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Expert Analysis

The Right of Election And Tax Apportionment



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Love and Marriage. Death and Taxes. Each of these issues are recurrent themes in estate administration and litigation. 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 $50,000 or one-third of the net estate outright by exercising what is known as the right of election.

The public policy is fairly straightforward; however, the logistics of calculating the elective share and the correlating tax consequences of that election can be complex. This article seeks to review the effect of exercising a right of election, how to calculate the elective share and the consequences to the other beneficiaries of the estate.

Right of Election

New York follows a so-called "forced heir" rule in that testators cannot disinherit their surviving spouse. Pursuant to EPTL 5-1.1-A, the surviving spouse of a decedent can elect against the estate if she has not received the greater of $50,0001 or one-third of the decedent's net estate.2

To calculate this pecuniary amount, first, all of the probate assets of the estate, testamentary substitutes and any debts owed to the decedent are added together. EPTL 5-1.1-A. Real property located outside of New York State is also included (even though that property is not included on a New York State estate tax return or otherwise administered in a New York probate proceeding). EPTL 5-1.1-A(c)(7). Once the monetary value of the assets of the estate are added together, the debts of the decedent, administration expenses and funeral expenses are deducted to determine the value of the net estate for purposes of the elective share. Estate taxes are not deducted when determining the net estate for this purpose. EPTL 5-1.1-A(a)(2).

Once the net estate is calculated and the one-third elective share is determined, the value of any property the surviving spouse otherwise received under the will, property received outside of the will or property received by other statutory testamentary substitutes must be deducted from the elective share amount. In other words, after applying these credits, the difference is the amount the surviving spouse is entitled to receive from the estate.

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But for the election by the spouse, this pecuniary amount (that now must be allocated to her) would have otherwise been allocated elsewhere. It is an amount that New York State dictates a surviving spouse must receive, regardless of the decedent's directives. The salient question becomes from what source is the elective share paid.

As set forth in EPTL 5-1.1-A(c)(2), the elective share amount is taken ratably from the beneficiaries under the will, the beneficiaries of testamentary substitutes and intestate distributees. The surviving spouse is entitled to a share of everyone's benefits, and each beneficiary must contribute to the elective share proportionately. As explained in In re Rosenzweig's Will, 19 NY2d 92, 97 (1966), "[b]y apportioning the [elective] share against all beneficiaries, the general plan of the will may be, to a great extent, preserved and the balance maintained between the respective preliminary and residuary beneficiaries." Although this may seem straightforward, in practice, several issues may arise.

Tax Apportionment

The interplay of the elective share and tax apportionment can sometimes add a second layer of complexity to this issue. The tax apportionment clause could effectively be the biggest disposition in a will.3 Indeed, it has been held that the tax clause itself under a will is a beneficial disposition.4 The testator may direct that certain beneficiaries pay the estate taxes (and that others do not), but absent a directive under the will, EPTL 2-1.8 governs as a default provision.

Pursuant to EPTL 2-1.8, all beneficiaries of an estate must contribute whatever estate tax is due on the amount the beneficiary is receiving. If a beneficiary received property that caused the estate to incur estate taxes, that beneficiary must bear his proportionate share of the estate tax. This concept has sometimes been referred to as "equitable apportionment."5 The beneficiaries of non-probate assets, such as life insurance, pensions, jointly owned property and lifetime trusts, must also bear a portion of the estate taxes if the assets they received were included in the gross taxable estate. EPTL 2-1.8(e).

Non-taxable bequests generally do not have to bear any portion of the estate tax because their bequests did not add to the estate tax incurred by the estate. EPTL 2-1.8(c)(2). For example, the share of an estate that passes to a surviving spouse normally qualifies for an unlimited marital deduc-

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tion and will be relieved from any tax. IRC 2506. Because that money is not taxed, the surviving spouse does not have to contribute any money toward any estate tax which may be due—absent a contrary direction in the will. This is true even if the spouse exercises his or her right of election and effectively disregards the terms of the will. For tax purposes, she is still a surviving spouse and the marital deduction still applies.

There are a few distinct exceptions to this rule. The first situation concerns a spouse who executes a waiver agreeing to take an elective share in a qualified terminable interest property trust or QTIP. A QTIP trust is set up so that a spouse receives all of the income of the trust for life with the remainder left to other beneficiaries. The estate of the first-to-die spouse can take the marital deduction for the full value of the trust in his or her estate, even though the surviving spouse received a terminable interest. I.R.C. §2056(b)(7). When the surviving spouse later dies, the trust is included in his or her gross estate under I.R.C. §2044, and the estate taxes on it are payable out of the trust unless the decedent provides otherwise. I.R.C. §2207A.

Another anomaly occurs when the surviving spouse is not a U.S. citizen (who does not receive the benefit of a marital deduction). Because the non-citizen spouse does not have an unlimited marital deduction (and the estate does not receive the benefit of that deduction) the non-citizen spouse must pay her portion of the estate tax (unless the will directs otherwise).

Recent Case Law

A recent case, Matter of Priedits, 40 Misc3d 482 (Surr Ct Suffolk Co 2013), illustrates the complexity of this issue. Priedits involved a particularly thorny fact pattern. There, the decedent's will provided several pre-residuary legacies to friends and the residuary estate to a charity. The will did not provide for decedent's spouse who was a non-citizen, and the surviving spouse subsequently asserted her right of election.

It was only later in an accounting proceeding that the estate tax issue arose in several contexts including: (i) Did the spouse's choice to reject the will (and exercise her right of election) also forfeit her interest in the will's tax apportionment clause?; (ii) Was the spouse exonerated from her share of tax contributions?; and (iii) Should the beneficiaries' contribution to the elective share be computed before or after their dispositions were reduced by estate taxes? This issue was particularly complicated because the tax apportionment clause directed that all taxes be paid by the residuary beneficiary—a charity.

When a spouse elects against a will, she rejects all of the provisions of the will and "surrenders" her rights under the will. Matter of Rosenzweig, 19 NY2d 92 (1966). It would appear inconsistent, then, that the spouse can accept the will's tax apportionment provision, but reject the rest of the will to claim an elective share.6

Upon review, and under these very specific facts, the court looked to the provisions of EPTL 5-1.1-A(a)(4)(A) which states in pertinent part that the "...terms of such will or other instrument [elected against] remain otherwise effective so far as possible…"7 From that provision, the court asserted statutory support for the continuing effectiveness of the testator's direction that all taxes be paid from the residuary—even as against the surviving spouse who rejected the provisions of the will.8

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The court also referred to EPTL 5-1.1-A(a)(2), which 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 EPTL 2-1.8."9 From that provision, the court extrapolated that nothing contained in EPTL 2-1.8 obligates a surviving spouse (who elects against the will) to pay taxes not otherwise apportioned against her. The court was also particularly persuaded because the testator had specifically and intentionally opted out of the default tax apportionment statute under EPTL 2-1.8.

Estate taxes again played a significant role in Priedits in the context of each beneficiary's contribution to the elective share. The question was whether the beneficiary's interest in the estate should be determined before or after the estate taxes were deducted. The substantial (approximately $2 million) estate taxes which were assessed solely against the charitable residuary beneficiary made a significant difference in this context. If the charity's contribution was determined before the estate taxes were deducted, then it paid a significantly higher contribution toward the elective share.

The court again looked to EPTL 5-1.1-A(a)(2) and the calculation of the right of election wherein the net estate did not include estate taxes. Notably, however, EPTL 2-1.8(c)(1) states, in relevant part, that the "tax shall be apportioned among the persons benefited in the proportion that the value of the property or interest received by each such person…" (emphasis added).

With respect to each of these issues, Priedits highlights a tension between different ideals and public policies that should be resolved by further review10 and potential legislative amendments.

Conclusion

It may not be enough for practitioners to simply create estate planning documents which reflect the wishes of a testator. Married testators must also consider the right of election and what could occur if a surviving spouse chooses to exercise that right. In addition, practitioners should fully educate their clients about the consequences of including—or not including—a tax apportionment clause and the default provisions under EPTL 2-1.8.

1. If an estate is less than $50,000, the surviving spouse receives the entire estate. EPTL 5-1.1-A(a)(2).
2. EPTL 5-1.1-A applies to decedents who died after Aug. 31, 1992. EPTL 5-1.1 applies to decedents who died prior to that date.
3. Turano, Practice Commentaries EPTL 2-1.8 (McKinney's).
4. See Matter of Wu, 24 Misc3d 668 (Surr Ct New York Co 2009)(finding a tax clause was a "beneficial disposition" under EPTL 3-3.2 and was therefore void where the clause benefitted an attesting witness who received the proceeds of two life insurance policies).
5. See NOTABLE STATE LAW DEVELOPMENTS, SV024 ALI-ABA 171 , 176 discussing Matter of Priedits, 40 Misc3d 482 (Surr Ct Suffolk Co 2013).
6. Id.
7. See John Farinacci, "Spouse versus Charity: Estate Tax Apportionment," Lexis Nexis Legal Newsroom Estate and Elder Law Blog, May 14, 2013.
8. Id.
9. Id.
10. The charity and the Attorney General have appealed the Priedits decision to the Appellate Division, Second Department, Docket No. 2013-04417.