TAX APPORTIONMENT

STEPHANIE E. DONAHO,
Locke Liddell & Sapp, LLP
3400 JPMorgan Chase Tower
600 Travis Street
Houston, Texas 77002

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Chapter 27

Table of Contents

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Stephanie E. Donaho

I. SCOPE OF OUTLINE

This outline addresses substantive and drafting considerations concerning tax apportionment, and includes examples of both general tax allocation clauses and drafting for specific situations. Federal and Texas law are discussed.

II. TYPES OF TAXES TO BE APPORTIONED

There are a number of different types of taxes commonly referred to as "transfer" or "death" taxes which a draftsperson must consider in preparing a will or trust instrument. These include the following:

A. Federal estate taxes (generally);
B. State inheritance taxes (many non-Texas jurisdictions still have them);
C. Special use or other recapture taxes pursuant to IRC § 2032A and 2057;
D. Generation-skipping transfer taxes;
E. Q-TIP recapture taxes under IRC § 2044;
F. Foreign death taxes; and
G. Interest and penalties on any one or more of the above.

The primary emphasis of this outline is estate taxes; however, a number of the other taxes described above will be addressed.

III. OVERVIEW OF APPLICABLE LAW

A. Federal Law

1. GENERALLY

There are a number of provisions in the Internal Revenue Code ("IRC") which address apportionment of one or more of the taxes described in Section II above. The most significant ones are IRC § 2206 through 2207B and IRC § 2603. These are discussed in detail below. Others include: IRC §§ 2002 (payment to be made by executor), 2203 (applicability of tax to persons in possession), 2032A and 2057 (allocation of recapture tax on special use valuation to qualified heirs), 2204 (executor cutting short period of personal liability for tax), 2205 (reimbursement from estate for taxes paid by non-executor), 2603 (allocation of generation-skipping transfer taxes), 6321 (tax liens), 6324(a)(2) (special lien with respect to estate and gift tax), 6901 (transferee liability), and 31 U.S.C. § 3713 (liability of persons in possession).

2. IRC SECTION 2206

a. Unless the testator's Will "directs otherwise", the executor of an estate may recover from a beneficiary of life insurance (to the extent the proceeds do not qualify for the marital deduction) a portion of the estate tax attributable to the inclusion of the proceeds in the taxable estate.

b. The right of recovery is based on the average, rather than the marginal, tax rate, and is expressed as a fraction of the tax. The numerator is the proceeds of such policies. The denominator is the "taxable estate".

3. IRC SECTION 2207

a. Unless the testator's Will "directs otherwise", the executor of an estate may recover estate taxes attributable to the release, lapse or exercise of a general power of appointment.

b. This tax is also recoverable on an average, rather than a marginal, tax rate basis using the same fraction as described in Section 2206.

4. IRC SECTION 2207A

a. This section allows the executor of a surviving spouse's estate to recover tax owed by that estate pursuant to IRC § 2044 from the Q-TIP property giving rise to the tax. It covers both estate tax and gift tax, while IRC §§ 2206 and 2207 apply only to the estate tax.

b. The executor may recover the tax at the marginal rate, rather than the average rate. In other words, the executor can recover the difference between what the estate tax would have been without the Q-TIP property, and the tax as it is with the Q-TIP property.

c. Please note that reimbursement at a marginal rate can be inequitable when the residuary beneficiaries of the two spouses are different. Had the two spouses died simultaneously, the tax burden on each estate would have been substantially the same. However, the tax burden on the estate of the first spouse to die with the right of recovery specified in Section 2207A can be as high as a flat rate equal to the highest marginal rate,

while the overall tax on the estate of the second spouse is unlikely to be that high.

d. Section 2207A, and the marginal rate right of recovery, addresses only federal taxes. State inheritance taxes are governed by state law. Cleveland v. Compass Bank, 652 So. 1134 (Ala. Sup. 1994, reh. denied 1995). Fortunately, Texas Probate Code Section 322A(l) makes it clear that state law will follow federal in law this regard.

e. If a draftsperson wishes to provide a right of recovery in any fashion other than that specified in 2207A (i.e., using the average rate), please note the possibility that the failure to follow Section 2207A strictly could be considered a gift from the second-to-die testator and/or the beneficiaries to the remainder beneficiaries of the estate of the first spouse to die, and may raise generation-skipping transfer issues. The IRS considers such tax unrecovered by beneficiaries an "addition" to the Q-TIP trust. Treas. Reg. §26.2601-1 (b)(1)(v)(C). Fortunately, Treas. Reg. §26.2652-1 (a)(5), Example 7, makes it clear that this rule is inapplicable when a reverse Q-TIP election has been made.

f. Section 2207A specifically includes penalties and interest, which are not covered in either Section 2206 or Section 2207.

g. In 1997, both § 2207A and § 2207B (infra) were amended to deal with the waiver of the right to recover estate taxes. In the case of § 2207B, Congress eliminated a requirement that a waiver specifically refer to the statute (a model that many practitioners wanted not only retained but expanded to cover § 2207A). However, the new language in both sections provides that a testator must "specifically indicate an intent to waive any right of recovery under this subchapter with respect to such property." The emphasis on specific testator intent presumably allows a court to ignore (in many cases) a generic "pay all taxes" clause, but is still ambiguous.

5. IRC SECTION 2207B

a. This section gives the executor a right of reimbursement for taxes attributable to the inclusion of Section 2036 property in the estate of a decedent. It applies to §§ 2036(a) and (b), as well as to § 2036(c). However, it appears to have been specifically enacted to address the possibility that an unintended tax could be assessed on property no longer in the estate of a decedent as a result of § 2036(c). The right of recovery is at an average, rather than a marginal, rate. Section 2207B also covers gift tax, interest and penalties.

b. This Section takes on increased importance with the popularity of revocable living trusts, which are usually included in estates under both Sections 2036 and 2038. It can thus be argued that there is a Federal tax apportionment statute which directly impacts living trusts.

6. IRC SECTION 2603

This section contains a statutory apportionment scheme for the generation-skipping transfer tax.

a. In the case of a taxable distribution, the generation-skipping transfer tax is paid by the transferee.

b. In the case of a taxable termination or a direct skip from a trust, the generation-skipping transfer tax is paid by the trustee. Unless "otherwise directed" in the Will or trust agreement, the tax is allocated to the property constituting the transfer. For instance, if a trust created for a child terminates and one-third is distributable to a grandchild while two-thirds is distributable to the child's siblings, the tax payable as a result of the taxable termination with respect to the one-third of the trust will be paid from that one-third, and not allocated across the board.

c. In the case of a direct skip other than a direct skip from a trust, the generation-skipping transfer tax shall be paid by the transferor. This is straightforward in the case of an inter vivos gift. With respect to a testamentary gift, once again the general rule that the tax is payable out of the assets passing to the distributee applies. This allocation is actually helpful, since the tax on direct skips is reduced by the amount of generation-skipping transfer tax that is payable, causing an interrelated calculation that effectively reduces the rate of tax.

B. Texas Law Prior to 1987

1. GENERALLY

Texas historically took the common law approach to tax apportionment, but has recently adopted equitable apportionment by statute effective September 1, 1987. Prior to that time, estate and inheritance taxes were allocated in the same manner as debts and expenses.

This means that they were allocated to the residuary estate.

2. NON-PROBATE ASSETS

There was some question, even prior to the apportionment statute, as to whether Texas' common law non-apportionment treatment extended to non-probate assets. The Texas Supreme Court specifically left that issue unresolved. Sinnott v. Gidney, 322 S.W.2d 507 (Tex. 1959).

C. Statutory Apportionment in Texas

Effective for decedents dying after September 1, 1987, there is a fairly detailed statutory scheme addressing estate and inheritance tax apportionment in Texas. Texas now adopts the rule of equitable apportionment, with each recipient of a portion of the taxable estate being charged with his or her pro-rata share of the taxes. Texas Probate Code ("TPC") § 322A. The statute addresses not only the allocation of taxes, interest and expenses, but also the allocation of deductions and credits and the method of enforcement by the executor. There have been several amendments designed to further clarify the statute.

IV. ANALYSIS OF SECTION 322A

A. General

The basic formula for tax apportionment in Section 322A is contained in subparagraph (b)(1) thereof, which provides that the "portion of each estate tax that is charged to each person interested in the estate must represent the same ratio as the taxable value of that person's interest in the estate included in determining the amount of the tax bears to the total taxable value of all of the interests of all persons interested in the estate included in determining the amount of the tax." In other words, the amount of each beneficiary's tax shall be a fraction thereof, the numerator of which equals the taxable value of the gift and the denominator of which equals the taxable value of the entire estate. One question which has arisen is what is the meaning of "taxable value". Does it mean "gross value to be taxed"? Does it mean net value to be taxed, i.e., the value of what the beneficiary receives less charges such as administration expenses and debts? The resolution of this issue can significantly affect the actual tax burden. See Article IV(D), infra. One thing "taxable value" almost certainly does not include is the "gross-up" of taxable gifts made during life.

B. Use of "Average Rate" in Apportionment

Under TPC § 322A, taxes are generally allocated on an average tax rate basis, rather than a marginal tax rate basis, with a fraction of the tax being apportioned to each gift having a numerator equal to the taxable value of the gift and a denominator equal to the taxable estate of the decedent. TPC § 322A(b)(1).

C. Allocation of Credits and Deductions

TPC §§ 322A(d)-(f) contain provisions governing allocation of deductions and credits. The treatment of typical deductions and credits can be summarized as follows:

a. marital deduction → marital gift
b. charitable deduction → charitable gift
c. unified credit → pro rata to all parties bearing tax burden
d. state death tax credit → pro rata to all parties bearing tax burden
e. foreign tax credit → pro rata to all parties bearing tax burden
f. credit for tax on prior transfers → pro rata to all parties bearing tax burden
g. gift tax credit → pro rata to all parties bearing tax burden

D. Debts and Administration Expenses

One area of uncertainty under the statute is how to handle debts and administration expenses. This in part relates to the lack of clarity of "taxable value" as used in the basic tax allocation formula. The confusion is augmented by the fact that Section 322A(c), which purports to govern the allocation of "any deduction", refers only to three additional subsections covering such topics as charitable and marital deductions, without any mention of the basic Schedule J and K deductions. This could imply that there is no special allocation of these deductions. There are two possible resolutions to this uncertainty. First, and the most likely, is that the reduction of a gift by debts or by administration expenses deducted on the estate tax return is reflected in the "taxable value" of that gift. This would be the most fair result, for instance, when an estate is divided between a $500,000 specific bequest and a $500,000 residuary, with $100,000 in debts charged to the residuary, resulting in a net residuary gift of $400,000. The formula would be applied as follows: 500,000/900,000 (5/9) of the total tax would be paid by the specific bequest legatee and 400,000/900,000 (4/9) of the total tax would be paid by the residuary legatee. This interpretation is the most

likely one, and certainly conforms to other efforts in the statute to strike equity. If "taxable value" means "net value", this would explain the fact that Section 322A(c) does not address the debt and expense deductions. NOTE: If administrative expense deductions are taken on the income tax return rather than the estate tax return, then the value of the residuary gift should not be reduced by those expenses in calculating how much estate tax the residuary should bear. Otherwise, the total of the fractions will not equal 1. The second alternative interpretation of debt and expense allocation is that "taxable value" means the gross value of the gifts themselves, and the gross value of the estate. Under this interpretation, the residuary and specific bequest legatees in the above example would each pay 50% of the tax. It may be that a legislative clarification is in order.

E. Federal Pre-emption

It is likely that the Federal statutes pre-empt the Texas scheme if the testator has not expressed his wishes in that regard. See dicta in Riggs v. Del Drago, 317 U.S. 95 (1942). This issue was more specifically resolved, however, by the 1991 amendments to TPC § 322A, which clarify that the federal "apportionment" statutes shall govern when applicable. TPC §§ 322A(b) and (l). This would, for instance, apply to the right to recover Q-TIP property, which is calculated on a marginal tax basis under the Federal statute and under the Texas statute would otherwise be calculated under an average tax basis.

F. Document Override

The statute can be overridden by a provision in a Will or other document which addresses apportionment. TPC § 322A(b)(2). Thus, the Texas statute, like the Federal tax statutes cited above, applies only in the event that the Will or trust agreement does not address the issue. This means that the concern over whether or not the use of general language in a Will expresses an intent to override the statute will continue to be a legitimate and controversial issue in Texas even after the enactment of Section 322A.

G. Allocation to and Among Non-Probate Assets

TPC § 322A(b)(2) provides that a direction concerning tax apportionment in a document can only apply to the assets disposed of by that document (except in the case of a Will). From a drafting standpoint, therefore, it is important to note that a testator can allocate the taxes arising from non-probate assets to his probate estate although it is unlikely he can allocate probate taxes to non-probate assets under this language. TPC § 322A(b)(2). Under the exception for a Will, the dilemma continues as to how specific the language must be to "provide otherwise".

H. Conflicting Provisions/Instruments

TPC Section 322A(b)(3) also addresses the possibility that there will be conflicting provisions in different instruments. This is clearly an increasingly likely result as pourover Wills and living trust combinations become more popular. In the event of a conflict, the instrument disposing of the property being taxed controls with respect to that property. If there is a conflict between instruments executed by different persons, then the direction of the person in whose estate the property is included controls. This subsection will not resolve the problem where the Will of a husband and wife conflict with respect to Section 2044 property, since that property is always included in the estate of the surviving spouse.

I. Tax Apportionment to Split Interests

Pursuant to both TPC Sections 322A(d) and (h), taxes allocable to a life estate or term of years or other similar interest are allocated to the corpus. This is true even in the case of charitable remainder trusts where part or all of the corpus would otherwise be entitled to a deduction. As a result, careful planning needs to be done with respect to tax allocation in such situations in order to maximize the estate tax deduction, if so desired. Care needs to be taken to comply with the split interest rulings by the IRS, which require that if a life or term interest owner's death causes tax collectible from the split interest trust, such tax must be paid by the surviving term holders or the trust will not qualify for the charitable deduction. Rev. Rul. 82-128, 1982-2 C.B. 71.

J. Apportionment of Certain Interest and Expenses

1. GENERAL

a. TPC Section 322A(m) provides that interest on extended estate taxes and interest and penalties on deficiencies shall be apportioned "equitably to reflect the benefits and burdens of the extension or deficiency and of any tax deduction associated with interest and penalties." Nonetheless, if any penalty or interest is due to negligence of the fiduciary, then these sums can be charged to the personal representative.

b. Subsection (m) should be contrasted to TPC § 322A(q), which directs that interest and penalties assessed by the taxing authority shall be allocated pro-rata in accordance with subsection (b), unless a court determines that this is inequitable or that the expense is attributable to the negligence of the personal representative. To the extent these subsections conflict, a possible explanation may arise from the fact that (m) was enacted as part of the 1991 amendments, while (q) is part of the original 1989 statute. Query: Does (m) govern but the provisions of (q) require that a court must make the "equitable" determination? This would certainly be an inconvenient result in independent administrations.

2. BENEFITS OF SECTION 6166

Although subsection (m) creates an equity standard, there are some situations in which the statute directs the allocation of expenses. For example, if the date for payment of any portion of estate taxes is extended through provisions such as Section 6166, then the recipient of property subject to that election shall receive both the benefits (i.e., the extension of payment) and the burden (i.e., the interest on the tax) associated with the extended tax. TPC Section 322A(k).

3. EXECUTOR'S EXPENSES OF ALLOCATION

TPC Section 322A(r) provides that expenses incurred by the representative "in determination of the amount, apportionment, or collection of the estate tax shall be apportioned among and charged to persons interested in the estate" in the same manner as the tax is apportioned. This could include, for example, a portion of attorney's fees, executor's fees, appraisal fees and/or accountant's fees. A beneficiary has the ability to seek an alternative allocation if this result is otherwise unfair. This is an extremely important provision with respect to the actual administration of tax apportionment, since it gives the executor a possible weapon against a beneficiary who is not being cooperative concerning prompt payment of any taxes due. It is also unclear whether subsection (r) will apply in cases when a Will may be silent on tax apportionment or may specifically adopt Section 322A, but contains a provision allocating all administration expenses to the residuary estate.

K. Collection

1. GENERAL

The personal representative is charged with the duty to collect any tax apportioned to a beneficiary pursuant to Section 322A.

2. WHEN EXECUTOR HAS POSSESSION OF ASSETS

TPC Section 322A(t) provides that an executor may withhold from distribution any assets until the recipient has paid his or her share of the estate tax. This means that specific bequests which are not free from estate tax burdens could be withheld from distribution for several years. Query: Will the estate owe interest on assets which must be withheld from distribution merely because of the undetermined final amount of tax liability? An executor may choose to withhold estimated tax liability from a gift and distribute the remaining portion in order to avoid possible imposition of interest. This issue was not specifically addressed when TPC Section 378B was amended in 1993 to provide interest on pecuniary gifts.

3. WHEN EXECUTOR DOES NOT HAVE POSSESSION OF ASSETS

TPC Section 322A(n) imposes upon the personal representative an obligation to recover tax from individuals who receive assets that do not come into the hands of the executor (i.e., life insurance proceeds, pension benefits or other non-probate assets). However, Section 322A makes it clear that this duty can be waived by the other affected parties or can be disregarded by the personal representative if the personal representative in his or her "reasonable judgment" determines that a proceeding to recover the tax is not cost-effective. In making this determination, however, please note that attorneys fees may not be properly considered if recovery of those fees under Section 322A(y) (see item 6 below) is likely.

4. WHEN CAN THE EXECUTOR RECOVER?

a. TPC Section 322A(v) provides that an executor "may not be required" to initiate necessary actions to recover tax until at least 90 days after the date of the final determination of the amount of estate tax by the Internal Revenue Service. This does not resolve the issue of when an executor is authorized to begin such proceedings. Since the amount of tax any particular beneficiary may actually owe will not be determined with certainty until after any Internal Revenue Service audit, it could be argued that the executor has no

authority until such time. On the other hand, this could jeopardize the ability of the executor to pay the tax or ensure collection at a later date.

b. An executor may want or need to collect from insurance proceeds or other non-probate assets prior to the initial filing in order to have adequate liquidity. It is not clear that this can be done against the will of a beneficiary, although such a right would be a logical interpretation of the statute. The difficulty is in determining a tax liability figure that would not be overstated in the event of adjustments on audit.

c. TPC § 322A(v) specifically relieves the executor from any liability for failing to institute collection efforts until the 90 day period described above. Nonetheless, an executor will want to be careful to take possession of all probate assets to which tax can be apportioned, and make exceptions (i.e., personalty in the possession of heirs) only when adequate provision for taxes is made.

d. Texas Property Code Section 42.0021 and Texas Insurance Code Section 1108.051, provides that certain assets are immune to claims of creditors. These include life insurance, IRAs, and annuities. Can a beneficiary of these assets defeat the Section 322A reimbursement claims of a decedent's estate? While this has been argued in lower courts, no Texas appellate court has yet decided the matter. In the case of life insurance proceeds, there would be an argument that IRC Section 2206 pre-empts the state rule. But such an argument does not exist for IRAs and annuities.

5. JUDICIAL PROCEEDINGS

Proceedings to recover tax shall be instituted in the same court in which proceedings for the administration of the estate are pending or have been completed or, if no such proceedings are pending, in a court in which venue for the administration of the estate of a decedent would be proper. TPC Section 322A(s).

6. UNCOLLECTED TAX

Any uncollected tax is apportioned among the other distributees on a pro-rata basis in accordance with TPC § 322A(b)(1). TPC § 322A(o). Any party paying more than his or her share has a right of recovery against the non-paying distributee.

7. COSTS OF COLLECTION

If a personal representative is forced to sue to recover the tax apportioned to a beneficiary, then the prevailing party in such litigation is entitled to recover necessary expenses, including reasonable attorney's fees. TPC Section 322A(y).

L. Miscellaneous

1. IRC SECTION 2032A

TPC Section 322A(i) contains specific provisions dealing with the apportionment of any tax associated with Section 2032A elections and recapture taxes.

V. CASES WHERE DRAFTING MADE A DIFFERENCE

As painful as it is, the importance of properly drafted tax clauses can best be illustrated by examples of situations in published cases in which failure to consider the full consequences of a tax apportionment clause has resulted in litigation or related problems.

A. Accidental Override of Q-TIP Right of Recovery: In Re: Estate of Gordon, 510 N.Y.S.2d 815 (N.Y. Sur. 1986)

1. This is the classic "horror story", which fortunately had a happy ending. However, the court had to really stretch to cure the attorney's malpractice, and it is not at all clear that other courts will be as generous. The impact of this case was such that New York passed a statutory remedy. In this case, the testatrix was the beneficiary of a Q-TIP trust. The testatrix had a subsequent Will drawn, which contained the following provision:

> "I direct that all estate, inheritance and death taxes (including any interest and penalties) imposed by any jurisdiction by reason of my death with respect to any property includible in my estate for the purpose of such taxes, whether such property passes under or outside my Will be paid out of my Residuary Estate as an administration expense, without apportionment."

Id. at 817. A clearer example of an "override" of Section 2207A could hardly be found, especially since this was before the 1997 Amendment to Section 2207A. However, the court determined that the testator did not intend to override Section 2207A. The court held that greater specificity was needed, and used the very fact that the trust went to different remainder beneficiaries than those who took under the wife's Will as evidence that the wife could not possibly have intended to exonerate the remainder beneficiaries of the Q-TIP trust

from their tax liability. Note: This author has encountered at least one other case where this type of language was present. Fortunately, the beneficiaries of the estate were the same, and the only difference was whether or not the interest would be held in trust or pass outright. In that case, a settlement was reached between the beneficiaries.

2. Another example is Vahlteich v. Comm't, T.C. Memo 1994-168 (1994), reversed 69 F3d 537, 1995 WL 641318 (6th Cir. 1995). The Valteich case is a Tax Court case dealing with whether a decedent's Will charged the Q-TIP taxes to his residuary estate, thus reducing the charitable deduction. The language provided that "all, transfer, estate or inheritance taxes" in relation to decedent's estate or any trust . . . . . included as part of my taxable estate" shall be allocated to the residuary. The Tax Court found for the IRS, holding that this was an unambiguous override. The 6th Circuit, however, determined that this would frustrate the intent of the testator in minimizing taxes, and found for the taxpayer. This concept of interpreting tax allocation or similar provisions to maximize tax objectives can be found in other cases, e.g., Putnam v. Putnam, 316 NE 2d 729 (1974).

3. Even the "rich and famous" are not immune to these problems. See e.g., In re: Estate of Kuralt, 68 P.3d 662 (2003), which is a case where a handwritten codicil giving a residence to a business wreaked havoc on the marital deduction since taxes were assessed against the residuary.

B. Accidental Override of the General Power of Appointment Right of Recovery: Campbell's Estate v. United States, 449 F.Supp. 675 (D.N.J. 1977)

This is actually not a drafting problem for the apportionment clause, but a drafting problem which created a tax and, presumably, related apportionment difficulties. In this case, a draftsman prepared a Will and did not know that the testatrix had a pre-1942 general power of appointment over a trust of which she was a beneficiary. Under applicable law, the power of appointment did not cause inclusion of the trust in her estate unless she exercised it. The Will's residuary clause included the phrase "including any property over which I may have any power of appointment". Id. at 676. The court attempted to construe the intent of the testatrix in determining whether or not this was designed to exercise the power of appointment created under the trust. The court concluded that it was, and that the trust assets were therefore includible in the testatrix' estate for Federal estate tax purposes. In this case, the result was especially harsh since the residuary beneficiaries of the estate were the same as the beneficiaries of the trust who would take in default under the power of appointment. As such, it did not necessarily create an apportionment problem. However, apportionment difficulties can arise due to a draftsman's lack of knowledge regarding intended or accidental powers of appointment possessed by the testator or testatrix. For instance, in a situation in which there is a clear general power of appointment or in a situation in which a beneficiary serves as a trustee and the standard of distribution is sufficiently broad to create an "accidental" general power of appointment, the inclusion of tax apportionment language similar to that contained in the Gordon case (which is very common among practitioners) can create extreme hardship.

This author was involved in litigation lasting several years which resulted in a malpractice suit being filed against the drafter of the surviving spouse's Will for just this type of problem. In that case, the testatrix was a co-trustee of a trust created for her benefit which was not a marital deduction trust. It would therefore normally escape taxation at her death. However, the standard of distribution included "comfort", "welfare" and "emergency". The Internal Revenue Service argued that this created a general power of appointment. The residuary beneficiaries of the testatrix' estate were different than the beneficiaries of the trust created under her husband's Will, and her Will contained a broad tax allocation clause allocating all taxes attributable to her death to her residuary estate. That case resulted in a settlement after protracted litigation.

C. Preservation of One Type of Reimbursement Right may Presume Waiver of Others

The case of Tovrea v. Nolan, 845 P.2d 494 (Ariz. App. 1992), review denied (1993), demonstrates that not all courts are sympathetic to the dilemma caused by broad non-apportionment clauses. In this case, decedent had a very large insurance policy, the beneficiary of which was different than her probate estate. The tax apportionment clause was broad, but specifically excluded Q-TIP property. The effect of allocating tax on the insurance policy to the probate estate would be to wipe it out, and the estate beneficiaries used this fact to argue that there was an ambiguity in the Will sufficient to permit extraneous

evidence. The court disagreed. Rather than finding the 2207A reimbursement clause to be an indication of an intent not to burden the residuary estate, it found the inclusion of that clause strengthened the argument that taxes on other non-probate assets were to be allocated to the probate residuary, even if this eliminated the probate estate.

D. Texas Cases

1. General

For a long time, there were few Texas cases dealing with tax apportionment, especially cases interpreting Section 322A, which is relatively new. We do, however, have a few decisions of interest:

a. Texas has always had a strong case law tradition of enforcing the plain language of a Will, irrespective of perceived unfairness or inconsistency with tax planning. This is precisely what happened in Peterson v. Mayse, 993 SW2d 217 (Tyler 1999, writ denied). In this case, there was a significant non-probate insurance policy, and an IRA generating tax which effectively wiped out the probate estate passing to the spouse. The court noted the dearth of Texas law, and looked to other states for guidance. It ultimately held that while the direction in a Texas Will should be in relatively clear and unambiguous language, the override of Section 322A does not need to be explicit. The fact that the tax liability would wipe out the decedent's residuary estate, thus thwarting his presumed intent, was not considered sufficient under Texas law to allow the Court to ignore language which allocated taxes to the residuary, and then defined taxes as being "all" estate taxes assessed by reason of decedent's death. See also, Estate of Miller v. Comm'r, TC Memo 1998-416 (1998) affm'd 85 A.F.T.R. 2000-1047 (5th Cir. 2000).

b. This emphasis by Texas courts on enforcing explicit language is echoed in another Texas case, although in this case the result actually favored apportionment. In Rosen v. Wells Fargo Bank, et. al, 114 S.W.3d 145 (Tex. Civ. App. – Tyler 2003, no petition), the Will contained a pecuniary marital gift and a residuary bypass trust. The existence of taxable non-probate assets wiped out the residuary. The will allocated both probate and non-probate taxes to the residuary; however, the court found that since there was no residuary left, the taxes would be apportioned under Section 322A. In essence, they declined to interpret a tax allocation of non-probate taxes to the residuary probate estate to be the equivalent of an allocation to the probate estate itself since that was not explicitly stated. There is a strongly worded dissent.

c. The long established rule in Texas of strict interpretation, however, is being challenged by the recent Texas case of Patrick v. Patrick, 182 S.W.2d 433 (Tex. App. – Austin 2005, no petition history). In that case, the language of the will is somewhat more general, stating that "all taxes....which may be payable by reason of my death...shall be charged against and paid out of my estate." The court held that neither the term "taxes" nor "estate" was sufficiently clear and unambiguous to overrule Section 322A. It is unlikely that the Peterson court would have reached that same conclusion.

2. Failure to Consider Tax Apportionment in Drafting Codicil

Failure to address how a change in a bequest can affect the apportionment of taxes can cause hardship. This is exactly what took place in both Thornhill v. Elskes, 381 S.W.2d 99 (Tex. Civ. App. - Waco 1964, error ref'd n.r.e.) and Matthews v. Jones, 245 S.W.2d 974 (Tex. Civ. App. - Eastland 1952, error ref'd n.r.e.). In both cases, a Will existed which bequeathed property to a decedent's children. A subsequent codicil made gifts to a spouse from a subsequent marriage. In both cases, taxes were apportioned against the residuary estate. The gifts to the surviving spouse did not, however, qualify for a marital deduction. The result in both cases was that the codicil was not considered to have amended the tax apportionment clause, and the residuary beneficiaries were burdened with the tax attributed to the gift to the surviving spouse. It is unclear what the testator's intentions would have been in this regard, but it is almost certain that the draftsman did not consider the issue.

3. Imprecise Terminology

In drafting a tax apportionment clause, it is important to specify what taxes are being discussed. In Pipkin v. Hays, 482 S.W.2d 59 (Tex. Civ. App. - Austin 1972, error ref'd n.r.e.), litigation resulted from the fact that the tax apportionment clause used the term "inheritance taxes". It did not specifically mention estate taxes. The court found that the term "inheritance taxes" was used in its broader sense, and included all death taxes. However, the lack of drafting precision resulted in the expense and hardship of litigation.

E. Wills/Revocable Trusts and Conflicting Documents.

The increased popularity of pour-over Wills and revocable living trusts has the incidental impact of increasing confusion over tax allocation. Planning for this is discussed as a separate topic at Article IX, infra. However, there are a few examples of actual disputes which were complicated by the existence of multiple documents governing tax allocation. In one case, McKeon v. United States, 151 F3rd 1201 (9th Cir. 1998), the Court had to deal with a Will and two revocable living trusts – one which held community property and the other holding separate property. The separate property passed to children from a prior marriage. The community property trust – to which the Will gifted any remaining estate – was divided between a pecuniary marital gift and a bypass residuary. Since the bypass residuary was wiped out by the other trust, the community property trust passed entirely to a marital gift. The dispute was over the allocation of the tax caused by the separate property trust, with the IRS arguing that the Will directed payment out of the community property trust, and that the marital deduction was thus reduced. While the Court found for the taxpayer, it clearly stretched to do so. The Court found that "the decedent executed an integrated estate plan, consisting of a will and two trusts. The very nature of an integrated estate plan demands that the various provisions be considered in conjunction with one another." Based on certain Texas precedents, it is unclear that a Texas court would be willing to adopt this approach.

At about the same time, TAM 199915001 (1999 WL 220152) was issued. The decedent had a Will and a funded revocable trust. There was also an insurance policy outside of either which was includible under the three year rule. There were assets both in the estate and in the trust. The estate had a standard clause of paying taxes from the estate, and then left the remaining assets to the trust. The trust divided the estate between a pecuniary bypass and a residuary marital gift, and provided that no taxes could be paid out of the marital trust. The taxpayers argued that such protective language on the marital trust effectively prevented tax allocation to it – either directly or through the Will. However, the IRS ruled that the language in the Will was sufficiently specific that it overrode the trust. In essence, the existence of three documents – a Will, a revocable trust (which split on death into two trusts) and an insurance trust caused havoc on tax allocation planning and effectuation.

VI. DRAFTING APPORTIONMENT VS. NON-APPORTIONMENT

A. Generally

Most of us use will and trust forms and most of our forms have one or more preferred tax apportionment clauses. Although there may be significant special drafting to modify a form clause for the specific purposes of the client, most clients and draftsmen must make a basic decision as to whether to select an apportionment clause or a non-apportionment clause as the fundamental approach to tax apportionment in a particular document. This section of the outline includes examples of four general types of tax payment clauses, ranging from total non-apportionment to total apportionment, and describes some of the advantages and disadvantages associated with each. Each of these examples contains only a basic approach to drafting, and can and should be modified significantly. For example, many of the special provisions described in Article IX, infra, may need to be combined with a basic clause in order to provide a complete and satisfactory plan for the client. Each of these examples also takes the basic approach of excluding recapture taxes on special use valuation property and generation-skipping transfer taxes from the general scheme of apportionment. It is the position of this author that in most events those taxes are best allocated as provided in the statute, and that the chances of causing unintentional harm by an attempt to allocate them in a will or trust agreement greatly outweighs any possible deficiencies in the Internal Revenue Code sections otherwise governing their apportionment.

Although the following pages include drafting examples that contain a wide variety of options, this author's preferences can be derived from some basic guidelines which were first printed in Jonathan C. Blattmachr's November 14, 1994 article in The Chase Review, and are paraphrased here:

a. Always discuss with your client how taxes should be apportioned.
b. Put a tax direction clause in the Will even if the statute is what you intend to rely on.
c. Avoid directing that taxes on property passing outside the Will be paid from the probate estate unless the property is specifically identified in the Will.

d. As a general rule, do not allocate taxes in pre-residuary specific bequests to the residuary estate.
e. Only in rare instances should the residue bear the estate taxes on pre-residuary bequests of §6166 or §2032A property.
f. Carefully consider the consequences of directing that marital or charitable deduction gifts bear tax.
g. Clearly and unambiguously say what you mean and mean what you say -- and that's all.
h. Be wary when the pre-residuary gift qualifies for the marital deduction only by election.

B. Total Non-Apportionment

In this type of apportionment clause, all estate and inheritance taxes (and interest and penalties thereon) are allocated to the residuary bequest in a Will or trust agreement. These include taxes on both probate and non-probate assets.

1. ADVANTAGES

This type of clause is easy to draft and easy to administer. It is likely to cause less expense during the course of administration to the estate because the executor need not make complicated calculations or pursue possibly recalcitrant beneficiaries. Likewise, the executor will most likely have a broad range of assets with which to satisfy the tax, and need not negotiate with beneficiaries who receive illiquid assets regarding how they are to come up with the cash necessary to pay their pro-rata share of the tax.

2. DISADVANTAGES

More than any other option, this clause has the possibility of producing great inequity and resulting in accusations of malpractice. Most of the horror stories known to practitioners involve use of this type of clause when there are significant non-probate assets passing to persons who do not take under the Will. A classic example is a provision which unintentionally overrides the right of the executor to recover taxes incurred as a result of a general power of appointment or the existence of a Q-TIP trust, especially when the assets producing those taxes pass to different beneficiaries than those who receive the decedent's estate.

3. WHEN TO USE

It could be used (by the brave!) in estates which are likely to be non-taxable, particularly when it is combined in a single provision with the apportionment of expenses and debts. It is also appropriate in situations in which the drafter feels fully confident that he or she is familiar with all of the possible non-probate assets of the testator.

4. DRAFTING EXAMPLE

An example of a total non-apportionment clause is found on Appendix A.

C. Total Apportionment

In this type of tax apportionment clause, all taxes are allocated to each recipient on a pro-rata basis or as otherwise directed. There are two approaches to this type of clause. First, it is possible to merely incorporate the provisions of Texas Probate Code § 322A in the Will, and allow the executor to rely upon the language of applicable Texas and Federal law, as it develops, in determining the appropriate method of allocation and the rights of the executor. A second alternative is to provide the executor with a specific scheme of the testator's own choosing. The advantage of the former is simplicity of drafting and the avoidance of the possibility that the drafter will somehow neglect to address an important concern. The disadvantage of merely incorporating the statute is, of course, the fact that the statute is not very old and has not yet been subject to much judicial interpretation.

1. ADVANTAGES

Whatever the form, the advantage of total apportionment is equity. Each beneficiary who receives an asset which produces tax will bear the burden of that tax.

2. DISADVANTAGES

As indicated above, this type of clause is extremely difficult to draft in a way that covers all possible scenarios. It is perhaps even harder to administer than to draft, leaving the executor with a significant need for both legal and accounting services. Finally, this type of approach frequently ignores reality. If a beneficiary is receiving an illiquid asset, the apportionment of tax to that beneficiary may result in a significant hardship to the beneficiary if he or she does not have cash with which to pay his or her share of the tax. Another disadvantage deals with IRAs and qualified retirement plans. The IRS considers an estate tax allocation to such assets to be the functional equivalent of naming the estate (which is the primary obligor on such taxes) as a beneficiary. Since this precludes the IRA or qualified plan from receiving "designated beneficiary" status for "dribble out" purposes, the issue of whether adoption – either by silence or direction – of state law apportionment results

in acceleration of income tax. Some practitioners are concerned that while silence is probably safe, a direction would be problematic. It seems illogical, however, that a mere reference to applicable state or federal law applying would be a concern. This is, however, a very dangerous issue to draft for if a large IRA is involved.

3. WHEN TO USE

An apportionment clause is best used when there are significant non-probate assets which will generate tax (examples include the existence of general powers of appointment, insurance policies or employee benefits not passing to a surviving spouse) and/or where significant pre-residuary gifts are made. For example, an apportionment clause is generally in a Will which makes pre-residuary gifts of the family ranch to one child, some closely-held stock to another child and then divides the residuary between multiple beneficiaries.

4. FORM EXAMPLE

If a draftsman wishes to incorporate the provisions of Section 322A, the form found on Appendix B could be used. This option contains a sentence designed to clarify that "taxable value" for purposes of Section 322A means net value after taking into account debts and administration expense deductions. Please note that there is still an option to exclude gifts such as the specific bequest of personalty or an IRA. In this option, the taxes on those gifts are allocated to the Residuary Estate for the sake of simplicity. It is possible, of course, to allocate them on a pro-rata basis. Care should be taken in selecting this option that your client does not have real property outside Texas where a different state statute might arguably govern apportionment, unless the formula clarifies that Section 322A will apply in any event.

D. Non-Apportionment - Probate Only

In this approach to apportionment, all taxes on the probate estate are apportioned to the residuary, but the drafter protects against unintended consequences with respect to non-probate assets by allowing those to be picked up by Section 322A and/or the Federal apportionment statutes.

1. ADVANTAGES

This option is simple to draft and avoids the possibility of unintended depletion of the residuary estate due to the existence of large non-probate assets.

2. DISADVANTAGES

Very few; however, special drafting may be necessary for such assets as IRAs and/or reverse Q-TIPS.

3. WHEN TO USE

This type of clause can be used in a wide variety of circumstances, but is particularly appropriate in a Will that has little or no pre-residuary bequests or in a marital deduction Will where taxes are not expected, but where the drafter nonetheless wishes to have the client protected from the unexpected tax results of non-probate assets.

4. FORM EXAMPLE

An example of an apportionment clause which allocates only those taxes generated by probate property can be found on Appendix C. Please note the special provisions regarding taxes attributable to IRAs, qualified retirement plans and exempt Q-TIPS.

E. Non-Apportionment - Specific Exceptions Only

In this approach to apportionment, all taxes are apportioned against the residuary estate, except for items which are specifically described.

1. ADVANTAGES

It allows the drafter to provide the advantages of the non-apportionment approach when there are miscellaneous smaller non-probate assets (e.g., small life insurance policies, IRAs, etc) while still protecting against inequities caused by specific assets.

2. DISADVANTAGES

Because only specified types of assets are covered, there is still a possibility of unexpected tax consequences. Another disadvantage of this approach is that it is not as easy to draft as that contained in Paragraph D above. It may be lengthy to draft and therefore result in client rebellion.

3. WHEN TO USE

This is appropriate when the will does not contain significant pre-residuary bequests, and the testator generally wants all taxes allocated against the residuary, but the drafter knows about the existence of a Q-TIP trust, the existence of trusts of which the testator is a beneficiary or other specific assets to which the testator wishes to allocate taxes.

In addition, this general approach is an appropriate alternative to Paragraph D for those draftsmen who like specificity and completeness, even at the expense of