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Tough Problems in Estate Planning: Tax Issues

Apportionment
of
Slime???





Apportionment
of Taxes



Apportionment Problems in Planning:

1. Beneficiaries may be subject to different tax rates so impact on residuary beneficiaries if specific bequest
2. Affects size of bequests—if apportioned to bequest then beneficiary may not receive amount decedent wanted


When Apportionment is NOT Applicable

- ▶ No tax is due
- ▶ All property, both probate & non-probate, pass to the same people in same shares



Estates that Require Tax Apportionment Discussion

- ▶ Estate is likely to generate state or federal death tax
- ▶ Different instruments direct property to different beneficiaries in different states
- ▶ Substantial credits or deductions available to reduce portion of tax due
- ▶ Substantial portion of estate is composed of non-probate property






Take note of non-probate asset distribution

Apportionment Alternatives

- Default Rule: Taxes are paid from the residuary estate
 - Simplest & easiest form of apportionment from drafting & administration perspective
 - Allows Executor access to & control over the assets to pay the tax



Apportionment Alternatives

- Inside Apportionment: taxes allocated among all classes of bequests inside the probate estate
 - Each beneficiary under the Will bears pro rata share of taxes
 - Protects residuary beneficiaries by allocating tax to all bequests on pro rata basis
 - If specific bequest is specific property, does decedent want property to be distributed intact without liquidation? Inside apportionment may defeat decedent's intent to pass specific property to particular individuals since individual may need to liquidate property to pay pro rata share of tax

Apportionment Alternatives

- Outside Apportionment: burden of tax is allocated to property passing under the Will and property passing outside the Will, which is includible in decedent's estate for estate tax purposes
 - Usually spouse & children are residuary beneficiaries so if residue pays tax on non-probate assets then opposite of what decedent wanted
 - Most states have state apportionment statute that directs outside apportionment

Issues with Outside Apportionment

- Adds complexity to administration of the estate—Executor does not have control over the property & may not be able to collect the tax due on the property from the current owner
- If Will directs outside apportionment, & executor is unable to collect money (\$ already spent) then Will should direct secondary source for payment

Classes of Property Subject to Outside Apportionment:

- 
 Property transferred or powers relinquished within 3 years of decedent's death & includible in his or her estate for estate tax purposes [IRC 2035]
- 
 Property that falls under IRC 2036, 2037, 2038, 2039, 2041, 2042, and 2044

Does Client want to have probate estate bear burden for the tax due on non-probate assets?

- Has client identified all non-probate assets that are subject to tax @ death?
- Qualified accounts could represent a sizable amount of estate & to preserve income tax benefits, may not want tax allocated to funds
 - Funds withdrawn are subject to income tax
 - Does beneficiary have funds to pay tax if the account is not distributed in lump sum?
 - Does plan permit apportionment of tax against the plan itself or the withdrawal of funds from the account to be used to pay tax?

Equitable Apportionment

- Should bequest of property which generates exemption or deduction enjoy full benefit of exemption or deduction?
- Apportionment without equitable apportionment increases the total tax due, but increases the size of the shares passing to non-charitable or non-marital beneficiaries which the decedent may have wanted




Situations where Equitable Apportionment may create issues:

- Whether spousal intestate share is determined before or after the reduction in value of the estate for estate taxes
- Whether a spousal elective share is calculated based on the value of the estate before or after taxes are paid
- Whether a fractional residuary bequest or an interest to charity is determined based on the gross value of the residuary or the net value after taxes are paid.

Considerations when determining if marital or charitable bequests should bear portion of taxes:

- ▶ Does client want to minimize the total estate tax to be paid? Equitable apportionment will do that
- ▶ Does client want to equalize the shares passing to spouse or charity with those of other beneficiaries? If so, client wants tax deducted first and then divide the estate to the beneficiaries
 - ▶ Total tax paid is higher but non-charitable, non-marital beneficiaries receive more

Coordinating Across Entire Estate Plan

-  If multiple documents, then consider apportionment under each document
-  Provisions should create coordinated tax apportionment plan
-  Does each document have authority to govern payment of taxes for property other than the property passing under the document?

Ways to allocate among the documents:

- ▶ Each document provides that all taxes are paid from the probate estate
 - ▶ Issues of inside & equitable apportionment is addressed within the probate estate
 - ▶ Include in documents & Will an alternative source of payment in case probate estate doesn't have liquidity
- ▶ Will & trust provide that taxes are paid from trust to extent probate assets are insufficient
- ▶ Will & Trust provide tax paid from revocable trust
 - ▶ Inside & equitable apportionment needs to be included & be the same in both documents
 - ▶ If to be paid from RLT then include apportionment clause in Will too

Ways to allocate among the documents:

- ▶ Irrevocable trust could authorize trustee to buy assets from probate estate or RLT or lend money to probate estate or RLT
- ▶ Include provision regarding payment of tax in the event that assets of trust are determined to be includable in decedent's estate for federal estate tax purposes
- ▶ Coordinate tax apportionment between Husband & Wife

Tips when Drafting Tax Apportionment Clauses:

1) Discuss Tax Apportionment

- Apportionment changes size of beneficiary's share
- Changes the control Executor has over assets to pay tax
- Changes the liquidity of estate



Tips when Drafting Tax Apportionment Clauses:

2) Include Tax Apportionment Clause in Will 100% of time

- ▶ Client may move to another state where statutory default is different
- ▶ Statute can be modified over time
- ▶ Client may have assets outside PA

3) Avoid Blanket Waiver of Outside App

- Value of non-probate may be higher
- Includible in decedent's estate
- Client may want specific non-probate property to pass without tax burden



Tips when Drafting Tax Apportionment Clauses:

- 4) Avoid Blanket Waiver of Inside Apportionment
 - ▶ Client may exempt specific bequest to avoid subjecting beneficiaries of tangible personal property to tax
 - ▶ Value of certain items could be more than client expects & residuary beneficiaries bear burden
 - ▶ Limit specific bequests to specific value or % of estate



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