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The Estate Planning Council of Nassau County, Inc.

Defensive Estate Planning:

The Fine Art of Disinheritance, the Use of Tax Payment Clauses, and Other Considerations

A. The Fine Art of Disinheritance
B. The Use of Tax Payment Clauses
C. Additional Considerations: Avoiding Scrutiny, Avoiding Probate

Overview

This program will cover several topics that are all too frequently given short shrift by the estate planner's typical emphasis on the estate and gift tax considerations. With the advent of extraordinarily high federal exemption amounts[1] there are a host of other factors that, while always present, should be given renewed notice. After all, very few estates exceed $22,800,000.00!

The theme of this presentation is simple. Whatever efficiencies may be achieved on the taxation side of the ledger may be more than offset by the failure to anticipate litigation. For example, relevant to this presentation: the need to anticipate and to plan for a probate contest; the dangers of a poorly-drafted tax payment provision that may require construction by the court and may frustrate the intention of the testator/grantor. Strategies are necessary to protect clients and their families from protracted and ruinously expensive litigation. There is also the added development of adverse publicity in our media-mad age. For the most part, court files have always been matters of public record, but now one must consider the possibility of electronic access to court records where such records are freely spread across the internet and the tabloid press.

We will begin by discussing the techniques to avoid vexatious litigation by a disgruntled member of the family. All the tax efficiency achieved in an estate plan may be for naught if the disinherited person is litigious and spoiling for a fight with hated family members.

We will then consider why careful attention must be given to the drafting of tax apportionment/payment clauses in Wills and Trusts. It seems to this litigator that too many estate planners default into a standard provision that makes taxes an administration expense of the estate. In this age when so much wealth resides in non-probate assets, the default to the residuary estate may be contrary to the intent of the testator.

Finally, we will discuss some other related strategies to protect our clients.

The only caveat offered to our participants is the inevitable focus on New York law in this presentation. I am a New Yorker. However, in so far as the presentation discusses no contest or in terrorem clauses, it is fair to state that the majority of the states enforce such provisions

1 $11,400,000 in 2019 and $22,800,000 when portability enters the equation.

with certain reservations.[2] Moreover, and for good or ill, New York is a highly litigious state and the number of relevant cases dealing with these issues is astonishing and perhaps useful to the practitioners in all states.

[2] See Challis, Zaritsky, in a publically available ACTEC monograph, "State Laws: No-Contest Clauses," available at https://www.actec.org/assets/1/6/State Laws No Contest Clauses - Chart.pdf.

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Random Points to Ponder

- Publicity in the Digital Age
- Warning Signs:
  - A second marriage with children from prior marriages;
  - A family business and a possible struggle for control;
  - Fiduciaries, the procrastinator, the tyrannical, the conflicted;
  - Multiple Fiduciaries, deadlock, passivity
- Paper, paper, paper.

- Revocable trust and the pour-over will
    - keep in mind that any assets not transferred to the trust may necessitate a probate of the pour-over Will and that may expose the trust to public scrutiny.
    - Fiduciary Succession without court intervention;
    - Enforcement mechanisms.

A. The Fine Art of Disinheritance; Drafting in Contemplation of Probate Contests

"Happy families are all alike; every unhappy family is unhappy in its own way. "
- The opening lines of Tolstoy's *Anna Karenina*

"Trust everybody, but always cut the
cards." - Finley Peter Dunne

I. Introduction

II. Planning Techniques and Warning Signs

1. The *in terrorem* Clause, EPTL 3-3.5 and SCPA 1404
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I. Introduction

The lawyer who can draft a sophisticated and tax-efficient estate plan for a client and neglects to plan for an anticipated probate contest may be guaranteeing a result that will dissipate much if not all of the tax efficiencies achieved.

The art of disinheritance refers to some techniques that may be used to avoid the costs and expenses of protracted probate litigation.

I refer to the 'art' of disinheritance, because there is no set formula to accomplish the task of avoiding a probate contest. The practitioner must not feel secure in the simple reliance on an *in terrorem or* a no-contest clause in a Will. A few minutes research will disclose that while most states will enforce such clauses they are typically viewed with suspicion (especially when they are drafted in such a Draconian fashion as to disinherit third parties who have not contested the Will). Although *in terrorem* clauses are enforceable in New York

under EPTL 3-3.5, they are viewed with disfavor by the courts and are strictly construed (see, Matter of Alexander, 63 A.D.2d 612 [1st Dep't 1978]).

The following outline will consider some practical suggestions for accomplishing what your client, as testator, has clearly expressed to you - the desire to disinherit a person who otherwise would be a natural object of his or her bounty.

The practitioner should not conclude that this is an exercise in futility. However, the *in terrorem* clause necessitates a legacy to the hated family member. Testators will be resistant to such a strategy. But you must inquire of your client, "do you value your beneficiaries and their quiet enjoyment of their bequests and devises more than you hate that rotten son or daughter? " Unless the sum linked to the no-contest provision is adequate, the distributee will not be deterred from making objections, even in the presence of an *in terrorem* clause, hoping to "extort" a greater sum from the estate in order to prevent the costs and uncertainties of litigation. It is an almost incredible fact, but one your author has seen at least three times in the past ten (10) years - an *in terrorem* clause without any bequest to the otherwise disinherited person! And in several other instances, a bequest to a hated child in the sum of a few thousand dollars when the estate is many millions of dollars.

If a Will contains an *in terrorem* clause, then New York law allows a certain prescribed level of inquiry before the clause is triggered. The person affected by the clause is permitted to depose the witnesses, the attorney-drafter, and the nominated executor. Upon completion of these depositions, the person must choose - file objections to the Will or walk away with the legacy intact. But the law in New York has experience some substantial changes in recent years.

After Matter of Singer, 13 N.Y.3d 447 (2009), and the resulting 2011 amendments to EPTL[3] 3-3.5(b) and SCPA[4] 1404, it is clear that judicial suspicion of such provisions is expanding the scope of permissible litigation that may be permitted prior to filing objections. Whatever virtues may be possessed by such an approach, the result has been to expand the litigation and continue to frustrate the very thing the client sought to avoid. For example, in

3 New York's Estates Powers and Trusts Law.

4 New York's Surrogate's Court Procedure Act.

New York the old law created certain "safe harbors" provisions mentioned above. New York (in Singer and as later codified above) now provides for the potential objectant to seek court permission to expand the scope of discovery before triggering the *in terrorem* clause. Now the attorney for the nominated executor must make a motion to determine what additional disclosure the court will permit before triggering the clause.

It is respectfully submitted that if a state permits such maneuvers, then an attorney should be careful in failing to utilize them for fear of being second-guessed by a creature more dreadful that a disappointed heir, an unhappy client.

II. Planning Techniques and Warning Signs

1. The *In Terrorem* Clause

As we have seen above, this old warhorse remains a useful tool to be used but with a great deal of care because they are not favored by the courts. Some points to keep in mind when contemplating such a clause:

- create a substantial risk to the objectant, a risk (in the form of a legacy) that creates a realistic disincentive. It is very frustrating to see an *in terrorem* clause drafted that is supported by a minimal bequest to the disinherited distributee. After all, the logic behind the use of such a clause is the risk-reward calculation that provides the proper disincentive to the disgruntled heir. A client may balk when you suggest a bequest to a detested distributee, but make sure the client is aware of the mischief that disinherited family member may cause to the objects of that client's bounty and that a gift of a modest sum may deter the person form causing greater harm to the estate by a challenge to the instrument.

- describe the triggering event. I would argue that while the statute describes the situation which will trigger the clause, there is no harm and possibly much benefit to detailing the acts that will trigger the clause in the Will itself. Moreover, every effort should be taken to make sure said clause will not be construed narrowly. Here is a sample clause from Matter of Ellis, 252 AD2d 118 (2d Dep't 1998), that may be useful as a starting point:

If any beneficiary under this Will in any manner, directly or indirectly, contests this will or any of its provisions, any share or interest in my estate given to the contesting beneficiary, or to the beneficiary's issue[5]*, under this will is revoked.*

The practitioner might even want to consider the author's additions to this language (in bold):

If any beneficiary under this Will, ***or any codicil to it,*** *in any manner, directly or indirectly, contests this will or any of its provisions, any share or interest in my estate given to the contesting beneficiary, or to the beneficiary's issue, under this Will is revoked. In this context, the word "contests" includes any* ***and all conduct that it is not expressly exempted by SCPA 1404.***

- The Bekerman Variation. One of the speakers at this year's program is a friend of mine and a brilliant young estate planner. His name is Marc Bekerman and he has developed a brilliant evidentiary stratagem when utilizing *in terrorem* clauses. If Marc's client is willing to give a legacy to a hated child of a sufficiently deterrent amount, let us say $100,000. Marc will then ask them to change the legacy to $95,000 and on the date of the Will's execution have the client write a $5,000 check to the disfavored person and send it to him under cover of a letter that is relatively innocuous, "Dear Son, I know our relationship is very bad but I want you to have this money." Later, if the matter ever comes to trial because the unhappy family member filed objections and risked the legacy, one can imagine the possibilities of cross examining this person (who is undoubtedly alleging lack of testamentary capacity among other objections). After laying the proper foundation, imagine turning to the jury and asking, "And is it your testimony that your mother was incompetent on the day she wrote you a check that you cashed?"

- In drafting an *in terrorem* clause, the testator may want to designate the recipient of the property that will be forfeited by the *in terrorem* clause. This may provide an additional party with a strong interest in upholding the Will and its forfeiture provision. If the substitute

5 This model is useful for the disinheritance of the beneficiary's issue. You can be sure that the courts will closely examine the effect of such a provision.

party is a charity, then the charity and (in New York) the Attorney General become parties to the contest. For example,

> *If any beneficiary under this Will in any manner, directly or indirectly, contests this will or any of its provisions, any share or interest in my estate given to the contesting beneficiary, or to the beneficiary's issue ,* ***under this will is revoked and that share or interest in my estate is given to the American Heart Association.***

2. Matter of Singer

The practitioner should know that in New York there has been relatively recent changes in the law relating to *in terrorem* clauses. What had been perceived as a trend toward strict enforcement of such clauses (See, *e.g.*, Matter of Ellis, 252 AD2d 118 [2d Dep't 1998], Matter of Singer, 17 Misc. 3d 365 [Surr.Ct. Kings Co. 2007 [Lopez-Torres], aff'd 52 AD3d 612 [2d Dep't, 2008]) was reversed by the Court of Appeals in Matter of Singer, 13 N.Y.3d 447 (2009). The Court of Appeals ruled that although SCPA 1404 and EPTL 3-3.5 established the approved depositions and scope of discovery before triggering the clause, the Court ruled that circumstances may exist that would make it permissible to depose persons outside the statutory parameters without suffering forfeiture. Just what are the natures of such "safe harbors" would be was left as a matter within the trial courts' discretion.

In response to Matter of Singer EPTL 3-3.5(b)(3)(D) was amended as follows (the added provision is underlined and in bold):

> (D) The preliminary examination, under SCPA 1404, of a proponent's witnesses, the person who prepared the will, the nominated executors and the proponents in a probate proceeding **and, upon application to the court based upon special circumstances, any person whose examination the court determines may provide information with respect to the validity of the will that is of substantial importance or relevance to a decision to file objections to the will.**

SCPA 1404 was amended in a similar fashion. These changes will increase the costs and delays of probating a will that seeks to disinherit a distributee as applications will be made in the Surrogate's Court on a case-by-case basis testing the limits of the *in terrorem* clause. After all, if the practitioner fails to zealously pursue the new provisions of the law, he or she may face charges of malpractice.

It is respectfully submitted that it is increasingly important to consider the other means by which a distributee may be successfully disinherited, including the all too frequently overlooked strategy of "stacking" wills (see below).

3. Should the planner set forth in the Will the reason for disinheritance?

No, the planner should not set forth in the Will the reason for disinheritance. Occasionally, one will see a Will that states concrete reasons for disinheriting a distributee. This is a controversial suggestion that many estate planners eschew for good reasons. If the testamentary instrument contains such explanatory language, it then gives another opportunity for attack in the probate contest. If a testator states in his or her Will that a reason for disinheriting a son is that the son never called or visited the parent, then this will introduce a new issue for the trial, possible leading to the conclusion by the jury that the testator was unduly influenced by another sibling or that he or she lacked testamentary capacity or was suffering from an insane delusion. For example, suppose the objectant introduces telephone records that reflect that he or she called the decedent on a weekly basis for extended periods.

These considerations notwithstanding, there may very well be incidents that dictate in favor of such explanatory language. It should also be noted that if the practitioner should advise the testator that explanatory language is proper, that bitter and accusatory language may expose the estate, at least in some states, to the tort of "testamentary libel."[6]

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6 It is believe that at least two states have recognized the tort of testamentary libel, New York and Tennessee. An example. In 1908 a testator with an extreme dislike for his son-in-law left him 50 cents and directed that the purpose of the gift was to "enable him to buy for himself a good stout rope with which to hang himself, and thus rid mankind of one of the most infamous scoundrels that ever roamed this broad land or dwelt outside of a penitentiary."See, Kluft, Defamation From Beyond the Grave: Using Your Last Will To Get In The Last Word. https://www.trademarkandcopyrightlawblog.com/2014/10/testamentary-libel/

4. Extraneous Supporting Documentation

The single most important suggestion when representing a client in this matter is the care and attention to detail given the drafting process by the attorney. The use of notes by the drafter and drafts of unexecuted Wills is vitally important to document each stage of the planning process. These documents will be very useful during a probate contest (see, e.g., Matter of Zirinsky, 43 A.D.3d 946 [2d Dep't 2007], aff'd 9 N.Y.3d 815.)

Just as the careful practitioner gets a family tree and affidavit from a client, so too the attorney might consider the use of affidavits from friends and neighbors that give some background to the decision of the testator to disinherit a distributee. At the very least, the attorney might want to get a list of the names and addresses of such people who are otherwise disinterested in the estate but could provide some information supporting the disinheritance.

5. Preserving Prior Wills . What is the legal status of prior wills executed by a testator when he or she executes and then revokes a subsequent will? There are risks of running afoul of Matter of Huang, 11 Misc. 3d 325, 811 N.Y.S.2d 885 (Sur.Ct. NY County 2005) that held that a presumed act of revocation by destruction may not similarly operate to revive prior wills. Huang ruled that EPTL 3-4.6 may be an obstacle to admitting an earlier Will to probate if a later Will, even though incapable of being probated, was sufficiently executed so as to preclude the revival of the earlier instrument.[7] However, that being said, if a Will is denied probate after trial, there may be no obstacle to offering a previous instrument for probate and avoiding intestacy, especially if the jury's verdict was based on lack of testamentary capacity. After all, if the instrument is defective as an expression of the testator's wishes due to the lack of testamentary capacity, that taint of incapacity should also extend to the supposed revocatory act. Therefore, a useful estate planning technique may still be to have the testator execute several Wills over the course of a reasonable period of time so that each one stands as a separate obstacle to intestacy that would benefit the disinherited distributee. See point 6 below.

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[7] See also, Matter of Sharp, 68 A.D.3d 1182, 889 N.Y.S.2d 323 (3d Dep't 2009), following the reasoning of *Huang* and discussing the doctrine of dependent relative revocation and how it does not apply in these situations.

6. Stacking Wills

A war story. Once upon a time a client came to your author as the nominated executor of a Will. The estate was a large one, well over $40 million. The sole beneficiary was a charity. The testator was a very ill young woman, in and out of mental hospitals for many years. In fact, the Will offered for probate was executed within a week of her release from such an institution. Out of the blue appeared this woman's half-brother, a person with no relationship to the testator except a father who left one woman to come to New York to have a child (the testator) with another woman. A the first court appearance, I advised the half-brother's attorney that the testator had executed at least five prior Wills all of which did pretty much the same thing. I said to the attorney, "I have only to be lucky before a jury once."

Implicit in the foregoing discussion is the technique of deliberately having the client execute a series of Wills so as to present the objectant with the prospect and expense of having to overcome several instruments. If your client is adamantly opposed to an in terrorem clause giving the hated family member a penny, then consider having your client return to your office periodically to execute another and identical or very similar Will for a nominal fee.

7. Inter Vivos Gifts to the Disinherited

We discussed this technique above, but it bears its separate mention here. This is a cousin to the *in terrorem* clause. Here, the practitioner may suggest to the testator when the Will is executed to make a contemporaneous gift to the disinherited person. Of course, the testator has to overcome the aversion to doing that, but after you have convinced him or her of the value of an *in terrorem* clause, it should not be difficult to have him or her take some of that legacy and give it to the distributee at that time. Why? Well, if the distributee is going to object to the Will, then he or she will be put in the uncomfortable position of objecting to the Will but defending the contemporaneous gift. What's more, if the Will contest should be successful, then the gift can be compelled to be returned to the estate in a discovery proceeding.

8. Transparency during life

Informing the distributee of a testamentary scheme has been suggested by some estate planners but is rarely utilized because the testator is desirous of maintaining whatever good

relationship may exist with that distributee. Nevertheless, this is one method that can be utilized if the circumstances warrant. However, if the client has no relationship with a family member, then why not have that client inform that person that no provision has been made for him or her under the Will?

9. Trusts.

Finally, the use of the revocable trust is frequently advertised as a means to avoid probate. However, the mere fact of avoiding probate will not insulate the estate from challenge on the trust level. Nevertheless, a revocable trust that holds title to most or all of a person's assets, when coupled with a Will that pours over into that trust introduces another useful obstacle to post mortem challenges. If the Objectant proceeds to challenge the trust, then the Will can be offered for probate if it has not already been. The Objectant must now fight a two-front battle.

B. Drafting Tax Payment Provisions (Selected Problems in New York)

I. Introductory Concepts
   A. The probate estate and the taxable estate
   B. Common choices on apportionment

II. Inside Apportionment and Outside Apportionment
   Abatement or Apportionment?
      Matter of Kleila[8]

III. Competing Instruments, Conflicting Provisions
      Matter of Collia[9]
      Matter of Wu[10]

IV. The Impact of Foreign Taxes
      Matter of Herz[11]

V. Marital Issues and Charitable Interrelated Calculations
      Matter of Rosenzweig[12]
      Matter of Priedits[13]
      Matter of Beebe[14]

VI. The QTIP Trap, Intra-residuary: apportionment or not?
      Matter of Feil[15]

VII. Construing the Instrument and the Limits of Judicial Discretion
      Matter of Rhodes[16]

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8 NYLJ, May 29, 1997, p.32, col.5 (Sur.Ct. Nassau County [Radigan, S.])

9 118 AD2d 778, 500 NYS2d 286 (2d Dep't 1986)

10 24 Misc3d 668, 877 NYS2d 886 (Sur.Ct. New York County, Glen, S.)

11 85 NY2d 715, 628 NYS2d 232 (1995)

12 19 NY2d 92, 278 NYS2d 192 (1966)

13 132 AD3rd 769, 18 NYS3d 387 (2d Dep't 2015), aff'g 40 Misc3d 482, 961 NYS2d 731 (Sur Ct Suffolk County, 2013 [Czygier,S.])

14 268 AD2d 943, 702 NYS2d 683 (3d Dep't 2000)

15 27 Misc3d 274, 894 NYS2d 837 (Sur Ct., Nassau County [Riordan, S.])

16 22 Misc3d 766, 868 NYS2d 513 (Sur.Ct. Westchester County 2008)

I. Introductory Concepts

"The single most likely provision to generate error in standard estate planning documents is the tax payment provision."[17]

Let's begin by expressing the writer's strong presumption in favor of statutory apportionment. In New York, EPTL 2-1.8 requires *pro rata* apportionment across the asset spectrum that constitutes the gross taxable estate on the federal estate tax return. It is a default statute, therefor the governing instrument may provide otherwise. It is respectfully submitted that the default provisions of the New York statute express a wisdom that is frequently ignored by the estate planner. There are circumstances that justify the deviation from the statutory *pro rata* apportionment but they are far fewer and less advantageous than the frequency with which one sees non-apportionment provisions in Wills. Your writer is a litigator and has on many occasions heard an estate planner say that he or she always drafts for the taxes to come out of the residuary and did not see the need to explain that to the testator with any degree of specificity. The upshot of this planning decision is frequently to result in the disinheritance of the testator's major beneficiaries.

Does the reader have confidence that such a complicated decision is properly explained to the testator, and that the decision to preclude apportionment is one made with the informed consent of the testator?

The writer's bias is reflected in the governing case law on these issues. Once a tax exoneration clause comes under review, it is subject to strict scrutiny. The Court of Appeals has long held that "[t]here is a strong policy in favor of statutory apportionment and those controverting its application must bear the burden of proof." (Matter Shubert, 10 N.Y.2d 461,472, 180 N.E.2d 410, 413, 225 NYS2d 13, 23 [1962].) This preference is merely a recognition of the commonsensical fact that the apportionment statute was enacted to prevent the entire burden of an estate tax being borne by the residuary legatees, who generally are the principal objects of the decedent's bounty. This would happen when a casually drafted Will provides for taxes to be an estate expense or to be paid by the residuary estate. Thus, courts have

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17 Jeffrey N. Pennell, Tax Payment Provisions and Equitable Apportionment, University of Miami Institute on Estate Planning, Vol. 22, pp. 18-129, 1988.

strictly construed tax payment provisions and seek to find ways to rule that each beneficiary will bear his or her or its share of the estate taxes "in the absence of a clear, unambiguous direction to the contrary in the will." (Matter of Schubert, 10 N.Y.2d 461, 180 N.E.2d 410, 225 N.Y.S.2d 133 [1962].) Therefore, the careless effort to draft a tax apportionment clause may not achieve its goal and result in the courts default to the statute and is just an added cost to the estate's administration that the estate would have been free from such expenses had the planner merely remained silent on apportionment.

A. The probate estate and the taxable estate

Much of our wealth resides in assets not subject to the provisions of the Will. Of course, that does not mean that such assets are immune from estate taxation. What might constitute the probate estate is frequently different than the gross taxable estate. Thus, the federal gross estate includes the following kinds of property:

1. Property in which the decedent had an interest (IRC 2033);
2. In some cases, jointly owned property (IRC 2044);
3. In some cases, annuities and pensions payable to the decedent's beneficiaries after his death (IRC 2039);
4. In some cases, life insurance on the decedent's life (IRC 2042);
5. In some cases, property transferred by the decedent with "strings attached" (IRC 2036, 2037, 2038);
6. In some cases, property transferred by the decedent with "strings attached" if the decedent cut those strings within the last three years of his life (IRC 2035);
7. Property over which the decedent had (and in some cases, exercised or released) a general power of appointment (IRC 2041); and
8. Gifts taxes on any gratuitous transfers made after 1976 and within the last three years of the decedent's life. (IRC 2035).[18]

In New York the gross estate is the federal gross estate with the following modifications: real property outside New York is not included. (Tax Law 954(a)(1) and tangible personal property outside New York is not included. (Tax Law 954(a)(1).

[18] N.B. The gratuitous transfers themselves are not part of the gross estate if the decedent died after December 31, 1981, but they may be part of the estate tax computation as Adjusted Taxable Gifts. This distinction may prove to be very important because the Adjusted Taxable Gifts are probably immune from apportionment.

B. <u>Common Choices on Apportionment.</u>

The language chosen by the planner, aside from its frequent disconnect between the planner's intent and the testator's intent, each of these issues are recurrent themes in estate administration and litigation. For example, consider the following provisions of a Will:

1-"Taxes are to be paid out of my residuary estate;"

2-"Taxes are to be paid as administration expenses;"

3-"Taxes are not to be apportioned;"

4-"Taxes are to be paid from my probate estate;"

5-"The executor shall pay all administration expenses, debts, and taxes as soon as practicable."

Which of the preceding testamentary provisions require apportionment across all assets classes? Only #5.

What if the residuary estate is itself bifurcated, i.e., split between specific gifts and a general set of percentages to the remaining residuary beneficiaries?

There are several problem areas that we will discuss. One area in which this becomes particularly complex is where a decedent fails to provide (or adequately provide) for his or her surviving spouse by Will. It is the long-standing public policy of New York that a decedent cannot wholly disinherit a spouse. At a minimum, a surviving spouse is entitled to elect to receive one-third of the net estate outright by exercising the statutory right of election under EPTL 5-1.1A.

Here are some general planning points to ponder before we consider the problems.

1. When should Tax Apportionment become a concern?

Careful consideration of tax apportionment issues is necessary whenever (1) estate is likely to generate federal transfer tax; (2) different instruments direct disposition of property; (3) substantial credits or deductions are likely to be available to reduce the portion of tax due; or (4) a substantial portion of estate is composed of non-probate property. If testator's will does not include tax apportionment clause, applicable state law will allocate death taxes by statute. In New York, there is EPTL 2-1.8. It will require pro rata apportionment from all the assets that made up the gross taxable estate.

2. The Fiduciary of decedent's estate is responsible for payment of estate tax imposed on decedent's taxable estate.

Apportionment of tax can be directed by testator's will, applicable state law, or federal statute. Federal statutes provide right of recovery in cases of life insurance proceeds includable in decedent's estate, property includable as result of general power of appointment, QTIP property and property includable as result of retained life estate. In addition, the Internal Revenue Code directs payment of generation-skipping transfer tax from property constituting generation-skipping transfer. The estate's executor is given the right to collect the non-probate estate's pro rata share of the estate taxes in a proceeding under EPTL 2-1.8 with the added benefit that attorneys' fees are to be paid by the person against whom the proceeding is commenced.

3. Drafting Tax Apportionment Clauses in General.

Tax apportionment clause should address how taxes, interest and penalties are to be apportioned and whether any right of recovery should be waived. Clause must also address method of apportionment.

4. Method of Tax Apportionment.

Testator may direct all taxes to be paid from residue of his or her probate estate. Under outside apportionment, the tax burden due on assets passing outside of testator's will which are includable in decedent's estate for death tax purposes are allocated to that property. Outside apportionment may protect client's estate from death taxes imposed on "surprise assets." Inside apportionment addresses issue of whether taxes will be allocated among all classes of bequests within probate estate.

5. Taxes, Interest and Penalties to Be Apportioned.

Tax apportionment clause should allocate federal estate tax, state death tax and generation-skipping transfer tax. Interest and penalties generated by each type of tax should be apportioned in same manner that tax is apportioned.

6. Allocation of Deductions, Credits and Other Tax Benefits for Purposes of Apportioning Tax.

Equitable apportionment addresses issue of whether bequest of property which generates exemption or deduction should enjoy full benefit of exemption or deduction. Benefit of certain deductions, exemptions, exclusions and credits can be allocated to benefit of property generating benefit for purposes of tax apportionment.

7. Tax Apportionment to Temporal Interests.

Default rule of tax apportionment with respect to temporal interests apportions tax to principal. Consider altering the default rule by inclusion of a proper tax apportionment clause in estate plan after careful consideration to the fact that the share of apportionment will come out of the principal.

8. Coordination of Tax Apportionment Clauses in Multiple Documents.

9. Suppose a testamentary gift states as follows: "

> If my sister, AB, and/or my nephew, CD, shall survive me, I direct my Executors . . .to purchase a commercial annuity that will provide my sister, AB, with payment of $100,000 per month during her lifetime, and upon her death . . . would provide my nephew, CD, with a payment of $100,000 per month during his lifetime . . . with both monthly payments to be adjusted by [the Consumer Price Index]."

The Will otherwise provides expressly for tax apportionment across all asset classes subject to the Federal Estate Tax. Does this language require a net gift to AB and CD and operate as an implicit exemption from estate tax apportionment? The cost of the annuity is approximately 26 million dollars. Will the annuity in reality be only approximately 60% of the amount specifically designated by the testator.

For estate plan that requires using variety of documents to implement it, apportionment of taxes on property passing under each document must be considered in relation to whole estate plan. Tax apportionment plan may be limited by extent to which each document can authorize payment of taxes out of any property other than property passing under that document. Estate planning documents drafted for spouses should have coordinated tax apportionment clauses, even if different attorneys represent husband and wife. (See Matter of Feil, below.)

II. Inside Apportionment and Outside Apportionment

The drafter may draft an instrument that apportions estate taxes against probate assets. This is called "inside apportionment" model. Under such an apportionment clause, the fiduciary may look to only the assets includible in the probate estate and apportions the tax burden among those assets *pro rata*. Therefore, non-probate assets such as life insurance, annuities, qualified

retirement accounts, jointly owned assets with a right of survivorship, and assets with a "payable on death" designation will not be used to pay estate taxes.[19] The drafter can also utilize a provision that provides for outside apportionment. The entire gross taxable estate is now subject to apportionment and such a provision will apportion the tax burden among the includible assets pro rata. While outside apportionment adds more assets to the apportionment pool, it may still exclude assets held by properly structured irrevocable trusts or assets gifted during the decedent's lifetime that are considered Adjusted Taxable Gifts by the IRS Some examples.

Matter of Kleila. In this case, a specific devisee of the decedent's residence, sought the court's construction of several provisions of his mother's will. Specifically, he seeks a construction which would apportion estate taxes among all the beneficiaries of both probate and non-probate assets. The executor, opposed the construction sought by the devisee and cross-petitioned for permission to sell the devised realty pursuant to an executed contract of sale and to pay all estate taxes and administration expenses from the proceeds of sale thereof.

> SEVENTH: I direct that all the estate, inheritance or death taxes, by whatever name called, including the interest and penalties thereon, imposed by the laws of any jurisdiction by reason of my death upon or in relation to property includible in my estate, for the purpose of such taxes, whether such property passes under or outside of this will, be paid out of my estate as an expense of administration without apportionment.

It should be noted that a direction in a will to pay estate taxes out of "my estate" or "as an expense of administration" is a direction to pay the taxes out of the residuary. In Kleila, the residuary estate was insufficient to pay either administration expenses or estate taxes. The court held that to the extent that the residuary estate is insufficient to pay estate taxes, the default apportionment statute (EPTL 2-1.8) not the abatement statute (EPTL 13-1.3) governs. Hence, the residuary is first wiped out and then the remaining assets of the estate, both probate and non-probate must contribute in a pro rata share of the shortfall for the taxes.

III. Competing Instruments, Conflicting Provisions

[19] See EPTL 2-1.8(c)(1), 1-8.1(d- 1), 2-1.13; Recipients of some inter vivos gifts includible in the decedent's gross estate are not subject to outside apportionment rule. (See Matter of Metzler, 176 A.D.2d 15, 579 N.Y.S.2d 288 (1st Dep't 1992).

Recall at the outset it was mentioned the difficulties that arise when there are different instruments governing the overall estate plan and care must be given to assure that they do not conflict. Let's consider what happens when problems crop up.

In Matter of Wu, the brother was the beneficiary of two insurance policies on the decedent's life valued at an amount in excess of 3 million dollars. He was not, however, a beneficiary under the Will. He was, however, one of two attesting witnesses to his sister's Will. The brother claimed that a non-apportionment tax clause of the decedent's will absolved him of any liability. The court found that as a witness, the brother's testimony was necessary for probate of the will pursuant to SCPA 1404(1). If effective, the tax clause would require that the brother's tax obligation be satisfied by a disposition from the residuary estate, thus preserving the full death benefit payable to him under the policies. The court rules that such a result in favor of the brother was tantamount to a testamentary disposition to him. Accordingly, the tax provision constituted a "beneficial disposition" within the meaning of EPTL 3-3.2(a). The brother's knowledge of the life insurance policies was irrelevant since the application of EPTL 3-3.2(a)(1) to a non-distributee was absolute. Therefore, because the tax clause of the decedent's will was ineffective as to the brother, estate taxes were to be apportioned against the life insurance proceeds of which he was beneficiary in the manner provided in EPTL 2-1.8. The court wrote:

> The court is mindful that when a will is executed the identity of beneficiaries of non-testamentary assets is not readily apparent, whereas beneficiaries of testamentary gifts are ordinarily named in the will or can be ascertained fairly easily. Any forfeiture [for being a witness] resulting from unwitting use of a non-testamentary beneficiary as an attesting witness will most likely arise, as here, in the context of a tax non-apportionment clause covering assets passing outside of the will. It behooves any drafter using such clause to be fully informed of the testator's non-probate assets to avoid unintended consequences, some of which may have even greater potential for frustrating the testator's intent.

In Matter of Collia, the decedent provided in her will that all taxes which became payable by reason of her death be paid out of her residuary estate without apportionment. However, Decedent had created a trust before she executed this Will. A provision of the trust provided that upon death any deficiency in taxes should be paid by her trustee to her legal representatives. The trust did not specifically require non-apportionment of the tax payments. The question for the Second Department was whether the provision of the Will which directed

non-apportionment controls the payments of moneys from the trust. The court held that it did. It reasoned that the plain language of the statute provided that "where a testator otherwise directs in his will" the apportionment provision of that statute shall not apply. In other words, where the Will is silent, equitable apportionment will apply. The court also held, citing a Court of Appeals case, that in cases where directions concerning apportionment differ between a trust instrument and a Will, the Will, speaking as it does at the time of the decedent's death, takes precedence over the provision of the earlier, non-testamentary disposition. (See also Matter of Cord, 58 NY2d 539 [1983], rearg denied 60 NY2d 586 [1983].)

IV. **The Impact of Foreign Taxes**

In Matter of Herz, the issue was who was to pay a foreign inheritance tax, the German *Erbschaftsteuer* tax. Petitioner, the nephew of the testator, was also a beneficiary and a co-executor of the will. The will made bequests to petitioner and to respondents, other beneficiaries and provided that "all estate, inheritance, and other death taxes shall be paid" out of the estate. You recall that we have already concluded that such provision is interpreted to mean the residuary pays the tax. The testator's Will provided:

> "I give and bequeath the sum of TWO HUNDRED FIFTY THOUSAND ($50,000.00) Dollars to my sister's grandson, YORK WINTER, Brucker Weg 3, 8520 Erlangen, West-Germany, on the condition that he keeps these funds for himself and does not give them to his parents or sisters or brother and keeps them outside of Germany [emphasis in original].

Petitioner, who lived in Germany, sought to have the German tax Erbschaftsteuer paid out of the estate. The Will provided:

> "All estate, inheritance, and other death taxes, payable by reason of my death, shall be paid out of my estate as an expense of administration without apportionment or proration. This clause covers all testamentary and non-testamentary property whether passing before, on or after my death."

Respondents, citing to other language in the will and to the rule that such a tax would not be paid absent the express intent of the testator, argued that petitioner should pay the German tax. The surrogate and the appellate division both held for respondents, but the Court reversed. The court first emphasized the importance of determining and effectuating the intent of the testator. After examining the *Erbschaftsteuer*, the Court concluded that it was an inheritance tax and as such, was subject to the non-apportionment clause which expressly directed all estate

taxes to be paid from the estate (i.e., residuary) funds. The *Erbschaftsteuer* met the definition of an inheritance tax, that the testator had expressly provided for all estate, inheritance, and other death taxes to be paid from the estate, and that to order otherwise was to contravene the intent of the testator.

V. Marital Issues and Charitable Interrelated Calculations

This may be the most difficult subject to address because the interplay of non-taxable dispositions and the apportionment is strewn with mine fields for the planner.

If there is time at the end, we will discuss the Rosenzweig decision but let's put it aside for now since it is really of topic and useful only to illustrate a general tendency of the courts when dealing with any sort of apportionment issue.

In Matter of Priedits, we had a contested accounting proceeding wherein a charity was the residuary beneficiary and a disinherited non-citizen spouse, who had exercised her right of election. The decedent named his wife the beneficiary of two IRAs amounting to more than $1.1 million. That amount was a testamentary substitute but even when taken onto consideration, was still not enough to satisfy an elective share calculation. The Will provided for taxes to be paid out of the residuary. The sole residuary beneficiary was a charity, The Latvian America Association.

According to the charity, when the surviving spouse "opted out" of the estate plan by filing a right of election, she could no longer rely upon the apportionment provision and that she had to share in the estate tax. The court disagreed. It noted that EPTL 5-1.1-A (a) (2) provides in relevant part that "nothing contained herein relieves the surviving spouse from contributing to all such taxes the amounts apportioned against him or her under 2-1.8" The court ruled that "Although the arguments of the American Latvian Association and the Attorney General speak to the forfeiture of benefits that [the spouse] derives under the terms of decedent's will, it is clear from a plain reading of decedent's will that the tax burden, if any, was to be borne by the recipient of the residue of his estate, in this case the Charity."

In Matter of Beebe, the Decedent, after making certain specific bequests to friends, relatives and the retirement home in which she resided prior to her death, directed, that her residuary estate be distributed as follows: one third to a charity, one third to a second charity and one third, to be shared equally, to three relatives, including petitioner Raymond S. Perry, Jr., the co-executor of her estate. The apportionment clause required taxes to be paid out of the

residuary. One of the charities argued that the taxes should be apportioned among the three non-charity residuary beneficiaries. The court disagreed. Such a ruling will require an inter-related calculation because as the charitable beneficiary shares in the tax, the benefit to the charity decreases and the deduction correspondingly decreases.

VI. The QTIP Trap, or Intra-residuary: apportionment or not?

In Matter of Feil, the residuary clause of the decedent's Will, among other things, created a set of charitable lead annuity trusts (CLATs). However, the Will also provided for a 20,000,000 trust for children if Decedent's spouse predeceased him. If she predeceased her husband, a pre-residuary specific bequest of $ 20,000,000 would pass to the continuing trusts of article seventh for the benefit of the issue of the husband. That bequest would pass free from estate taxation because article twelfth required non-apportionment, thereby requiring taxes to be paid from the residuary estate which was the sole remaining beneficiary of the will. If the wife survived Louis, as she did, then the entire estate passed to the wife in the residuary estate, albeit in a marital trust subject to a QTIP election. However, even in the event that the wife survived her husband, the $ 20,000,000 bequest to the continuing trusts did not disappear. Instead, it survived in the residuary clause, lurking inchoate in the marital trust as one of two classes of remainder beneficiaries of the marital trust when Gertrude died. The other class of remainder beneficiaries upon the termination of the marital trust is the series of charitable lead annuity trusts, or CLATs.

The daughter took the position that the $ 20,000,000 bequest to the continuing trusts retained its tax-favored position regardless of either its status as a pre-residuary bequest (if wife predeceased husband) or as the remainder of the marital trust (if wife survived husband, as she did). The son argued that the non-charitable portion of the residuary estate bore the burden of the tax due on the remainder of the marital trust when the decedent's wife died. The court agreed with the daughter.

> The rules of EPTL 2-1.8 did not apply if the testator directed otherwise in his or her will. Based on the will as a whole, the decedent intended that the CLAT bequest survive intact. To come to the conclusion advanced by the son would have required a finding that the decedent intended a tax-free gift to the CLATs if his wife died before he did but not if he died first. This was unlikely and unsupported by the will language. The son's argument would have accepted that

the decedent's intent was that none of his estate go to his issue but be used instead to produce a double tax free estate. This was unlikely.

"Finally, the daughter's reliance on "true residuary" jurisprudence is appropriate and the court considers it to be an extension of her other arguments. In this line of cases, the distinguishing factor in determining when courts should parse a residuary clause for apportionment purposes is when there is a bequest of a specific dollar amount contained within a portion of the will which is ostensibly the residuary clause. Where a residuary distribution is divided between fractional or percentage shares (see Matter of McKinney, 101 AD2d 477, 477 NYS2d 367 [2d Dept 1984]), courts typically conclude that intra-residuary apportionment applied and that, absent an unequivocal exoneration from statutory apportionment within the residue, all residuary beneficiaries bear the taxes attributable to their share of the residue, and all exempt beneficiaries are entitled to the benefit of the charitable (or marital for that matter) deduction. Therefore, the non-charitable portion of the residuary assumes the full burden. However, when a residuary distribution is divided between specific dollar amounts and a further distribution of the "balance" or the "amount remaining" (see Matter of Kindermann, 21 NY2d 790, 235 NE2d 452, 288 NYS2d 480 [1968]), then the specific bequests are exonerated from paying any portion of the estate taxes, and the estate taxes are charged entirely against the "true residuary," even if the true residuary is charitable.

VII. Construing the Instrument and the Limits of Judicial Discretion

In Matter of Rhodes, we witness a very sophisticated tax apportionment provision in the Will. For all the thought and effort that went into the provision, it was insufficient to prevent litigation when transfers after the Will was executed complicated matters. The provision reads as follows:

Under ARTICLE FIRST, decedent sets forth a statement of his testamentary intent:

> "I have given much thought and deliberation to the provisions which I make for each of you . . . . While I have equal love and affection for my sons . . . I recognize that I make disproportionate provisions for my sons . . . for reasons I deem sufficient. In arriving at the specific provisions which I make . . . I have taken into account, among other factors, the provisions which I have made for each of them during my lifetime, in certain cases my son's connection with the particular assets which I bequeath to him or his issue, and in the case of the disposition of my business interests, the efforts certain sons have made in helping me run and develop the particular business."

The tax clause, set forth under ARTICLE EIGHTH, provides, in part, as follows:

> "All inheritance, succession, transfer and estate taxes . . . payable by reason of my death in respect of all items included in the computation of such taxes which shall

> have passed under the provisions of this Will, shall be paid by my Executors as follows:
> "(A)All taxes with respect to property passing under this Will shall be apportioned in accordance with the law of New York, notwithstanding the foregoing, I direct that any such taxes resulting from the bequests under Clauses SECOND, THIRD and FIFTH of this Will shall be paid by my Executor out of my residuary estate, without apportionment or reimbursement from any beneficiary.
> "(B)I intend that all taxes described in paragraph (A) of this Clause with respect to property passing outside of the provisions of this Will shall be apportioned in accordance with the law of New York . . . .
> "(D) I wish to record that I have given great consideration as to how I have directed that the taxes described in paragraph (A) of this Clause are to be paid with respect to property passing under and outside my Will and to whom I have burdened with the payment of such taxes. I believe that the provisions which I have arrived at are equitable for all of my family members."

As well drafted as the foregoing provision demonstrates, it did not prevent a construction proceeding to ascertain the interplay between the so-called "preferred dispositions" and the fact that the residuary was insufficient to pay the estate taxes. In effect, the court noted that the major benefit under the Will passed through Article FOURTH to two sons and ruled that since Article FOURTH was excluded from the definition of "preferred dispositions," it was to be the source of the remaining taxes owed.

Rhodes also illustrates another feature of tax apportionment issues, the difference between the gross taxable estate and the concept of an adjusted taxable gift. In Rhodes, the decedent made a gift to one of his children and his spouse within three years of death. The child also assumed the burden of paying the gift tax on the transfer making the transfer a so-called "net gift." The court was asked to decide whether the gift tax (which was added to the gross taxable estate because the gift was made within three years of death had to share in the apportionment. It held that it did.

C. Additional Considerations: Avoiding Scrutiny, Avoiding Probate

Random Points to Ponder

- Publicity in the Digital Age
- Warning Signs:

  - A second marriage with children from prior marriages; - A family business and a possible struggle for control; - Fiduciaries, the procrastinator, the tyrannical, the conflicted; - Multiple Fiduciaries, deadlock, passivity
- Paper, paper, paper.
- Revocable trust and the pour-over will

  - keep in mind that any assets not transferred to the trust may necessitate a probate of the pour-over Will and that may expose the trust to public scrutiny.
  - Fiduciary Succession without court intervention;
  - Enforcement mechanisms.