Tax Apportionment Clauses

Take-Away: The application of Michigan's *default* rules for the allocation or apportionment of estate or inheritance taxes can often lead to surprises, and thus unequal inheritances, when the decedent's estate plan relies, in part, on ladybird deeds, transfer-on-death beneficiary designations, or sizable IRAs with designated beneficiaries.

Background: In the past we have covered, albeit lightly, the importance of having a tax apportionment clause in a Will, which addresses the allocation of estate and inheritance taxes among the decedent's beneficiaries. Not much thought has been extended to the allocation of federal estate taxes over the past several years, primarily due to the 2107 Tax Act with his extremely generous applicable exemption amounts and the *portability* of exemptions between spouses. That causal regard to federal estate taxes may change as we look ahead to the schedule *sunset* of an individual's high applicable federal transfer tax exemption amounts.

Michigan Law: The allocation or apportionment of death taxes, i.e., estate and inheritance, among beneficiaries, referred to in the statute as *death taxes* , is covered in MCL 700.3920. The statute sets for a common set of rules when the Will or Trust does not expressly allocate that tax burden. In short, the Michigan statute provides a set of *default* rules when the governing instrument is silent. With a Will, the death taxes are generally borne by the residuary beneficiaries of the decedent's estate. [MCL 700.3920(1)(a).] With a Trust, the statute allocates the death tax burden on property that passes through the Trust; this death tax burden is therefore not on assets specifically bequeath to a trust beneficiary.

Specific Bequests: Specific bequests of assets or devises of real estate will avoid any death tax burden if the statute's *default* rules are applied- in the absence of an express allocation of the tax liability, a specific bequest or devise escapes its share of the death tax burden.

Shortfall: If the residue of the estate or Trust is insufficient to pay the death tax attributable to all nonresiduary interests, the balance of the death tax will be apportioned, pro rata, among those recipients whose assets generate the tax based on the value of those interests. [MCL 700.3920(1)(b).]

Beneficiary Designations and Survivorship: For those property interests that pass by beneficiary designation, e.g., an IRA or TOD account, or survivorship, e.g., a ladybird deed, intestacy, or in an annuity payout, the death taxes associated with those transfers must be apportioned pro rata among, and paid by, all the recipients and beneficiaries of those assets or interests, based on the value of the interests that cause the death tax, unless the allocation of the death tax is expressly waived. [MCL 700.3920(1)(c).]

Statutory Exclusions: Excluded from Michigan's statutory *default* rules on the allocation of death taxes are a series of federal estate tax allocation rules which are in the Tax Code. These federal estate tax allocation rules often create some surprises, in part because some are not applied in the same manner as others. These federal tax allocation rules create estate tax recovery/reimbursement rules available to a Personal Representative, or they give the right to recover an estate tax amount that has already been paid by the Personal Representative from the property recipient for federal estate taxes paid.

-Life Insurance: The Personal Representative possesses the right to recover the pro rata federal estate tax attributable to a life insurance policy- the actual death benefit paid, in which the insured-decedent held an insurable interest. The right to be reimbursed can be waived by the insured-decedent, but only if this right of reimbursement is waived in the decedent's Will. Restated, this right of reimbursement cannot be waived in the decedent's revocable Trust. [IRC 2206.]

-Powers of Appointment: The Personal Representative possesses the right to recover federal estate tax attributable to the recipient of property over which the decedent held a general power of appointment. The right of recovery is on a pro rata basis, based on the value of assets that are received by those appointees. An exception to this recovery rule is when a surviving spouse holds a general power of appointment over trust assets that qualify for the federal estate tax marital deduction under IRC 2056(b)(5). Again, this right of recovery/reimbursement can be waived by the decedent, but the waiver must be located in the decedent's Will. [IRC 2207.]

-QTIP Trusts: The Personal Representative possess a right to recover federal estate taxes attributable to QTIP property. However, there is a different set of recovery rules apart from the recovery rules just summarized. First, the reimbursement is for the incremental federal estate tax burden that is attributable to the QTIP Trust, i.e., the value of which is included in the surviving spouse's taxable estate, not the pro rata federal estate tax paid that is reimbursable for any life insurance or general power of appointment assets, the value of which are also included in the decedent's estate. Second, the waiver of this right of reimbursement by the decedent by the decedent's fiduciary, can be either in the decedent's Will or Trust. Third, if the decedent wants to waive this right of recovery/reimbursement for QTIP property, a general statement of waivers will not work; there must be an explicit waiver of this right of reimbursement/recovery in the governing instrument, e.g., *"I direct that the Personal*

Representative of my estate waive any right of reimbursement he/she may possess for death taxes attributable to qualified terminal interests included in my estate." [IRC 2207A.]

-Retained Interests: Some lifetime transfers will nonetheless be included in the transferor's taxable estate often due to the 'string' provisions of the Tax Code, e.g., IRC 2036. These retained interests might include GRATs, QPRTs, or life estates, or retained powers to control the use and enjoyment of transferred property. The Personal Representative possesses the right to recover federal estate taxes attributable to the value of these retained interests in such lifetime property transfers. Excluded from this statutory right of recovery, however, is a retained interest in a charitable remainder Trust (CRT.)

-IRAs: Somewhat surprisingly the Tax Code is silent when it comes to a Personal Representative's right to recover, or be reimbursed for, federal estate taxes caused by the decedent's IRA or 401(k) account, which normally uses a designated beneficiary. In this situation, Michigan's *default* statute will apply unless it is expressly waived by the decedent.

How clear the decedent's direction is to waive death tax apportionment was recently in the news with a decision from the Nebraska Supreme Court.

Shaddick v. Hessler, 316 Nebraska 600 (May 10, 2024)

Facts: Mike created a Trust for his children and his romantic partner, Lori. [Say no more when it comes to answering the question why there was probate litigation over tax apportionment!] The Trust instrument directed the trustee "*to pay from this Trust all inheritance and estate taxes."* The Trust, as amended, provided that a residence was to be distributed "outright" to Lori, prior to the division of the Trust's residue. On Mike's death, the successor trustee allocated all inheritance taxes to the Trust's residuary estate, i.e., *after* the distribution of the residence to Lori. This allocation of the inheritance tax liability thus impacted the residuary shares received by Mike's children, i.e., Lori received the residence without it being burdened by the inheritance tax associated with the residence, which effectively was shifted to the children's share of the Trust's residue.

Dispute: Mike's children claimed that the trustee should have equitably apportioned the inheritance taxes due on Mike's death among all beneficiaries of Mike's estate, including the taxes associated with the residence that Mike devised to Lori. Mike's children claimed that equitable apportionment of the inheritance tax burden would produce more *fair* result for *all* trust beneficiaries.

Trial Court: The trial judge held that the Trust's language clearly directed the payment of the inheritance taxes solely from the Trust's assets, i.e., the residue, rather than apportioning the inheritance tax liability among all the beneficiaries of Mike's estate based on the value of the assets that each beneficiary received.

Nebraska Supreme Court: The Supreme Court affirmed the trial judge's decision. A couple of points made by the Court included:

Drafter's Affidavit: While the trial judge considered the affidavit of the attorney who drafted the Trust and its amendment, the Court found that consideration of the affidavit was not pivotal to the trial judge's decision, which focused instead on the Trust's clear language of the source of assets to be used to pay any inheritance tax.

Extrinsic Evidence: The Trust instrument must use clear and unambiguous language for a court to deviate from statutory tax apportionment patterns- Nebraska's statute was much like Michigan's, meaning specific bequests and devises are presumed to not bear their equitable share of any death tax burden when the instrument is silent.

Make the Settlor's Intent Clear: The attorney who drafted the Trust had to ensure that the settlor's intention regarding the tax burdens is explicitly stated within the Trust instrument to avoid litigation to ensure that the settlor's intentions were upheld. While the settlor's intention was clear, obviously that clear expression of intent did not stop litigation between his children and his girlfriend.

Fiduciary Duty: The federal statutes that pertain to estate tax recovery/reimbursement give the Personal Representative the right to be reimbursed, which right carries with it's the discretion to assert the right. The fiduciary, whether a Personal Representative or a trustee, has the duty of impartiality to all beneficiaries. If the fiduciary exercises the right of reimbursement from beneficiaries who received the property from the decedent, that has the effect of reducing the wealth that the beneficiary would otherwise have received. It should come as no surprise, then, that some beneficiaries view the fiduciary's discretionary exercise of this right of recovery, or the decision to not exercise the right of recovery, as a violation of the fiduciary's fiduciary duty to treat all beneficiaries impartially, or a disgruntled beneficiary's sense of unfairness. Consequently, a Will or Trust should clearly direct the fiduciary, as part of its discretion, to exercise all rights of recovery or reimbursement under the Tax Code, or to expressly waive such statutory default rules of tax allocation, to deflect claims by beneficiaries that the exercise of such discretion results in an *unfair* (or unequal) distribution of wealth in violation of the fiduciary's duty of impartiality. In short, more attention needs to be given to an estate plan's tax allocation provisions than has been the case in recent years.

Conclusion: If federal estate tax considerations and concerns are resurfacing considering the scheduled *sunset,* we should probably be talking to clients about the potential exposure for federal estate taxes as well as the source of how those federal estate taxes are to be paid. Clients will need to address and acknowledge the reality whether those death tax allocation or apportionment provisions will lead to an unequal distribution of wealth. This will become even more problematic if the governing instrument is silent on tax allocations and Michigan's *default* statute applies with its rules.

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