Tax Apportionment

<u>Examples</u>

In all examples: (1) decedent (D) has made lifetime gifts equal to the applicable exclusion amount available at decedent's death, (2) assume no administration expenses or debts, and (3) decedent dies a resident of your state.

Example 1:

Tax apportionment clause in will:

> "All Federal or State estate taxes, inheritance taxes, if any, or other death taxes, together with interest and penalties thereon, that may by reason of my death be attributable to my probate estate or any portion of it, shall be paid by my Executor out of the residue of my estate disposed of by this Will, without adjustment among the beneficiaries thereof, and shall not be charged against or collected from any beneficiary of my probate estate."

Examine clause.

Notes:

(1) Note, only addresses apportionment inside the probate estate.

(2) Who bears the estate taxes if estate taxes are not apportioned to beneficiaries of probate estate?

Example 2:

D and her lawyer do not address tax apportionment in their estate planning meetings. D informs her lawyer that her assets valued at $6 million are in her name and that she wishes to leave her estate equally to her children, stressing the importance of equality. D's signs a will containing the following tax apportionment clause: "I direct that all estate taxes arising as a result of my death on property passing under this Will, or on property outside this Will, shall be paid by my residuary estate." Two years after executing her will, D takes out a term life insurance policy valued at $3 million payable to her son.

How are estate taxes allocated?

Notes:

(1) Is tax apportionment clause effective?

(A) At issue is apportionment of estate taxes among entities rather than inside the entity.

(2) Does lawyer have a duty to foresee the possibility that after the documents are executed the client may create non-probate property?

Example 3:

Assume D's will contains a non-residual devise of $2 million to D's son. The residue of D's estate (valued at $4 million) passes equally to D's spouse and D's daughter. Assume D's will does not contain a tax apportionment clause.

How are estate taxes allocated?

Issue:

1. Are pre-residuary devises exempt from tax?
2. How are estate taxes in the residue apportioned?

Example 4:

Assume the same facts as in Example 3, except the will contains the following tax apportionment clause:

"I direct that all estate taxes be paid by my residuary estate." What is result?

A. Does the conclusion change if one of the witnesses to the will's execution states that the decedent asked before executing the will whether her spouse and her daughter will receive equal amounts since they both are left half of her estate and the lawyer answered: "yes."

B. Does the conclusion change if the cover letter containing a draft of the executed will states: "her residue passes ½ to your spouse and ½ to your daughter?" No mention is made of estate taxes.

Example 5:

D's will leaves D's residuary estate, valued at $5,000,000 to her children. D's estate also includes a joint bank account payable on D's death to a friend valued at $2,000,000. D's will contains the following tax apportionment clause:

> "I direct my Personal Representative to pay out of the property which would otherwise become a part of the Residuary Estate, all estate, inheritance, transfer and succession taxes, including interest and penalties thereon, which may be lawfully assessed by reason of my death. I waive on behalf of my estate any right to recover any part of such taxes, including any beneficiary of life insurance on my life and anyone who may have received from me or from my estate any property which is taxable as part of my estate."

How are estate taxes allocated?

Example 6:

Assume D has made lifetime taxable gifts equal to her applicable exclusion amount. Assume D wants to treat both of her children equally. D wants to give her daughter the closely held business which D believes is worth $10 million. D has marketable securities worth $10 million and cash of $500,000. You have drafted a will which devises the residue of her estate into revocable trust. Article I of the trust contains recitations about the family status. Article II contains the terms to apply during D's lifetime. Here are some options for the dispositive provisions:

Option 1:

Article III: Devise business to daughter.

Article IV: Balance of trust to son.

Option 2:

Article III: Devise business to daughter.

Devise $10 million to son.

Article IV: Balance of assets split 50/50 between son and daughter.

Option 3:

Article III: Devise balance of trust equally to daughter and son. Direct that daughter's share is to be funded with stock in business.

What are pros/cons of each option?

Example 7:

Albert's will established testamentary trust for his son Bert. Albert dies resident of state X. Trust grants Bert a testamentary power to appoint to the creditors of Bert's estate by specific reference to the trust agreement. To the extent he fails to exercise the power to appointment, the trust passes to Bert's issue. Bert dies a resident of your state. His will does not exercise the general testamentary power of appointment. However, his will directs that the additional estate taxes arising due to the inclusion of the trust in his estate be apportioned to that trust. Bert's taxable estate without the general power of appointment trust is equal of this applicable exclusion amount. He leaves his estate to an unrelated individual. Assume the general power of appointment trust has a value of $5 million on Bert's death. Estate tax of $2 million ($5 million x 40%).

How are estate taxes allocated?

Example 8:

Husband dies a resident of State X. State X has enacted a pure estate tax apportionment statute. Husband's will creates QTIP trust for surviving spouse (D). QTIP provides on D's death, $1 million passes to daughter, with balance of assets (valued at $2 million on D’s demise) passing to son. QTIP has no tax apportionment clause and make no mention of estate taxes. D is a resident of your state and engages your services to prepare her estate planning documents. D desires to treat her children equally and “rebalance the wealth” given her husband’s “unequal” treatment. How do you address the tax apportionment issue?