2010: It Was a Very Good Year...To Die–Or Was It?

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2010: IT WAS A VERY GOOD YEAR . . . TO DIE—OR WAS IT?

S. Alan Medlin,* F. Ladson Boyle,** & Howard M. Zaritsky***

Editors' Synopsis: On December 17, 2010, Congress reinstated the estate tax and the generation skipping transfer tax, with changes from the prior tax regime. Estates of decedents dying in 2010, before the reinstatement of those transfer taxes, have a choice: apply the new tax regime or elect out. This Article discusses some of the tax factors affecting this choice. In addition to the tax issues for these decedents, the lack of any estate or generation skipping transfer tax at the time of their deaths could cause document construction problems that impact the allocation of their estates among beneficiaries. This Article examines the construction problems and proposes disclaimers and family settlement agreements as possible solutions in certain cases.

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I. INTRODUCTION

Congressional action and inaction affected decedents dying in 2010. The so-called repeal of the estate and generation skipping transfer (GST) taxes in 2001\(^1\) was actually a stepped increase in the amount of property that could pass free of estate and GST taxes through 2009.\(^2\) The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) allowed decedents dying in 2010 (hiatus decedents) to transfer property free from estate and GST taxes but restored both taxes in 2011 with rather limited protection—the applicable exclusion amount dropped to $1 million, which also lowered the GST exemption to $1 million indexed for inflation since 1997.

After 2001, many estate planners initially expected Congress to permanently repeal the estate and GST tax regime but, as 2010 approached, revised their expectations to anticipate that, before 2010, Congress would impose some type of estate and GST tax for hiatus decedents. Neither occurred, and the estates of hiatus decedents seemingly could escape estate and GST taxes.

Nevertheless, during 2010, estate planners conjectured that Congress still might enact a new estate and GST tax regime and retroactively apply it. Estate planning was in flux because of the uncertainty. On December 17,
2010, Congress enacted retroactive estate and GST tax legislation (2010 Tax Act), but the impact of the retroactive change on hiatus decedents was eased somewhat because the legislation allowed estates of hiatus decedents to elect out of the retroactive estate and GST taxes but with possible income tax basis consequences.

Both the congressional failure to impose estate and GST taxes for 2010 before 2010 and the enactment of the retroactive estate and GST taxes in December 2010 create issues and problems for estates of hiatus decedents. Fiduciaries charged with administering the estates of hiatus decedents will feel these problems most severely.

A. Election Out Problems

The 2010 Tax Act creates an “estate tax regime,” which broadly changes the estate, gift, and GST tax rules for 2010, 2011, and 2012 and permits the 2001 law to resurface in 2013. Effective January 1, 2010, section 301 of the 2010 Tax Act reinstates the estate tax and the date of death, fair market value basis rules. The estate tax regime reinstates the estate tax retroactively with a full $5 million applicable exclusion amount and a 35% top tax rate that, because it applies to all estates above $500,000, creates a flat 35% estate tax rate above the basic exclusion amount. The estate tax regime also reinstates the GST tax retroactively with a $5 million exemption and a top tax rate of 35%.

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4 The tax regime of the 2010 Tax Act lasts for two years. See § 101, 124 Stat. at 3298. Thus, estate planning remains in flux. The title of the portion of the 2010 Tax Act applicable to transfer taxes is entitled, perhaps ominously for long-term estate planning, “Title III: Temporary Estate Tax Relief.” Tit. III, 124 Stat. at 3300. Much has been and presumably will be written about the tax planning issues stemming from the 2010 Tax Act. See, e.g., HOWARD M. ZARITSKY, PRACTICAL ESTATE PLANNING IN 2011 AND 2012 (Thomson Reuters/WG&L, 2011).

5 Estate planning is still in flux because the 2010 Tax Act’s provisions continue only through 2012, but this Article focuses on the problems relevant to the estates of decedents dying in 2010. See § 101, 124 Stat. at 3298.

6 See § 301, 124 Stat. at 3300.

7 For decedents survived by a spouse, the 2010 Tax Act now defines “applicable exclusion amount,” a term coined by EGTRRA, as the basic exclusion amount ($5 million) plus any unused basic exclusion amount ported from the deceased spouse’s estate to the surviving spouse. See § 303, 124 Stat. at 3302-04.

8 See § 302(a), 124 Stat. at 3301.
Two important and time-sensitive issues relate to estates of hiatus decedents. First, construing tax-sensitive language in wills and revocable trusts may be problematic because estate or GST taxes may not have been applicable to the decedent’s estate on the date of the decedent’s death. This construction problem may directly affect the disposition of the decedent’s property among the various beneficiaries.

Second, the personal representative of the estate of a hiatus decedent must choose whether to allow the estate to be taxed under the estate tax regime (with a 35% rate, a $5 million applicable exclusion amount, a $5 million GST exemption, and an income tax basis in the decedent’s assets equal to their fair market value on the date of death) or elect out of the estate tax and into the carryover basis regime (with no estate tax, a modified carryover basis for income tax purposes, and a $5 million GST exemption but no GST tax on 2010 GST taxable transfers).

B. Hiatus Construction Problems

For certain hiatus decedents, including those who died after the December 17, 2010 effective date of the 2010 Tax Act, construction problems may exist. Many wills and revocable trusts drafted to be estate-tax sensitive divided a decedent’s estate or revocable trust between a surviving spouse or a trust for a surviving spouse (hereinafter collectively described as a gift to a surviving spouse) and a gift to other family members or a trust for family members (hereinafter collectively described as a gift to a credit shelter trust). A division between beneficiaries also may exist based on the applicable GST exclusion.

The controlling document often defines the division between the surviving spouse and the credit-shelter trust by a formula that uses estate or GST tax terms. Such a formula might, for example, give to the credit-shelter “the maximum amount of the decedent’s estate that may pass free of estate taxes.” Alternatively, the formula might give the surviving spouse an amount equal to the optimal marital deduction less the credit-shelter amount—all of the estate reduced by the greatest amount of property that can pass to others free of federal estate taxes. When these formulas use terms that refer to federal estate taxes, such as the unified credit, the applicable credit amount, the applicable exclusion amount, the exemption equivalent, the optimal marital deduction, the maximum marital deduction, or the GST exclusion, the division of the property of the decedent’s estate or re-
vocable trust becomes problematic because these terms had no meaning in 2010 until December 17.10

For several reasons, these construction problems remain despite the 2010 Tax Act. First, the usual rule for construing a testator’s intention applies the law in effect at the date of death: the testator speaks through the will at the time of death and presumably knows the facts and law applicable at that time.11 If the will or revocable trust of a 2010 decedent12 contained tax-sensitive terms but no express provisions about allocating the estate if no estate or GST taxes existed at the time of death, then the retroactive application of the 2010 Tax Act arguably should not cure property allocation construction issues because no estate or GST taxes existed at the time of death.13 This position is buttressed by the ability of a 2010 decedent’s estate to opt out of the 2010 Tax Act’s retroactive tax regime.14 Thus, for state law construction purposes, a court may construe the decedent’s will or trust, speaking at the time of the decedent’s death, to contain meaningless terms. A federal enactment that retroactively applies tax law does not necessarily retroactively affect state law construction issues; beneficiaries may still argue about the meaning of the tax-based formulas in the will or trust. Moreover, it is not uncommon for tax-sensitive wills and trusts to define tax terms by referring to the Internal Revenue Code (Code) in effect at the time of the decedent’s death. One might argue the division of the decedent’s property is based on the tax meaning of the formula even though the estate elected out and the decedent died after December 17, 2010.

10 See also infra Part III.A.


12 This analysis assumes that the decedent died before the enactment date of the 2010 Tax Act, which was December 17, 2010.

13 Even if the retroactive effect of the 2010 Tax Act could be construed to result in a determination that an estate tax was in effect on the date of death of a 2010 decedent, the tax-related terms might make no sense. For example, the 2010 Tax Act uses the term “basic exclusion amount” in some situations, in lieu of EGTRRA’s “applicable exclusion amount.” See, e.g., Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 303, 124 Stat. 3296, 3303. The pertinent language in the document would rely on EGTRRA terms, which might not translate readily to the terms in the 2010 Tax Act.

14 See infra Part II.
Second, the hiatus construction problem clearly exists for estates of 2010 decedents whose personal representatives elect out of the retroactive estate tax. By choice, these estates are not subject to any estate tax regime at the date of death. Third, some documents contain alternative dispositive provisions based on whether the estate is subject to estate or GST tax.

II. REPEAL OF 2010 REPEAL WITH AN ELECTION OUT

The 2010 Tax Act gives the personal representative of a 2010 decedent’s estate the power to elect out of the estate tax regime and into the carryover basis regime.15 If the personal representative does not make an election, the estate will be subject to the estate tax regime.16

Some thought this election was a political necessity because some estates had planned based on the legislative promise that no estate tax would be levied in 2010.17 Some also believed that one or more of the estates of several billionaires who died in 2010 would strongly litigate any attempt to retroactively reinstate the estate tax, unless an election out of the estate tax was included. Such litigation would likely result in a victory by the government but leave the state of the estate tax uncertain for many years while the case made its way through the courts.18

For some estates with very clear governing instruments (or no governing instrument), total assets well below $5 million, no lifetime post-1976 taxable gifts, and no interspousal transfers to the decedent within the year ending on the date of death, the personal representative may have little reason to consider electing out of the estate tax. The basis adjustments under section 1014,19 which gives the assets of the estate an adjusted basis equal to their estate tax value and thereby eliminates any built-in taxable gains, will provide favorable income tax treatment for the estate assets without any offsetting unfavorable estate tax treatment.20 For other estates, however, this

15 See § 301(c), 124 Stat. at 3300.
16 See id.
17 Some believe this planning included the postponement of certifiable death until 2010 by the continued use of extraordinary life-prolonging measures.
18 Wealthy decedents dying in 2010 included New York Yankees owner George Steinbrenner, Texas oil pipeline tycoon Dan Duncan, textile magnate Roger Milliken (although he died after the enactment of the 2010 Tax Act), and media magnate John Kluge.
19 See I.R.C. § 1014.
20 Even for estates under $5 million, however, situations may arise in which the election out of the estate tax will be logical. For example, the personal representative of a decedent who executed a 2000 will leaving his children the maximum amount that could pass free of estate taxes and who had not changed it thereafter, whether due to disability, laziness, or
election may create difficult tax and nontax choices, and generate substantial amounts of potentially very hostile litigation.

A. Factors in Electing Out of the Estate Tax

The decision whether to elect out of the estate tax regime and into the modified carryover basis regime will often be difficult. The personal representative must calculate the estate taxes that would be due if no election is made and which beneficial shares will bear the taxes, and then calculate the income taxes that will be due if the election is made and the beneficial shares that will bear these taxes. Projecting the tax effects of the modified carryover basis rules requires calculation of the net appreciation in each asset, the character of the gain on the sale of each asset, the tax rate applicable to the gain on the sale of each asset, when each asset is likely to be sold and whether tax benefits exist that might reduce the tax on such sales, and how the modified carryover basis rules will apply to these assets. The relevant factors that the personal representative should consider combine the issues of the income tax consequences of carryover basis, possible GST taxes, possible estate taxes, a weighted comparison of potential income and estate taxes, and other related factors such as passive losses and partnership interests.22

B. Fiduciary Responsibilities

The personal representative of an estate owes both a duty of fairness and impartiality towards all of the beneficiaries of the estate and a duty to conserve the estate, including a duty to minimize taxes.23 These duties gen-

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21 The uncertainty and complexity of the carryover basis analysis is exacerbated by complications such as the carryover basis rules generally providing for a basis stepped up to the date of death fair market value to a limit of $1.3 million, with a $3 million limit for surviving spouses. See I.R.C. § 1022(b), (c)(1).

22 See ZARITSKY, supra note 4, ¶ 2.02; Howard M. Zaritsky, Issues for Electing Out of the Estate Tax for 2010 Decedents, 23 PROB. PRAC. REP. 1 (Feb. 2011).

eraly mean that the personal representative must make every effort to minimize the total taxes on all the beneficiaries and the estate.

The election not to apply the estate tax regime will, in many cases, create a conflict between the interests of different beneficiaries and sometimes between the interests of particular beneficiaries and the personal representative’s duty to conserve estate assets by minimizing taxes. Situations in which the avoidance of estate taxes benefits a different beneficiary than the avoidance of income taxes and situations in which conserving the estate by reducing estate taxes comes at the cost of higher income taxes to the beneficiaries put the personal representative in a very difficult situation. These conflicts primarily happen in two situations.

At common law and under the terms of many wills and revocable trusts, estate taxes, like other debts, are the primary responsibility of the residuary estate. Specific gifts bear estate taxes in such estates only if the residue is insufficient. This treatment reflects the belief that a testator or grantor who makes a gift at death of a specific sum of money or a specific item of property likely wants that gift to pass free of taxes. Thus, the estate taxes are paid from the residuary estate.

In those cases, the beneficiary of a specific gift of an appreciated asset does not really benefit by the election out of the estate tax regime, unless the residuary estate is inadequate to pay the estate taxes. The beneficiary does, however, bear the burden of the future income taxes on the net appreciation in the assets on the date of death. These beneficiaries, therefore, may seriously object to an election out of the estate tax regime.

The second situation in which the beneficiaries who bear the income taxes are likely to differ from those who bear the estate taxes occurs when the state law or the governing instrument (or both) equitably apportion estate taxes. Equitable apportionment means that the shares of the estate that are eligible for an estate tax deduction receive the benefit of that deduction. Equitable apportionment typically means that the amounts passing to or in a qualifying trust for either charity or the surviving spouse do not bear estate taxes. Thus, a surviving spouse who is receiving substantially appreciated

assets may seriously object to an election out of the estate tax regime, even though the estate as a whole will benefit substantially from this election.

Another conflict of interest may arise when the decedent’s instruments actually anticipated the possibility of estate and GST tax repeal. The EGTRRA stated in 2001 that there would be no estate or GST tax in 2010, which led many practitioners to include alternative dispositions in wills and revocable trusts executed after 2001, depending on whether the decedent died in a year in which the estate or GST tax applied to the decedent’s estate. These documents may actually leave the estate assets to different beneficiaries, depending upon whether the personal representative elects out of the estate tax regime.

Of course, the wording of the instrument may also determine whether an election out of the estate tax regime should be construed as if the decedent died and the estate tax did not apply with respect to the decedent’s estate. Practitioners will need to carefully parse the precise wording of the governing instrument to determine whether an election not to have the estate tax regime apply will cause an alternate disposition to take place, whether intended or not.

The existence of different dispositions that depend upon whether the personal representative elects out of the estate tax regime with respect to the decedent’s estate creates a special problem for a family member serving as a personal representative. The personal representative has a duty of loyalty to the estate and must put the estate’s interests ahead of the personal representative’s personal interests. A personal representative will significantly benefit by making or refraining from making the election out of the estate tax regime and should seriously consider either resigning or having a special administrator appointed to make this election or refrain from making it.

The personal representative facing one of these problems should prepare the most detailed analysis possible of the different tax consequences of an election out of the estate tax regime, taking into account the myriad factors that affect the relative importance of estate and income tax liabilities. The personal representative then should seek the consent of all the estate beneficiaries to this proposed election (or non-election). If the beneficiaries will not or cannot agree or if some beneficiaries are minors or incompetent individuals, the personal representative should consider asking the court that

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supervises the administration of the estate to approve the proposed election or non-election. The personal representative should notify all of the beneficiaries, assure that minor or incompetent beneficiaries have a guardian *ad litem* appointed, and give each of the beneficiaries a chance to argue their position before the court. A court order, if the court will provide one, should provide the personal representative with good protection against liability for breach of fiduciary duty.

The fiduciary’s conflict of interests may be more serious if a 2010 “patch” statute has been enacted. Many state legislatures became concerned in 2009 and 2010 that most wills and trusts that included formula clauses dividing the estate between different beneficiaries—based on such tax terms as the applicable exclusion amount, the unified credit, the maximum marital deduction, and the available GST exemption—would be impossible to interpret in 2010 if no estate or GST tax were levied. This led eighteen states to enact statutes that construe a formula clause in a will or trust of a decedent who dies in 2010 as referring to the estate tax rules in effect on December 31, 2009. Two other states have statutes that authorize the fiduciary or beneficiaries to bring an action to construe a will that includes such clauses.

Opinions may differ on the impact of such statutes on a hiatus decedent’s will or trust in light of the 2010 Tax Act. A court may construe the last sentence of the Virginia statute, which is substantially similar to lan-

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guage in seventeen of the other statutes, as rendering the entire statute irrelevant in 2010 because the 2010 Tax Act retroactively reinstates estate tax. On the other hand, a court may seek to give some meaning to the statute by holding that it applies if the personal representative elects out of the estate tax regime.

If these statutes continue to apply after an election out of the estate tax, a personal representative’s election to apply the carryover basis regime would also create a nonmarital share equal to $3.5 million, rather than a nonmarital share equal to $5 million. Once again, the election by a beneficiary serving as personal representative will raise extensive issues of self-dealing and self-interest, and any personal representative should either obtain consent of all of the affected beneficiaries or submit the issue for court approval.

1. Equitable Adjustments

Generally, the courts may require, or at least permit, a personal representative to adjust the shares of the various beneficiaries of an estate when an election clearly works a disproportionate disadvantage. The seminal case on these equitable adjustments was the 1955 decision In re Warms’ Estate, in which the personal representatives deducted administration expenses on the estate’s fiduciary income tax returns instead of on the estate tax return. This approach worked to the advantage of the income beneficiaries and to the detriment of the remainder beneficiaries.

The New York Surrogate’s Court held that the personal representatives should credit the residuary trust with an amount equal to the tax savings that would have been allocable to such trust had administration expenses been deducted from principal in computing the estate tax. The court explained:

The tax option which results in a benefit to the income beneficiary, especially where she is co-executrix, should not be exercised to the detriment of the remaindermen. The remainder interest is entitled to the benefits which would have resulted if the expense with which it is charged had been deducted on the estate tax return. The question which would have arisen if the personal representatives had no option but would have had to deduct from income taxes an expense otherwise chargeable to principal need not here be

35 Based on the applicable exclusion amount for 2009 under EGTRRA.
decided. The court holds that the corpus of the residuary trust should be credited with the amount which represents the tax saving which would have been allocable to such trust had the administration expenses been deducted from principal in computing the estate tax. 37

A myriad of other situations exist that require or allow an equitable adjustment. 38 Many of these involve the confluence and conflict of a personal representative’s duties. 39 For example, the Uniform Principal and Income Act of 1997 (UPIA) 40 specifically authorizes certain equitable adjustments.

From a common law perspective, certain duties of a personal representative interact to create the potential for an equitable adjustment: (1) the duty of impartiality; (2) the duty of conserving the estate; (3) the duty to account, including the allocation of principal and income; and (4) the duty to comply with Subchapter J by reporting estate income for tax purposes. 41 By complying with the duty to save taxes, the personal representative may violate the duty of impartiality. 42 When two or more fiduciary duties conflict when making certain tax related decisions, the fiduciary may need to consider making an equitable adjustment, either under the common law or the UPIA. 43

UPIA section 506 provides for equitable adjustments for some tax reasons:

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a

37 Id. at 171.
39 See id. at 586.
41 See Boyle, supra note 38, at 586.
42 See id.
43 See id.
transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.44

Although an election with respect to a hiatus decedent certainly seems to fall within the ambit of UPIA section 506(a)(1) regarding an election or decision affecting a tax matter, the language of section 506(a)(1) also requires that the election involve a shifting of benefits between income beneficiaries and remaindermen. Granted, a hiatus election out of the estate tax may disparately affect income and remainder beneficiaries but perhaps not in the way intended by the UPIA. For example, a hiatus election may shift tax consequences between a marital share and a bypass share, with the bypass share being a trust with income and remainder beneficiaries. A hiatus election out may not shift benefits of the bypass trust between income and remainder beneficiaries and may not, therefore, fall within the intended scope of UPIA section 506. However, the common law origins of the equitable adjustment was to right a wrong. Estate planners should consider whether a court would extend the doctrine to hiatus problems. Equitable

adjustments started with Warms, but as other inequities arose as a result of tax elections and conflicting duties of a personal representative, courts were willing to order other equitable adjustments.\(^4\)

The precise types of equitable adjustments required when making or not making an election out of the estate tax will depend upon the particular facts and how the individual state's courts construe the equitable adjustment rules.\(^4\) Nonetheless, it is highly likely that some form of equitable adjustment will be appropriate whenever an election affects the interests of different beneficiaries in different ways.\(^4\)

Failing to make an equitable adjustment may create income and transfer tax consequences for an estate or a beneficiary. For example, a beneficiary entitled to an equitable adjustment who fails to assert the right may be considered to have made a taxable gift to other beneficiaries.\(^4\) Personal representatives should, therefore, consider not only direct but possible correlative tax consequences when considering equitable adjustments.

One argument is that, when not making the election favors one beneficiary over another, the failure to make the election also gives rise to an equitable adjustment.\(^4\) This theory may have some appeal, but courts generally have declined to require an equitable adjustment when inaction by a personal representative results in an inequity.\(^5\) Whether the failure to elect out of the estate tax will be viewed as justifying an equitable adjustment remains unclear.

C. Taxable Gifts by Interested Personal Representatives

The gift tax broadly defines a taxable gift as every completed transfer for less than full and adequate consideration in money or money's worth, regardless of the presence or absence of donative intent, unless a specific exemption, exclusion, or deduction applies.\(^5\) A transfer of trust property to a beneficiary by a trustee who has no beneficial interest and is acting merely in a fiduciary capacity is not a taxable gift.\(^5\)

\(^{45}\) See Boyle, supra note 38.
\(^{46}\) See id.
\(^{47}\) See id. at 586.
\(^{48}\) See Boyle, supra note 38, at 585.
\(^{49}\) See id. at 586 n.70.
\(^{50}\) See id. at 596.
\(^{52}\) See Treas. Reg. § 25.2511-1(g)(1).
Clearly, a personal representative who is not also a beneficiary of the estate should not have a personal gift tax problem merely because the personal representative elects or declines to elect out of the estate tax regime. The same may not hold true, however, for a personal representative who is also a beneficiary of an estate and whose decision to elect or not to elect out of the estate tax reduces the personal representative’s interest in the estate. A court may treat such a personal representative beneficiary as having made a taxable gift to the beneficiaries whose shares are thereby increased.53

Section 2514 states that a power to appoint property that does not belong to one among a class that includes the holder personally is a general power of appointment, the lapse or exercise of which (in favor of someone else) is a taxable gift.54 The gift tax rules do state, however, that a trustee’s administrative powers are not general powers of appointment, even if they may benefit the trustee personally, as long as the trustee “has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties.”55

The question arises, however, whether this exception applies to some of the situations described above, in which the personal representative’s decision whether to elect out of the estate tax can directly reduce the holder’s interest in an estate. This situation may be more than the mere incidental consequence of the discharge of the personal representative’s fiduciary duties and may raise serious gift tax problems for a beneficiary who is also the personal representative of a hiatus decedent’s estate. In such situations, the exercise (or non-exercise) of the election out of the estate tax may arguably be viewed as the equivalent of the exercise, release, or lapse of a general power of appointment held by the personal representative beneficiary, or the personal representative beneficiary may be deemed to have transferred a property interest individually held by the personal representative. Either analysis could result in significant gift tax liability for the personal representative beneficiary. Furthermore, this issue is particularly troubling when personal representatives must resolve conflicts of interest against themselves but doing so will result in gifts.

53 See Boyle, supra note 38, at 604.
III. HIATUS CONSTRUCTION PROBLEMS

As discussed earlier, state law construction problems arise when a 2010 decedent’s estate planning documents are drafted with reference to estate or GST tax sections or terms.

A. Background

The results of different tax-term-based formulas in documents for estates of hiatus decedents, however, potentially are quite different from what the decedent might have expected because no estate or GST tax was in effect at the date of death and the technical tax terms used had no meaning. For example, a formula that gives the surviving spouse the maximum marital deduction less the greatest amount that can pass to other family members free of federal estate taxes seems to leave the surviving spouse nothing because the entire estate can pass free of estate taxes to other family members; the cutback provision takes everything away from the surviving spouse. Whether this result is what the decedent intended is uncertain and demonstrates the construction issue.

Tax-sensitive formulas are complicated further by collateral provisions often included in a will or revocable trust, such as the provision that the marital devise must be satisfied solely with property that qualifies for the federal estate tax marital deduction. For example, a devise to the bypass trust of the decedent’s applicable exclusion amount and the residue to the surviving spouse would seem to give the entire estate to the surviving spouse because there is no applicable exclusion amount in 2010, but if the will then states that the spouse is to receive only assets that qualify for the federal estate tax marital deduction, the spouse would seem to receive nothing. In this situation, these formulas arguably do not direct the disposition of the decedent’s property at all because the division is based on tax terms that have no meaning in 2010 and the residuary estate may, by default, pass by intestacy.

When a typical prer residuary marital deduction formula arguably leaves nothing outright to the surviving spouse because the marital deduction devise is reduced by the most that may pass free of estate taxes, the surviving spouse might contend that the spouse has a right to some portion of the decedent’s estate; otherwise, the apparent devise to the spouse becomes meaningless. One canon of will construction is that all parts of a decedent’s will should be given meaning, if possible. The traditional application of construction rules, however, is predicated on the principle that the decedent had

an intention about a particular issue but did not clearly express it. The decedent possibly had an intention about a division of assets during the estate tax hiatus but failed to express that intent in the documents, but also possible—and perhaps likely—is that the decedent did not even consider that possibility. Had the decedent considered the possibility of dying during the 2010 hiatus, the documents would probably express an intent about that prospect.

Although common law construction principles might apply to resolve the dilemma, and some states have enacted statutes attempting to deal with the construction problem, court construction might not be a solution. Proactive solutions, such as disclaimers and family settlement agreements, in which the beneficiaries determine the effect of the documents, might be the best course to accomplish a favorable result for a family that is not disputatious.

B. Disclaimers

1. Qualified Disclaimers Overview

With one exception, a disclaimer must be valid for tax law and property law purposes to accomplish tax benefits.

a. Tax Requirements

For tax purposes, a disclaimer must be “qualified” if the transfer to the disclaiming party—the disclaimant—is to be ignored for estate and gift tax purposes. The Code requires that a qualified disclaimer be in writing and “signed either by the disclaimant or by the disclaimant’s legal representative.” To qualify, the disclaimer must be “irrevocable and unqualified,” and the disclaimed interest must pass to someone other than the disclaimant,

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57 See Restatement (Third) of Property: Wills and Donative Transfers § 10.1 (2003); see also, e.g., Estate of Swallen v. Comm’r, 98 F.3d 919 (6th Cir. 1996); Fleming v. First Union Nat’l Bank, 555 S.E.2d 728 (Ga. 2001); Pringle v. Houghton, 88 N.W.2d 789 (Iowa 1958); In re Scheyer’s Estate, 59 N.W.2d 33 (Mich. 1953); Crockett v. Scott, 284 S.W.2d 289 (Tenn. 1955).
59 See supra note 32; see also Medlin, Zaritsky, & Boyle, supra note 58.
60 See discussion infra Part III.B.1.b.
61 See I.R.C. § 2518.
62 See id.
unless the disclaimant is the transferor’s spouse. The disclaimant may not accept any benefit from the disclaimed interest; the receipt of consideration for disclaiming an interest is considered an acceptance of benefits that disqualifies the entire disclaimed interest.

A disclaimant may disclaim part of an interest but only if it is a separate interest created by the transferor. For example, if a decedent creates a trust giving the disclaimant separate interests in income and principal, the disclaimant may disclaim the income interest and retain the principal interest or vice-versa. If the transferor gave property outright to the disclaimant, however, the disclaimant could not separate the fee interest into a life estate and a remainder and disclaim either. Furthermore, a life tenant cannot disclaim a certain term of years while retaining the rest of the life estate.

A disclaimant may disclaim a separate interest if it is severable. The regulations define severable property as that “which, after severance, maintains a complete and independent existence,” such as shares of corporate stock.

In addition to the rules regarding disclaimers of income and principal interests in trust, section 2518 imposes limitations on the ability to disclaim an interest in trust. A disclaimant cannot disclaim an interest in a specific trust asset while retaining some other interest in the trust, unless the disclaimer results in the removal of the specific asset from the trust. Even if the disclaimer causes the removal of the specific asset from the trust, that asset cannot pass by alternate means to the disclaimant, unless the disclaimant is the spouse of a deceased transferor.

The disclaimant may, however, disclaim an undivided portion of the trust, as opposed to a specific asset. The regulations define an undivided portion as “consist[ing] of a fraction or percentage of each and every sub-

\[\begin{enumerate}
\item[64] Treas. Reg. § 25.2518-2(a).
\item[66] See Treas. Reg. § 25.2518-3.
\item[67] See S. Alan Medlin, An Examination of Disclaimers under UPC Section 2-801, 55 ALB. L. REV. 1233, 1283 (1992).
\item[69] Id.
\item[70] See Treas. Reg. § 25.2518-3(a)(2).
\item[71] See Treas. Reg. § 25.2518-2(a)(5).
\item[72] See Treas. Reg. § 25.2518-3(b).
\end{enumerate}\]
stantial interest or right owned by the disclaimant in such property . . . extend[ing] over the entire term of the disclaimant's interest.\textsuperscript{73}

A qualified disclaimer of a testamentary interest requires that the disclaimant make the disclaimer within nine months of the transferor's death or, if later, nine months after the disclaimant reaches the age of 21 years.\textsuperscript{74} Upon the transfer of an interest resulting from the exercise or lapse of a general power of appointment, the transferee must disclaim within nine months of the exercise or lapse.\textsuperscript{75} The transferee of an interest pursuant to the exercise or lapse of a nongeneral or special power, however, must disclaim within nine months of the creation of the power.\textsuperscript{76}

Section 2518 requires that "the interest passes without any direction" by the disclaimant.\textsuperscript{77} However, that section may authorize a qualified disclai-
mer that would not be valid according to state law, or vice-versa—the so-called transfer disclaimer. For tax purposes, the disclaimant may transfer the interest to another transferee if that transferee would have taken after a valid state law disclaimer.\textsuperscript{78} Thus, in contravention of the general rule prohibiting "direction of the property," the disclaimant may affirmatively transfer an interest within limitations, yet qualify for tax disclaimer treatment. Whether a transfer disclaimer is possible depends on the construction of section 2518. A disclaimer need not qualify as a transfer disclaimer if it satisfies state law.\textsuperscript{79} To qualify as a transfer disclaimer, however, the property must pass to the person who would take if the state law disclaimer were effective.\textsuperscript{80} If the state law disclaimer is ineffective—and it must be or the transfer disclaimer would be unnecessary—then determining who would have received under state law may be problematic.

\textsuperscript{73} Id.
\textsuperscript{74} See Treas. Reg. § 25.2518-2(c)(1).
\textsuperscript{75} See Treas. Reg. § 25.2518-2(c)(3).
\textsuperscript{76} See id.
\textsuperscript{77} I.R.C. § 2518(b)(4).
\textsuperscript{78} See I.R.C. § 2518(c)(3) (providing that a transfer will be deemed a qualified disclaimer if it meets requirements similar to section 2518(b)(2) and (3) and if it "is to a person . . . who would have received the property" pursuant to a disclaimer that would qualify under § 2518(b)).
\textsuperscript{79} For example, under the early common law an intestate interest could not be disclaimed, but now the tax law permits the transfer of a disclaimed intestate interest to the next person in the intestacy line. See Hardenberg v. Comm'r, 17 T.C. 166 (1951), aff'd 198 F.2d 63 (8th Cir. 1952); Tech. Adv. Mem. 8310006 (Nov. 26, 1982).
\textsuperscript{80} See Medlin, supra note 67, at 1289-90.
For property law purposes, disclaimers may be effectuated by common law rules or by statute, depending on the jurisdiction. The National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated three discrete uniform acts: the Uniform Disclaimer of Transfers by Will, Intestacy or Appointment Act (UDTWIAA), which applied only to testamentary or probate transfers; the Uniform Disclaimer of Transfers Under Nontestamentary Instruments Act (UDTNIA), which governed only inter vivos nontestamentary or nonprobate transfers; and the Uniform Disclaimers of Property Interests Act (UDPIA), which combined the other two acts for states wanting to govern both lifetime and deathtime transfers. Each of these acts contained a provision deferring to the applicable tax requirements for disclaimants wanting to effectuate a qualified tax disclaimer. Although the Joint Editorial Board (JEB) for the Uniform Probate Code (UPC) generally incorporated the UDTWIAA into section 2-801 of the pre-1990 UPC, the JEB replaced the provisions of UPC section 2-801 with the UDPIA in 1990. Importantly, UPC section 2-801 did not defer to tax law, as did the

81 See id., supra note 67, at 1234-39.
82 The three uniform acts were originally introduced in 1973 by NCCUSL. See Handbook of the National Conference of Commissioners on Uniform State Laws 159-68, 202-20 (1973). The amended versions of these acts were approved by NCCUSL in 1978. See 8A U.L.A. 85, 93, 111 (1983).
83 8A U.L.A. 93 (1983). The 1973 version of the UDTWIAA was based substantially on a proposed act by the Special Committee on Disclaimer Legislation of the American Bar Association's Section of Real Property, Probate and Trust Law.
84 See id. § 1, 8A U.L.A. 96 (1983).
85 See 8A U.L.A. 111 (1983). The 1973 version of the UDTNIA was substantially based upon a proposed act by the Special Committee on Disclaimer Legislation of the American Bar Association's Section of Real Property, Probate and Trust Law.
86 See id. § 1, 8A U.L.A. 112 (1983).
90 The JEB for the UPC serves as the oversight panel for three groups with substantial interests in the development and reform of trusts, estates, guardianship, and probate law: NCCUSL, the American College of Trust and Estate Counsel, and the Section of Real Property, Trust and Estate Law of the American Bar Association.
91 The JEB explained that the replacement of the UDTWIAA by the UDPIA was consistent with the general theme of other 1990 UPC amendments, which recognized the
three uniform disclaimer acts. Because significant differences existed between the property law aspects of UPC section 2-801 and the tax law considerations of Code section 2518, the disclaimant intending a tax qualified disclaimer generally had to comply with both property and tax law.\textsuperscript{92}

In 2002, NCCUSL replaced UPC section 2-801, as well as the three disclaimer acts, with the introduction of the UDPIA.\textsuperscript{93} UDPIA is found at part 11 of article 2 in the current version of the UPC. NCCUSL describes UDPIA as "the most comprehensive disclaimer statute ever written" and intends for the act "to allow every sort of disclaimer."\textsuperscript{94}

To be effective for property law purposes, a disclaimer must satisfy the applicable law of the pertinent jurisdiction, whether common or statutory law applies. Different states have different mechanisms for authorizing disclaimers, whether by common law rule or by one or more versions of the various uniform statutes. Although this Article is not intended to provide a comprehensive treatment of the rules in each jurisdiction, some requirements for a valid disclaimer under state law apply generally.

Generally, any person or that person's representative may disclaim.\textsuperscript{95} The representative may be such fiduciaries as the disclaimant's personal representative, conservator, guardian, or attorney in fact.\textsuperscript{96} Absent statutory authority, some jurisdictions allow a personal representative to disclaim on behalf of a decedent,\textsuperscript{97} but some courts have refused to allow disclaimers

\footnotesize{pervasive use of "dispositive provisions not contained in wills." UNIF. PROB. CODE § 2-801 cmt., 8 pt. 1 U.L.A. 209 (1998).}

\footnotesize{\textsuperscript{92} Except for a transfer disclaimer. See supra text accompanying notes 77-80.


\textsuperscript{94} Id.


\textsuperscript{97} See, e.g., In re Howe's Estate, 163 A. 234 (N.J. Prerog. Ct. 1932). A married couple died in an automobile accident, although the wife survived the husband by a few days. See id. at 236. The wife's administratrix sought to disclaim her devise from her husband's estate. See id. The court recognized the ability of a decedent’s representative to disclaim on behalf of the decedent, but the attempt was not timely. See id. at 237-38.
after death. After the 1990 amendment, section 2-801 remained silent about a trustee's ability to disclaim an interest on behalf of a trust beneficiary. UDPIA expressly authorizes a trustee to disclaim, and case law precedent also exists. As with disclaimers for federal tax purposes, state law disclaimers may be total or partial. Partial-interest disclaimers can disclaim life estates or income interests in trust as well as remainder or principal interests in trust. For a partial disclaimer to be effective, some courts have required the interest disclaimed to have its own independent and separate identity.

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98 See, e.g., Rock Island Bank & Trust Co. v. First Nat'l Bank of Rock Island, 185 N.E.2d 890 (Ill. 1962); see also In re Estate of Morgan, 393 N.E.2d 692 (Ill. App. Ct. 1979), aff'd, 411 N.E.2d 213 (Ill.1980). In Estate of Morgan, the deceased disclaimant's will poured over the residue, including property the personal representative attempted to disclaim, into an inter vivos trust created by deceased disclaimant. The probate court maintained discretion to disallow disclaimer by a personal representative, considering not only statutory filing procedures and common law rights but also the deceased disclaimant’s intent as evidenced by her estate plan.


101 See, e.g., McClintock v. Sahill, 530 N.E.2d 164 (Mass.1988). In McClintock, the decedent’s will left his residuary estate to a revocable trust. The revocable trust provided that certain assets were to be distributed to a trust for the decedent’s grandchildren. After the decedent’s death, one trustee of the grandchildren’s trust disclaimed the distribution to produce an estate tax savings for the decedent’s estate. The trustee believed the disclaimer would ultimately benefit the decedent’s grandchildren because it would result in current estate tax savings, which the decedent’s wife intended to pass along to the grandchildren. Some time thereafter, the Service questioned whether the trustee had the power to make the disclaimer under local law. See id. at 165. The court determined that the trustee had the power to disclaim on behalf of the grandchildren’s trust. See id. at 166.


For example, a disclaimant may not be allowed to divide an income interest in trust into separate terms, retaining part and disclaiming the rest.\textsuperscript{105}

State law also may require the disclaimer to occur within a certain time. The appropriate time period may depend on whether the disclaimed interest is a present or future interest and whether the disclaimed interest passed at the transferor's death or during lifetime.\textsuperscript{106} UDPIA, however, does not impose a time period.\textsuperscript{107} The lack of a state law time period does not allow the disclaimant to avoid the tax law requirement of a timely disclaimer.\textsuperscript{108}

Even if a state has a disclaimer statute, the statute may not provide the only method of disclaiming for property law purposes.\textsuperscript{109} Disclaimer statutes may include procedural requirements such as filing and delivery to a fiduciary.\textsuperscript{110}

\subsection*{2. Hiatus Use of Disclaimers}

Disclaimers may be used to obtain a more favorable tax plan under a document that did not accurately address the disposition of the estate of a hiatus decedent. Assume, for example, that a decedent's will leaves to a nonmarital or bypass trust an amount equal to the decedent's applicable exclusion amount and leaves the surviving spouse the rest of the estate. Also, assume that the surviving spouse's estate would be large enough to incur a tax upon the surviving spouse's death after 2010. Of course, we do not know what the applicable exclusion amount will ultimately be, though it is scheduled to be $5 million for 2011 and 2012.\textsuperscript{111} Because there is no appli-
cable exclusion amount in 2010 for a hiatus decedent, this formula appears to leave the entire estate outright to the surviving spouse. In this situation, the best estate tax result probably would be for the estate to pass to a bypass trust that will not be included in the surviving spouse’s gross estate. The surviving spouse and the other family members might argue that the will should be construed in this manner because the instrument did not really reflect an intent that the entire estate pass to the surviving spouse. It is not clear, however, whether a state court would sustain this construction, using either common law or recently enacted statutory construction rules. Even if the state court adopted this construction, the construction may not be accepted by the Service.

Furthermore, one may argue that the spouse’s failure to forcefully demand the right to the entire estate results in a taxable gift under Revenue Ruling 84-105. In this ruling, the Service held that a surviving spouse who failed to assert a right to a fully funded marital devise made a gift to the estate’s residuary beneficiaries at the time the probate court approved the estate’s final accounting. The ruling also held that the failure of the spouse to object to the underfunding was not a qualified disclaimer by the surviving spouse because it did not occur within nine months of the decedent’s death.

In the assumed fact pattern above, if the spouse is a beneficiary of the bypass trust, any deemed gift by the surviving spouse will also result in the potential inclusion of the bypass trust in the spouse’s estate under section 2036. Moreover, because of the potential application of section 2702, the deemed gift by the surviving spouse will likely be valued without subtracting the value of any beneficial interest that the spouse has in the trust.

A better approach would be for the surviving spouse to disclaim all or part of the marital devise, causing those assets to pass to the beneficiaries who would have taken the estate had the spouse not survived the decedent. In this example, the trust may be the bypass or now residuary trust. The op-

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112 See supra Part I. The absence of an exclusion assumes the decedent died before December 17, 2010, or elected out of the estate tax regime.
113 See supra note 32.
114 See infra Part III.C.2.a.
116 See id. at 198.
117 See id.
118 See I.R.C. § 2036.
119 See I.R.C. § 2702.
eration of section 2518, which treats the transfer as if it had been made directly from the decedent to the actual recipient (the bypass or residuary trust), avoids the imposition of a gift tax on the surviving spouse and avoids treating the spouse as the transferor for purposes of section 2036.\footnote{See I.R.C. § 2518.}

Neither a disclaimer nor a court order interpreting the decedent’s instruments may be necessary if the marital devise was made to a QTIP trust for the surviving spouse, rather than outright. No QTIP election exists with respect to estates of hiatus decedents,\footnote{For estates that elect out of the estate tax, a QTIP election is not available.} and the assets of the QTIP trust should not be included in the surviving spouse’s gross estate under section 2044.\footnote{Section 2044 is not applicable to trusts for which a QTIP election is not made. See Treas. Reg. § 20.2044-1(c).} Thus, when the terms of the QTIP trust and the bypass trust are identical during the spouse’s lifetime, it does not matter which trust receives the decedent’s assets.

Of course, if the bypass trust has multiple beneficiaries or if the spouse is not a beneficiary of the bypass trust, a substantial nontax difference can arise between the probable disposition under the instrument—all to the marital share—and the disposition that the decedent may have intended—some funding of the bypass trust. A spouse may choose to disclaim part of the marital share, even when held in trust, to assure that the other family members receive a share of the estate that is sufficient to preserve family harmony and avoid extensive family litigation.

In many cases, a formula division for a hiatus decedent may result in a construction leaving the entire estate to someone other than the surviving spouse. For example, if a will leaves to the decedent’s adult children an amount equal to the most that can pass free from federal estate taxes and the balance outright to the decedent’s surviving spouse, a court may determine, by common law construction or available statutes,\footnote{See supra note 32.} that all of the estate passes to the adult children in 2010. A disclaimer by the decedent’s children of some portion or all of their devise would fund the marital share to the extent of the disclaimer and without gift tax consequences. Determining how much to disclaim in favor of the surviving spouse to accomplish the best tax result may involve guessing what Congress eventually does, or does not do, with the estate tax after 2012. The family may not want to fund the marital share beyond the exemption amount, whatever that may eventually be, to avoid tax upon the surviving spouse’s estate.
3. **Potential Tax Problems**

Several common situations may raise problems in establishing that a surviving spouse’s disclaimer is a qualified disclaimer. The most common problem arises if the surviving spouse has a testamentary special power of appointment over the trust to which the disclaimed assets will pass. The regulations state that such a power to direct the disclaimed property will cause the disclaimer not to be qualified.\(^{124}\) The spouse can, however, disclaim the power of appointment at the same time that the spouse disclaims an interest in the marital devise to assure that the disclaimer is qualified.\(^{125}\)

A similar problem can arise if the surviving spouse is a trustee of the trust to which the disclaimed assets pass. The surviving spouse may not retain, even as a trustee, the power to determine the beneficial enjoyment of the disclaimed assets.\(^{126}\) Therefore, the surviving spouse cannot retain the power to distribute income or principal among a group of beneficiaries, unless that power is limited by an ascertainable standard.\(^{127}\) Retention of a power of invasion, other than a noncumulative power to withdraw no more than $5,000 or 5% of the trust fund annually or a power limited by an ascertainable standard, may cause the disclaimer not to be qualified.\(^{128}\) Of course, if the power is not limited by an ascertainable standard, any deemed gift by the spouse is likely to be incomplete for gift tax purposes and includible in the surviving spouse’s gross estate under section 2041.\(^{129}\) When powers held in a fiduciary capacity are a potential problem, the surviving spouse can decline to serve as trustee, in addition to making the disclaimer.\(^{130}\)

4. **Other Formula Issues**

The use of a disclaimer by the surviving spouse may clarify the amount passing to a residuary trust, even if the most logical construction is that the spouse should receive nothing under the instrument. For example, assume that the decedent leaves to the surviving spouse the minimum amount of property necessary to reduce the federal estate tax to zero or to the lowest possible amount. A court would likely interpret this formula as leaving

\(^{124}\) *See* Treas. Reg. § 25.2518-2(e)(5), ex. 4.

\(^{125}\) *See* Treas. Reg. § 25.2518-2(e)(5), ex. 5.

\(^{126}\) *See* Treas. Reg. § 25.2518-2(e)(2).

\(^{127}\) *See* *id.*


\(^{129}\) *See* I.R.C. § 2041.

\(^{130}\) *See* Priv. Ltr. Rul. 8509092 (Dec. 6, 1984).
nothing to the surviving spouse, but a disclaimer will confirm what may seem obvious and avoid the need for a suit to construe the instrument.

A disclaimer may also clarify what appears to be the right result when the marital devise is based on a formula that gives the spouse the amount of the maximum marital deduction less the applicable exclusion amount. In this situation, what passes to the nonmarital trust is less clear because there is presumably neither a maximum marital deduction nor an applicable exclusion amount for a 2010 decedent. A court could construe this situation as leaving the spouse nothing. In such situations, the surviving spouse’s disclaimer of all interests in any marital share also would avoid the need for a suit to construe the instrument.

The preceding two examples assume that receiving nothing suits the surviving spouse, or if the residuary devise is to a bypass trust with the surviving spouse as a beneficiary, that it suits the surviving spouse to take only the interest in the bypass trust. If taking nothing or taking only an interest in the bypass trust does not suit the surviving spouse, the surviving spouse may be reluctant to confirm that the spouse is not entitled to any portion of the decedent’s estate. In such situations, other construction rules may be needed to resolve the ambiguity.131

5. Disclaimers That Do Not Work

When a preresiduary, pecuniary bypass trust formula leaves to the credit-shelter trust an amount equal to the applicable exclusion amount or the estate tax exemption equivalent, with the residue passing to the surviving spouse, a disclaimer by the surviving spouse may not be a viable option to fund the credit-shelter trust. In this situation, a disclaimer by the spouse potentially creates an intestacy, with respect to whatever the spouse was entitled to receive and disclaimed. Further disclaimers by other intestate takers will not fund the credit-shelter trust either.

In such a circumstance, a disclaimer or a series of disclaimers by several beneficiaries will not resolve the potential ambiguity. A court construction action or a family settlement may be necessary to provide certainty in such a case.132

Another variation to a common pattern presents another problem. For example, assume that the decedent leaves outright to the decedent’s children the most that may pass free of estate taxes and the residue to a QTIP trust for the surviving spouse. A disclaimer by the children to fund the QTIP

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131 See generally Medlin, Zaritsky, & Boyle, supra note 58.
132 See id.
trust is not a qualified disclaimer if the children are the remainder beneficiaries of the QTIP trust, as is common. The attempted disclaimer is impermissibly severing the children's fee interest in the property; effectively, the children are disclaiming the right to income for the spouse's lifetime and retaining the remainder in violation of Treasury Regulation section 25.2518-3. In such cases, the children might need to consider also disclaiming their interests in the QTIP trust, if they are willing.

6. **GST Formulas**

Similar construction issues arise when the decedent's estate or revocable trust is divided between trusts that are exempt from the federal GST tax and trusts that are not exempt. Formulas are often used for this division based on the GST exemption amount defined in section 2631(c). The 2010 hiatus problem seemingly existed for these types of formulas because section 2631(c) defined the amount of the GST exemption with reference to the "applicable exclusion amount under section 2010(c) for such calendar year." For decedents dying in 2010, there was no applicable exclusion amount until the 2010 Tax Act.

The 2010 Tax Act retroactively reinstated the applicable exclusion amount for 2010, setting the amount at $5 million. The GST exemption also thereby was reinstated retroactively for all of 2010. Furthermore, the GST exemption appears to be available even to a 2010 estate the personal representative of which elects out of the estate tax.

GST formula devises commonly provide that a trust is to be funded with an amount equal to the decedent's unused GST exemption. Such a formula easily could pass nothing to the GST-exempt trust with respect to the estate of a pre-December 17, 2010 decedent. In such cases, if the balance of the decedent's estate is given to a marital trust, a disclaimer by the surviving spouse does not seem to fund the GST trust; rather, such a disclaimer likely will create an intestacy.

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134 I.R.C. § 2631(c).
135 See supra Part I.A.
137 See supra text accompanying notes 7-8.
If a will or trust of a pre-December 17, 2010 decedent leaves the decedent’s children all of the estate in excess of the largest amount that can pass to a residuary GST-exempt trust, the construction dilemma is even more difficult. The cutback language may not result in any property passing to the GST-exempt trust. Moreover, a disclaimer by the children to fund the GST-exempt trust will not be a qualified disclaimer if the children are beneficiaries of the GST-exempt trust because the attempted disclaimer would violate the rule that property must pass to someone other than the disclaimerant. In such cases, the children might need to consider also disclaiming their interests in the GST-exempt trust.

7. Fractional Share Formulas

Tax sensitive formulas usually may be classified as either pecuniary formulas or fractional share formulas. A testator may use a pecuniary formula to define the devise to the surviving spouse or the devise to the credit-shelter trust in terms of a fixed dollar amount. A fractional share formula that divides the estate or trust between the surviving spouse and the credit-shelter trust is usually a division of the residue of the decedent’s estate or remainder of the property in the decedent’s revocable trust.

The wording of each of the pecuniary formulas discussed above, or similar wording, may be useful to define the numerator of a fractional share division of the decedent’s residuary estate or the remainder of the decedent’s revocable trust, with the denominator of the fraction being defined as the residue of the decedent’s estate or the remainder of the trust estate for a revocable trust. In each of the fractional share alternatives, the issue remains the same, and disclaimers may solve only some of the construction problems.

8. More Time to Comply

Normally, a disclaimant must make a qualified disclaimer within the nine-month time period after the decedent’s death. However, section 301(d) of the 2010 Tax Act extends the time for filing an estate tax return for the estate of a decedent dying after December 31, 2009, and before the date of enactment on December 17, 2010. The time extension includes any elections on such returns and any disclaimers of interests in such es-

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139 See supra text accompanying notes 70-71.
141 See § 301(d), 124 Stat. at 3300.
tates, until at least nine months after the date of enactment. Because the nine month anniversary of the date of enactment falls on a Saturday, the date to file such returns, elections, and disclaimers is September 19, 2011.

The extension of time to make disclaimers may be a double-edged sword. The extension gives the disclaimant a significant time to determine the tax effects of the disclaimer but also gives the disclaimant a significant time to do something that the Service could perceive as accepting the gift or bequest and thus would disqualify the disclaimer.

Also, some state laws may require that a disclaimer be made within nine months of the date of the transfer. A disclaimant using the federally-extended time within which to make a disclaimer probably will need to actually transfer the disclaimed assets to the persons who would have received the assets if the disclaimer were valid. Furthermore, fiduciaries may find themselves unable to take advantage of this additional time to make disclaimers because state law will deny them authority to do so.

C. Family Settlement Agreements

If the beneficiaries agree, another way to avoid the risks of an unwelcome court determination is to reach a family settlement agreement. State law widely sanctions family settlement agreements, either at common law or by statute. Courts have noted that avoiding protracted and unnecessary litigation often supports the settlement of an estate. Moreover, courts typically are allowed, but not required, to accept the terms of a family settlement agreement. The tax consequences of these agreements, however, also deserve attention.

To be effective for property law purposes, a family settlement agreement must satisfy the applicable law of the pertinent jurisdiction, whether common law or statutory law applies. Although this Article’s intent is not to provide a comprehensive treatment of the rules in each jurisdiction, some

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142 See id.
143 See Medlin, supra note 67, at 51; see also supra Part III.B.1.b.
144 See I.R.C. § 2518(c)(3).
145 See, e.g., Merkel v. Long, 117 N.W.2d 130, 136 (Mich. 1962) (“Harmonious disposition of the matter... will serve to ‘avoid the expense, bitterness of feeling and disturbance of the orderly pursuits of life which are so often the incidents of lawsuits’ as well as the needless delay of distribution of the corpus of the trust fund.”); Detroit Trust Co. v. Neubauer, 38 N.W.2d 371, 381 (Mich. 1949) (“That it was for the benefit of all parties interested in the estate, presently or prospectively, to avoid litigation that might perhaps prove expensive and protracted is obvious.”).
requirements for a valid family settlement agreement apply generally and are demonstrated by the UPC and the UTC.

1. Family Settlement Agreements Under the UPC and UTC

The UPC recognizes the ability of parties to enter into family settlement agreements and of courts to approve them. The UPC authorizes two basic models: a private settlement agreement and a court-approved settlement.

UPC section 3-912 allows parties to enter into a binding private settlement without court approval.146 UPC section 3-912 allows fewer than all of the beneficiaries to enter into a settlement agreement and requires the personal representative to abide by any agreement.147 Section 3-912 states:

Subject to the rights of creditors and taxing authorities, competent successors may agree among themselves to alter the interests, shares, or amounts to which they are entitled under the will of the decedent, or under the laws of intestacy, in any way that they provide in a written contract executed by all who are affected by its provisions. The personal representative shall abide by the terms of the agreement subject to his obligation to administer the estate for the benefit of creditors, to pay all taxes and costs of administration, and to carry out the responsibilities of his office for the benefit of any successors of the decedent who are not parties. Personal representatives of decedents' estates are not required to see to the performance of trusts if the trustee thereof is another person who is willing to accept the trust. Accordingly, trustees of a testamentary trust are successors for the purposes of this section. Nothing herein relieves trustees of any duties owed to beneficiaries of trusts.148

Statutes such as UPC section 3-912 that recognize nonjudicial settlement agreements are based on the notion that beneficiaries are free to do whatever they want with their property once they own it outright. If beneficiaries can transfer property however they want once the property is distrib-

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147 See id.
148 Id.
uted to them, then why not allow them to rearrange their eventual ownership interests before the property is distributed to them?149

UPC sections 3-1101 and 3-1102 provide a process for court approval. These sections authorize a court to approve a family settlement agreement if the court determines there is a good faith controversy and the proposed agreement is just and reasonable.150 The good faith controversy requirement should be met in most—if not all—of the hiatus construction cases. If the court approves the proposed settlement, it can order the personal representative to sign the order.151 Section 3-1101 provides for the consequences of a court-approved family settlement agreement:

A compromise of any controversy as to admission to probate of any instrument offered for formal probate as the will of a decedent, the construction, validity, or effect of any governing instrument, the rights or interests in the estate of the decedent, of any successor, or the administration of the estate, if approved in a formal proceeding in the Court for that purpose, is binding on all the parties thereto including those unborn, unascertained or who could not be located. An approved compromise is binding even though it may affect a trust or an inalienable interest. A compromise does not impair the rights of creditors or of taxing authorities who are not parties to it.152

Section 3-1102 describes the process for obtaining court approval:

(1) The terms of the compromise shall be set forth in an agreement in writing which shall be executed by all competent persons and parents acting for any minor child having beneficial interests or having claims which will or may be affected by the compromise. Execution is not required by any person whose identity cannot be ascertained or whose whereabouts is unknown and cannot reasonably be ascertained.

(2) Any interested person, including the personal representative, if any, or a trustee, then may submit the

149 See id. cmt.
150 See id. § 3-1102, 8 pt. 2 U.L.A. 304-05 (1998).
151 See id.
152 Id. § 3-1101, 8 pt. 2 U.L.A. 303 (1998).
agreement to the Court for its approval and for execution by the personal representative, the trustee of every affected testamentary trust, and other fiduciaries and representatives.

(3) After notice to all interested persons or their representatives, including the personal representative of any estate and all affected trustees of trusts, the Court, if it finds that the contest or controversy is in good faith and that the effect of the agreement upon the interests of persons represented by fiduciaries or other representatives is just and reasonable, shall make an order approving the agreement and directing all fiduciaries subject to its jurisdiction to execute the agreement. Minor children represented only by their parents may be bound only if their parents join with other competent persons in execution of the compromise. Upon the making of the order and the execution of the agreement, all further disposition of the estate is in accordance with the terms of the agreement. 153

Court-approved settlement agreements provide the additional benefit of allowing the beneficiaries to argue that the will, as construed per the settlement, created the desired result all along, so that no gift tax issue arises as it might with a section 3-912 agreement. As noted by the comment to UPC section 3-912, “an agreement among successors under this section would involve transfers by some participants to the extent it changed the pattern of distribution from that otherwise applicable.” 154

The UTC similarly recognizes the ability to settle trust construction issues. Section 111 authorizes interested persons to enter into a nonjudicial settlement if it does not thwart a material purpose of the trust. 155 Section 411 allows a court to approve the modification of a trust upon agreement of the beneficiaries if the modification is not inconsistent with any material purpose of the trust. 156

In jurisdictions that have adopted a version of the UPC but not the UTC, a family settlement agreement can nevertheless affect trusts. A technical amendment was made to UPC sections 3-1101 and 3-1102 in 1993.

153 Id. § 3-1102, 8 pt. 2 U.L.A. 304-05 (1998).
The comment to UPC section 3-1101 provides: "1993 technical amendments to this and the following section clarified original intention that the described procedure would be available to resolve controversies other than those concerning a will."\(^{157}\)

The 1993 technical amendment makes clear that the intention of the original UPC sections 3-1101 and 3-1102 was always to include controversies in addition to mere will and trust controversies.

Further, the language of section 3-1102(2) lists a broad class of persons who are to execute an approved agreement: "the personal representative . . ., the trustee of every affected testamentary trust, and other fiduciaries and representatives."\(^{158}\) Section 3-1102(3) broadly requires notice to, among others, "all affected trustees of trusts," without any limitation that those affected trusts be testamentary trusts.\(^{159}\) If section 3-1102 could not affect inter vivos trusts, then such statutory language would be rendered meaningless.

Another issue that may arise with family settlement agreements involves the necessity for the appropriate fiduciary's consent. UPC section 3-1102 provides that fiduciaries have an opportunity to be heard at a settlement approval hearing but do not have the authority to veto a settlement presented to the court for approval.\(^{160}\) Although UPC section 3-1102 recognizes that a fiduciary may be a party to a settlement and even propose its approval to the court, it provides that the court can direct a fiduciary who is not a party to the settlement to execute the agreement after it is approved by the court.\(^{161}\)

The comment to UPC section 3-1102 explains why the fiduciary's approval is not required:

The thrust of the procedure [for approving a settlement] is to put the authority for initiating settlement proposals with the persons who have beneficial interests in the estate, and to prevent executors and testamentary trustees from vetoing any such proposal. The only reason for approving a scheme of devolution which differs from that framed by the testator or the statutes governing intestacy is to prevent dissipation of the estate in wasteful

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\(^{158}\) Id. § 3-1102(2), 8 pt. 2 U.L.A. 304 (1998).

\(^{159}\) Id. § 3-1102(3).

\(^{160}\) See id.

\(^{161}\) See id.
litigation. Because executors and trustees may have an interest in fees and commissions which they might earn through efforts to carry out testator's intention, the judgment of the court is substituted for that of such fiduciaries in appropriate cases. A controversy which the court may find to be in good faith, as well as concurrence of all beneficially interested and competent persons and parent-representatives provide prerequisites which should prevent the procedure from being abused. Thus, the procedure does not threaten the planning of a testator who plans and drafts with sufficient clarity and completeness to eliminate the possibility of good faith controversy concerning the meaning and legality of his plan.\(^\text{162}\)

Thus, because a fiduciary suffers from a conflict of interest from the possible self-serving goal of incurring additional fees and commissions, the UPC does not require the consent of the fiduciary.

A recent case demonstrates a judicial explanation of the rationale for not requiring the consent of a fiduciary. In *In re Will of Liss*,\(^\text{163}\) the testator's will made devises to ten charities. The successors entered into a private settlement agreement, settling what the court described as complex litigation.\(^\text{164}\) The case involved the state attorney general because some of the successors were charities.\(^\text{165}\) The state attorney general, after an extensive review, determined that the settlement was in the best interests of the charities because of a substantial chance that the charities would lose the will contest and, thus, their devises.\(^\text{166}\) The court recognized the danger to the charities if the will contest were successful: "If this litigation is permitted to continue, they [the charities] may lose and never receive anything or win and find that in victory their net recovery is less than what is definitely available at this time."\(^\text{167}\)

The personal representative argued that the charitable beneficiaries were not within the definition of competent successors required by the state

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\(^{162}\) *Id.* § 3-1102 cmt. (emphasis added).


\(^{164}\) See *id.* at 457.

\(^{165}\) See *id.*

\(^{166}\) The court noted that the necessary involvement of the state attorney general "merely reflects a value judgment made by our society that in matters involving charities the Attorney General should have the power to intervene as protector of the public interest." *Id.* at 459.

\(^{167}\) *Id.* at 460.
private settlement statute, but the *Liss* court nevertheless found that the personal representative lacked standing: "It is equally evident that the personal representative is not an aggrieved party, and that he has no standing to resist the interested parties' wish to settle this will contest."\(^{168}\) Thus, *Liss* is consistent with the concern of UPC section 3-1102 about the conflict of interest of a fiduciary stemming from the issue of fees.

*Liss* also addressed other issues relevant to UPC section 3-1102. The court cited the proper behavior for a fiduciary who was not a party to a settlement agreement among competent successors: "[W]hen faced in a will contest with an agreement which complies in all respects with N.J.S.A. 3A:2A-81, decedent's personal representatives should abide thereby, or, at most, in a nonadversarial manner, present the agreement for court approval if he desires the additional personal protection afforded by N.J.S.A. 3A:14-4."\(^{169}\)

Citing precedent, the *Liss* court noted that a court can approve the compromise of a will contest despite the objections of the fiduciary.\(^{170}\)

The *Liss* court rejected the personal representative's contention that the court could not approve the settlement without taking testimony on certain

\(^{168}\) *Id.* at 458 (citing *In re Rogers*, 83 A.2d 268, 275 (Essex County Ct. 1951)).

\(^{169}\) *Id.* at 459.

\(^{170}\) *See id.* at 458. Just as a fiduciary does not have to consent to a family settlement agreement, the fiduciary may not have the right to appeal the settlement. *See, e.g.*, First Nat'l Bank of Dewitt v. Yancey, 826 S.W.2d 287 (Ark. Ct. App. 1991) ("It is a general rule that a trustee, acting in its representative capacity, cannot by an appeal litigate the conflicting claims of beneficiaries"); Estate of Fowler, 860 S.W.2d 380 (Mo. Ct. App. 1993) ("The fact that a personal representative has an individual or personal interest in the estate does not create standing to appeal solely in his representative capacity. Rather, he must be 'aggrieved' or adversely affected in his official or representative capacity as opposed to his individual capacity."); Krause v. Tullo, 835 S.W.2d 488 (Mo. Ct. App. 1992) ("[E]xecutor or administrator as such is not aggrieved or prejudiced by a decree determining the rights of beneficiaries and hence may not appeal."); *In re Savage's Estate*, 650 S.W.2d 346 (Mo. Ct. App. 1983) ("Even though a personal representative is named as party, he is not entitled to appeal every judgment pertaining to the estate as an "aggrieved party". To appeal as such, a personal representative must be adversely affected in his representative capacity as distinguished from his personal capacity"); *In re Estate of Wirebaugh*, 616 N.E.2d 245 (Ohio Ct. App. 1992) ("Ordinarily, executor is not aggrieved party[, and, thus, may not appeal probate court order in his individual capacity] in a proceeding which affects only the rights of the beneficiaries."); Fried v. Fried, 582 N.E.2d 1038 (Ohio. Ct. App. 1989) ("Executor cannot appeal a judgment which does not prejudice him in his representative capacity"); Boulger v. Evans, 377 N.E.2d 753 (Ohio 1978) ("It is a general principal that a fiduciary may not appeal a judgment which does not affect him prejudicially in his representative capacity.").
issues. The court found nothing in the statutes that required testimony for the approval of a settlement. The court recognized that, because of the ongoing complex litigation, the judge had gained appropriate knowledge about the case. "Indeed, it has properly been noted that ‘in almost every case [involving court approval of the settlement of an estate litigation] the taking of testimony is unnecessary . . . ’" The court held that a limited hearing would not aid the court and that a "plenary hearing is precisely the event which a settlement is intended to avoid." The Liss court also noted that the applicable statute, New Jersey’s version of UPC section 3-912 concerning private settlement agreements, required the personal representative to abide by the terms of the agreement.

Although the approval of a family settlement agreement may not require the consent of a fiduciary, a fiduciary who does consent may speak for the beneficiary of any affected trust and override the objection of the beneficiary. For example, in University of Southern California v. Moran, a husband and wife executed a joint revocable trust with pour-over wills and named an attorney to serve as personal representative and trustee. The trust provided that, upon the death of the surviving spouse, the trustee would distribute $50,000 for the care of their dog, $10,000 to each of their named nieces and nephews, and the remainder to the university. Two nephews threatened to contest the will, and the attorney-trustee entered into a settlement agreement providing for the payment of $175,000 to the nephews. However, the attorney refused to sign the settlement agreement in his capacity as personal representative without probate court approval. Upon receiving notice of the compromise, the university opposed the motion to approve it. The nephews contended that the university lacked standing to

\[\text{\textsuperscript{171}} See Liss, 445 A.2d at 459.\]
\[\text{\textsuperscript{172}} See id.\]
\[\text{\textsuperscript{173}} See id. at 460.\]
\[\text{\textsuperscript{174}} Id. (citations omitted).\]
\[\text{\textsuperscript{175}} Id.\]
\[\text{\textsuperscript{176}} See id. at 459.\]
\[\text{\textsuperscript{177}} 617 S.E.2d 135 (S.C. Ct. App. 2005).\]
\[\text{\textsuperscript{178}} See id. at 136.\]
\[\text{\textsuperscript{179}} See id. at 137.\]
\[\text{\textsuperscript{180}} See id.\]
\[\text{\textsuperscript{181}} See id.\]
contest the compromise, and the trial court agreed. The university appealed.

Citing the usual rules of statutory construction, the appellate court reviewed the state’s version of UPC sections 3-1101 and 3-1102. Because the appellate court was addressing the compromise involving the decedent’s estate, the court had to determine whether the university had a beneficial interest in light of the lack of a statutory definition. The court cited analog state statutory provisions related to the UPC: the definition of devisee, which is a trustee of a trust receiving a devise and the provision binding the beneficiaries of a trust when an order is binding on the trustee. Moreover, the appellate court cited policy considerations as support for the nephews’ position. If the university’s argument was correct, then any beneficiary could scuttle a family settlement and encourage rather than discourage litigation. Because family settlements are favored under the law, such a power in a sole beneficiary could undermine the public policy of reducing family disputes.

Consequently, the appellate court determined that the better policy was to allow the trustee to represent the interest of the trust beneficiaries for purposes of a family settlement. The appellate court observed that its ruling did not leave the university without a voice. Although the university did not have a beneficial interest for purposes of executing the compromise according to the state’s version of UPC section 3-1102, it was an interested person entitled to notice of the petition to approve the compromise and to voice its objection in court, which could affect the probate court’s decision. The appellate court affirmed the lower courts.

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182 See id.
183 See id.
184 See id. at 138-42.
185 See id. at 140.
186 See id. at 140.
187 See id. at 141.
188 See id.
189 See id.
190 See id.
191 See id.
192 See id. at 141-42.
193 See id. at 142.
2. Tax Consequences of a Family Settlement Agreement

Statutes based on UPC section 3-912 or UTC section 111 recognize the essential concept that beneficiaries are trading their property, or at least what will soon be their property; therefore the beneficiaries giving up a larger share may be treated as making a gift.\(^{194}\) Consequently, the Service may scrutinize such a private agreement for more than just hiatus issues and explore whether a gift tax is also due.

The Service may not give much weight to family settlement agreements that are not approved by a court. For example, in Technical Advice Memorandum 201004022,\(^{195}\) the decedent died leaving a will that made several devises to various individuals, including the decedent’s son for life, with the remainder of each devise passing to a charitable trust that the decedent had created during life. The decedent, however, neglected to make a residuary devise.\(^{196}\)

The charitable trust claimed that the residue was omitted by scrivener’s error and that the charitable trust was the residuary beneficiary.\(^{197}\) The decedent’s son claimed that, as intestate heir, he was the residuary beneficiary.\(^{198}\) The son and the charitable trust negotiated for several months and then agreed to divide the residuary estate.\(^{199}\) The Service, in technical advice, stated that the charitable trust lacked an enforceable claim, and therefore the amounts passing to it were not passing from the decedent, but rather from the son.\(^{200}\) Thus, such amounts were not deductible for estate tax purposes.\(^{201}\) The Service relied primarily on several marital deduction cases that concluded that payments under a settlement agreement were not deductible unless the spouse had an enforceable right properly interpreted under state law.\(^{202}\) The existence of an adversary contest and a good faith settlement is not sufficient.\(^{203}\)

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\(^{194}\) See supra Part III.C.1.


\(^{196}\) See id.

\(^{197}\) See id.

\(^{198}\) See id.

\(^{199}\) See id.

\(^{200}\) See id.

\(^{201}\) See id.

\(^{202}\) See id.

\(^{203}\) See id.; see also Estate of Hubert v. Comm’r, 101 T.C. 314 (1993), aff’d on other grounds, 63 F.3d 1083 (11th Cir. 1995), aff’d on other grounds, 520 U.S. 93 (1997); Ahmanson Found. v. United States, 674 F.2d 761 (9th Cir. 1981).
extended to the charitable deduction area in *Terre Haute First National Bank v. United States.*

The Service observed that state law presumes that a decedent did not intend an intestacy, but that presumption "is met by an equally potent presumption that an heir is not to be disinherited except by plain words or necessary implication." Here, too, the Service stated the will was not ambiguous but merely did not dispose of the residue; therefore, testimony of the drafter or others should not have been admissible. The Service never suggested that any special weight or deference should be afforded the settlement agreement.

a. *Bosch and Family Settlements for Hiatus Decedents*

While courts that usually favor family settlements are likely to recognize the special exigency of clarification during the hiatus, these agreements appear at first blush to raise possible risks under *Commissioner v. Estate of Bosch.* No matter which of the various routes to interpret a hiatus will or trust is used, any lower state court order, including one approving a family settlement, is potentially subject to challenge by the Service, unless the lower court order is appealed to the highest court of a jurisdiction. Such an appeal may be unusual and unlikely in most cases.

Under *Bosch,* the Service and the federal courts are not required to recognize a construction by a local court if they believe the construction is not consistent with the interpretation that would have been rendered by the highest court in the state. The Service and the federal courts need only give "proper regard" for the views of the lower courts. For example, a trial court order construing a will that leaves the decedent's children an amount equal to the applicable exclusion amount as establishing a $5 million children's share may be viewed by the Service and the federal courts as incorrect and as actually constituting a $5 million gift by the surviving spouse. If the nonmarital share is held in a trust for the spouse and descendants, the assets

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206 See id.

207 See id.


209 See *In re Paul F. Shur Trust,* 222 P.3d 506 (Kan. 2010); *In re Estate of Keller,* 46 P.3d 1135 (Kan. 2002) (authorizing direct appeal in cases of will or trust construction where Bosch problems exist).
deemed given away by the spouse could arguably be includible in the spouse’s gross estate under sections 2036 or 2038.210

Lower court constructions or interpretations of hiatus issues, especially non-adversarial family settlements, may be more open to Service scrutiny because of Bosch. When the lower court order is supported by reasonable evidence—such as testimony of the drafting attorney as to the decedent’s intent, possible correspondence to or from the decedent, and statements made to independent parties—a challenge by the Service is less likely to succeed. In the context of actions to determine the decedent’s intent concerning how a tax-sensitive formula is to be construed, finding any precedent is likely impossible. The maxim “No will has a brother or twin” is often used to indicate that virtually every will construction case is dependent on its unique set of facts because the goal is to determine the intent of that testator.211

But Bosch might be less of a problem for hiatus family settlements than might first appear. Bosch concluded that the highest court of New York, based on existing precedent, would not have affirmed the friendly ruling of the trial court, but Bosch involved a question of law.212 In that case, Mrs. Bosch released a general power of appointment to convert it into a special power of appointment.213 After Mr. Bosch’s death, his estate sought to have the trial court nullify the release.214 The trial court obliged, but the U.S. Supreme Court determined that the lower state court was at odds with established precedent.215

In Bosch, no dispute arose as to the facts, only a dispute as to the legal effect of the facts. No such legal precedent will exist for construction of formula provisions: formula construction actions and settlements will determine the decedent’s intent, which is a question of fact, not law as was involved in Bosch.

Presumably, thousands of decedents died in 2010 with documents that use tax-sensitive formulas in need of construction. Each estate will be unique as to each decedent’s intent, even when similar language is used. The question will always be one of fact, so Bosch may not present a problem.

210 See I.R.C. §§ 2036, 2038.
212 See Bosch, 387 U.S. 456.
213 See id. at 458.
214 See id. at 459.
215 See id.
The Service may not agree with this conclusion about facts versus law. In a 1996 action on decision, concerning Estate of Goree v. Commissioner, the Chief Counsel's Office stated:

Estate of Bosch does not require the application of an appellate review standard to factual findings related to lower state court determinations. Rather, Estate of Bosch holds that lower state court judgments are not binding on the Tax Court, including factual determinations, and that the Tax Court should reconsider such judgments de novo.

Goree involved disclaimers that the Service contended were not valid under Alabama state law, although approved by a probate court order. In reaching its decision, the Tax Court applied the Alabama standard of review for factual issues: "whether [the probate court's] decision was 'plainly and palpably erroneous.'" The action on decision recommended against an appeal in Goree. The Chief Counsel was unsure whether "the ultimate conclusion of the Tax Court would have been altered by the adoption of the proper standard for review of factual conclusions of the state court."

In Estate of O'Neal v. Commissioner, the North Alabama District Court favorably cited Goree. However, the Fifth Circuit in Delaune v. United States cited but did not follow the Goree holding concerning the standard on review by the federal courts.

In Estate of Salter v. Commissioner, the Fifth Circuit considered the degree a lower court order should be binding. It stated:

While the decree of the Chancery Court is not binding on this Court, we are entitled to "give it proper regard" In the absence of a case specifically in point, the best measure of that "regard", we think, would be to determine, from

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217 Id.
218 Id.
219 See id.
220 Id.
221 81 F. Supp. 2d 1205 (N.D. Ala. 1999), aff'd in part, remanded in part 258 F.3d 1265 (11th Cir. 2001), on remand 228 F. Supp. 2d 1290 (N.D. Ala. 2002) (Bosch issue not addressed on appeal.).
222 143 F.3d 995 (5th Cir. 1998).
223 545 F.2d 494 (5th Cir. 1977).
existing precedent, in our best judgment, whether the Supreme Court of Mississippi would have affirmed the Chancellor's decree had there been an appeal. 224

The Northern District Court of Alabama in Estate of McDonald v. United States 225 favorably cited and further held that "[u]nder Alabama law, a reviewing court must affirm the trial court's findings of fact unless those findings are 'plainly and palpably erroneous.'"226 This standard is the same standard the Tax Court applied in Goree. The district court noted the distinction between questions of fact and questions of law, concluding that "when no material facts are disputed and an appeal solely focuses on the application of the law to the facts the trial court's decision is reviewed de novo,"227 but a hiatus construction question likely is not a matter of law but is a question of fact—the decedent's intent. The Eleventh Circuit affirmed McDonald without opinion.228

Thus, for 2010 estates with hiatus construction issues, the Bosch issue should be resolved on whether the settlement is entirely a question of fact and what standard the appropriate state supreme court would apply on appeal. The answer to that might vary depending on applicable state law.

Perhaps more problematic for the Service to apply Bosch to a hiatus family settlement is the question of retroactivity. Bosch involved a taxpayer's attempt to have a lower court retroactively interpret the document—that is, the lower court issued its order in Bosch after the potential taxable event.229 Mr. Bosch had died before the family sought the surrogate's court order determining the effect of Mrs. Bosch's partial release of her power of appointment.230 In hiatus settlements, however, the decedent's death was not a taxable event because there is no estate tax in 2010 if the personal representative elects out.231 Instead, the family settlement determines the disposition of the decedent's property and does not attempt to retroactively alter the tax result.

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224 Id. at 500 (citing Estate of Bosch v. Comm'r, 387 U.S. 456 (1967)).
226 Id. at 1289-90 (citing Smith v. Muchia, 854 So.2d 85, 92 (Ala. 2003).
227 Id. at 1290 (citing Allstate Ins. Co. v. Skelton, 675 So.2d 377, 379 (Ala. 1996)).
228 116 F. App'x 246 (11th Cir. 2004).
230 See id.
231 This assumes that the personal representative chose the carryover basis regime. See supra Part I.A.
The Service recognized this distinction in Revenue Ruling 73-142. In the ruling, the decedent, during lifetime, held a power over a trust that would have caused an estate tax inclusion if the decedent held the power at death. However, before the decedent’s death, the decedent brought a construction action that ultimately resulted in an extinguishment of the prohibited power. This court order was likely in conflict with decisions of the highest court of the state, according to the ruling. Nevertheless, the Service concluded that the lower court order was the law of the case and binding on the parties before the taxable event, and thus binding on the Service. As a result, the property was not included in the decedent’s estate.

Neither Bosch nor Revenue Ruling 73-142 appear to directly cover the hiatus situation because the potential taxable event, if one exists, is the family settlement itself: the settlement has potential gift tax consequences for the person who does not assert a right to property under the decedent’s will or trust. In Revenue Ruling 84-105, the Service ruled that a surviving spouse made a gift when the spouse did not object to a final accounting of a decedent’s estate when the estate’s personal representative proposed to underfund the marital deduction trust. This situation is somewhat similar to the situation in a hiatus family settlement. The taxable event has not already occurred nor will it occur in the future, but if a taxable event occurs, it occurs simultaneously with the family settlement. However, a hiatus settlement is different from the facts of Revenue Ruling 84-105. In the ruling, the amount due to the marital trust clearly was undisputed. In a hiatus family settlement, the agreement resolves the ambiguity of the amount that should pass to the various beneficiaries under the terms of the decedent’s will or trust. The evidence that supports the settlement should identify the uncertainty as well as the decedent’s probable intent. The fact that the settlement is not attempting to establish a retroactive tax benefit also distinguishes hiatus settlements from Technical Advice Memorandum 201004022 discussed above.

233 See id.
234 See id.
235 See id.
236 See id.
238 See id.
239 See id.
The family settlement should resolve a legitimate ambiguity in all events. Hiatus family settlements should not be used to redraft the decedent’s estate plan to meet the wishes of the family if the result is patently inconsistent with the wording of the document and the evidence supporting the settlement. Such a misuse of the process likely will result in a gift under the theory of Revenue Ruling 84-105.240 If a wholesale alteration of the document is needed or desired, the participants should look to see if a disclaimer or a series of disclaimers can achieve the desired result. A qualified disclaimer avoids the gift tax issues that arise under Revenue Ruling 84-105.241 In fact, the ruling notes that the failure to object to the funding of the marital trust was not a qualified disclaimer because it was done more than nine months after the decedent’s death.242 The Service recognized that qualified disclaimers can achieve the desired result if timely made.243

Consequently, probate lawyers should be careful in using family settlement agreements and friendly trial court orders to resolve interpretative problems raised by the lack of an estate tax in 2010. If a state court order produces a result that is not supported by the facts or that is not reasonable, the Service will have a good argument to treat it as a new series of taxable transfers for estate and gift tax purposes. For example, if it is unclear whether a formula clause should result in the entire estate passing to the

240 Most of the relevant cases deal with the Service disallowing deductions for amounts arising from a settlement with the surviving spouse. The courts have required not only a good faith settlement, but also that the surviving spouse have a legally enforceable right to a portion of the estate before the settlement agreement. Without this pre-existing, legally enforceable right, the Service has disallowed a deduction for settlements. See, e.g., Carpenter v. Comm’r, 52 F.3d 1266 (4th Cir. 1995) (Because surviving spouse did not have a life estate with general power of appointment, the terminable interest prohibition precluded the estate from claiming the marital deduction and did not give the surviving spouse a bona fide claim that could be settled with the estate.); In re Fung’s Estate, 58 Fed. Appx. 328 (9th Cir. 2003) (Surviving spouse conveyed her residuary interest in favor of a full interest in certain property, but deduction disallowed because estate failed to adequately value the residuary of the estate, therefore not adequately valuing the property that the surviving spouse surrendered in the settlement.); Davies v. United States, 124 F. Supp. 2d 717 (D. Me. 2000) (Estate settled with surviving spouse by granting liquidation of an annuity in exchange for the spouse’s elective share rights. Deduction was disallowed because surviving spouse did not have an enforceable right to the annuity independent of her elective share interest in the entire estate.); Mergott v. United States, No. Civ. A. 99-1456, 2000 WL 1718723 (D.N.J. Sept. 19, 2000) (Because the surviving spouse did not elect to receive elective share and the existence of a trust in spouse’s favor was central to the testator’s intent, no bona fide legal claim existed and deduction disallowed.).
241 See supra note 240.
243 See id.
spouse or the entire estate passing to a nonmarital trust that would pay in-
come to the spouse for life and to pay the remainder to the couple’s descen-
dants, the Service could ignore a family settlement agreement that would
result in the entire estate passing to the nonmarital trust. The Service could
treat the funding of that trust as a gift of the entire estate to the trust by the
surviving spouse, with a retained lifetime income interest, resulting in a
large taxable gift of property (and the possible application of section 2702)
that would not even be removed from the spouse’s gross estate for future
estate tax purposes because of section 2036. Practitioners, therefore, should
tread carefully when using family settlement agreements in this context.

IV. CONCLUSION

The congressional decision to wait until December 17, 2010, to rein-
state the estate tax not only failed to resolve will and trust construction
problems for decedents who died during 2010 using tax-derived formulas to
dispose of their estates but also created an additional problem for those es-
tates: whether to elect out of the retroactively-imposed estate tax regime.
Because no estate tax existed when those decedents died, or because their
estates chose a no estate tax regime, the tax-language-based dispositive pro-
visions were rendered ambiguous or even meaningless. Determining the
decedent’s dispositive intent is consequently problematic.

Courts could resolve the construction problems using common law or
statutory methods. However, for beneficiaries wanting certainty, disclaimers
and family settlements may be the tools of choice. Those beneficiaries must
follow certain rules to effectuate disclaimers or family settlements and
should also consider possible adverse tax consequences resulting from their
choices.