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Apportionment is an important but confusing subject, and two recent decisions interpreting apportionment waiver clauses in wills and revocable trusts under Illinois law make new and even more confusing law. This article analyzes these cases and provides drafting suggestions.

## Even More Uncertainty about Estate Tax Apportionment

“**E**state-tax apportionment.” Three words likely to cause any estate planning attorney to break into a sweat. Why? Because taxes can have a profound impact on an estate, and the estate-tax apportionment provision – which allocates the burden of paying the tax – can have a bigger dollar impact than any other part of a will or trust. What’s more, even if you choose an appropriate tax payment clause based on your client’s knowledge of the facts – including ownership of and beneficiary designations for all assets – those facts are almost certain to change by the time of the client’s death.

Unfortunately, the choice and drafting of estate-tax payment clauses in Illinois has become even more difficult as a result of two cases decided in the last two years, one from the state appellate court and one from the seventh circuit.

In *Estate of Williams*, the third district held

that when a decedent’s will provides for estate taxes to be paid from the residuary estate and waives apportionment against other assets, but

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the residuary estate is insufficient to pay the taxes, the waiver of apportionment is ineffective with respect to the deficit.<sup>1</sup> *Williams* is significant primarily because the court overruled its decision in *Estate of Fry*,<sup>2</sup> discussed below, and in so doing created a conflict with the fifth district's decision in *Landmark Trust Company v Aitken*.<sup>3</sup>

In *Lurie v CIR*, the decedent had executed a will with estate-tax payment language similar to that in *Williams*. However, the decedent had also executed a revocable trust that directed payment of estate taxes from its assets without apportionment.<sup>4</sup>

The seventh circuit made two important holdings in *Lurie*: (1) the language in the "pour-over" will that effectively incorporated the revocable trust by reference governed the payment of estate taxes that exceeded the residuary estate and (2) even without such language in the will, it is proper under Illinois law to consider both the will and revocable trust agreement to determine the decedent's intent about payment of estate taxes.<sup>5</sup>

### Illinois law on apportionment

**The property that generates the tax pays its proportional share.** The default rule of apportionment provides that the estate-tax burden be borne proportionately between the probate estate and the nonprobate assets (e.g., property held in a revocable trust) that generate the tax. Illinois has adopted the rule of apportionment of estate taxes by case law.

The Illinois Supreme Court first concluded that apportionment should apply to intestate estates in *Roe v Estate of Farrell*.<sup>6</sup> Shortly thereafter, in *Estate of Gowling*, the court extended the rule of apportionment to testate estates if the decedent's will contained no direction for payment of estate taxes or did not clearly waive apportionment.<sup>7</sup>

**Waiver that overrides the default standard.** Subsequent Illinois cases addressed the language necessary to constitute an effective waiver of apportionment. These cases have concluded that a direction to pay estate taxes from the decedent's residuary estate, without contribution or reimbursement, constitutes a waiver of apportionment.

For example, a waiver of "any right to recover from any person, including any beneficiary of insurance on my life, any part of such taxes so paid"<sup>8</sup> was ef-

fective, as was a direction that "all estate and inheritance taxes which shall become payable by reason of my death shall be treated as part of my just debts [,] and no beneficiary shall be required to reimburse my estate for any estate or inheritance tax on his or her account or chargeable to him or her."<sup>9</sup> As recently as December 2006, the first district held that a waiver of apportionment was effective and the residue of the probate estate was responsible for paying all taxes merely by directing that "all taxes shall be paid by my estate."<sup>10</sup>

**"Burden of the residue" rule.** Illinois also applies the "burden on the residue" rule within the probate estate if the will contains no direction regarding payment of taxes, meaning that after specific and general bequests the probate estate is responsible for paying all taxes generated by the probate estate.<sup>11</sup> The fourth district in *Estate of Gowling* explained the rationale for

applying apportionment between probate and non-probate assets but not within the probate estate:

Absent a contrary direction, there are sound reasons for not requiring contribution within the probate estate, while at the same time apportioning the tax burden between the probate and nonprobate assets. Within the probate estate, the burden on the residue rule prefers specific over general bequests and devises in the allocation of tax burdens and for that reason is not manifestly unfair or a great distance apart from what a decedent's desires might ordinarily be assumed to be.... On the other hand, "[i]t is unfair to deplete the residue and general (probate) estate for the benefit of nontestamentary assets when the decedent may not have considered such assets as part of his estate for death tax purposes but which are included under the broad concept of what constitutes the 'gross taxable estate.'"<sup>12</sup>

### The problem—when the residuary estate doesn't cover tax liability

*Williams*. Even with these two well-settled principles, a problem arises if the residuary estate is insufficient to pay the taxes and the decedent's will directs that the estate's taxes be paid from the residuary estate without contribution from other assets. Prior to *Williams*, two Illinois appellate courts agreed that, in such

circumstances, the specific and general bequests under the will would abate in order to pay the taxes and expenses.<sup>13</sup> However, in *Williams*, the third district was asked to reconsider its decision.

In *Williams* – as well as in *Fry*, the precedent under reconsideration in *Williams* – the decedent died owning probate and nonprobate assets. In both cases, the will directed payment of the estate taxes from the residue of the probate estate without apportionment or reimbursement, but the residuary probate estate was insufficient to pay all taxes.

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## The third and fifth districts have reached contrary conclusions about waiver of apportionment when the residuary probate estate doesn't cover taxes, creating a conflict in Illinois.

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In *Fry*, the court held that the waiver of apportionment was effective as to all nonprobate assets, with the result that the estate taxes that exceeded the residuary probate estate were payable from the other probate assets (i.e., those that would have been used to satisfy specific

1. 366 Ill App 3d 746, 853 NE2d 79 (3d D 2006), appeal denied, 222 Ill 2d 573, 861 NE2d 655 (Nov 29, 2006).

2. 188 Ill App 3d 336, 544 NE2d 109 (3d D 1989).

3. 224 Ill App 3d 843, 587 NE2d 1076 (5th D 1992).

4. 425 F3d 1021 (7th Cir 2005).

5. Id at 1026.

6. 69 Ill 2d 525, 372 NE2d 662 (1978).

7. 82 Ill 2d 15, 411 NE2d 266 (1980).

8. *Callner's Estate v American Nat Bank & Trust of Chicago*, 24 Ill App 3d 268, 270, 320 NE2d 384, 386 (1st D 1974).

9. *Estate of Overturf*, 353 Ill App 3d 640, 642, 819 NE2d 324, 326 (4th D 2004).

10. *Estate of Malik v Lashkariya*, 369 Ill App 3d 457, 457, 861 NE2d 272, 274 (1st D 2006); see also *Estate of Wheeler*, 65 Ill App 2d 201, 203, 213 NE2d 35, 36 (1st D 1965) (waiving "on behalf of my estate any right to recover from any person any part of such taxes so paid").

11. See *Estate of Maierhofer*, 328 Ill App 3d 987, 990-91, 767 NE2d 850, 852-53 (3d D 2002) (citing and discussing cases refusing to extend the apportionment doctrine to the probate estate).

12. *Estate of Gowling*, 77 Ill App 3d 548, 553, 396 NE2d 82, 86 (4th D 1979), quoting A. Fleming, *Apportionment of Federal Estate Taxes in Illinois Current Status and Drafting Suggestions*, 63 Ill Bar J 522, 523 (1975).

13. *Fry* (cited in note 2); *Landmark Trust* (cited in note 3).

and general bequests).

Overruling its decision in *Fry*, the court in *Williams* concluded that the direction to pay taxes from the residue without apportionment or reimbursement merely reflected an intent to prohibit the residuary beneficiary from recovering from the recipients of nonprobate assets or specific bequests any portion of the taxes actually paid by the residuary estate. Beyond that, the court concluded, the will was silent as to how to pay the taxes in excess of the residuary estate.

As a result, the appellate court upheld the lower court's decision (though based on different reasoning), which had held that the will was ambiguous and, therefore, directed apportionment of the excess taxes between the decedent's probate and nonprobate assets.<sup>14</sup> A petition for leave to appeal was filed, but the Illinois Supreme Court declined to hear

the case.

**Landmark Trust.** In overruling *Fry*, the third district ruling in *Williams* creates a conflict with the fifth district's decision in *Landmark Trust*.

In *Landmark Trust*, the combination of preresiduary specific and general bequests and increased taxes due to nonprobate assets caused the residuary probate estate to be insufficient to pay all of the estate taxes. Although the probate estate was sufficient to pay the taxes if the specific and general bequests were to abate, the executor instead argued that the taxes should be apportioned among the probate and nonprobate assets due to the insufficiency of the residuary estate.

The court concluded that the direc-

tion against reimbursement for payment of any taxes evinced a clear intent to waive apportionment but that it was not a direction against abatement for the spe-

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## For clients with significant assets outside the probate estate, is it still appropriate to use a clause that directs payment of all taxes from the residuary without apportionment?

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cific and general bequests.<sup>15</sup> As a result, the probate estate was responsible for payment of all such taxes and the general bequests would abate before the specific bequests. Because the third and fifth districts have reached contrary conclusions about the effect of a waiver of apportionment when the residuary probate estate is insufficient, there is now a conflict under Illinois law over the proper allocation of estate taxes in such circumstance. Although the result is clear for a client who dies as a resident of one of those districts, it is uncertain how the appellate courts in other districts will rule.

Further, even if a client resides in the third or fifth district now, there can be no assurance that the client will reside there at time of death. It is also possible that the Illinois Supreme Court will resolve this conflict in some future case in favor of a rule that may be inconsistent with an attorney's current apportionment language. Given this uncertainty, there are two choices for an attorney in drafting the tax payment language in a will to be sure it is clear and reflects the client's intent, regardless of whether the rule of the third or fifth district prevails.

One choice is to direct apportionment of taxes under the will, which is less likely to cause abatement of specific or general legacies when nonprobate assets generate tax liability and spreads the burden between probate and nonprobate assets. The other choice is to pay taxes from the residuary probate estate and waive apportionment but add a direction about what should occur if the residuary estate is insufficient to pay such taxes.

### Sample tax-apportionment language #1: Waiving apportionment

You'll want to draft a provision waiving apportionment if a client (1) has primarily probate assets, all of which are disposed of under a residuary clause, or substantial specific or general bequests and the recipients of those assets are favored over the residuary beneficiaries, or (2) has both probate and nonprobate assets but wants to favor the nonprobate recipients. Consider the following sample language:

My Executor shall pay out of the principal of my residuary estate all estate, inheritance, succession, or transfer taxes and any income or similar taxes on appreciation (including interest, penalties, and any excise or supplemental taxes) assessed or imposed by the laws of any domestic or foreign taxing authority at the time of or by reason of my death (referred to collectively herein as "death taxes"). Except as otherwise provided herein, I hereby waive on behalf of my estate any right to recover from any person any part of the death taxes so paid; provided however, that if my residuary estate is insufficient to pay the death taxes, I direct first that the general bequests or legacies hereunder shall abate proportionately and, after the general bequests or legacies are abated in full, then the specific bequests or legacies hereunder shall abate proportionately, to pay the death taxes which my residuary estate is insufficient to pay.<sup>1</sup>

This clause abates specific and general bequests if the taxes exceed the residuary estate, allowing the non-probate assets to pass without paying any tax. If you instead want the non-probate assets to bear the taxes that exceed the residuary probate estate, you can adapt the sample language in sample #2 (page 309) to direct apportionment of the excess.

The client can still pick one or more specific or general bequests to bear a portion of the taxes; for example, if a testator bequeathed a business to one child, he or she might want to provide that the child pay taxes related to the business but that taxes otherwise be paid from the residuary probate assets.

Obviously, if your client has a small probate estate and substantial nonprobate assets, the estate taxes could exceed the entire probate estate, even if you use the language above. In that case, apportionment would apply by default to taxes that exceed the probate assets.

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1. This language does not specifically address waiver of rights of recovery under the Internal Revenue Code, such as Section 2207A (certain marital deduction property) and Section 2207 (property over which decedent had a power of appointment).

14. *Williams* at 750-51, 853 NE2d at 83-84.

15. *Landmark Trust* at 856, 587 NE2d at 1085.

This will require a discussion with your client, in particular, about the impact of taxes on nonprobate assets and specific bequests. Of course, you should also describe the effect of the tax payment provisions in writing to your clients because, as discussed at the beginning of this article, facts are likely to change after you have drafted a client's documents. Clients are also unlikely to remember the significance of that language when acquiring or creating nonprobate assets in the future.

### **Williams and Lurie**

The decision in *Williams* also potentially conflicts with the seventh circuit's decision in *Lurie*. As in *Williams*, *Fry*, and *Landmark Trust*, the decedent in *Lurie* had executed a will that directed payment of the estate taxes from the residuary estate and waived apportionment, but the residuary probate estate was insufficient to pay the taxes.

Unlike in those cases, the decedent in *Lurie* had also executed a revocable trust that directed payment of estate taxes from the trust assets to the extent the residuary probate estate was insufficient. In prior rulings, Illinois courts had not been asked to consider whether a decedent could waive apportionment in a revocable trust, but had only held that a decedent could do so in a will.<sup>16</sup>

The seventh circuit first held that the combination of the specific "pour-over" language in the will and the provisions of the revocable trust agreement that directed payment of the estate taxes from the trust's assets constituted the decedent's direction through the will regarding payment of the taxes.<sup>17</sup> The "pour-over" language of the will required that all probate assets remaining after payment of expenses and taxes be distributed to a revocable trust created by the decedent and that the revocable trust agreement should govern the administration and distribution of such assets.

To the extent the residuary probate estate was insufficient to pay taxes, the revocable trust agreement itself directed that estate taxes should be paid from the trust's assets without reimbursement from others. Therefore, the seventh circuit concluded that the decedent's will had in fact instructed as to the source of payment of estate taxes if the residuary probate estate was insufficient. That is, the language in the revocable trust agreement to pay the estate taxes from the trust's assets should be followed be-

cause the will mandated that the revocable trust agreement should govern.<sup>18</sup> In essence, the court treated the will as if it incorporated the terms of the revocable trust agreement by reference.

Second, the court held that even if the "pour-over" will had not contained such specific language regarding the revocable trust agreement, the terms of both

the will and revocable trust agreement should be examined to determine the decedent's intent regarding payment of estate taxes.<sup>19</sup> Because the revocable trust

16. See, for example, *Roe v Estate of Farrell*, 69 Ill 2d 525, 372 NE2d 662; and *Estate of Grant*, 83 Ill 2d 379, 415 NE2d 416 (1980).

17. *Lurie*, 425 F3d at 1026-27.

18. *Id* at 1025-26.

### **Sample tax-apportionment language #2: dividing among probate, nonprobate assets**

For a client with considerable nonprobate assets – or assets that may be includible in the gross estate for federal estate-tax purposes but are not part of the probate estate – apportionment among the probate and nonprobate assets makes sense. Consider the following sample language:

My Executor shall pay out of the principal of my residuary estate all estate, inheritance, succession, or transfer taxes and any income or similar taxes on appreciation (including interest, penalties, and any excise or supplemental taxes) assessed or imposed by the laws of any domestic or foreign taxing authority at the time of or by reason of my death (referred to collectively herein as "death taxes"), subject to apportionment as provided herein. Except as otherwise provided herein, it is my intent that each person who shall receive a bequest or devise hereunder; any property as a surviving joint tenant, any property as a designated beneficiary thereof or any other property which passes on my death other than pursuant to the provisions of this Will (referred to collectively herein as "Bequests" or separately as a "Bequest") shall bear a proportionate share of the death taxes to the extent that the value of the Bequest he receives is includible in my gross estate for federal estate tax purposes; provided, however, that, unless otherwise provided herein, neither (i) pre-residuary specific and general bequests or legacies hereunder nor (ii) Bequests or any other property which do not generate any death taxes, including assets for which a marital or charitable deduction is elected for federal estate tax purposes, shall be charged with a portion of the death taxes.

If your drafting goal is that taxes generated by the probate estate be borne proportionately by the specific and general bequests as well as the residue, delete the reference to "residuary" in the first line and delete clause (i) in the last sentence. Or, you can modify the language granting a specific or general bequest to indicate that each must bear its proportionate share of taxes, notwithstanding the general tax-payment direction.

You can also reach this result by providing for distribution of a specific dollar amount or item as part of the residuary clause, but you must take care that the provisions are truly part of the residuary distribution. In situations where this language could create a conflict over payment of taxes – for example, if some beneficiaries of the residuary estate are charities – it should be modified accordingly.

### **Sample tax-apportionment language #3: will plus revocable trust**

If you're drafting both a will and a revocable trust for a client, revise the language in samples #1 or #2 to refer to the trust. Also, consider adding the following language to the client's will and including corresponding payment language in the revocable trust:

If there shall be in existence at my death a trust established by me under which I have retained the right to revoke, alter or amend the terms thereof (referred to as a "Revocable Trust"), then to the extent my residuary estate is insufficient to pay the death taxes and, in accordance with the directions on apportionment herein, my Executor shall seek payment of such items from a Revocable Trust. My Executor shall certify to the Trustee of a Revocable Trust the extent to which my residuary estate is insufficient to pay the death taxes.

agreement itself mandated payment of estate taxes from its assets without reimbursement, it had effectively waived apportionment for the other nonprobate assets.

### **A conflict?**

In light of the holdings in the *Williams* and *Lurie* cases, there are circumstances in which the interpretation of a “pour-over” will and a revocable trust agreement could differ depending on whether an Illinois state court concludes that *Williams* or *Lurie* applies.

Assume the following: (1) a will directs payment of taxes from the residuary estate without apportionment, (2) the language in the will differs from that in *Lurie* by directing distribution of the remaining assets to the revocable trust without incorporating the trust agreement by reference or directing that the assets be administered and distributed pursuant to its terms, and (3) the trust agreement provides that estate taxes be paid from the trust’s assets without apportionment.

In that common scenario, it is unclear whether a state court would follow *Williams* (although in the third district *Williams* would probably apply) or *Lurie*. If the reasoning of *Williams* applies, the logical conclusion is that the estate taxes in excess of the residuary estate would

be apportioned among the probate and nonprobate assets. If, on the other hand, the rationale in *Lurie* applies and the revocable trust had sufficient assets to pay the taxes, apportionment would not apply, but instead the trust assets would be used to pay the taxes.

### **Drafting tips**

The lesson from these decisions is that providing for estate-tax payment at a decedent’s death has become even more complicated but also more important.

Be sure to discuss the implications of estate taxes with your client. For clients who own significant assets that are not part of the probate estate, practitioners should consider carefully whether to continue using a tax payment clause that directs payment of all taxes from the residuary without apportionment (for clients who do want to waive apportionment, see sample provision #1 on page 308).

While apportionment of the taxes among all assets that generate tax may appear fair, it may not reflect the client’s intent. The client may view specific bequests as similar to joint tenancy assets, or may have a residuary beneficiary to whom the client truly wants to leave “whatever is left.”

If it is clear that a client wants the taxes to be paid from the probate estate

and wants the specific and general bequests to abate before nonprobate assets are used to pay taxes, that direction should be made clear in the will in order to avoid the result in *Williams* (see sample provision #2 on page 309). Moreover, when a will and revocable trust are used, the tax payment clauses must be drafted to reach the same result, whether assets are held in the probate estate or the trust (see sample provision #3 on page 309).

Finally, the *Lurie* decision suggests that other documents that contain tax payment directions or require waiver of their provisions must be considered. For example, in addition to a revocable trust, you as attorney must examine a marital trust created on the death of a spouse for the surviving spouse and irrevocable trusts, whether or not created by the decedent.

### **Conclusion**

The recent holdings demonstrate the intricacies and required detail needed to plan for payment of estate taxes from the proper assets at a client’s death. By discussing the ramifications with your clients and care, it may be possible to avoid pitfalls inherent in conflicting rules of law and changing circumstances. ■

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19. Id at 1027.