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TAX CLAUSES TO DIE FOR

By Daniel B. Evans

Is a direction in a will that all death taxes shall be paid from the residue of the estate an example of malpractice *per se*?

Before you snort and turn the page, consider the large number (and potential value) of the assets that might be included in the gross estate for federal estate tax purposes in accordance with the Internal Revenue Code ("Code") even though the assets do not pass under the will:

- revocable trusts, as well as property held "in trust for" or "payable on death" to a named beneficiary (Code § 2038);
- property in joint names with right of survivorship (Code § 2040);
- life insurance that the decedent owned (or in which the decedent had an "incident of ownership") and that is payable to a beneficiary other than the estate (Code § 2042);
- qualified retirement benefits, individual retirement accounts, and other forms of annuities with a named beneficiary (Code § 2039);
- trusts over which the decedent had a general power of appointment, such as a marital deduction trust created before 1982 (Code § 2041);
- trusts for which a qualified terminable interest property (QTIP) election was made to qualify the trust for a gift tax or estate tax marital deduction (Code § 2044);
- property transferred by the decedent with a retained power or interest, such as a transfer of a residence with a retained life estate, a "qualified personal residence trust," or a charitable remainder trust with a succeeding noncharitable beneficiary (Code § 2036); and
- property subject to a contract that is legally binding but does not reduce the value of the property for federal estate tax purposes, such as a business buy-sell agreement with a family member (Code § 2703).

Although the beneficiaries of these kinds of transfers are *usually* the same as the beneficiaries of the residue of the estate, they don't have to be and, if they aren't, then whether the death taxes are paid out of the residue or are apportioned among all of the assets of the gross estate can make a big difference.

For example, consider a marital deduction trust (with a general power of appointment) created for the benefit of a husband in a second (or third) marriage, the remaindermen being the deceased wife's children from an earli-

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er marriage. On the death of the husband, the entire marital trust will be subject to federal estate tax. If the husband's will leaves his estate to his own children but specifies that all death taxes should be paid from the residue of his estate, his children will be paying the estate tax on assets passing to his stepchildren. Depending on the respective values of the marital trust and the husband's estate, this could be catastrophic. If the marital trust is large enough, the beneficiaries of the residue of the estate could receive *nothing.* (In 2006, a marital trust of $4 million would result in enough federal estate tax to wipe out a probate estate of $1.7 million, because the estate tax on the combined $5.7 million would be slightly more than $1.7 million.)

It is also possible for a parent to create a benefit for one child without realizing the effect on the other children. So a parent who transfers a residence or a bank or brokerage account into joint ownership with one child, or who makes one child the beneficiary of a life insurance policy or retirement benefit, might not have any idea of the potential tax burden on the other children. For example, consider a parent with two adult children, a son and a daughter, and a $5 million estate consisting of $4 million in investments and a $1 million home. If the son lives with the parent, the parent might put the house in joint ownership with the son, figuring that $2 million is enough for the daughter and that a 40–60 split is close enough to 50–50. But the daughter is not going to get $2 million if the parent's will directs all death taxes to be paid from the residue. If the parent dies in 2006, the federal estate tax will be $1.38 million, which means that the after-tax residue is $2.62 million and each child's share of the residue is $1.32 million. So, instead of receiving the $2 million that is 40% of the pre-tax estate (or even the $1.81 million that is 50% of the gross estate after taxes), the daughter will receive only $1.32 million, which is about 36.5% of the after-tax estate. Is that what the parent expected? Probably not. And if the parent expressed her expectations to her children, the difference between those expectations and what actually happens could make for a very unhappy daughter. Unhappy beneficiaries often litigate, typically against the lawyer who wrote the will.

Doing Nothing

Directing that all taxes be paid from the residue can produce a result quite different from what happens without the direction, because federal law and state law usually direct the apportionment of taxes among nonprobate assets.

Federal law includes the following provisions for the payment of the federal estate tax:

- Beneficiaries of life insurance policies can be required to contribute their proportionate shares of the federal estate tax (Code § 2206).
- Property subject to a general power of appointment is also subject to a proportionate share of the federal estate tax (Code § 2207).
- QTIP trusts are required to pay the net increase in federal estate tax resulting from the inclusion of the trust in the gross estate (Code § 2207A).
- Property over which the decedent has retained the use or income during lifetime (and thus included in the gross estate under Code § 2036) is subject to a proportionate share of the federal estate tax (Code § 2207).

All of these rights can be waived in the decedent's will. The first two can be waived by a general waiver or a direction to pay all death taxes, but the second two require a more specific waiver (which will protect some beneficiaries from the foolishness of testators and their lawyers).

More important, the Uniform Estate Tax Apportionment Act, the Uniform Probate Code, and the laws of most states direct that death taxes be equitably apportioned (that is, allocated in proportion to value) between the probate estate and the taxable assets passing outside of the probate estate. See, e.g., UPC § 3-916. So, if one fourth of the federal gross estate consists of retirement plan benefits, the beneficiary of the retirement plan benefits should pay one-fourth of the federal estate tax.

Thus, a will that has no tax clause will usually result in the apportionment of the federal estate tax among the beneficiaries of the gross estate in proportion to the value of their interests, while a direction that all death taxes be paid from the residue can result in a significant reduction, or perhaps depletion, of the probate estate.

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The provisions of federal law and state law that are described above represent the judgment of legislators that, unless the testator directs otherwise, the burden of death taxes should be divided among the beneficiaries in proportion to the value of their interests, and that this apportionment of taxes will most often carry out the intentions of the testator. Sometimes there are circumstances in which it might be better (or the client might prefer) that the estate tax on a particular nonprobate asset should be paid out of the residue of the estate, but a lawyer should not countermand the general principle of tax apportionment without a good reason. Are there any?

Rationalizations

For many lawyers, directing that the taxes be paid from the residue appears to be a kind of habit or reflex, like wearing a coat and tie. When pressed,

estate planners often give one or more of four reasons for directing that all death taxes be paid from the residue of the estate.

Client Expectations

Many practitioners seem to believe that "pay all taxes from the residue" is what clients expect, which is nonsense. Most clients barely understand how to calculate the federal and state death taxes and certainly do not understand how the burden of the taxes can be shifted among beneficiaries.

Furthermore, the residue of an estate usually passes to the persons that the testator most wants to benefit, and the proportions expressed for those beneficiaries usually represent the general intent of the testator. Anything that could reduce the interests of those beneficiaries, or change the proportions of the interests of those beneficiaries, is likely to be *contrary* to the intentions of the testator.

It is probably correct that a direction in a will for a beneficiary to receive $10,000 (or a particular item of jewelry) expresses the intention of the testator that the beneficiary receive that amount or that item free of tax, so that the tax on that gift must be paid by the residue of the estate, but that same intention cannot be transferred reliably to a joint account, "in trust for" account, IRA beneficiary designation, or life insurance beneficiary designation.

Liquidity

Many practitioners seem to assume that the residue of the estate is a source of liquidity, hence that the taxes should be paid from the residue even if there is no effect on the burden of the tax because it is easier to pay taxes from the more liquid residue than from jointly owned real estate or other assets passing outside of the probate estate. This assumption is probably wrong more often than it is right.

In the author's experience, the most common nonprobate assets included in the federal gross estate are jointly owned (or "in trust for") bank accounts and brokerage accounts, life insurance proceeds, and retirement benefits. Life insurance is one of the most liquid of all assets, the proceeds being payable in cash within a short time after death. Bank accounts and brokerage accounts in joint names (or "in trust for") also represent either cash or marketable securities readily reducible to cash. Any trust funds that might be included in the federal gross estate, such as marital deduction trusts, usually represent marketable securities as well, and should be considered liquid. The only assets that should be considered illiquid are retirement benefits, and then only because of the tax advantages of the deferral of payment, and real estate that is either in joint ownership with the decedent or that was transferred by the decedent while retaining the income or use of the property; here, tax apportionment will cause a problem for a beneficiary only if he or she is not receiving any other benefit from the estate that could be used to pay a proportionate share of the death taxes *and* the beneficiary either does not wish to sell the property or is unable to sell (or mortgage) the property before the estate tax is due. This unlikely combination of circumstances is no reason to run the risk of distorting the client's estate plan by routinely directing that all taxes be paid from the residue.

Convenience

Some lawyers have objected to the effort of apportionment and prefer the convenience of paying all of the taxes from one source, the residue of the estate. The idea of calculating the fractions of the gross estate represented by each asset passing outside of the will, apportioning the death taxes accordingly, and then collecting the apportioned taxes from the beneficiaries of each asset seems to them to be too much work.

Of course, if apportionment does not affect the shares of the beneficiaries (because the beneficiaries of the nonprobate assets are the same as the beneficiaries of the probate assets), then it does not need to be done, regardless of what the will says, because the beneficiaries can agree to the payment of taxes from the residue of the estate. The alternative is for the beneficiaries to pay their shares of the death taxes to the executor, and then later receive back a distribution of the same amount as part of the distribution of the estate, an obvious waste of time.

Requiring apportionment in all cases is therefore relatively risk-free. If apportionment turns out to be irrelevant to the beneficiaries, then the apportionment does not need to be done. But if apportionment changes the shares of the beneficiaries, then apportionment should be waived only to carry out the wishes of the testator or for some other good reason.

Should taxes be paid from the residue as a matter of convenience to the executor (or the executor's lawyer) regardless of the consequences for the beneficiaries? To state this question is to answer it. The primary goal of estate planning is to divide the client's

assets according to the client's wishes, and the tax clause can affect the division of assets. If the client makes an informed decision to pay all taxes from the residue, that is one thing, but large sums of money should not change hands without the client's conscious decision merely for the convenience of the executor.

Certainty

Many practitioners seem to believe that a consideration of all of the different types of nonprobate assets that *might* be included in the estate is not necessary, because they *know* what the client owns, and estate tax apportionment is not needed.

The problem with this response is that many of the assets that can be included in the federal gross estate are arranged by the client without the advice of a lawyer. A lawyer can be very diligent in ascertaining all of the client's assets, but the client can go out and open a joint bank account or "pay on death" brokerage account (or change beneficiary designations) the very next day.

So you never know. The nonprobate transfers that can be included in the gross estate are too common, and can be arranged too easily, to rely on the hope that your client will do nothing unexpected.

Apportionment Advantages

As shown above, the arguments in favor of paying all taxes from the residue do not bear close scrutiny, while a failure to apportion taxes could distort the interests of the beneficiaries. Furthermore, it might be advantageous to require apportionment of taxes even if there is no change in the relative interests of the beneficiaries, because requiring that death taxes be paid from assets passing outside of the will can increase the net after-tax value of the assets passing under the will and so increase the value of the assets subject to the will's disability provisions or spendthrift provisions.

For example, suppose that, after the execution of the will and before the death of the testator (or before the distribution of the estate), one of the testator's adult children suffers an incapacitating accident or illness. Under a disability clause in the will, the executor can withhold that share of the estate and apply the income and principal for the child as needed, but retirement benefits, jointly owned property, or other assets passing to the child directly and outside of the will might require the appointment of a guardian. By requiring the estate of the incapacitated child to reimburse the parent's estate for the child's share of estate taxes, the executor can reduce the assets subject to the guardianship proceedings and increase the assets subject to the disability provisions of the will. This would probably not eliminate the need for the guardianship proceedings, but it might reduce the duration and cost of the guardianship.

A similar situation might arise if a beneficiary developed creditor problems and the will included both an enforceable spendthrift clause and a minority or disability clause applicable to an adult unable to manage financial affairs. If the beneficiary understood the problem and agreed to the arrangement, the beneficiary might be able to pay his share of death taxes into the estate before his other creditors could reach those assets, creating a larger fund for the support of the beneficiary until the creditor issues are resolved. The cooperation of the beneficiary is necessary, because if the beneficiary is truly insolvent and truly irresponsible, he might spend the nonprobate asset before the executor can act, leaving the executor with nothing but a right of recovery against someone with no assets.

When Not to Apportion

There are three types of assets for which it is usually best not to apportion: assets passing outside of the will that qualify for the federal estate tax marital or charitable deductions but that might be subject to some state death tax or foreign tax, and trusts that are wholly or partially exempt from federal generation-skipping tax but subject to federal estate tax because of a "reverse QTIP election."

Assets passing outside of an estate that qualify for the federal estate tax marital deduction are quite common and include life insurance, retirement benefits, and all assets owned jointly by a husband and wife (although only half of the asset is included in the gross estate under Code § 2040(b)). But the marital deduction will be reduced if any death tax is payable by the surviving spouse on those assets (Treas. Reg. § 20.2056(b)-4(c)), which could cause problems in estates in which marital deduction planning is

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important. Although it does not appear that any state would impose a death tax on a nonprobate asset qualifying for the federal estate tax marital deduction, some foreign countries might. In any case, the safest course of action should be to direct that any death tax on assets otherwise qualifying for the marital deduction should be paid from the estate.

Similar considerations apply if there are assets passing outside of the will that qualify for the federal charitable deduction in whole or in part. See Code § 2051(c). Payment of death taxes by the estate of the grantor of an inter-vivos charitable remainder trust will often be appropriate if the grantor has retained an interest during his or her lifetime and there is a succeeding noncharitable beneficiary, because otherwise the trust document will require the beneficiary to pay the death taxes attributable to the trust, and the beneficiary may not have the funds to pay those taxes. See Rev. Rul. 82-128, 1982-2 C.B. 71.

The third type of asset for which it is probably best not to apportion death taxes is a generation-skipping

trust for which a "reverse QTIP" election has been made in accordance with Code § 2652(a)(3). Under the generation-skipping tax regulations, it is permissible to pay the federal estate tax on that kind of trust without being considered to have made a constructive addition to that trust, so that the same inclusion ratio will continue to apply. See Treas. Reg. § 26.2652-1(a)(5), ex. 8. If the goal is to maximize the value of assets passing free of federal generation-skipping tax, then usually it will be best for tax purposes for a decedent who is the beneficiary of the QTIP trust to pay the federal estate tax on the trust out of the decedent's own assets. There may be nontax reasons to require apportionment, however, such as whether the remaindermen of the QTIP trust are related to the decedent or are persons whom the decedent wishes to benefit.

Discretion

Desiring to avoid unnecessary apportionment and yet avoid disasters, some practitioners decide to give the executor (or the trustee of a revocable trust) the discretion to apportion or not. This is seen most frequently in revocable trusts from which the executor has the discretion, but not the obligation, to get additional funds to pay death taxes, but this kind of direction is sometimes seen even in otherwise simple wills. In either case, it is a mistake.

One problem is a lack of any standard to guide the executor (or trustee) in making the decision. In exercising discretion to exercise most kinds of tax elections, the usual goal is to minimize the total tax burden of the estate and beneficiaries, but in questions of apportionment the total tax burden will usually be the same whether or not the taxes are apportioned. So what criterion is the executor to apply? Is it a question of convenience to the executor? Whether the beneficiaries will have the funds to pay apportioned taxes? Or is the executor supposed to channel the spirit of the decedent to determine the decedent's wishes on a matter that the decedent never actually considered?

If the discretion of the executor is unrestricted, then the executor has what amounts to a power of appointment to change the beneficial shares of the estate, which seems weirdly inconsistent with the directions in the rest of the will. The executor is not given any discretion over the division of the estate (for example, no one writes, "I give my daughter between 40% and 60% of my estate, as my executor, in her sole discretion, shall determine"), so why should the executor be given the discretion to reduce or enlarge beneficial interests in nonprobate assets by requiring or not requiring the apportionment of death taxes?

This kind of discretion would seem to be a surefire prescription for litigation, particularly if the executor is one of the beneficiaries and can use the discretion to increase his or her share of the estate at the expense of others. A grant of discretion to the executor does little to diminish the prospects for unhappy beneficiaries and litigation but simply changes the issue to be litigated from whether the attorney committed malpractice in drafting the will to whether the executor abused his or her discretion.

Sample Tax Clauses

For all of the reasons described above, it is best to start with the presumption that the client's probate estate should pay only the death taxes on the assets that pass as part of the probate estate, together with the death taxes on any assets qualifying for the federal estate tax marital deduction, and that all other taxes should be apportioned as allowed by law. In the course of reviewing the estate plan with the client, it may be determined that there are some nonprobate assets for which the taxes should be paid from the probate estate, but those should be exceptions to the rule, and the "standard" tax clause should require apportionment of the taxes on nonprobate assets.

Most state statutes require that death taxes on pre-residuary gifts be paid from the residue, and that is probably what most clients expect (that is, a gift of $10,000, or a specific gift of a family heirloom, should be free of tax to the recipient). But there can be exceptions to this principle, particularly when the client wants a family business, farm, residence, or vacation property to go to one particular child (or group of children), and yet the client wishes to treat all of the

children (or other beneficiaries) with some degree of equality.

If the lawyer calculates the projected death taxes and the effect of those taxes on the distributive shares, and then the lawyer and client decide to pay death taxes in a way that is different from the standard clause, the most likely consequence is that the lawyer will make any necessary adjustments by carving out exceptions from a standard tax clause, not by inserting an entirely different clause.

For a married client, the following clause should fulfill these goals:

> My executors shall pay from [the nonmarital portion of] my residuary estate all death taxes payable by reason of my death with respect

to (1) all property and interests passing under my will and (2) all property and interests that pass to my [husband or wife] outside of my will and that could qualify for the federal estate tax marital deduction. To the fullest extent allowable by law or any governing instrument, my executors shall recover from any property or interest passing outside of my will all other death taxes that my executors may be required to pay by reason of my death.

This clause does not explicitly mention apportionment but directs the executor to pay the taxes "with respect to" the probate estate and marital deduction property and to recover all other taxes "to the fullest extent allowed by law or any governing instrument." In most cases, "allowable by law" will mean apportionment.

The reference to "the nonmarital portion of" the residuary estate is for those estate plans in which the residue is divided so that only a part of the residue qualifies for the federal estate tax marital deduction, and the words "nonmarital portion" should be changed to whatever terminology is used in the rest of the will to describe the part of the residue that is not intended to qualify for the marital deduction.

For an unmarried client, the clause would be somewhat simpler:

My executors shall pay from my residuary estate all death taxes payable by reason of my death with respect to all property and interests passing under my will. To the fullest extent allowable by law or any governing instrument, my executors shall recover from any property or interest passing outside of my will all other death taxes that my executors may be required to pay by reason of my death.

For a married client for whom generation-skipping planning is relevant, and who might be the beneficiary of a marital deduction trust for which a "reverse QTIP" election has been made, the following clause should be appropriate:

My executors shall pay from my residuary estate all death taxes payable by reason of my death with respect to all property and interests passing under (a) my will and (b) any trust created by my [husband or wife], [name], that is included in my gross estate by reason of section 2044 of the Internal Revenue Code but of which I am not considered to be the grantor for federal generation-skipping tax purposes. To the fullest extent allowable by law or any governing instrument, my executors shall recover from any property or interest passing outside of my will all other death taxes that my executors may be required to pay by reason of my death.

In the same section of the will, or a later definitional section, there should be some definitions:

"Death taxes" shall include all inheritance, estate, transfer, and succession taxes, federal, state, and foreign, but shall not include any generation-skipping transfer tax under Chapter 13 of the Internal Revenue Code, and "taxes" shall include any interest or penalties that may be added to taxes.

All references to federal estate, gift, and income tax laws, or to a specific section of the Internal Revenue Code, shall be references to the relevant section or sections of the Internal Revenue Code of 1986, as amended from time to time before or after my death, or to any similar provisions of any future federal revenue law.

Finally, a funded revocable trust that is part of an estate plan with a "pour-over will" might include the following tax clause:

If my residuary estate is not sufficient to pay all death taxes that my executors are directed to pay from my residuary estate in accordance with the provisions of my will, the trustees shall distribute to the executors of my estate an amount sufficient to pay those death taxes. However, my trustees shall not distribute to my executors any property that is not subject to a death tax payable by my executors if other trust assets are available for distribution and those other assets are subject to all of the death taxes payable by my executors.

Conclusion

The core problem with a direction to pay all taxes from the residue of an estate is that it is usually either irrelevant or disastrous. If the beneficiaries of the residuary estate are the same as the beneficiaries of the taxable estate (that is, the assets passing outside of the will are divided in approximately the same manner as the residuary estate), then the direction is largely meaningless, because the benefits received by each beneficiary and the net tax burden payable from each beneficiary's interests should be the same regardless of the source of the tax payments. If the beneficiaries of the residuary estate are not the same as the beneficiaries of the taxable estate, however, the result can be a disaster, because the residuary beneficiaries are usually the primary objects of the testator's estate plan, and the residue might be obligated to pay a large tax bill for assets that do not benefit those beneficiaries or might not even benefit anyone in the testator's family.

Ideally, the apportionment of death taxes will be considered explicitly during the estate planning process, but the estate planner still needs to consider the consequences of the testator making changes to the title of assets and to beneficiary designations without consulting the planner. Given this uncertainty and the dangers of directing that all taxes be paid from the residue, the safest course of action is to presume that death taxes payable on nonprobate assets should be paid by the beneficiaries of those assets and not the probate estate. ■