

Due to the obvious conflict of interest, I resigned from both of them. It is my understanding, though, that Brian is presently “negotiating” with Amy. I definitely want to know how this plays out.



¹ *Jensen v. Comm.*, TCM 2010-77

² IRC §108(i)

³ IRC §108(a)(2)(A)

⁴ IRC §108(h)(4)

⁵ IRC §§108(b)(5), 1017(b)(3)(A)

⁶ IRC §1017(b)(2)

⁷ Treas. Regs. §1.108-7(a)(2)

⁸ IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)

⁹ IRC §1017(d)(1)(B)

¹⁰ IRC §108(h)(1)

¹¹ Treas. Regs. §1.121-1(e)(1)

Estate tax allocation: How to decide who pays

ESTATES: Allocating estate taxes among beneficiaries may be complex, even in common arrangements.

By Richard B. Malamud, J.D., LL.M., CPA

Guest Contributor

The question of how the estate tax is paid is simple when there is only one beneficiary or all beneficiaries receive a *pro rata* inheritance. In that case, the estate (or revocable living trust) simply pays the tax.

The question is not as simple if some of the decedent's assets are subject to the estate tax but are not in the possession of the decedent's estate, such as with life insurance paid directly to the beneficiary or a Qualified Terminable Interest Property (QTIP) trust.

Sample estate

Suppose Mom dies in 2013 and her son receives \$3,000,000 from her life insurance policy and her two daughters share her \$7,000,000 estate. What is the effect if their share must pay all of the estate tax?

Assuming a 40% tax on the taxable estate over \$5,250,000,¹ the \$1,900,000 tax (\$10,000,000 - \$5,250,000 × 40%) would result in the daughters each receiving \$2,550,000 (\$3,500,000 - \$950,000).

The effect is that receiving half of \$7,000,000 actually results in less of an inheritance than receiving \$3,000,000 outside the estate.

The same result occurs if, instead of life insurance, Mom's spouse, Dad, predeceased her and left \$3,000,000 in a QTIP trust that is paid to the son, and Mom's estate of \$7,000,000 is left to pay the estate tax.

Is this the proper result, or should a portion of the estate tax be allocated to the recipient of the life insurance, QTIP, or other property passing outside the estate?

If a \$3,000,000 life insurance policy was paid to the son and \$7,000,000 was in the estate, net of expenses, leaving a taxable estate of \$10,000,000, the son would be liable for 30% of the estate tax. Assuming a 40% tax of \$1,900,000, the son's share would be \$570,000 (\$1,900,000 × 30%).

The answer does not involve a question of fairness. Rather it is a question of how the will, trust, state law, and federal law apply to the allocation of the estate tax.

In the above example, the son may assert that this is no different than if Mom had left him a \$3,000,000 specific bequest and her will provided that the specific bequests not bear any of the estate tax and that the estate, “shall bear all of the taxes, debts, etc.”

The other children may argue that property passing outside the estate is not the same as a specific bequest that has been explicitly exempted by the will from paying any tax. If the will simply states that the estate shall pay all taxes, they will argue that clause is not specific and is so

ambiguous that it should not prevent the allocation of the estate tax to their brother.

If the beneficiaries don't agree, a court will have to determine the intent of the decedent's will or trust and the applicability of state and federal law. Since this is a state law issue, determining "intent" will vary based on state statutes, case law, and the exact wording of the will or trust.²

Federal tax provisions

The Internal Revenue Code has many sections that deal with allocating the estate tax when there is property that passes outside the estate. When those provisions apply, an executor, a trustee, and even an heir can collect an allocated share of the estate tax from a beneficiary. Unfortunately, the Code sections do not provide a mechanism for collecting the reimbursement.

In the case of life insurance, IRC §2206 allows the executor to collect an allocation of the estate tax from the recipient based on the ratio of the life insurance proceeds to the total taxable estate tax, unless the will directs otherwise.

IRC §2203 defines the term executor to include administrators, "or, if there is no executor, or administrator, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent." Thus, if there is no executor, it would appear that the trustee of the living trust could arguably be the "executor" and be entitled to recover the allocated estate tax. Treas. Regs. §20.2031-1 lists persons in receipt of a decedent's property. It lists agents, representatives, and other custodians of property, but does not explicitly list trustees, who should probably be included in that list as one of those three.

In the case of property transferred under a general power of appointment that is included in the decedent's estate, IRC §2207 allows the executor to collect from the recipient of an amount included in the decedent's gross estate under a general power of appointment in the same manner as in the case of life insurance, unless the will directs otherwise.

In the case of a lifetime transfer of property in which the decedent retained a life estate under IRC §2036, IRC §2207B allows the decedent's estate to collect the tax based on the percentage of the estate tax that is the same percentage as the ratio of the property to the total taxable estate. This will not apply if "the decedent in his will (or a revocable trust) specifically indicates an intent to waive any right of recovery under this subchapter ... with respect to such property."

In the case of property that was included in the taxable estate because it was the pre-deceased spouse's QTIP trust, IRC §2207A provides that the decedent's estate is entitled to recover from the QTIP recipient the estate tax caused by the inclusion of that property in the taxable estate.

The allocation is calculated by comparing the estate tax with and without the QTIP property. This will not apply if "the decedent in his will (or a revocable trust) specifically indicates an intent to waive any right of recovery under this subchapter ... with respect to such property."

EXAMPLE 5-1: A QTIP with \$3,000,000 is included in an estate which had a taxable estate of \$7,000,000 before the QTIP is added.

Difference payable by the QTIP trust		
Tax on \$7,000,000	$\$7,000,000 - \$5,250,000 \text{ exemption} = \$1,750,000 \times 40\%$	\$700,000
Tax on taxable estate	$\$10,000,000 - \$5,250,000 = \$4,750,000 \times 40\%$	\$1,900,000
Difference payable by QTIP trust beneficiary		\$1,200,000

In this case, the son would get \$1,800,000 (\$3,000,000 - \$1,200,000) and the daughters \$3,150,000 each (50% of \$7,000,000 - \$700,000).

A similar provision provides for allocation for the generation skipping transfer taxes under IRC §2603. The section provides that the tax shall be paid by the “transferee.” It further states that unless otherwise directed in the trust by a “specific reference to the (generation skipping transfer tax)” the tax shall be charged to the property transferred.³

IRC §2205 can be used by a beneficiary to seek reimbursement when he or she pays more than their *pro rata* share of the estate tax. This does not prevent the IRS from collecting all of the estate tax from one beneficiary, it simply allows that beneficiary to seek reimbursement from the other(s).⁴

Notice that the sections are slightly different in defining who can seek reimbursement and where and how the decedent can direct that the statute not apply.

One article states: “Sections 2206 and 2207, permit only a will to provide a contrary direction on apportionment. On the other hand, Sections 2207A and 2207B would allow a revocable trust, in addition to a will, to provide otherwise.”⁵

Further explaining (with emphasis added): “**If Sections 2206 and 2207 preempt state law** apportionment statutes, then a will provision will be necessary even if a state recognizes the ability to apportion taxes by a revocable trust. For example, if a California resident provides in a revocable trust that taxes on life insurance be paid from the trust, the direction may not be recognized because Section 2206 allows the direction to be made only in a will.”⁶

State law

Even if the property that passes outside the estate is not covered by federal tax law, state law may provide the same or similar requirements for allocation.

For example, California Probate Code Section 20110 provides that “... any estate tax shall be equitably prorated among the persons interested in the estate ...” This does not apply if “... the decedent in a written *inter vivos* or testamentary instrument ... specifically directs that the property be applied to the satisfaction of an estate tax or that an estate tax be prorated to the property in the manner provided in the instrument.”

It then states that “If federal law directs the manner of proration of the federal estate tax, the California estate tax shall be prorated in the same manner.” IRC §20111 then provides that “The proration ... shall be made in the proportion that the value of the property received by each person interested in the estate bears to the total value of all property received by all persons interested in the estate ...” An earlier version of this section said that it includes all property included for federal estate tax purposes.⁷ This is consistent with IRC §20116, which provides that the personal representative has a duty to collect from property that did not come into the possession of the representative.

This section appears to be much broader than the federal law, as it does not appear to be limited to specific types of property as are the federal provisions.

Sometimes a will says that the estate shall pay all taxes. Is that enough to override IRC §2207A? Not according to a Wisconsin case that held that a clause in the will that said the estate should pay all taxes did not prevent the estate from recovering from the beneficiaries of the QTIP trust.

The court said “... that the pay-all-taxes clause in [her] will does not ‘otherwise direct,’ as required by 26 U.S.C. §2207A(a)(2), to exonerate the beneficiaries of the QTIP trust from contributing their share of the estate taxes.”⁸

A Texas case found that even though the will provided that all taxes payable by reason of death be paid out of the estate, this didn’t prevent the apportionment of the estate tax to the beneficiary who received the IRA outside the estate: “Apportionment of death taxes among both probate and non-probate assets is the general rule, which is subject to an exception only when there is a contrary direction in the will. ... The exception applies when the testator provides a specific directive as to the manner of payment of estate taxes.”⁹

The court found that the will wasn’t specific and it didn’t limit the payment of the tax to the residuary of the estate.

The same is true in New York, where "... in the absence of a clear, unambiguous direction to the contrary in the will, apportionment pursuant to statute will be directed. There is a strong policy in favor of statutory apportionment, and those controverting its application must bear the burden of proof."¹⁰ This has been the holding in numerous cases in New York.

About the author

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- ¹ IRC §2001(c) (indexed for inflation)
- ² See, for example, *Nutt v. Wells Fargo Bank* (2006) 853 N.E.2d 79
- ³ See Catherine Veihmeyer Hughes, "Tax apportionment in estate planning: Not just how much, but from whom," *The Practical Tax Lawyer* (Summer 1998), which states "The effect of section 2603(b) is not clear, however as it applies to direct skips"
- ⁴ Treas. Regs. §20.2205
- ⁵ Ira Mark Bloom, "Revocable Trusts in the Federal Estate Tax Apportionment Arena: Suggestions for Reform" (2008) 62 U. Miami L. Rev. 767, 800. This article also has an excellent discussion of state law and the uniform code. See also, Wendy C. Gerzog, "Equitable Apportionment: Recent cases and continuing trends" (Winter 2007) 41 *Real Property, Probate and Trust Journal*, 671
- ⁶ See Bloom, at 803. Footnote omitted
- ⁷ See *Estate of Buckhantz* (1953) 120 Cal.App.2d 92
- ⁸ *Firststar Trust Company v. First National Bank of Kenosha* (1995) 197 Wis.2d 484; 541 N.W.2d 467. For a complete discussion on the topic of will clauses and state law, see Mark R. Siegel, "Who should bear the bite of estate taxes on non-probate property?" (2010) 43 *Creighton L. Rev.* 747
- ⁹ *Patrick v. Patrick* (2005) 182 S.W.3d 433, 437
- ¹⁰ *Matter of Shubert* (1962) 10 N.Y.2d 461, 471; 180 N.E.2d 410

Remember: Most tax-exempt organizations must file in May

TAX: The due date for filing is the 15th day of the fifth month after the close of the tax year. Organizations that do not file for three consecutive years lose their tax-exempt status.

By Renée Rodda, J.D.

Associate Editor

Although they are exempt from income taxation, exempt organizations are generally required to file annual returns of their income and expenses with the IRS. The form the organization must file depends on its financial activity.

2010 Tax Year and Later	Form to File
Gross receipts normally ≤ \$50,000 Note: Organizations eligible to file the e-Postcard may choose to file a full return	990-N
Gross receipts < \$200,000, and Total assets < \$500,000	990-EZ or 990
Gross receipts ≥ \$200,000, or Total assets ≥ \$500,000	990
Private foundation	990-PF