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The Estate Tax **Apportionment** Clause: Friend Or Foe?

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EPTL §2-1.8 provides that, in the absence of a testamentary provision to the contrary, each beneficiary of a will shall be required to pay his pro-rata portion of estate taxes.[1] What is also contemplated by this section, however, is the possible inclusion by a testator in his or her will, of a tax apportionment clause in order to relieve certain of the named beneficiaries of the responsibility of paying their pro-rata share of such taxes.[2]

This is most usually accomplished by providing that all taxes due upon the death of the testator, whether passing by will or by operation of law, are to be paid from the residuary estate and not shared pro-rata by all beneficiaries.

This provision can have far-reaching implications which directly affect the testamentary scheme devised for a testator, such that a prudent draftsman must not neglect tax apportionment issues when considering how to effectuate an estate plan. When constructing the plan, the draftsman must take into account property owned by the testator which may pass by operation of law at the time of the testator's death. While these assets pass outside of the will and as such, are not probate assets, they are includible in the gross estate for estate tax purposes.

A further complicating consideration is that while these assets may not exist at the moment a plan is effectuated, one must plan in the event the testator acquires them in the future. These types of assets include life insurance policies, jointly held real estate, IRAs and pension plan distributions. Commonly, apportionment clauses provide that all of the death taxes shall be paid out of the residuary estate; however, after inclusion of the value of the presently existing or thereafter acquired non-probate assets, the residuary estate may, after payment of the tax, be rendered insolvent. This may not truly be the intent of the testator.

Clearly it is the task of the attorney draftsman to be certain that the testator considers all of the options available as well as the assets from which the tax burden is to be met, so that the testator has a clear understanding of which beneficiaries are bearing the burden of the estate taxes. It is critical, therefore, that the client understands that the failure to apportion taxes among his or her beneficiaries can greatly affect the rights of inheritance of the residuary beneficiary, who may after payment of the tax, see his or her inheritance substantially reduced, in some cases to zero.

Simply put, taxes and the allocation of the burden to pay them, can have a profound impact on the testamentary scheme contemplated by the testator. It is this possibility that should make even the most experienced draftsman amongst us sit up and take note before altering the statutory scheme and delegating the payment of tax to the residuary estate in a pro forma will clause.

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To take this analysis one step further, should one be considering specifying that all taxes due upon the death of the testator with respect to property passing both under and outside of the will are to be paid, without apportionment, out of the residuary estate, it is imperative to inform the client that those who benefit from non-probate assets are considered beneficiaries of an estate and are affected by the inclusion of a tax apportionment clause.[3]

The client must understand that all specific legatees and all beneficiaries of non-probate assets will receive their gifts free and clear of any taxes, while the assets left to the beneficiary of the residuary estate are significantly, if not completely, exhausted. Hence, the drafter, in assisting the testator in determining how or if to shift the tax burden amongst beneficiaries must inquire if non-probate assets such as life insurance proceeds, IRAs and pension plan distributions exist, because all are includible in the taxable estate.

In such a situation, the existence of the typical tax apportionment clause will inure to the beneficiaries of these non-probate assets far beyond what the testator may have intended. This result can be especially onerous when the beneficiary of a large life insurance policy, the proceeds of which pass outside of the estate but are includible in the taxable estate, receives the proceeds of the policy without the concurrent responsibility to pay estate taxes upon that sum, while the person named as the residuary beneficiary must, as a result of the non-apportionment clause, pay taxes on the policy as part of the payment of all taxes from the residuary estate.

If the drafter of the will does not inquire as to the non-probate assets and the intent of the testator with respect to taxes due and payable on the same, and includes an apportionment clause

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which does not impose the attendant tax burden on the beneficiary of each non-probate asset pro-rata, the testamentary scheme envisioned by the testator may be rendered ineffectual as a result of the imposition of an unintended tax liability upon the residuary beneficiary and the corresponding windfall to the beneficiary of the non-probate assets.

Such a provision was recently adjudicated in the Surrogate's Court, New York County, in *Matter of Wu*, where, despite the existence of an apportionment clause which directed that all estate taxes be paid from estate assets as a debt of the decedent, the court found a creative way to shift the attendant tax burden to the non-probate beneficiary of a $3 million life insurance policy.

Brother and Witness

Harry Wu, brother of the decedent, Cynthia Wu, was one of two witnesses to her will. Mr. Wu, unbeknownst to himself, was also the beneficiary of a life insurance policy.[4] The will in question included a non-apportionment clause which provided that all estate taxes be paid by the executor of the estate as if the taxes were the decedent's debts.[5] Thus, Mr. Wu was entitled to the value of the life insurance policy without the burden of paying his portion of the estate taxes. The decedent's husband, the residuary beneficiary, brought a proceeding before the Surrogate seeking to charge Mr. Wu his share of estate tax.

The controversy in this case arose due to the fact that Mr. Wu was a witness to the decedent's will.[6] Mr. Wu argued that at the time he witnessed the will, he did not know he was a beneficiary of a life insurance policy and thus should not be made to suffer a penalty by the payment of tax from the proceeds of the policy.

In reaching its decision and directing that Mr. Wu pay his proportionate share of the tax, the court found that his testimony was necessary to the probate of the will and therefore, that the tax exoneration non-apportionment clause was invalid as to him. The court reasoned that a witness to a will may not benefit from the same and that the discharge of the obligation to pay taxes as a result of the non-apportionment clause was, in and of itself, a benefit to Mr. Wu (whether he was aware of it or not), since the EPTL would have allocated his pro-rata share of tax to him by statute in the absence of such a clause.

While the court admitted that the result could be perceived as harsh, it was less so than when an "innocent witness-beneficiary loses an entire bequest."[7] Moreover, the court opined that Mr. Wu's argument of being oblivious to the presence of the clause in the will was irrelevant.[8] An insight into the reasoning of the court in reaching this conclusion perhaps may be gleaned from the fact that the Surrogate, in dicta, stated that ordinarily, the beneficiary of a life insurance policy is required to pay a portion of the estate taxes because the attorney-draftsman would include an apportionment clause requiring that the beneficiary do so.[9] This is not the "ordinary" provision, unless of course, the will itself is silent and the statute is applied to pro-rate the estate taxes amongst both probate and non-probate beneficiaries.

Intent of the Testator

The holding in *Wu* was based on the premise that Mr. Wu was an interested witness (his benefit being provided in the tax exoneration clause), and that his testimony was necessary to admit the decedent's will to probate. If Mr. Wu were not a witness to the will, the included apportionment clause would have benefitted him greatly since Mr. Wu would have received the proceeds of the policy tax-free.

Thus, while the crucial mistake made in this case was allowing Mr. Wu to be a witness to a will while he was a beneficiary of a non-probate asset, it is instructive to the issue at hand in many ways in that it begs the question that the court had to answer: what was the intent of the testator? She clearly wished her brother to have a substantial sum of money, but did she really intend for her estate, and thus, her husband, to bear the sole burden of paying the estate tax? Did she know and understand that the non-probate asset was includible in the taxable estate? While waiving apportionment may be appropriate in most cases caution should be exercised where waiving apportionment would be unfair.

It appears that the court, in reaching its decision, reasoned that it was unlikely that the decedent, when creating her will, contemplated that all of the estate taxes, including the taxes stemming from the life insurance policies, would be paid solely out of the residuary estate. Absent the clause, the taxes would have been equitably apportioned among all of the beneficiaries, including the beneficiaries of the life insurance policies. Further, the fact that Mr. Wu was an interested witness to the will would not have mattered. He would have taken his large payment subject to his payment of a portion of the estate taxes—the very result that the court, charged with discerning the true intent of the testator, imposed upon him.

While it may be said that a well-drafted apportionment clause in a will is the sign of a knowledgeable draftsperson, most often even the best-laid plans can and are undone by acts of the testator. Not so in *Wu*. Instead, if it was truly the intention of the testator that the estate bear the entire tax burden, it was the act of the attorney/draftsperson which undid the testamentary scheme. The attorney allowed a family member to witness his client's will and did not ascertain that the family member was the beneficiary of a non-testamentary asset. Had professional, uninterested witnesses been used rather than a family member, Mr. Wu would have received the life insurance proceeds without the burden of contributing a portion of the estate tax, which would appear to have been the intent of the testator based upon the most literal reading of the will.

What does *Wu* teach us? On the surface, at first glance, one would simply say that a family member should not witness a will unless the attorney is certain that he or she does not benefit from the testator in any way. If one looks a bit closer, however, it teaches us that careful drafting of a will is imperative and that pro forma clauses included as a matter of course may produce results never intended by a testator.

Most of us focus on important tax planning options that can be used in estate planning, and often use apportionment clauses to aid in that planning. We must be mindful, however that minimization of tax is not necessarily the ultimate aim of an estate plan. Rather, we must draft a plan that truly conveys our client's intent, while reducing the potential estate tax liability to be borne by the beneficiaries on the date of death. We must take into consideration many things which may cause us to lose sight of what must be our ultimate focus: that we must explain to our clients the potential outcomes that exist by virtue of the plans they are putting in place, so they can understand them and choose those that truly encompass their intent. An estate plan that does otherwise is no plan at all if the wishes and desires of the client are circumvented by poor drafting.

It is **critical** that the client understands that the failure to apportion taxes among his or her **beneficiaries** can greatly affect the **rights of inheritance** of the residuary beneficiary, who may after payment of the tax, see his or her inheritance substantially **reduced**, in some cases to zero.

1. See N.Y. EST. POWERS & TRUSTS §2-1.8(a).
2. See id; see also *Matter of Will of Collia*, 475 N.Y.S.2d 237, 240 (N.Y. Sur. 1984).
3. See 28 U.S.C. §2042(1); see also *Matter of Bayne's Will*, 102 N.Y.S.2d 525, 527 (N.Y. Sur. 1950).
4. See *Matter of Wu*, 877 N.Y.S.2d 886, 887 (N.Y. Sur. 2009).
5. See *Matter of Wu*, 877 N.Y.S.2d at 888.
6. See id. at 887.
7. See id.
8. See id. at 888.
9. See N.Y. EST. POWERS & TRUSTS §2-1.8(c)(1) (2000); see also *Matter of Wu*, 877 N.Y.S.2d at 888.