



WRMarketplace

An AALU Washington Report

Thursday, 5 October

WRM#16-40

The WRMarketplace is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The WRMarketplace provides deep insight into trends and events impacting the use of life insurance products, including key take-aways for AALU members, clients and advisors.

The AALU WRNewswire and WRMarketplace are published by the Association for Advanced Life Underwriting® as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU-members-**the nation's most advanced lie insurance professionals.**

TOPIC: Estate Tax Apportionment – Surprise: Whose Paying My Transfer Tax Bill?

MARKET TREND: With the number of valuable assets passing outside of probate on the rise, more focus must be placed on the allocation of estate taxes.

SYNOPSIS: Individuals usually have a clear idea of how much they wish to give to various family members. Without a clear understanding of the tax allocation rules, this can easily be frustrated. Federal and state laws do provide default rules for the allocation of estate taxes among estate beneficiaries. These default apportionment rules, however, can be overridden in the individual's will and other testamentary documents. Careful consideration of how taxes are allocated among all of the individual's estate assets can help avoid unintended results that derail the individual's legacy plan.

TAKE AWAYS: Apportioning estate taxes among various bequests is complex and requires an understanding of the individual's wishes and assets and knowledge of the Federal reimbursement and applicable state apportionment statutes. Well thought out and carefully drafted tax apportionment provisions will facilitate carrying out the client's intent and minimize controversy regarding the payment of taxes following the client's death. A defective tax apportionment clause, however, can increase estate taxes and

potentially trigger an estate tax when one would not otherwise be due. Life insurance in an irrevocable life insurance trust can play a vital role in solving tax apportionment issues by providing an alternate source of funds for gifts to descendants (especially children of a prior marriage) or for the payment of estate tax (by making loans to the estate or acquiring property from the estate).

The allocation of estate taxes (so-called “tax apportionment”) among an individual’s beneficiaries may be one of the most important but often overlooked considerations in developing a legacy plan. Tax apportionment issues most often come up with clients who have substantial non-probate assets (such as life insurance and retirement plans), illiquid assets (such as a family business or family home), or multiple marriages and children from a prior marriage. Failure to thoughtfully consider and plan for where the estate tax burden falls can derail the entire legacy plan and lead to unintended consequences, including an unnecessary increase in the total estate tax liability, the unintended disinheritance of intended beneficiaries and litigation. The good news: life insurance can provide the perfect solution.

FACT PATTERN

To illustrate the importance of estate tax apportionment, consider the following fact pattern:

John died in 2016 at the age of 65. At the time of his death, he was married to Katie who is age 55. They were married for 20 years and have one child, Olivia, who is 18 years old. John has two additional children from a prior marriage, Noah and Sophie, ages 27 and 30.

At the time of his death, John’s estate was valued at \$38 million. His will contains the following dispositive provisions:

- All of his tangible personal property, valued at \$500,000, is to be distributed to Katie.
- His mountain ranch (which John inherited from his father), valued at \$2,500,000, is to be distributed to his brother, Sam.
- The rest of the estate (\$30 million) is to be divided as follows: 50% to a marital trust for Katie with the remainder to Olivia, and 50% divided into equal shares and held in trust for Noah and Sophie.

John also has an IRA valued at \$5,000,000 which is to be distributed to Noah and Sophie.

The estate tax allocation among the bequests will depend upon the application of Federal and state law, along with any overriding provisions found in John’s will.

ESTATE TAX ALLOCATON – FEDERAL AND STATE STATUTORY FRAMEWORK

Default estate tax apportionment rules are found in Federal and state laws. Absent provisions in an individual’s will or other testamentary documents, these default rules determine how the estate tax is apportioned (that is, which beneficiaries bear the estate tax burden).

Federal Reimbursement Laws

The Internal Revenue Code (“IRC”) doesn’t really include estate tax apportionment provisions. Absent state law or a direction under the decedent’s will to the contrary, estate taxes are to be paid out of the “residue” of the decedent’s estate before it is distributed.¹ The executor may then exercise the reimbursement rights granted under the IRC, such as the right to collect estate tax attributable to life insurance proceeds or other non-probate assets.² The right to reimbursement, however, does not exist for all assets that pass outside of the decedent residuary estate.³ Even though the IRC requires that the tax be paid from the estate residue, it does not address how the tax will be allocated among the residuary beneficiaries.

- ✓ The following chart illustrates the allocation of taxes on John’s estate under the IRC reimbursement rules:

Allocation of Taxes Under the Federal Rules			
Bequest	Value	Share of Estate Tax	Share of Estate Tax (Without Allocation to Marital Trust)
IRA	\$5,000,000	\$0	\$0
Tangible Personal Property	\$500,000	\$0	\$0
Mountain Ranch	\$2,500,000	\$0	\$0
50% of Residue to Marital Trust	\$15,000,000	\$4,262,466.50	\$0

50% of Residue to Trusts for Noah and Sophie	\$15,000,000	\$4,262,466.50	\$6,820,000
Total	\$38,000,000	\$8,524,933	\$6,820,000

State Apportionment Laws

State laws provide the primary basis for estate tax apportionment and will apply unless the individual directs otherwise in his or her will. While state laws vary widely, such laws generally fall into two categories.

Common Law Apportionment. Under the common law approach all estate taxes are paid out of the residuary estate. If the residuary estate is insufficient to pay the taxes, then the balance is paid out of other bequests. Only a handful of states (e.g., Arizona, Georgia, Iowa, and Kansas) still use the common law approach.

There are several drawbacks to this approach. First, the common law approach places the estate tax burden on the residuary beneficiaries (usually the most important to the decedent). Second, the common law apportionment does not exempt bequests that qualify for the marital or charitable deduction, resulting in reduced deductions and a higher estate tax obligation. Last, this type of apportionment can totally eliminate the residue if there are substantial non-probate assets.

- ✓ The following chart illustrates the allocation of taxes on John's estate under the common law apportionment rules:

Allocation of Taxes Under Common Law Apportionment Rules			
Bequest	Value	Share of Estate Tax	Remaining Bequest
IRA	\$5,000,000	\$0	\$5,000,000
Tangible Personal Property	\$500,000	\$0	\$500,000
Mountain Ranch	\$2,500,000	\$0	\$2,500,000
50% of Residue to Marital Trust	\$15,000,000	\$4,262,466.50	\$10,737,534
50% of Residue to Trusts for	\$15,000,000	\$4,262,466.50	\$10,737,534

Noah and Sophie			
Total	\$38,000,000	\$8,524,933	\$29,475,068

Pro Rata Apportionment. Most states have moved away from the common law approach and have adopted a form of pro rata apportionment that addresses how the estate tax burden is allocated among the beneficiaries of the decedent’s probate estate (so-called “inside apportionment”) and non-probate estate (so-called “outside apportionment”).

- Inside Apportionment. Inside apportionment rules generally provide that the estate tax is allocated among all of the beneficiaries of the probate estate rather than just the residue.
- ✓ The following chart illustrates the allocation of taxes on John’s estate under inside apportionment rules:

Allocation of Taxes Under Inside Apportionment Rules			
Bequest	Value	Share of Estate Tax	Remaining Bequest
IRA	\$5,000,000	\$0	\$5,000,000
Tangible Personal Property	\$500,000	\$127,850	\$372,150
Mountain Ranch	\$2,500,000	\$647,773	\$1,852,227
50% of Residue to Marital Trust	\$15,000,000	\$3,873,855	\$11,126,145
50% of Residue to Trusts for Noah and Sophie	\$15,000,000	\$3,873,855	\$11,126,145
Total	\$38,000,000	\$8,523,333	\$29,476,667

- Outside Apportionment. Outside apportionment rules define how the estate tax will be allocated among non-probate assets, like an IRA or life insurance. Each disposition of a non-probate asset bears a pro rata share of the tax.

- ✓ The following chart illustrates the allocation of taxes on John’s estate under outside apportionment rules with the tax on the probate estate paid by the residue:

Allocation of Taxes Under Outside Apportionment Rules			
Bequest	Value	Share of Estate Tax	Remaining Bequest
IRA	\$5,000,000	\$1,193,491	\$3,806,509
Tangible Personal Property	\$500,000	\$0	\$500,000
Mountain Ranch	\$2,500,000	\$0	\$2,500,000
50% of Residue to Marital Trust	\$15,000,000	\$3,665,721	\$11,334,279
50% of Residue to Trusts for Noah and Sophie	\$15,000,000	\$3,665,721	\$11,334,279
Total	\$38,000,000	\$8,524,933	\$29,475,067

- Equitable Apportionment. Equitable apportionment is a variation of inside and outside apportionment allowing bequests that generate a deduction or credit (such as gifts that qualify for the marital or charitable deductions) to be exempt from bearing a share of the estate tax burden.

- ✓ The following chart illustrates the allocation of taxes on John’s estate under full inside, outside, and equitable apportionment:

Allocation of Taxes Under Full Inside, Outside, and Equitable Apportionment Rules			
Bequest	Value	Share of Estate Tax	Remaining Bequest
IRA	\$5,000,000	\$1,515,404	\$3,484,596
Tangible Personal Property	\$500,000	\$0	\$500,000
Mountain Ranch	\$2,500,000	\$757,702	\$1,742,298
50% of Residue to Marital Trust	\$15,000,000	\$0	\$15,000,000

50% of Residue to Trusts for Noah and Sophie	\$15,000,000	\$4,546,894	\$10,453,106
Total	\$38,000,000	\$6,820,000	\$31,180,000

OVERRIDING FEDERAL AND STATE APPORTIONMENT LAWS BY WILL

While the default Federal and state rules may be appropriate for some individuals, they generally are not appropriate for the majority of individuals with taxable estates. If an individual's legacy plan includes large non-probate assets or dispositions to a spouse or charity, state apportionment laws can easily undermine the plan. Fortunately, Federal and state laws can be overridden by the individual's will and other testamentary documents.

Tax apportionment provisions should be included in all documents that are part of the legacy plan - including revocable and irrevocable trusts (just in case the assets are pulled into the individual's estate at death). Well-designed tax apportionment provisions will (i) address inside, outside, and equitable apportionment, (ii) designate those bequests that should not bear estate taxes (such as tangible personal property, nominal bequests, retirement plan accounts, and gifts that qualify for the marital and charitable deductions), (iii) provide coordination across all of the individual's legacy plan documents, (iv) define how the Federal estate tax exclusion and other estate tax credits are to be allocated, and (v) define which taxes are to be paid (e.g., Federal, state, inheritance, generation-skipping transfer, etc.).

- ✓ John's will can override the default estate tax apportionment rules and provide a more efficient allocation of the estate tax burden. For example, the will could direct that the tangible personal property, ranch, and marital trust pass free of estate tax. The will could also provide that tax on the IRA could be paid from the trusts for Noah and Sophie.

Allocation of Taxes Under John's Will			
Bequest	Value	Share of Estate Tax	Remaining Bequest
IRA	\$5,000,000	\$0	\$5,000,000
Tangible Personal Property	\$500,000	\$0	\$500,000
Mountain Ranch	\$2,500,000	\$0	\$2,500,000
50% of Residue to Marital Trust	\$15,000,000	\$0	\$15,000,000
50% of Residue to Trusts for Noah and Sophie	\$15,000,000	\$6,820,000	\$8,180,000
Total	\$38,000,000	\$6,820,000	\$31,180,000

A SOLUTION: LIFE INSURANCE

Frequently, the most valuable, important, and illiquid assets in an individual's estate - the family business and the family home - are burdened with the largest share of tax or the estate has insufficient liquid assets available to cover the tax. Life insurance held in an irrevocable life insurance trust ("ILIT") can help solve estate tax payment problems that cannot be resolved through a tax apportionment clause. A properly structured ILIT can ensure that insurance proceeds are not part of the insured's estate and provide liquidity for payment of taxes by either making loans to the insured's estate or purchasing assets from the estate.

ILITs can also be instrumental when planning for blended families. Individuals in a second (or third...) marriage with children from a prior marriage are frequently torn between providing for the spouse and the children and can run into estate tax issues attempting to provide for both sets of beneficiaries. An ILIT can provide assets outside of the estate that benefit children, thus permitting a more traditional legacy plan that defers the payment of estate tax until the death of the surviving spouse.

- ✓ The following chart illustrates how a \$10,000,000 life insurance policy in an ILIT could be used to alleviate the estate tax burden on John's estate using tax apportionment provisions in the will:

Proposed Distribution Using Life Insurance in an ILIT			
Bequest	Value	Share of Estate Tax	Remaining Bequest
\$10,000,000 Life Policy in an ILIT for Noah and Sophie	\$10,000,000	\$0	\$10,000,000
IRA to Katie	\$5,000,000	\$0	\$5,000,000
Tangible Personal Property to Katie	\$500,000	\$0	\$500,000
Mountain Ranch to Sam	\$2,500,000	\$0	\$2,500,000
Credit Shelter Trust for Noah and Sophie	\$2,950,000	\$0	\$2,950,000
Residue to Marital Trust for Katie	\$27,050,000	\$0	\$27,050,000
Total	\$48,000,000	\$0	\$48,000,000

CONCLUSION

The state default apportionment rules can result in wide variations as to how taxes are allocated and who bears the ultimate tax burden. The following chart illustrates the differences in the remaining bequests under the different default rules:

Bequest	Comparison of Remaining Bequests Under Different Tax Apportionment Rules					
	Federal	Common Law	Inside	Outside	Full Equitable	Apportionment by Will
\$5,000,000 IRA to Noah and Sophie	\$5,000,000	\$5,000,000	\$5,000,000	\$3,806,509	\$3,484,596	\$5,000,000
\$500,000 Tangible Personal Property to Katie	\$500,000	\$500,000	\$372,150	\$500,000	\$500,000	\$500,000

\$2,500,000 Mountain Ranch to Sam	\$2,500,000	\$2,500,000 0	\$1,852,227	\$2,500,000	\$1,742,298	\$2,500,000
50% of Residue to Marital Trust for Katie (\$15,000,000)	\$10,737,534	\$10,737,534 4	\$11,126,145	\$11,334,279	\$15,000,000	\$15,000,000
50% of Residue to Trusts for Noah and Sophie (\$15,000,000)	\$10,737,534	10,737,534	\$11,126,145	\$11,334,279	\$10,453,106	\$8,180,000
Total	\$29,475,068	\$29,475,068	\$29,476,667	\$29,475,067	\$31,180,000	\$31,180,000

Full equitable apportionment provides the most protection for marital and charitable bequests, but is not the default in many states. Best practices would dictate that advisors specifically address tax apportionment in all legacy planning documents (including those that are not expected to increase the estate tax burden), even if the default state rules are being used, to anticipate an unforeseen shift of the burden that may arise years after the legacy plan is in place from changes in the tax laws or relocation of the client to another state. Including provisions in the legacy planning documents also permits tax apportionment to be tailored to meet the client’s unique needs and circumstances.

TAKE AWAYS

- Apportioning estate taxes among various bequests is complex and requires an understanding of the individual’s wishes and assets and a knowledge of the Federal reimbursement and applicable state apportionment statutes.
- Well thought out and carefully drafted tax apportionment provisions will facilitate carrying out the client’s intent and minimize controversy regarding the payment of taxes following the client’s death. A defective tax apportionment clause, however, can increase estate taxes and potentially trigger an estate tax when one would not otherwise be due.
- Life insurance in an irrevocable life insurance trust can play a vital role in solving tax apportionment issues by providing an alternate source of funds for gifts to

descendants (especially children of a prior marriage) or for the payment of estate tax (by making loans to the estate or acquiring property from the estate).

¹ IRC § 2205.

² Federal reimbursement provisions are found in IRC §§ 2205-2210.

³ Id. at 1.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

WRM #16-40 was written by Greenberg Traurig, LLP

Jonathon M. Forster

Martin Kalb

Richard A. Sirius

Steven B. Lapidus

Rebecca Manicone

Counsel Emeritus

Gerald H. Sherman 1932-2012

Stuart Lewis 1945-2012