TAX APPORTIONMENT

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Chapter 27
I. SCOPE OF OUTLINE ........................................................................................................................................... 6

II. TYPES OF TAXES TO BE APPORTIONED ........................................................................................................ 6
   A. Federal estate taxes (generally) ....................................................................................................................... 6
   B. State inheritance taxes .................................................................................................................................. 6
   C. Special use or other recapture taxes pursuant to IRC § 2032A and 2057 ....................................................... 6
   D. Generation-skipping transfer taxes ............................................................................................................... 6
   E. Q-TIP recapture taxes under IRC § 2044 ....................................................................................................... 6
   F. Foreign death taxes ...................................................................................................................................... 6
   G. Interest and penalties on any one or more of the above .............................................................................. 6

III. OVERVIEW OF APPLICABLE LAW ................................................................................................................. 6
    A. Federal Law ................................................................................................................................................. 6
    B. Texas Law Prior to 1987 .............................................................................................................................. 7
    C. Statutory Apportionment in Texas ............................................................................................................... 8

IV. ANALYSIS OF SECTION 322A .......................................................................................................................... 8
    A. General ......................................................................................................................................................... 8
    B. Use of "Average Rate" in Apportionment ..................................................................................................... 8
    C. Allocation of Credits and Deductions ......................................................................................................... 8
    D. Debts and Administration Expenses .......................................................................................................... 8
    E. Federal Pre-emption ................................................................................................................................... 9
    F. Document Override .................................................................................................................................... 9
    G. Allocation to and Among Non-Probate Assets ........................................................................................... 9
    H. Conflicting Provisions/Instruments ............................................................................................................ 9
    I. Tax Apportionment to Split Interests .......................................................................................................... 9
    J. Apportionment of Certain Interest and Expenses ..................................................................................... 9
    K. Collection .................................................................................................................................................... 10
    L. Miscellaneous ............................................................................................................................................. 11

V. CASES WHERE DRAFTING MADE A DIFFERENCE .......................................................................................... 11
B. Accidental Override of the General Power of Appointment Right of Recovery:
C. Preservation of One Type of Reimbursement Right may Presume Waiver of
   Others ...................................................................................................... 12
D. Texas Cases .......................................................................................... 13
E. Wills/Revocable Trusts and Conflicting Documents ...................................... 14

VI. DRAFTING APPORTIONMENT VS. NON-APPORTIONMENT ................................................. 14
   A. Generally ............................................................................................ 14
   B. Total Non-Apportionment ..................................................................... 15
   C. Total Apportionment .......................................................................... 15
   D. Non-Apportionment - Probate Only .................................................... 16
   E. Non-Apportionment - Specific Exceptions Only .................................... 16

VII. APPORTIONMENT IN MARITAL DEDUCTION PLANNING - AT DEATH OF
     THE FIRST SPOUSE TO DIE ................................................................. 17
    A. Basic Dilemma .................................................................................. 17
    B. Debts ................................................................................................ 17
    C. Administration Expenses .................................................................... 17

VIII. APPORTIONMENT IN MARITAL DEDUCTION PLANNING - AT SECOND
      SPOUSE’S DEATH ............................................................................ 18
    A. Generally .......................................................................................... 18
    B. Drafting for Payment of Tax on Q-TIP ................................................. 18
    C. Drafting for Separate Share Marital Trust ......................................... 18
    D. Allocation of Tax Between Distributees .............................................. 18

IX. REVOCABLE LIVING TRUSTS ........................................................................ 19

X. SPECIAL DRAFTING SITUATIONS .................................................................. 19
   A. Split Interests ...................................................................................... 19
   B. Apportionment Within the Residuary .................................................. 20
   C. "Preresiduary" Residuary Gifts ............................................................. 20
   D. Employee Benefits .......................................................................... 20
E. Disclaimer ...................................................................................................................... 20
F. Interest and Penalties..................................................................................................... 21
G. Inheritance Taxes ........................................................................................................ 21
H. Inter Vivos Gifts .......................................................................................................... 21
I. Use of Tax Apportionment as a Bequest ..................................................................... 21
J. IRC Section 303 ........................................................................................................... 22

XI. DRAFTING FOR THE EXECUTOR ............................................................................ 22
   A. Election Protection ..................................................................................................... 22
   B. Protection Regarding Pursuit of Taxes ...................................................................... 22

XII. CONCLUSION ............................................................................................................. 23
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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 drafts-person 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 (transferor 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.


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 legates 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

I. 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(y) 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., personality 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.


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 Vahlteich 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.


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 estate, 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) aff'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 includable 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
element 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 drafter 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
Tax Apportionment

adding extra length. There are legitimate differences between draftsmen on this point of view.

4. **FORM EXAMPLE**
   An example of how such a clause could be drafted can be found on Appendix D.

VII. **APPORTIONMENT IN MARITAL DEDUCTION PLANNING - AT DEATH OF THE FIRST SPOUSE TO DIE**

A. **Basic Dilemma**

1. **GENERALLY**
   In preparing a marital deduction Will, it is of course expected that there will be no Federal estate taxes. For Texas residents, it is also likely that there will be no state inheritance taxes since Texas no longer has an inheritance tax; however, it is possible that the testator will own real property or immovables in other jurisdictions. There is thus a possibility that there may be some inheritance tax, since not all states give a full deduction for state inheritance tax on Q-TIP gifts. In addition, there is always a possibility of Federal estate tax through disclaimer, failure to elect Q-TIP, partial Q-TIP election or some other scenario.

2. **HOW TO ALLOCATE?**
   Although there are numerous combinations of clauses which can produce a classic marital deduction Will, the two most common are a pecuniary bypass/residuary marital gift, and a pecuniary marital/residuary bypass gift. As the estate tax exemption grows, the latter appears to be by far the most popular drafting format that this author has seen. However, many drafters continue to draft by the general rule that, when it can be anticipated, the residuary estate should always be the larger gift, in order to avoid potential problems with acceleration of IRD when funding an unusually large pecuniary gift and/or with capital gain recognition if date of death values are used as part of the funding formula. As a result, consideration needs to be given to drafting for both possibilities. In order to do that, the drafter needs to understand how the tax allocation clause will interact with debt and expense apportionment as well.

B. **Debts**
   Although this outline does not specifically address apportionment of debts and expenses, such apportionment is just as important in marital deduction planning as the apportionment of estate and inheritance taxes. Because debts of a decedent are always deductible for estate tax purposes, this author believes that debt should be allocated to the marital gift. This allows for a more efficient use of the credit shelter bequest, and reduces the value of assets which will be includible in the estate of the surviving spouse at his or her subsequent death. **Caveat:** Care should be taken when drafting for debt allocation when specific bequests are made of assets pledged to secure debt (i.e., acquisition debt). Check with the testator to determine his true intent. Also, debts against insurance policies or to pension plans should probably be treated differently and allocated to the asset itself.

C. **Administration Expenses**

1. **EXECUTOR HAS ELECTION ON WHERE TO DEDUCT**
   Allocation of administration expenses is one of the most difficult issues, since these expenses are not always deducted on the Federal estate tax return. Instead, the executor has the election to deduct such expenses on the Federal estate tax return or on the income tax return for the estate. IRC §§ 2053 and 642(g). However, under the IRS regulations, expenses associated directly with probate or with the transfer of assets cannot be both deducted on the Form 1041 and allocated to trust accounting income. This forces the deduction of these expenses on the estate tax return in some cases.

2. **HOW TO HANDLE**
   There are two approaches to administrative expense allocation. In one, most commonly used where there is a pecuniary marital gift, the definition of the marital deduction gift takes into account the allocation of administration expenses, e.g., the pre-residuary gift is specifically increased – and thus the bypass residuary is specifically decreased – for estate administration expenses deducted on the Form 1041. The advantage of this approach is that it allows the estate to “make the call” on where to deduct the expenses after the death of the first spouse, where the relative value of a current income tax deduction vs. a larger bypass can be properly assessed. On the other hand, because both the size of the pecuniary gift and the nature of the assets funding it are in the discretion of the executor, this gift will clearly carry out DNI to the pecuniary devisee (in this case the marital deduction gift). That may not be advisable when funding a pecuniary bypass trust. For that reason, it is more common where the pre-residuary gift is to the bypass trust to define the gift of the estate
tax exemption in a fixed fashion, where it is not reduced or altered by allocation of estate administration expenses. Those expenses are then allocated to the marital gift residuary. This avoids having DNI pass out to the bypass trust, which would have its net value reduced. It also ensures that the bypass trust will always be funded at its full value, thus minimizing estate taxes. However, it limits the executor’s ability to deduct administration expenses on the Form 1041 solely to those expenses which can – under the final IRS regulations – be safely allocated to trust accounting income. This takes away some of the estate’s flexibility, but is this author’s preferred approach in large estates.

VIII. APPORTIONMENT IN MARITAL DEDUCTION PLANNING - AT SECOND SPOUSE’S DEATH

A. Generally

As described earlier in this outline, the drafter of the Will of a surviving spouse must be careful not to override unintentionally the right to recover taxes provided in Section 2207A and/or the apportionment of tax provided in Texas Probate Code Section 322A. This could result in hardship to the residuary beneficiaries of the surviving spouse’s estate. However, there are also tax allocation provisions that can be contained in the Will of the first spouse to die to help deal with allocation of the taxes which are due from the Q-TIP trust.

B. Drafting for Payment of Tax on Q-TIP

Since the draftsman never knows when the surviving spouse will have his or her Will re-done by another attorney who is not aware of the existence of the Q-TIP trust, it is a good idea to protect against the possibility that the surviving spouse may accidentally override the right of recovery. As a result, a clause contained in the Q-TIP provision in the Will of the first spouse to die which directs payment of taxes at the death of the surviving spouse is advisable. In addition, it may be further advisable to provide for reimbursement of the tax burden to the surviving spouse’s executor, rather than direct payment to the Internal Revenue Service. This prevents litigation resulting from conflict between the two Wills.

C. Drafting for Separate Share Marital Trust

When there are two Q-TIP trusts created in the Will of the first spouse to die, one designed to contain the generation-skipping transfer tax exemption and the other designed to contain the remainder of the marital gift, the drafter must decide how to pay the estate tax attributable to the inclusion of both trusts in the estate of the surviving spouse. In an effort to maximize generation-skipping transfer tax planning, it may be advisable for the Will of the first spouse to die to direct payment of the tax on both trusts from the non-exempt marital trust. This allows the full exemption to pass in a manner exempt from generation-skipping transfer taxes. This approach was approved by the Internal Revenue Service in Treas. Reg. §26.2652-1(a)(5).

Appendix E contains an example of how this works when there is a separate gift defined to an exempt Q-TIP. Appendix F is an example of how this works where there is a single marital trust gift, and reliance on a mandated “split” clause.

D. Allocation of Tax Between Distributees

So far, the discussion has been limited to drafting for payment of the tax on the marital trust which is assessed at the death of the surviving spouse. If, after the tax is paid, the trust will be distributed on a fractional or percentage basis, or to "issue per stirpes", it is not necessary to further address allocation of the tax among the Q-TIP trust remaindemen. However, it is not uncommon for a Will to contain special "bequests" after the death of the surviving spouse. For instance, a Will may provide that, upon the death of the surviving spouse, the family business will pass to son and the remaining assets to another child. It then becomes important to address how the tax will be allocated between the two beneficiaries. Unfortunately, many tax allocation clauses deal only with taxes assessed against the estate of the decedent, and if an apportionment clause is chosen, it will not necessarily apply to the apportionment of the payment from the trustee to the surviving spouse's estate after the death of the surviving spouse. It may therefore be advisable to include a special provision that addresses this issue. Since the draftsman will have had to deal with the possibility of tax apportionment as between the son and daughter (in the above example) based on the possibility that the spouse of the testator may not survive, then presumably that same type of provision could be incorporated by reference. For instance, the following type of language could be used at the end of Appendix E or F.

The payment to the personal representatives of the estate of my surviving spouse described in the preceding sentence shall be allocated between the beneficiaries of the
Marital Trust described in Paragraph ___ of Article ___ in the same manner as provided in Paragraph ____ [the basic tax allocation clause] as if I had died at the time of such succession and as if my spouse had predeceased me.

IX. REVOCABLE LIVING TRUSTS

The increasing popularity of revocable grantor trusts has given rise to a greater demand to have clients' dispositive provisions contained in an inter vivos trust, with a complementary pour-over Will. If this type of estate planning strategy is used, one of the most important tasks of the draftsman will be to coordinate the tax, debt and expense allocation provisions. In doing this, the scrivener must also keep in mind that he or she will have little control over the degree to which the testator actually funds the trust during his or her lifetime. All of the assets could still be in the testator's name. Or all could be in the trust. Or only certain assets could be in the trust, with the remainder in the testator's name. Or, as in the McKeon decision, supra, there could be a separate property and a community property trust, so that assets are held in at least three places — not including other types of non-probate property. The challenge is to have clauses in the Will and in the Trust which are not only coordinated, but which work irrespective of where the assets are located. In this regard, one should keep in mind that Section 322A permits a Will to allocate taxes governed by other documents to an estate, but a non-Will document (such as a revocable trust) can only direct the allocation of taxes with respect to assets governed by that instrument. Section 322(b)(2). However, that section mentions that the direction concerning apportionment of estate tax in an instrument is limited to the assets "passing under the instrument", and one could argue that both the probate and the trust assets are ultimately passing under the trust, which allows the trust to govern what happens. All of these issues raise more questions than answers, which is why apportionment clauses in these types of situations are "works in progress". One way to handle the matter is to select the "probate only" tax allocation clause in the Will, and then to direct that the taxes are to be allocated between the various gifts — which are customarily set forth in the Trust Agreement and not in the Will — as provided in the Trust Agreement. There is one potential trap in this analysis. Under Texas law, it is generally possible to incorporate an existing document by reference into the Will, but not a future document. See, e.g. Jordan v. Virginia Military Institute, 296 SW2d 952 (Tex. Civ. App. – San Antonio, no writ history 1956). As a result, it is not as clear as one might like that a future amendment to the Trust would be properly effectuated unless the Will is re-executed each time the Trust is amended or restated. While tedious, that is certainly the preferred option, at least if any of the changes to the trust involve either an amendment and/or a restatement of the tax allocation clause. An example of a Will provision governing apportionment of estate tax when there is a revocable trust is found at Appendix G. An example of a coordinated Trust tax allocation provision is found at Appendix H.

X. SPECIAL DRAFTING SITUATIONS

This section addresses a variety of situations which may need to be specifically addressed in the Will. These drafting provisions can be appended to the general tax apportionment clause. If this is done, it should be clarified that they overrule allocations otherwise provided for, so as not to create a conflict within the Will.

A. Split Interests

1. **GENERALLY**

   Section 322A of the Texas Probate Code specifically addresses apportionment to split interests, such as life estates and terms for years. Section 322A(h). For instance, the tax attributable to the life tenant is not assessed against his or her share, but is assessed against the fund of property itself. This will of course reduce the interest of the life tenant, but is primarily a burden on the remainder.

2. **CHARITABLE DEDUCTION PLANNING**

   If the life estate has a charitable remainderman, this will result in a decrease of the charitable deduction and a resultant interrelated tax computation, causing a higher tax rate than would otherwise be applicable. As a result, if a charitable interest is involved, the drafter should consider allocating the tax burden attributable to the life estate/remainder to another gift in the Will. This would not, of course, be appropriate to the extent that this gift was the primary gift in the governing instrument.

3. **ILLIQUID ASSETS**

   Another situation in which the drafter should consider allocating the tax burden away from split interests is when the life estate is being given in illiquid
property, such as a house, ranch or other asset which would not easily permit the payment of taxes.

B. Apportionment Within the Residuary

1. **Generally**
   
   Although most residuary clauses leave property either to one beneficiary or to a class of beneficiaries who have similar interests (i.e., children), residuary clauses are often split between an entity qualifying for a deduction (i.e., the spouse or a charity) and others. An example includes "I leave my residuary estate one-half to my wife and one-half to my children". Care needs to be taken in drafting an apportionment clause which generally apportions taxes against the residuary to specially allocate taxes away from the gift which qualifies for the marital or charitable deduction unless that is contrary to the intent of the testator. Care should also be taken with respect to allocation of expenses and debts. For instance, while taxes may not be allocated to the marital or charitable gift, the testator may want all debts and expenses allocated equally between the deductible and the non-deductible gift. With respect to administration expenses, however, see the discussion at Article VII(E), supra. Failure to make special provisions, but instead the mere inclusion of a clause that apportions tax to the residuary itself could override TPC § 322A. At the very least, there is a possibility of litigation. See Estate of Phillips v. Comm'r, 90 T.C. 797 (1988).

2. **Possible Q-TIP Problems**

   If the residuary estate is split between a non-deductible gift and a gift to a Q-TIP trust, particular care needs to be taken with attempts to allocate taxes away from the marital gift unless the testator is making a well-informed and intended decision to the contrary. For instance, what happens if the Q-TIP election is not made? This would certainly be a possibility if the surviving spouse is the executor in a second marriage situation. The surviving spouse may decide not to elect Q-TIP to avoid tax problems in his or her own estate, especially if he or she knows that all the taxes attributable to his or her failure to elect will be allocated to others.

C. "Prer residuary" Residuary Gifts

   The interpretation of a testator's intent with respect to allocation of taxes, debts and expenses against the residuary estate can be complex when a gift labeled the "residuary estate" appears to have a prer residuary as well as an ultimate residuary gift. See, e.g., Hunt v. Smith, 744 S.W.2d 1 (Tex. 1987). Another example would include the following:

   "B. Residuary Estate. I leave the rest, residue and remainder of my estate as follows: my closely-held business to my daughter and everything else to my descendants, per stirpes".

   This so-called "residuary bequest" actually includes a specific bequest and a residuary. However, the labeling of the clause as the residuary estate and the use of the language "rest, residue and remainder" clouds the issue and could be productive of litigation. It is important to make every residuary bequest a "true residuary bequest" and to separate out any other gifts as specific or general bequests.

D. Employee Benefits

1. **Annuity Payments**

   In allocating taxes, the draftsman should consider whether or not the recipient of a retirement benefit has the option to receive the benefit as an annuity rather than in a lump sum. It may be a hardship to the recipient to bear a pro-rata share of the taxes when he or she would otherwise find it advantageous to receive the benefit in an annuity over time. The IRS takes the position that a will which allocates debt or taxes to an IRA in qualified plan makes the "estate" a partial recipient, thus negating the ability to "dribble out" the benefit. See discussion at Article VI (C), supra.

E. Disclaimer

   The draftsman may consider including, either as part of the tax apportionment clause or in the disclaimer provision, a special allocation of taxes resulting from the disclaimer to the disclaimed property itself. For example, in a marital deduction estate, there would presumably only be taxes if the disclaimer covers sufficient property to exceed the exemption equivalent. As a result, there would be no exemption equivalent bequest and, no matter where your normal first choice for tax allocation lies, the tax burden is likely to be allocated against the marital gift. This results in the increased marginal rate problem described earlier in this outline. Allocation of the tax against the disclaimed property not qualifying for the marital deduction is obviously a better solution. An example of language which can be added to the disclaimer provision is shown on Appendix J.


Alternative methods of handling this issue are shown in Form Excerpts #6 and 7, supra, located on Appendix F.

F. Interest and Penalties

As a general rule, the drafter should be careful in dealing with interest and penalties on tax whenever the administration expenses under a Will are allocated differently than the taxes. For instance, it is common to have an apportionment or a partial apportionment clause for tax purposes, and yet have all administration expenses allocated against the residuary. If the drafting is not clear, there could be a debate among the beneficiaries as to whether or not the interest on any deferred taxes is an "administration expense" or is part of the tax which is to be allocated. If the testator desires to have interest and penalties on taxes allocated in the same manner as the taxes, the drafter should specifically so provide.

G. Inheritance Taxes

Texas has no inheritance tax at the present time. However, the pick up tax could revive after 2010 (when the 2001 tax bill sunsets). And, in addition, numerous states have enacted separate inheritance taxes, and not all of them have the same exemption as the Federal estate tax. As a result, it is quite possible that the estate of a Texan will owe inheritance tax on the death of either or both spouses, perhaps even in cases where there is no estate tax. This could be particularly problematic when a large vacation home outside of Texas is left in a specific bequest to someone other than the residuary legatees. Care should be taken to consider inheritance tax issues when non-Texas real property is owned. Some pre-death planning, such as transferring the asset to an LLC or limited partnership, may allow avoidance of such taxes. But some jurisdictions have gotten more sophisticated, and now assess inheritance tax to such “pass through” vehicles in a manner similar to what they have long done when the property is in a revocable trust.

H. Inter Vivos Gifts

Texas Probate Code Section 322A does not contain any provision which allocates estate taxes to the recipient of an inter vivos gift which is not part of the gross estate but which increases the tax base by being "grossed up". This could cause inequity amongst family members, and is something a scrivener should consider when a large inter vivos gift is made to one but not all of a testator's children.

1. EXAMPLE

A testator (T), with an estate of $4 million, has three children, A, B and C. T makes a $2 million gift to A during the testator's lifetime, entirely consuming the unified credit. T then drafts a Will in which T's remaining estate is bequeathed to B and C only, under the theory that A has already received his or her share of the inheritance.

2. PROBLEM

Although this type of bequest seems to have achieved equity, in reality it ignores the fact that B and C will bear the entire tax burden caused by the full $6 million, whereas A will have received his inheritance "tax-free".

3. SOLUTIONS

The solution to this dilemma depends greatly upon the size of the decedent's estate. In the above example, where the estate is only $4 million, there is no way to achieve equity once the $2 million gift is made to A. No Texas or federal law has been found that provides the estate with a right of recovery against someone who has received a taxable gift during lifetime which absorbs the unified credit. If, however, T's estate is large enough, there are several possibilities. Perhaps the easiest would be for T to make specific bequests to B and C equal to the gift which was made to A, and then to have the residuary estate shared equally by A, B and C. The estate taxes would be allocated to the residuary. In this manner, A, B and C all received equal tax-free gifts. Depending on the size of the gift to A, however, this requires that T have a significant remaining estate. A more complex solution would be to treat A, B and C equally as residuary beneficiaries in the Will, but draft a tax allocation clause which allocates to A a significantly greater share of the taxes based on the inclusion of the taxable gift as part of the assets which A is treated as having received under the Will.

I. Use of Tax Apportionment as a Bequest

Generally, use of tax apportionment is a way of ensuring that a bequest which the testator desires to make bears its pro-rata share of the estate and inheritance tax burden. However, it is possible to use a tax apportionment clause to, in essence, make an additional bequest. This could occur, for example, in the following situation:

Example: Testator (T) has an estate of $5 million. Testator is single and has two
children, A and B. The most significant asset of testator's estate is a closely-held company, which is worth $3 million. A is active in the business and B is not. Testator wishes to treat A and B equally, but leave A the business.

There are a number of ways that an estate planner can resolve this issue. Perhaps the most straightforward one is to try to purchase insurance which will provide benefits for B. Assume, however, that insurance is either uneconomical, unavailable or of no interest to T. In that case, one alternative would be to leave the business to A and the remaining estate to B. A would thus receive a $3 million bequest and B would receive a $2 million bequest. However, the estate taxes could be apportioned in such a way that A has a disproportionate tax burden. In this case, the goal would be to apportion sufficient taxes to A so that the net value of A's bequest, after taxes, is equal to what B receives (after taxes, if any). This strategy requires, of course, that the asset A receives be sufficiently income-producing or have sufficient borrowing capacity to bear the taxes, since the rate on that asset may greatly exceed the maximum rate (55%) which would otherwise apply.

This author has drafted such a provision and would add one caveat: it's complicated! Care needs to be given both to coming up with a formula which will take into account changing values and providing A the benefits of the liquidity which will otherwise pass to B. For instance, the executor may need to be authorized to utilize B's inheritance to "lend" to A for a limited period of time. If so, the draftsman needs to consider whether or not interest is appropriate.

J. IRC Section 303
Internal Revenue Code Section 303 provides for sale or exchange treatment for the redemption of qualified stock in order to pay death taxes and expenses. However, this treatment is only available if the recipient of the stock under the Will or Trust Agreement bears the burden of the estate taxes and estate administration expenses. As a result, Section 303 should be kept in mind by any draftsman when making a specific bequest of closely-held stock. Such a bequest may call for use of an apportionment clause, rather than a non-apportionment clause.

XI. DRAFTING FOR THE EXECUTOR.

A. Election Protection

There are a number of elections available to the executor which affect estate and inheritance taxes. Examples include the Q-TIP election, the allocation of generation-skipping transfer tax exemption, the reverse Q-TIP election and the decision to deduct expenses on the estate tax return or the income tax return. Draftsmen should consider a general provision relieving an executor from responsibility for making or failing to make an election, if that is the testator's desire. The following is an example of such a clause:

"My executor shall incur no personal liability whatsoever for making or failing to make any tax election and need make no compensating adjustment with respect thereto."

B. Protection Regarding Pursuit of Taxes

Texas Probate Code Section 322A places an affirmative duty on an executor to recover taxes owed by beneficiaries of probate and non-probate assets. With respect to probate assets, the matter is fairly straightforward because the executor generally has possession of those and can defer distribution of the asset until the tax burden is paid by the beneficiary or from the asset itself. With respect to non-probate assets, however, the executor may have an affirmative duty to pursue claims against persons who are not beneficiaries of the estate. In many cases, this may be difficult and, perhaps, uneconomical. Consideration should be given to including provisions which address the possibility that an executor may in good faith determine that it is uneconomical to pursue collection of taxes against a recipient.

1. PROTECTION OF EXERCISE OF DISCRETION

One option is to specifically provide that the executor may, in his or her discretion, determine that it is uneconomical to pursue any rights granted under Texas Probate Code Section 322A or under the Will against any person as a recipient of assets included in the gross estate of the testator. Language can be included protecting the executor's exercise of this discretion so long as he or she acts in good faith and without gross negligence. See also TPC Section 322A(n)(2).
2. **SPECIFIED THRESHOLD**  
Because granting discretion to the executor may place the executor in a difficult position, a Will may contain a provision which specifically provides that the executor shall not pursue collection of tax against recipients thereof when the tax attributable to all assets received by the recipient is less than a specified dollar amount. An example of such a provision is shown on Appendix H. (This provision is authored by Mr. Noel Ice, of Cantey & Hanger in Fort Worth, whom the author greatly acknowledges for his kindness in allowing its inclusion in this outline.)

This provision is ideally used with a provision that otherwise allocates taxes as provided by Section 322A of the Texas Probate Code or which has a detailed apportionment clause. Examples of both of those are found earlier in this outline.

**XII. CONCLUSION**  
Because of the multitude of choices with regard to tax apportionment, ranging from silence (therefore relying upon the Federal and state apportionment schemes) to extremely detailed apportionment clauses, it is important that this issue be specifically addressed with the client before instruments are drafted, at least when there are significant non-probate assets passing to different beneficiaries than those under the Will or when there are large specific bequests. There is not necessarily a "right way" or a "wrong way" to apportion taxes. In preparing this outline, the author discovered that there are significant differences of opinion amongst many experts regarding a number of the issues addressed in this outline. However, every draftsman should be able to explain to an estate beneficiary either at the testator's death or at the subsequent death of a surviving spouse why the testator chose a specific tax apportionment scheme.
APPENDIX A

"Total Non-Apportionment"

Allocation of Taxes. Except as otherwise specifically provided herein, all estate and inheritance taxes (including interest and penalties thereon, which shall be included in the term "taxes" for purposes of this paragraph) assessed under the provisions of any tax law against any assets of my estate, whether or not passing hereunder, or against any beneficiary of my estate as a result of my death, shall be charged against and paid from my Residuary Estate, without apportionment. By this provision, I specifically intend to waive any rights of reimbursement my estate may have pursuant to applicable Federal or state law. The taxes allocated pursuant to this paragraph shall not, however, include any additional or recapture tax imposed by Sections 2032A or 2057 of the Internal Revenue Code or any tax on generation-skipping transfers imposed by Chapter 13 of the Internal Revenue Code.

APPENDIX B

"Total Apportionment"

Allocation of Taxes. Except as otherwise specifically provided herein, all estate and inheritance taxes (including interest and penalties thereon, which shall be included in the term "taxes" for purposes of this paragraph) assessed against the provisions of any tax law against any assets of my estate, whether or not passing hereunder, or against any beneficiary of my estate as a result of my death, shall be charged against, paid or otherwise allocated as provided by applicable state and Federal law. In the event of a difference in applicable provisions between state and Federal law, Federal law shall control. In the event of differences in applicable provisions between states, laws applicable in the jurisdiction of my domicile shall control. For purposes of this paragraph, the term "taxable value" as used in Section 322A of the Texas Probate Code shall mean the net value as finally determined for Federal estate tax purposes, after taking into account the amount and allocation of deductions taken and allowed pursuant to Section 2051 of the Internal Revenue Code. [Notwithstanding the above, neither (a) the assets passing in Paragraph ___ of Article ___ nor (b) any individual retirement account or qualified plan benefit payable over the life expectancy of any descendent of mine shall be charged with any such taxes, and the estate and inheritance taxes otherwise allocated to such assets shall instead be charged to my Residuary Estate, without apportionment.]
APPENDIX C

"Probate Only – with exception"

Allocation of Taxes. Except as otherwise specifically provided herein, all estate and inheritance taxes (including interest and penalties thereon, which shall be included in the term "taxes" for purposes of this Paragraph) assessed under the provisions of any tax law against any assets of my probate estate passing hereunder shall be charged against and paid from my Residuary Estate, without apportionment. Any estate, inheritance or other taxes attributable to assets that do not pass under this Will shall be apportioned, paid or otherwise allocated as provided or permitted by applicable law, except that no taxes shall be recovered from any trust includable in my estate under Section 2044 of the Internal Revenue Code which has an inclusion ratio of zero (0) for generation-skipping transfer tax purposes, although my Executor may, to the extent otherwise provided, collect payment for the taxes otherwise attributable thereto from any other trust includable in my estate under Section 2044 of the Internal Revenue Code which has an inclusion ratio of one (1) for generation-skipping transfer tax purposes, to the extent authorized under the Will of my spouse. Furthermore, to the extent that any interest in a qualified retirement plan account or individual retirement account ("retirement benefits") is payable at my death to or for the current benefit of the same persons who receive (or for which trusts are created) as part of the disposition of my Residuary Estate, and if such retirement benefits may be distributed without penalty over the life expectancy of any of such person(s), then in such event the estate and inheritance taxes attributable to such retirement benefits shall be paid from my Residuary Estate, without apportionment. The taxes allocated pursuant to this Paragraph shall not include any additional or recapture tax imposed by Section 2032A or Section 2057 of the Internal Revenue Code or any tax on generation-skipping transfers imposed by Chapter 13 of the Internal Revenue Code.

APPENDIX D

"Total Apportionment – with exceptions"

Allocation of Taxes. Except as otherwise specifically provided below, all estate and inheritance taxes (including interest and penalties thereon, which shall be included in the term "taxes" for purposes of this paragraph) assessed under the provisions of any tax laws against any assets of my estate, whether or not passing hereunder, or against any beneficiary of my estate as a result of my death, shall be charged against and paid from my Residuary Estate, without apportionment. Notwithstanding the above, the following provisions with respect to the allocation of such taxes shall apply with respect to the following assets:

[list]

Examples of items that might be excepted out would be Q-TIPS (or at least non-GST exempt Q-TIPS, §2041 assets, §2036-2038 assets, and or large pre-residency gifts assets.

The taxes allocated pursuant to this Paragraph shall not, however, include any additional or recapture tax imposed to Sections 2032A or 2057 of the Internal Revenue Code or any tax on generation-skipping transfers imposed by Chapter 13 of the Internal Revenue Code.
APPENDIX E

Before making any principal distributions from the Marital Trust or the Exempt Marital Trust after the death of my spouse, the Trustee shall pay to the personal representative of the estate of my spouse the difference between the amount of estate and inheritance taxes payable by reason of the death of my spouse and the amount of such taxes otherwise payable had the principal of the Marital Trust and the Exempt Marital Trust not been included in the gross estate of my spouse for purposes of calculating such taxes. Such payment shall be made first from the Marital Trust before utilizing any assets of the Exempt Marital Trust.

APPENDIX F

Before making any principal distributions from the Marital Trust after the death of my spouse, the Trustee shall pay to the personal representative of the estate of my spouse the difference between the amount of estate and inheritance taxes payable by reason of the death of my spouse and the amount of such taxes otherwise payable had the principal of the Marital Trust not been included in the gross estate of my spouse for purposes of calculating such taxes. Such payment shall be made first from assets (including any separate trust into which the Marital Trust has been divided) which are not exempt for generation-skipping transfer tax purposes before making payment from assets which are so exempt.
APPENDIX G
Allocation of Taxes in Pour-Over Will

(1) Except as otherwise specifically provided herein, all estate and inheritance taxes (including interest and penalties thereon, which shall be included in the term “taxes” for purposes of this Paragraph) assessed under the provisions of any tax law against any assets of my probate estate passing under this Will shall be charged against and paid from my Residuary Estate, to be apportioned as provided in the Trust Agreement (defined herein). Nothing herein shall frustrate my intent regarding the allocation of taxes as set out in the Trust Agreement. Any estate, inheritance or other taxes attributable to assets that do not pass under this Will or the Trust Agreement shall be apportioned, paid or otherwise allocated as provided or permitted by applicable law or as provided by the governing instrument. Notwithstanding the above, any estate, inheritance or other taxes attributable to assets in a marital trust includable in my estate shall be apportioned, paid or otherwise allocated as provided or permitted by applicable law, except that no taxes shall be recovered from any trust includable in my estate under Section 2044 of the Internal Revenue Code which has an inclusion ratio of zero (0) for generation-skipping transfer tax purposes, although the taxes attributable to such trust can be collected from any other marital trust includable in my estate which has an inclusion ratio of one (1) for generation-skipping transfer tax purposes, to the extent authorized under the Will of my spouse, the Trust Agreement or otherwise. Furthermore, to the extent that any qualified retirement plan account or individual retirement account (“retirement benefits”) is payable at my death to or for the current benefit of the same persons for whose current benefit assets are distributed or trusts are created as part of the disposition of my Residuary Estate, and if such retirement benefits may be distributed without penalty over the life expectancy of any of such person(s), then in such event the estate and inheritance taxes attributable to such retirement benefits shall be paid from my Residuary Estate, to be apportioned as provided in the Trust Agreement. The taxes allocated pursuant to this Paragraph shall not include any additional or recapture tax imposed by Section 2032A or Section 2057 of the Internal Revenue Code or any tax on generation-skipping transfers imposed by Chapter 13 of the Internal Revenue Code.

(2) Notwithstanding anything to the contrary, if my estate lacks sufficient liquid assets to pay taxes and/or debts and expenses, then my Executor may request from the Trustee serving under the Trust Agreement such funds as are or may be needed to pay any taxes and/or debts and expenses associated with assets included in my estate for federal tax purposes.

APPENDIX H
Allocation of Taxes in Revocable Trusts.

(1) Except as otherwise specifically provided herein, all estate and inheritance taxes (including interest and penalties thereon, which shall be included in the term “taxes” for purposes of this Paragraph) assessed under the provision of any tax law against any assets of a Settlor’s taxable estate passing to or held under this Trust Agreement shall be charged against and paid from such Settlor’s Residuary Estate, without apportionment. Notwithstanding the above, any estate, inheritance or other taxes attributable to assets in a marital trust created under this Trust Agreement includable in the estate of the Surviving Settlor under Section 2044 of the Internal Revenue Code shall be apportioned, paid or otherwise allocated as provided or permitted by applicable law, except that no taxes shall be recovered from any such trust created under this Trust Agreement includable in such estate which has an inclusion ratio of zero (0) for generation-skipping transfer tax purposes, although the taxes attributable to such trust may be collected from any other marital trust includable in such estate which has an inclusion ratio greater than zero (0) for generation-skipping transfer tax purposes, to the extent authorized under this Trust Agreement or otherwise. Furthermore, to the extent that any qualified retirement plan account or individual retirement account (“retirement benefits”) are payable at a Settlor’s death to or for the current benefit of the same persons for whose current benefit assets are distributed or trusts are created as part of the disposition of such Settlor’s Residuary Estate, and if such retirement benefits may be distributed without penalty over the life expectancy of any of such person(s), then in such event the estate and inheritance taxes attributable to such retirement benefits shall be paid from such Settlor’s Residuary Estate, without apportionment. The taxes allocated pursuant to this Paragraph shall not include any additional or recapture tax imposed by Section 2032A or Section 2057 of the Internal Revenue Code or any tax on generation-skipping transfers imposed by Chapter 13 of the Internal Revenue Code.

(2) If any of a Settlor’s debts, estate and
inheritance taxes and/or administration expenses are attributable to an asset that passes to the Trustee acting hereunder and if the probate estate of the relevant Settlor lacks sufficient liquid assets to pay such debts, taxes and/or expenses, then the Trustee may provide funds to pay such debts, taxes and/or expenses to the personal representative of the estate of the relevant Settlor. Such payments of funds may be made in the discretion of the Trustee as he or she determines to be in the best interests of the beneficiaries of the trust(s) created hereunder.

(3) Notwithstanding anything to the contrary, no debts, taxes or expenses shall be allocable to the proceeds of any qualified retirement plan or individual retirement accounts made payable to the Trustee. In addition, any non-probate assets payable directly to the Trustee, and not to a Settlor’s estate, shall not be liable for the debts or administration expenses of the Settlor.

APPENDIX I

My Executor shall seek no contribution or reimbursement with respect to non-probate assets (other than proceeds payable to the trustee, as hereinafter provided and excluding Section 2044(a) assets), except to the extent that the combined taxes for which contribution or reimbursement is sought under this Paragraph exceed $______ with respect to the particular recipient of the non-probate assets, i.e., with respect to the "person interested in the estate" as that phrase is used in Texas Probate Code Section 322A. Any taxes which the executor does not collect pursuant to this provision shall be allocated to my Residuary Estate, without apportionment.