply to decedents who die in a year like 2010, where the federal estate tax is not applicable. Therefore, wills with formula clauses using such terminology should be amended to avoid confusion and possible litigation should a client die in 2010.

For clients of first marriages with children from such marriage, a codicil to the will leaving all assets on the death of the first spouse to a trust for the surviving spouse in which the surviving spouse is entitled to all income, appears to resolve many of the issues and ambiguities, and provides needed flexibility in the current environment. Such a trust results in the following advantages should the first spouse die in 2010: (1) There is no federal tax; (2) The trust is eligible for a $3-million step-up in basis; (3) There will be no estate tax in the surviving spouse's estate attributable to the trust assets, no matter what year surviving spouse dies, and no matter how large the trust assets; (4) The trust will be eligible to obtain marital deduction status for New Jersey estate tax purposes, in the first spouse's estate, thereby avoiding current New Jersey estate tax (Note: the New Jersey estate tax exemption is limited to $675,000; therefore, marital deduction is needed to avoid New Jersey estate tax. This can be accomplished by electing QTIP treatment for only New Jersey purposes.); and (5) Should Congress re-enact the estate tax retroactive to 2010 with (say) a $3,500,000 exemption, a partial QTIP election by the executor or a disclaimer by the surviving spouse, can result in utilizing the exemption.

Where you have a client in a more difficult situation, such as a client in a second marriage, with children from a first marriage, you need to discuss with the client specifically how much the client would want to pass to the children and how much to the spouse. A typical formula under prior law might have divided the estate between the maximum amount that could pass free of federal estate tax for the children, and the excess to the spouse. In 2010, using the

literal language of some formula bequests, all of the estate would pass to the children and nothing would pass to the spouse. In other formula clauses, the literal language could be construed to leave all to the surviving spouse, and nothing to the children. The wills of these clients should be reviewed and discussed with the clients as soon as possible to determine what their intent would be should death occur in 2010.

There are possible opportunities for clients with significant wealth to engage in GST tax planning in 2010. The safest course is to make outright gifts to grandchildren while there is no GST tax. It is possible that making a gift into a GST trust could be exempt from tax this year, but distributions to grandchildren in later years could be subject to GST tax, depending upon how Congress deals with this issue.

Administering the Estate of a 2010 Decedent

Under current law, there is no general "basis step-up," meaning that the assets of a person dying in 2010 do not receive a new basis equal to their fair market value at death. Rather, the estate assets continue to have the same basis that the decedent had, with the executor being permitted to allocate $1.3 million of additional basis to appreciated assets passing to anyone, and an additional $3 million basis to assets passing as "qualified spousal property (QSP)." Outright bequests to a spouse are eligible as QSP; however, outright bequests result in assets being included in the survivor's estate. Property passing in qualified trusts also result in the $3 million basis step-up, but as discussed previously, can result in avoidance of estate tax in the surviving spouse's estate.

In administering 2010 estates, executors should be counseled to avoid selling assets, or distributing assets to beneficiaries, until the law is clarified. If liquidity is needed, executors should consider borrowing or limiting the sale of assets that are eligible for either the $1.3 million basis step-up or $3 million basis step-up.

The new rules require executors to file a report for all estates in excess of $1.3 million of value in which among other items, the fair market value of property, property's basis in the hands of the decedent, holding period, and type of property is set forth. This report is due at the time for filing the decedent's final income tax return plus extension.

Representing Estates and Beneficiaries in Litigation

The 2010 situation could significantly affect both estates and beneficiaries because strict application of the tax law to a pre-2010 will may lead to results unintended by the testator. For example, a will devising a sum to a marital trust that is equal to the minimum amount necessary to avoid federal estate tax, and the balance to a family trust for the children, could result in leaving everything to the family trust and nothing to the spouse when the estate tax is zero. Such a result is clearly inconsistent with the testator's intent. In a friendly family situation, this may be resolved amicably by turning to N.J.S.A. 3B:23-9, permitting beneficiaries to alter the disposition of wills by agreement; however, in a strained family setting, this could cause protracted litigation.

In a potentially litigious situation (second marriage, perhaps), it is likely that N.J. courts will look to the Doctrine of Probable Intent, *Fidelity Union Trust Co. v. Robert*, 36 N.J. 561, 565 (1962). The purpose is: "to ascertain 'the probable intent' of the testator by a 'preponderance of the evidence' and to carry it out in accordance with [the testator's] wishes 'even though they are imperfectly expressed."

In applying the doctrine, courts endeavor to put themselves in the testator's position by looking for proof of all the circumstances surrounding the testator at the time of will execution until the testator's death. "Proof" includes various forms of extrinsic evidence that the court will review to determine whether the moving party has shown, by a preponderance of the evidence, that the proposed interpretation is more probable than not. If the burden has been met, the court will interpret the will in a manner that is consistent with the proponent's interpretation, even if that requires reformation of the will. Such was the result in *Matter of Estate of Branigan*, 129 N.J. 324 (1992), where the Supreme Court used the doctrine to reform a will in order to maximize tax efficiency in light of tax laws effected after the will had already been executed. The *Branigan* Court recognized that certain tax law changes often result in frustrating the intentions of a testator who executes his will in reliance on the tax laws that existed at the time the will was drafted and that reformation is required to affect the testator's true intentions regardless of subsequent changes in tax law. While *Branigan* dealt with tax avoidance, the policy grounds behind the decision are equally applicable to wills affected by the 2010 tax law under the same line of reasoning.

The 2010 law could be abused by litigants seeking to obtain more than their "fair" share. A litigator representing inadvertently disinherited beneficiaries must be diligent in investigating and obtaining as much extrinsic evidence as possible that will aid the court in reaching a desired result. However, the planner should advise his client to document his intentions in an executed will or codicil stating the client's wishes, should death occur in a year when there is no federal tax.■