PROPOSALS MADE BY ACTEC SUBCOMMITTEE

On October 20, I met with the UPC/UTA subcommittee of ACTEC to discuss the most recent draft of the revised Uniform Estate Tax Apportionment Act. It was a very helpful meeting. The subcommittee made a number of suggestions, most of which are substantive. I have described below the suggestions that were made. I would appreciate hearing from you as to your reactions to these suggestions. Some of the suggestions would require major changes to the approach taken in the current draft; and, given the short timetable left to us, it would be helpful to have some discussion of those proposals before the Committee meets again. Consequently, it would be helpful if the responses you send me are also sent to the other members of the Committee so that they can comment on your responses.

1. Perhaps the most significant proposal of the subcommittee concerns Section 4 of the current draft. Under the current draft, estate taxes are allocated among all persons interested in the apportionable estate including pre-residuary devisees and pre-residuary recipients of gifts in an inter vivos trust. That treatment accords with the approach adopted by most states in their current apportionment statute, and it conforms to the approach adopted in the Uniform Probate Code.

Some states, Pennsylvania is one example, have taken a different approach. Those states apportion estate taxes in the usual manner except that no taxes are apportioned to pre-residuary devisees or to pre-residuary recipients of interests in inter vivos trusts. The amount of estate tax that otherwise would have been attributed to a pre-residuary devisee is instead paid from the residue of the decedent''s estate and charged in the same manner as are administrative expenses. Similarly, the amount of estate tax that otherwise would have been attributed to the pre-residuary interests in an inter vivos trust are instead paid from the residue of that trust.

The subcommittee urged that pre-residuary devisees and trust interests be so insulated from estate taxes in the Uniform Act. The principal reason for this suggestion is their contention that this approach is what virtually all clients wish; or at least how virtually all estate planners draft wills on the assumption that such an insulation is what the client desires. Since the purpose of the Act is to anticipate what most parties would wish to happen if they had faced the issue, the subcommittee contends that the provisions of the Act should conform to what is commonly (and almost universally) done in testamentary documents that have dealt with the tax allocation issue.

If this suggestion is adopted, the provisions in the current draft to exclude from estate tax allocation all devises and gifts of $10,000 or less would become largely superfluous and could be dropped from the draft.

2. The subcommittee proposed a fall back provision if the proposal to exempt pre-residuary devises and gifts is not adopted. The subcommittee proposed that, in such a case, the Act exclude from apportionment devises or gifts of tangible personal property, other than personalty that is
used in a trade or business (e.g., heavy farm equipment would not be excluded from apportionment under this provision). The exclusion of an item from apportionment would be subject to a dollar ceiling so that if the value of a devise or gift exceeded that dollar figure, taxes would be apportioned to the recipient of

that item. Alternatively, the dollar ceiling could be set as a percentage of the value of the apportionable estate (for example, 1%); but most committee members preferred to employ a stated dollar figure in order to minimize the need for valuations of estate assets. This fall back provision might also make unnecessary the current Act''s exclusion of devises and gifts having a value of $10,000 or less.

3. State laws provide insulation from creditors for certain properties such as IRAs. The Subcommittee proposed that the Act provide that the claim for estate taxes apportioned to such properties be given priority over the state''s spendthrift provision, so that such assets can be reached by the personal representative or by others who bear the estate tax. An example of a provision creating an exception to a state law''s insulation of IRA property is Colorado law which subjects such properties to claims for child support.

4. Section 2(7) of the current draft defines ""property received by a person"" to exclude the value of an encumbrance to which the property is subject. A devise or gift of property may be accompanied by a requirement that the recipient make some payment or take on some liability as a condition of receiving the devise or gift. The subcommittee proposed that any such obligation, other than an obligation to pay taxes, should be deducted in determining the value that the recipient received; the reduction should not be limited to encumbrances on the transferred property.

5. Section 3(d) prevents a decedent from increasing the estate taxes apportioned to property over which the decedent ""had no power to alter immediately before the decedent''s death."" One concern raised by the subcommittee was whether the ""power to alter"" provision would apply to a surviving spouse''s testamentary general power of appointment over a section 2056(b)(5) trust since the power could not be exercised immediately before the spouse''s death.. Another issue raised was whether a surviving spouse who had an income interest is QTIP and who also had a special power of appointment over the QTIP would be deemed to have a power to alter a beneficiary''s interest in the trust so that the surviving spouse could increase the estate tax apportionable to that interest on the spouse''s death. Several suggestions were made as to how to resolve those issues in the draft. I would like the Committee''s views as to whether they believe that a surviving spouse should be prevented from increasing the tax apportioned to remaindermen of a QTIP interest (and perhaps thereby shift assets from the children of a first marriage either to children of a second marriage or to a second spouse). I believe that the problem of the testamentary general power can be solved with a minor drafting change.

6. The subcommittee raised another issue concerning QTIP trusts. When a QTIP is included in the gross estate of a surviving spouse under section 2044, the surviving spouse''s estate is allowed to recover from the QTIP the amount of federal estate tax caused by the QTIP, which amount of tax is determined at the spouse''s marginal estate tax rate. However, the current draft allocates to the QTIP recipients the estate tax on the surviving spouse''s estate as determined under that spouse''s average estate tax rate. The subcommittee felt that the use of the average estate tax rate is unfair to the beneficiaries of the surviving spouse''s estate, who often are the children of a second marriage. They propose that the Act provide that the estate tax apportioned to a QTIP be determined according to the marginal federal estate tax rate of the spouse. In support o this view, the subcommittee opined that the Act will run into trouble from the Estate and Gift Tax subcommittee of ACTEC if the tax apportioned to a QTIP is less than the amount that federal law permits an estate to recover. I hope to meet with the Estate and

Gift Tax subcommittee nest year to get their views.

An alternative to the above change is to apply the average rate to a QTIP, but to empower the surviving spouse to provide that a higher rate up to the marginal rate will apply. The subcommittee considered this alternative approach to be satisfactory.

I am not convinced that this change in applying tax rates to a QTIP should be adopted. However, I would like to hear from the Committee members on this issue. If a change is to be made, I would prefer that the change be one that allows the spouse to increase the rate up to the marginal rate, rather than just imposing the marginal rate in the first instance.

7. The subcommittee had a number of objections to Section 6. The most sweeping issue was their belief that no attempt should be made to deal with the problem of insulated property in which their are limited interests. The subcommittee believes that there are so many factual circumstances of such diverse nature that can arise that the Act should not attempt to deal with this problem. Instead, the subcommittee proposes that the matter be left to the parties to work out. That is what is occurring now, and the subcommittee believes that it seems to be working OK, so if it aint broke, don''t try to fix it. The subcommittee does believe, however, that a provision should be inserted in Section 9 describing what the Personal Rep is to do when the PR can''t collect the tax from a recipient.

I am not convinced that the Section 6 approach should be abandoned.. It seems to me that there will be adverse positions among the beneficiaries when this issue arises; if the law leaves it to the parties to resolve, it will be worked out; but the weaker parties will wind up with the short end of the stick. I would prefer to try to arrive at a fair result and leave it to the parties to work out a different arrangement if the Act is not satisfactory. I look forward to hearing the Committee''s views.

If the substance of Section 6 concerning insulated property is retained, the subcommittee suggested that it be taken out of Section 6 and placed into Section 9 as a provision for what occurs when a tax cannot be collected and so must be reapportioned.

8. If Section 6 is retained, some members of the subcommittee objected to the terms that are defined in Section 6(a) and referred to elsewhere in Section 6. They felt that the terms used are confusing or at least make it difficult to read that Section.

I agree that the terms employed are artificial, but it is useful to have specially defined terms to refer to the peculiar items dealt with in that section. I thought it was much less confusing than trying to define those items each time they were used. I am quite willing to search for better names if others dislike what was done here.

9. The subcommittee raised a question concerning Section 9. The issue raised was whether that provision protects a fiduciary who inadvertently distributes too much to a recipient because of not having withheld sufficient funds to pay the recipient''s share of the estate tax. The subcommittee proposed that the first clause of Section 9(a) be deleted so that the provision is not limited to situations where the fiduciary never had control of the property. I think that is a reasonable change and could be accompanied by a Comment.

10. The subcommittee objected to Section 10(b). The subcommittee was concerned as to who would bear the cost of the fiduciary''s enforcing the rights of some beneficiaries to reimbursement if no amount was collected from the

defendant. The subcommittee recommended that this subsection be deleted. If deleted, there should be a Comment as to why it is left to the parties to enforce their rights of reimbursement. If it is left in the act, the Comments should state that the cost of bringing such actions is to be borne by the persons who would benefit from collection of the amount claimed