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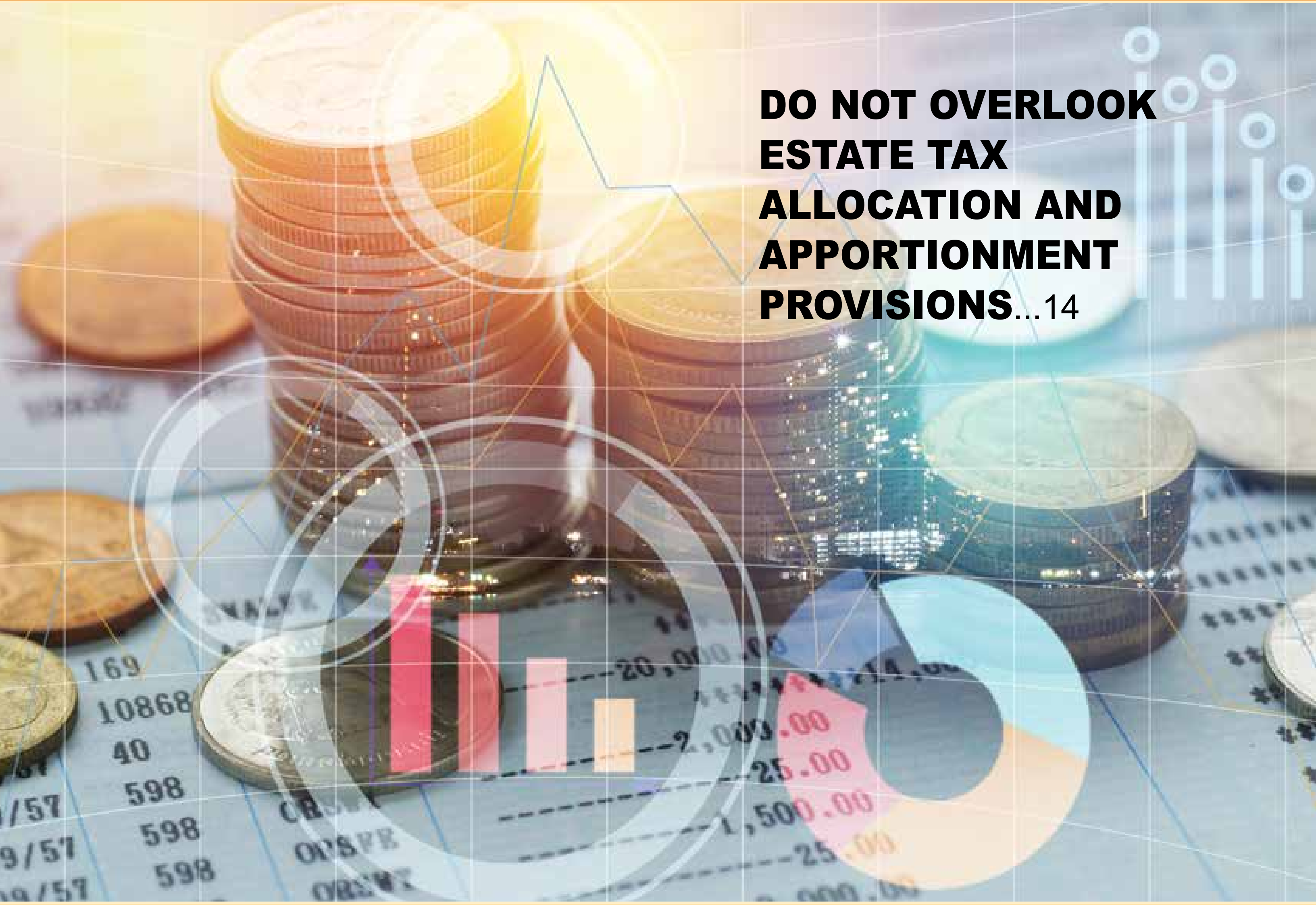
DO NOT OVERLOOK ESTATE TAX ALLOCATION AND APPORTIONMENT PROVISIONS...14



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SAVE THE DATES:

DO NOT OVERLOOK ESTATE TAX ALLOCATION AND APPORTIONMENT

By David Bruckman, Esq., MS Tax, CLU

It is important that estate planners take a comprehensive and holistic approach. This will enable the client to understand who will inherit his or her assets, and how such assets will pass. The attorney or planner, especially for complicated or taxable estates, should create a chart mapping which asset will pass to whom, when and how, what the taxes will be, who will pay such taxes, and with what money.

Consideration must be given to the client's intent, the titling of assets, any powers of appointment, and assets passing by operation-of-law. Then, it is imperative to craft a plan so that the cash will be available to enable the responsible party to pay the tax. The planner should pay careful attention to estate tax allocation provisions, which can be a vital component of the estate plan and necessary to ensuring a client's testamentary desires are fulfilled.

Some attorneys and planners do not spend adequate time and energy on the estate tax apportionment clause, which dictates who is responsible to pay the estate and other transfer taxes. Additionally, planners may fail to look at the "big picture" and consider all of the client's assets, including those passing outside the will by so-called "operation-of-law," such as life insurance, retirement accounts and jointly-owned assets. This can result in an estate tax allocation clause being poorly drafted, incorporating inapplicable or antiquated boilerplate language, or ignored altogether. Any of these mistakes or oversights can lead to delays, confusion, litigation, otherwise avoidable taxes, and/or unintended consequences. Some examples of which are discussed herein.

In the absence of an apportionment or allocation clause, the governing state's law will generally determine who will pay the taxes. Taxes due upon death, or as a result thereof, include federal income tax; state estate, inheritance, and income taxes; and federal estate and generation skipping transfer ("GST") taxes. There are typically three places where the money comes from to pay the applicable tax. One option is that the taxes are paid from the decedent's residuary estate, before making distributions to the beneficiaries of the residue. Another option, which is generally perceived to be more equitable (and which is the statutory default option in the State of New York, see E.P.T.L.§ 2-1.8), is that the estate taxes are paid by the person who receives the asset that resulted in the tax. The third option is to create a pool of available funds owned outside the estate, such as trust-owned life insurance insuring the life of the decedent.

A well-contemplated estate tax apportionment clause should contain or address the following:

1. Set forth if state and federal apportionment statutes apply, or will they be overridden;
2. Specify the taxes to which the clause applies, including federal estate tax, state estate, succession and inheritance taxes, and the GST taxes;
3. Instructions regarding the fund or funds from which the above taxes are to be paid;
4. Directions as to apportionment of non-probate (assets that pass by operation- of- law) assets; and
5. Instructions as to the specific allocation of the GST tax exemption.

Examples of Poor Planning

1. Here is a fairly simple example of how things can go wrong. Assume a father has three children; a daughter and two sons, A and B. He wants to benefit all his children equally. Further assume that the father's three primary assets are a family business that the father wants to leave for his daughter, an IRA, and a stock portfolio. Each asset is worth $6,000,000, so the estate will be subject to the federal estate tax (assume a 50% rate of tax for federal and state estate taxes). The IRA lists sons A and B as the beneficiaries. Also assume the children get along well with their father, but not so well with each other.

Upon the father's death, the stock portfolio will pass through probate under the father's will. The father's shares in his business will transfer, upon the father's death, to his daughter pursuant to a shareholders' agreement. Further assume that the father has no remaining unified credit from estate tax. His will, drafted by his matrimonial attorney, has a boilerplate provision that all estate taxes are to be paid from the residuary estate, and that the net probate estate should be divided equally between sons A and B, who happen to be the executors.

The good news is that the will named only the sons as beneficiaries rather than all three children, as that would have unevenly benefited the daughter. The bad news is twofold. The biggest problem is the result of the IRA and the business passing outside the will. Assume the estate taxes attributable to these assets are $6,000,000. The burden of paying the estate taxes on the entire estate, which total $9,000,000, is the responsibility of the residuary estate.

Thus, the sons are saddled paying the $3,000,000 of estate taxes attributable to the family business, which the daughter inherits. In other words, the daughter receives $6,000,000 free and clear, whereas the sons will have to apply the entire $6,000,000 of the stock portfolio to partially satisfy the $9,000,000 estate tax bill. They may need to liquidate the IRA to come up with the remaining $3,000,000, which happens to be what is left of the IRA after the sons pay income taxes on the distributions. This means the sons are left with nothing- hardly the result the father intended, which was that each child benefit equally, $3,000,000 each. This is an extreme example, but illustrates the point.

2. Sometimes, having the tax follow the asset can backfire. Assume a grandmother, as part of her estate and wealth transfer plan, designated a so-called "IRA Trust" the beneficiary of her Roth IRA. Further assume that the Roth IRA has investments of $2,000,000, that she is not taking any distributions (as none are required during her life), that the rest of her estate is going to her children, that her estate will be subject to federal estate tax, that she has substantially all of her estate tax and GST tax exemptions remaining, and that her grandchild is the beneficiary of the IRA Trust. The purpose of leaving the Roth IRA to her grandchild is for a maximum "stretch" after she dies. This means that the IRA Trust can base its required minimum distributions over the grandchild's life, but the trust can provide ongoing oversight and asset protection. The Roth IRA will pass outside the grandmother's will, but is subject to estate tax and, because the money is going to a grandchild, the GST tax. If the will lacks an apportionment provision, the IRA Trust will have to pay the estate taxes. Assume that when

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the grandmother dies the Roth IRA is worth $3,000,000 and the estate taxes attributable to it are $1,500,000. If the IRA Trust has no source of funds other than the Roth IRA, it will have to liquate the IRA to create the funds to pay the estate taxes. This is not only not the desired result, it is disastrous. Better options include (1) having the parents of the grandchild pay the estate taxes, (2) having the grandmother's residuary estate pay the taxes and/or (3) having trust-owned life insurance proceeds available to cover the taxes. The planner and the client also need to be certain that the executor or executrix of the grandmother's will is authorized to allocate the grandmother's GST tax exemption to the Roth IRA. Otherwise, the GST tax will have to be paid on the amount of the Roth IRA.

3. These sorts of problems happen in real life. Recently, in August 2015, the Baltimore City Orphans' Court ruled that the estate taxes attributable to the estate of Tom Clancy, the famous author, must be paid exclusively from a trust for the benefit of the adult children of his first marriage, thereby exempting the share going to his widow and their child from paying any estate tax. The judge held that none of Alexandra Clancy's (the widow) two-thirds share of the $83 million estate can be used to pay the almost $12 million estate tax bill. Instead, the taxes must be paid out of the approximately $28.5 million trust Clancy left to his four adult children from his first marriage. In so holding, the judge noted, in relevant part, that the controversy was due to the convoluted and "inartfully drafted" estate tax allocation provision in the will.

Conclusion

The estate planner should obtain as much information as possible and avoid reliance on boilerplate provisions. If the estate planner feels that he or she does not have all the facts, it is generally advisable not to overrule the applicable state statute.

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