

BASIC ISSUES OF ESTATE TAX APPORTIONMENT AND ACCOMPANYING PITFALLS

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When the authors committed to writing this article, the House had passed its version of the Federal Estate Tax bill which would have continued the estate tax rules and thresholds at 2009 levels. What we didn't know was that the Senate would allow the estate tax to lapse. While a presentation of the basic rules of estate tax apportionment and its pitfalls may appear inopportune given the present circumstances, the New York State Estate Tax remains. Even if the current federal law is not changed, the Federal Estate Tax will re-emerge in 2011. This being the case, the importance of successfully negotiating the rules and the pitfalls of estate tax apportionment remains as salient as ever.

The essential rules of estate tax apportionment statute have not changed since 1930. In that regard, the basic premise of estate tax apportionment, the default rule of "burden-on-the-recipient" is succinctly stated in EPTL § 2-1.8 (c)(1) as follows: Unless otherwise provided in the will or non-testamentary instrument, "[t]he tax shall be apportioned among the persons benefitted in the proportion that the value of the property or interest received by each such person benefitted bears to the total value of the property and interest received by all persons benefitted, the values as finally determined in the respective tax proceedings being the values to be used as the basis for apportionment of the respective taxes." In short, everyone who receives an interest subject to Federal and New York State Estate Taxes pays their equitable share. Despite the statute's apparent simplicity, problems interpreting the statute persist and improperly drafted exoneration clauses in testamentary and non-testamentary instruments continue to fail.

If the apportionment is based upon equity, why do so many wills and trusts contain exoneration clauses? Certainly there are times that the exoneration from estate taxes is consistent with the intention of the testator. The most likely cases involve pre-residuary pecuniary bequests of nominal monetary value or gifts of tangible personal property. The testator anticipates that the remaining assets of his or her estate will be able to absorb whatever nominal estate taxes are attributable to his pre-residuary bequests. However, if a testator's estate plan involves non-testamentary assets or dispositions to spouses or charities, things can easily go awry. As explained in detail below, even an experienced practitioner could cause serious, unintended consequences. Thus, extreme care is required in critically drafting the exoneration clause, making reasonably accurate projections of the estate taxes to be exonerated and understanding the impact of paying the exonerated taxes on the balance of the testator's plan.

Once a tax exoneration clause comes under review, it is subject to strict scrutiny. The Court of Appeals has long held that “[t]here is a strong policy in favor of statutory apportionment and those controverting its application must bear the burden of proof.”¹ The preference for statutory apportionment is given in light of the fact that the apportionment statute was “enacted to prevent the entire burden of an estate tax being borne by the residuary legatees, who generally are the principal objects of the decedent's bounty.”² Thus, courts have repeatedly held that each beneficiary will bear his share of the estate taxes “in the absence of a clear, unambiguous direction to the contrary in the will.”³ In case of doubt as to what a will means on the subject of estate taxes, the statutory direction to apportion taxes is absolute.

¹ *Matter of Shubert*, 10 N.Y.2d 461, 471 (1962).

² *In re Dettmer's Will*, 40 N.Y.S.2d 99, 103 (Surr. Ct. Kings Cty 1943).

³ *Shubert*, *supra* at 471.

While the determination of the sufficiency of a tax exoneration clause occurs in a will construction proceeding, the strict standard by which such determination is made is particular to tax apportionment cases. “The question of allocation should not be approached as would a construction question where in all events the meaning of the text must be determined from the content of the will. In a tax allocation problem the text of the will is to be scanned only to see if there is a clear direction not to apportion; and if such explicit direction is not found, construction of the text ceases because the statute states the rule.”⁴

The direction not to apportion must be “clear and unambiguous” in two respects. First, the direction to exonerate certain bequests from its share of taxes itself must be clear and unambiguous. In *Mills*,⁵ the clause “I direct that all estate, inheritance, transfer and succession taxes imposed upon my estate or any part hereof “ was construed to be initially ambiguous as to whether it referred to the decedent’s testamentary estate or the taxable estate. The court then noted that the words “my estate” appeared in the decedent will in several other instances but clearly referred only to the testamentary estate. Accordingly, the court limited the exoneration of estate taxes to the testamentary estate and apportioned taxes against the non-testamentary assets, two inter-vivos trusts.

Secondly, the testator’s directions of regarding the sources from which the taxes that were exonerated should be paid must also be “clear and unambiguous.”⁶ If, upon providing a clear direction that certain bequests are to be paid free of tax, the will is then silent as to the source of

⁴ *In re Mills Will*, 189 Misc. 136, 142 (Surr. Ct. N.Y. Cty 1946)(emphasis added).

⁵ *See id.*

⁶ *See Dettmer, supra* (statutory apportion applies “to all cases where the decedent by his will does not state in clear, definite and unmistakable terms the source or the method of the payment of the estate tax”).

payment for those exonerated taxes, statutory apportionment will nevertheless apply.⁷ In such a case, the bequests which were expressly exonerated pass free of estate tax and the estate taxes are apportioned against the other recipients of taxable assets.

Even if an exoneration clause appears to be clear and unambiguous on its face, it may be disrupted by other provisions of the Apportionment Statute acting in concert with the dispositive provisions of the will. Under EPTL §2-1.8(c)(2), any exemption or deduction allowed under the tax law by reason of the relationship of any person to the decedent, or the charitable purposes of the gift shall inure to the benefit of the person bearing such relationship or receiving such charitable gift, as the case may be. Significantly, the estate tax laws provide for unlimited marital and charitable deductions. In keeping with equity, such deductions should inure to the benefit of the spouse and charities because they reduce the taxable estate and would not otherwise affect the apportioned share of other tax recipients if the deduction was not granted by law. It is important to note, however, that not only does the apportionment statute allocate taxes, it exonerates spouses and charities from the payment of estate taxes.

A perfect example of how an otherwise clear and unambiguous exoneration clause was disrupted by the testator's plan can be found in the case *Matter of McKinney*.⁸ In *McKinney*, the decedent's will contained the following tax exoneration clause: "I direct that all of my estate transfer, inheritance and like taxes, including interest and penalties, if any, imposed or assessed by the United State of New York State Governments, or any duly constituted authority, upon or with respect to any property under this my Will, and any property passing outside my Will, which is required to be included in the taxable estate, including that property passing by the terms of

⁷ *See id.*

⁸ 477 N.Y.S.2d 367 (2d Dept. 1984).

trust created by me of this date, be paid out of my testamentary residuary estate herein and that no portion thereof shall be apportioned to or collected from the specific bequests contained in this Will or from distributions made from said trust.”⁹ In his residuary clause, the decedent left seventy percent (70%) of the residuary to a charity and thirty percent (30%) to a named individual. The court held that the two clauses, when read together, could be subject to two interpretations. First, the taxes could be paid “off the top” and both the charitable and non-charitable residuary bequests bear the payment of the tax. Second, because there was no explicit direction to pay the taxes off the top of the residuary and the charitable bequest is exonerated by statute, the non-charitable residuary interest must bear the burden of the estate tax liability. In holding that the latter interpretation was proper, the Second Department adopted the rules of statutory interpretation first enunciated by Surrogate Sobel in the *Matter of Olson*.¹⁰

1. When the will does not include any tax exoneration provision and the statutory rule of “burden-on-the-recipient” applies, a disposition to a surviving spouse or charity will receive the benefit of the tax deduction by virtue of the express provision of the tax apportionment statute (EPTL 2-1.8(c)[2]). That statute directs that the marital deduction or the charitable deduction “shall inure to the benefit” of the spouse or charity. This is as it should be. Such qualified dispositions are deducted from the gross estate reducing the taxable estate to those assets passing to beneficiaries other than the spouse or charity. In consequence total estate taxes are reduced and the taxes as reduced are apportioned solely against the recipients of dispositions not entitled to the marital or charitable deduction.

2. When the will contains a tax exoneration clause exonerating only specified dispositions, whether so exonerated or not, a disposition to the spouse or charity is exonerated by the express provision of the statute (EPTL 2-1.8, subd. [c], par. [2]). The other recipients bear the burden of the estate tax on the specifically exonerated dispositions.

⁹ *Id.* at 369.

¹⁰ See *McKinney, supra* at 371 (citing *Matter of Olson*, 77 Misc. 2d 515 (Surr. Ct. Kings Cty 1974)).

3. a. When the will contains a general tax exoneration provision directing that all estate taxes be paid out of the "residuary estate", "general estate", "principal of the estate" or words of like import, such a direction for reasons detailed infra does not exonerate a residuary disposition or multiple intra-residuary dispositions. Within the residuary the tax apportionment statute (EPTL 2-1.8) must be applied. The executor is required first to compute the estate tax on the pre-residuary dispositions, and deduct that sum "off the top" of the residuary thus reducing the residuary estate.

b. When the residuary includes a pecuniary disposition in a fixed sum qualifying for the marital or charitable deduction, such disposition will pay no part of the estate taxes. The remaining non-exonerated intra-residuary dispositions will bear the burden of all estate taxes including those on the exonerated pre-residuary disposition and those on the residuary dispositions. This again is by virtue of the tax apportionment statute (EPTL 2-1.8, subd. [c], par. [2]) which directs that all tax deductions shall inure to the benefit of the qualifying dispositions.¹¹

As the *McKinney* case exposes, an otherwise clear and unambiguous exoneration clause can fail to the extent that there can be apportionment within the residuary.

Even if one successfully negotiates this pitfall and causes the estate taxes to be charged against a marital or charitable bequest, a challenge to the exoneration clause is likely to ensue. Although not related to the issue of tax apportionment, the charging of estate taxes to a charitable or marital interest causes what is known as the "interrelated calculation" as it relates to the charitable and marital deduction. Simply stated, the marital/charitable deduction must be reduced by the amount of taxes which the marital/charitable interest must bear. That reduced deduction increases the taxes. The increased taxes are then utilized to further reduce the deduction, which further increases the taxes, and so on and so forth. Hence, the interrelated calculation. The effect of this scenario not only causes the spouse or charity to pay the estate tax, but the overall estate liability ends up being more than if the draftsman/testator had just decided to rely on apportionment.

¹¹ *Olson, supra* at 518-519.

This article has covered the pitfalls that may arise from just the basic issues involving estate tax apportionment. Cases that involve exoneration clause in multiple documents are covered by the rules set forth in EPTL § 2-1.8 (d) and require a separate discussion. As you can imagine, the problems involving those scenarios become magnified.

In conclusion, when dealing with issues of estate tax apportionment: 1) never, ever treat an estate tax exoneration clause as boilerplate language and 2) if you are unsure how your exoneration clause will operate or you suspect that your client has not provided all the necessary information to make a complete estate plan, say nothing and let the statute operate. After all, what's wrong with everybody paying their fair share!