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Best Practices for Addressing Tax-Apportionment Clauses

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One of the most important but often overlooked provisions of a will is the tax-apportionment clause that controls how state and federal estate and inheritance taxes are allotted among the beneficiaries of an estate. Given the generally high tax rates that are in effect, the allocation of estate and inheritance taxes can have a huge impact on the distribution of a decedent's assets. All too often, however, this aspect of an estate plan is either ignored or not properly evaluated thereby frustrating the testator's true dispositive wishes. Several key issues need to be considered by the practitioner when addressing this aspect of a client's estate plan.

Statutory Overview

New Jersey and federal apportionment statutes govern the allocation of both state and federal taxes in the absence of an overriding tax-apportionment clause within a will or trust. In general, under New Jersey law, state and federal estate taxes generated by all probate property are paid out of the residuary estate, and state and federal estate taxes generated by non-probate assets are paid by the transferees of the non-probate property. The New Jersey inheritance tax is paid by the respective beneficiaries generating the tax.

Federal statutes override the state statutes as to certain assets includible in the gross estate, such as life insurance, property included under Internal Revenue Code § 2036, and Qualified Terminable Interest Property ("QTIP") property. Although the federal statutes override any state apportionment statutes, a tax apportionment provision in a will or trust will override both state and federal statutes. Some of these federal statutes are discussed in more detail below.

Common Pitfalls

Problems often arise when a client executes a will that apportions all estate and inheritance taxes to the residuary estate, thereby overriding New Jersey's proportionate allocation statute. A residuary tax clause, which may end up in a will as "boilerplate" that is not specifically considered by the draftsperson or the testator, can have a significant distortive effect in many situations, several of which are illustrated below.

Most individuals have significant non-probate assets such as life insurance policies, retirement plans, annuity contracts, and jointly-held real estate and other property. Although such property typically generates estate and inheritance taxes, if the decedent's will contains a residuary tax clause, the recipients of non-probate assets would receive such assets without paying estate and inheritance tax, and the entire estate tax burden would fall on the residuary beneficiaries. This can cause huge problems where the non-probate and residuary beneficiaries are not identical.

A residuary tax clause can also cause problems with the distribution of probate assets. A testator may bequeath specific property such as real estate or a fixed dollar amount to one or more beneficiaries and leave the residuary estate to others. Under a residuary tax clause, the residuary beneficiaries are paying estate taxes not only on what they are receiving but also on the property specifically bequeathed, which may not be what the testator intended.

Similarly, wills that do not contain a tax-apportionment clause, which means that the New Jersey apportionment statute applies, can also frustrate a client's intentions. In many instances, the client intends for specific property to pass to a beneficiary

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tax-free and that the taxes on such property be paid out of the residuary estate. Examples might include marital and charitable bequests (discussed below), recipients of specific dollar amounts and specific tangible personal property or other illiquid assets such as business and real estate interests. In these situations, the apportionment statute results in these beneficiaries paying their pro-rata share of estate taxes, which may not be what was intended.

There are many other situations where an estate plan can go awry because taxes are not allocated as a testator intended. To avoid this, an estate planner must take note of all probate and non-probate assets passing at death, understand how taxes are allocated and devise a tax apportionment approach that truly achieves what the client wants.

Potential Tax Pitfalls

Attorneys also need to carefully draft tax-apportionment clauses to take into account the impact of how estate and inheritance taxes are allocated and come up with a plan that fulfills the client's intent and creates the best overall tax result. Below is an explanation of some of the federal tax apportionment rules and some examples where a drafter may wish to override these rules.

- **Generation Skipping Transfer ("GST") taxes:** The code includes apportionment rules governing the payment of Generation Skipping Transfer ("GST") taxes. The general rule is that the person or trust that generates the GST tax pays such tax. The GST tax apportionment statute requires a specific reference to the GST tax in order to override the statute. A testator may choose to override this statute in some circumstances. For example, if a testator leaves a specific bequest to a grandchild, who is a skip person, and the testator's GST exemption does not cover the entire bequest, the testator may want the GST tax to be paid out of the residue and not reduce the amount passing to the grandchild.

- **QTIP Property:** If a deceased spouse leaves assets to a surviving spouse in a QTIP trust that qualifies for the marital deduction, the QTIP trust assets are included in the estate of the second spouse to die. Under federal law, absent an overriding provision in the will or trust to the contrary, the executor of the second spouse's estate has the right to recover from the QTIP trust the amount by which the estate taxes were increased as a result of the inclusion of the QTIP trust property.

A decedent may override this statute in a will or trust. However, unlike the New Jersey statute that can be overridden with a general tax-apportionment clause, this overriding provision must specifically reference either the QTIP statute or the QTIP trust.

A testator may want to override the federal statute if the QTIP trust included in the testator's estate is exempt from GST tax and the testator's other assets pass to the same beneficiaries as the QTIP trust assets. In this case, the testator will not want to pay taxes out of the GST exempt QTIP trust, which would happen under the statute, but instead, should direct in his or her will that any taxes owed as a result of the GST exempt QTIP trust's inclusion in his or her estate be paid out of the residue of the testator's estate. A testator may also want to specifically override this federal statute if the testator prefers that the QTIP beneficiaries pay their proportionate share of the taxes but not at the highest marginal rate.

- **Circular Taxes:** If a testator is leaving assets to a spouse and/or charities, the tax-apportionment clause needs to take into account the effect of the marital and charitable estate tax deductions. If the entire estate is passing to a spouse or charity, then there is no estate tax due to the deduction. However, if a will or trust leaves only some assets to a spouse or charity, thus creating an estate tax, it is important to discuss the payment of taxes with the client because of the circular computation that occurs when taxes are paid out of assets that are subject to a charitable or marital deduction. The circular calculation occurs because the deduction is calculated based on what the spouse or charity receives after payment of taxes and taxes are determined in part on what the spouse or charity receives.

For example, assume that a testator leaves 50 percent of his residuary estate to a charity and 50 percent to his son, resulting in an estate tax based on the amount passing to the son. If the will directs that this tax be paid out of the residue with no specific direction to pay it out of the son's share, it will be deemed to have been paid equally out of both shares. The payment of taxes will reduce the charity's share and reduce the charitable deduction. By reducing the charitable deduction, the taxable estate is increased, thereby increasing the amount of taxes, which reduces the charitable deduction, and so on. The result is that the estate will pay more taxes overall than if all of the taxes were allocated to the son's share in the first place. For this reason, it is important to make sure that taxes are not paid out of property subject to the marital or charitable deduction. If a client insists, make sure that the client understands the consequences.

There are other examples of property that may be included in an estate, such as §2036 property and gift taxes paid within three years of death, that require thought as to the proper beneficiary to pay the taxes.

A tax-apportionment clause is one of the most important provisions in a will or trust because taxes can constitute such a large percentage of an estate. Unfortunately, attorneys all too often ignore these clauses at their peril and at the peril of the beneficiaries. As discussed above, even if a will or trust does contain a tax-apportionment clause, directing payment of all taxes out of the residue may not be the best tax result for the beneficiaries and may not mirror the testator's intent. Therefore, it is imperative that drafters carefully evaluate the allocation of taxes and discuss this issue with the client to make sure the client's objectives are achieved. ■