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A Message from the Section Chair

As we head into the "home stretch" of our program year, memories linger of our delightful summer. Hot, dry (a bit too much of each at times) and peaceful, except, of course, for the following:

1. **Estate and Gift Tax "Reform."** After months and months of waiting and endless speculation about prospects for repeal, Congress has finally spoken and ended all the confusion. At last, we know for certain that repeal is a definite maybe—at least for one year. Former Chair Sandy Schlesinger and some of our other speakers will address drafting and planning issues arising from the new legislation, which one wit has dubbed "The Restoration of Income and Credits, Honest Government, Earnings, Technology and Real Incentive Compensation Help the Economy Rebound Act of 2001." (You have to love the acronym!)

2. **Gramm-Leach-Bliley Act Privacy Requirement.** Many of us were caught unaware by the FTC requirement (and the July 1 deadline for compliance) that law firms rendering tax preparation or tax planning services must provide a written notice to clients regarding the firm's "privacy policy and practices." Given our well-established duty to preserve confidentiality, application of these rules to attorneys seems unnecessary and unwarranted. Hindsight reveals that the FTC probably would not have opposed a request for exemption, which may yet be forthcoming to provide relief from future compliance. The flurry

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of angry calls and messages to the initial "blast-fax" we posted provided living proof that the "kill-the-messenger" syndrome is not dead. In all seriousness, though, I do believe that the incident demonstrates the value of our ability to communicate quickly and effectively with our members.

3. **Principal and Income.** This past legislative session marked the long-awaited passage by the New York State Legislature of the Principal and Income Act. Governor Pataki signed the bill on September 4 (Chapter 243 of this year's legislation). Many of you will remember the very interesting discussion at a recent January meeting in New York City concerning the unitrust concept and related implications of the new legislation. We will be learning more about this subject at the Fall Meeting and also at next January's program.

4. **Multi-Disciplinary Practices.** New York has decided to loosen rules to allow lawyers to enter into previously prohibited business arrangements with non-lawyers, an issue that has split the legal community throughout the country. Starting November 1, attorneys will be permitted to enter into partnerships or other formal business relationships with accountants, financial planners, social workers and other professionals under regulations adopted in late July by the administrative board of the state court system. New York thus becomes one of the first states in the country to issue rules allowing what is often referred to as "multi-disciplinary practices."

Congratulations once again to Ira Bloom for putting together a most interesting and informative program for the Fall Meeting. I hope that those of you who were unable to join us in Napa will be able to attend next fall's meeting in Boston. The combination of outstanding programs and social events make the fall meetings a special treat.

As always, I look forward to hearing from you with comments and suggestions as to how we can make our Section more useful to you. Best wishes for an enjoyable autumn and for the reemergence of the Buffalo Bills as an NFL power. (Summer is not the only time for dreaming, you know.)

Stephen M. Newman

Editor's Message

As I write this column, the Section is preparing to hold its Fall Meeting in Napa Valley, California. Professor Ira Bloom has assembled a great program regarding planning for the entrepreneur and other hot topics. I hope that I will see many of you there, since in addition to the informational program, golf, tennis, wine-tasting tours and spa treatments are also available.

The Case Notes column has been a mainstay of this *Newsletter* for 14 years. After this much time, Arlene Harris, who will be our next Section Chair, is passing on her pen. Beginning in January, Ilene Cooper and Donald Klein will provide the column. I want to personally thank Donald and Arlene for the time and effort they have spent on behalf of the Section over these past many years. It has been of great help to the readers. I am sure the tradition will continue.

The Section is successful because of its many committees. Through the activity and interests of the persons working on committees, the Section has been most effective in having legislation passed and making changes that are beneficial to the clients we represent in our practice as well as to practitioners. I have provided descriptions of some of the committees for you in past issues in the hope that you might find one of interest and volunteer your services. This column is no exception.

The Ad Hoc Committee on Multi-State Practice is chaired by Professor Ira Bloom. Its current projects include the analysis of uniform laws that New York State has not enacted and recommendation for enactment, if appropriate. Those uniform acts include the 120 Hour Rule for Simultaneous Death, the transfer on death registration for securities, and selected aspects of the Uniform Trust Code. Professor Ira Bloom can be contacted by e-mail at ibloo@mail.als.edu.

Another committee is the Surrogates Court Committee, which concentrates its efforts on issues that relate to the operative aspects of proceedings before court, in both contested and uncontested settings. Presently, it is compiling data to update the 1987 handbook for *guardians ad litem*. In addition, the Committee is working on evaluations of statutory provisions related to fiduciary commissions, attorney's fees, and fiduciary appointments to determine if changes are required to better serve the public. This Committee is chaired by Cathryn M. Doyle, who can be reached at the Albany County Surrogate's Court, 16 Eagle Street, Room 118, Albany, NY 12207. The Chair is also the current Surrogate of that county. Additional committee members are always welcome.

Once again, I have been helped by our colleagues, who have produced articles for your review in this issue. John Rausch from the Internal Revenue Service has prepared an informative article regarding the centralized filing of estate and gift tax returns, which will take place on January 1, 2002.

In addition, two questions have been proposed to the *Newsletter*, which have been answered by Elizabeth A. Hartnett from Syracuse, and Jon Schumacher, a former Chair of the Section, who practices in Rochester. I am grateful for their detailed answers to the questions posed.

There are three articles regarding different parts of the new Tax Act. Blanche Lark Christerson from Bankers Trust Private Banking has written a clear article on GST changes. Dick Rothberg and Nancy Richardson have prepared an article on the Tax Act and included planning suggestions. Several lawyers from the Zurich office of Baker & McKenzie have provided an insight into the effect of the Tax Act on foreign aspects of estate practice.

These are but a few of the articles which have been written for your reading pleasure. I hope you find this issue informative.

I hope that you enjoy this issue of the *Newsletter*. Please know that I am always in need of articles and would appreciate any suggestions for sources, so that the *Newsletter* continues to be of informative value to this Section.

Magdalen Gaynor

Centralization of Filing Federal Estate and Gift Tax Returns by the Internal Revenue Service

By John F. Rausch

As part of the reorganization of the Internal Revenue Service, estate and gift tax returns will be filed and classified at a central location. The estate and gift tax returns for all states will be filed in the Cincinnati Service Center, effective January 1, 2002.

All federal estate tax and gift tax returns for residents of New York State filed on or after January 1, 2002 will be required to be filed in the Cincinnati Service Center rather than Andover or Brookhaven. It is important to remember that the January 1, 2002 date is the filing date for the estate and gift tax return and not the date of death or date of gift. Therefore, if the date of death is on or after March 1, 2001 the return is to be filed in Cincinnati. All gift tax returns for the calendar year 2001 are to be filed in Cincinnati. The returns are to be sent to Internal Revenue Service, Cincinnati, OH 45999 for regular mail; or Internal Revenue Service, Cincinnati Service Center, 201 West Rivercenter Blvd., Covington, Kentucky 41019, if a street address is needed for Federal Express, etc.

The centralization began January 1, 2001 when the states of Arkansas, Delaware, Hawaii, Iowa, Louisiana, Maryland, Minnesota, Mississippi, Missouri, New Jersey, North Carolina, Pennsylvania, South Carolina, Texas and Wisconsin, as well as Washington, DC, started to file estate and gift tax returns in the Cincinnati Service Center. Indiana, Kentucky, Michigan, Ohio and West Virginia previously filed in Cincinnati. All other states, including New York, will file in Cincinnati beginning for returns due on or after January 1, 2002.

If the estate and gift tax returns are filed in other service centers, e.g., Andover or Brookhaven, after January 1, 2002, the returns will be transshipped to the Cincinnati Service Center. This will result in delays processing the return and issuing the closing letter.

It is particularly important to remember to file the gift tax return in Cincinnati if the personal income tax return and the gift tax return are filed at the same time. In the past, many practitioners filed both together and relied on service center personnel to separate the returns when received and send the gift tax return to the estate and gift tax area of the service center. Filing in the wrong service center could result in delays in processing due to the transshipment of the return to the Cincinnati Service Center and possible erroneous assessment of penalties and interest for failure to file and/or failure to pay timely.

The groups working estate and gift tax returns in service centers other than Cincinnati will be gradually closed after December 31, 2001 to allow them to complete work received in 2001. The employees in those service centers will then be assigned to other jobs. Estate and gift tax returns filed in other service centers after January 1, 2002 will be transshipped to the Cincinnati Service Center by processing employees, resulting in delays in processing of the returns.

The estate and gift tax section in the Cincinnati Service Center will have seven groups. There will be a technical advisory group which will consist of a managing estate tax attorney, five experienced estate tax attorneys, one estate tax attorney reviewer, two transfer tax technicians and clerical support. Each of the estate tax attorneys will advise and oversee the work of one of five of the other groups. These groups will consist of a manager, four transfer tax technicians and seven tax examiners (who verify computations and input data to the central computer). The estate tax attorneys assigned to work with each of these five groups will work with the group in the handling and processing the estate and gift tax returns including classification. That group will deal only with estate and gift tax returns from "its" territory. Territories have replaced the old concepts of districts and regions. There will be five territories for estate and gift tax purposes divided geographically. (New York State and the six New England states are Territory 1.) The seventh group will be a clerical support group.

Each group will do classification of estate and gift tax returns one day a week. Classification is the process in which a preliminary decision to examine an estate or gift tax return is made. While most classification standards will apply nationally, local groups will provide input for types of returns and issues they believe merit examination based on issues that frequently occur in that geographic area. Selected returns will be held in Cincinnati until ordered, on a monthly basis, by the local groups. If there are more returns being held for a local group than are ordered in a month, the excess returns will be accepted as filed.

For those returns accepted on classification and those excess selected returns mentioned above a closing letter will be issued. Centralization will result in closing letters being issued earlier, as individual local groups will no longer be sending estate tax attorneys to a service center for classification once a month, or as in the case of the Albany and Buffalo offices, having returns sent to the offices monthly for classification. Centralization will also decrease the time needed to issue closing letters as there will be clerical employees permanently assigned to the estate and gift tax section rather than having the accepted returns sent to a typing pool for preparation of the closing letter as currently happens.

Other tasks that will be performed in the Cincinnati Service Center will include computations, adjustments and determinations on § 6166 elections (including claims for an additional interest deduction when the estate has paid the yearly interest); review of §§ 2032A and 2057 elections; preliminary determinations on penalties for failure to file and failure to pay under §§ 6651(a)(1) and (2); review of valuation of stocks and bonds including dividends and interest; correction of mathematical errors in preparation of the schedules and computation of the tax; determinations on requests for extension to time to file and/or pay (Form 4768) and perfection of returns (requesting omitted documents such as wills or trusts that are required to be filed with the return).

It should be noted that requests for release of lien of real estate will continue to be processed at the local office (where the decedent resided). If the request (Form 4422) is filed in the service center it will result in a delay in the release being issued. The service center will forward it to the local office for determination. Also remember to file Form 4422 where the decedent resided not where the property is located, e.g., if the decedent resided in Manhattan and owned a summer home in Lake George, file Form 4422 in Manhattan, or if the decedent resided in Orange County and owned an apartment in Manhattan, file Form 4421 in Albany.

John F. Rausch is the Estate Tax Group Manager in the Albany, New York office of the Internal Revenue Service.

The Latest Tax Changes: Sleeping Could Be Hazardous to Your Practice

By Richard S. Rothberg and Nancy H. Richardson

Only a trusts and estates practitioner asleep in the manner of Rip Van Winkle could have escaped the heralded passage and signing on June 7, 2001 of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("TRA 2001"). Much has already been written on the new law. Nevertheless, we thought it would be helpful to our readers to summarize the key features of TRA 2001, especially those provisions which require the immediate attention of attorneys practicing in the trusts and estates arena. We will also offer a few planning ideas to help cope with the uncertainty of the next decade. Even though the temptation may be strong to sleep until Congress fixes the mess, that course of action could prove disastrous to our clients and ourselves.

Set forth in the following table is a quick reference guide to the scheduled increases in the estate and gift tax applicable exclusion amounts, the GST exemption amounts, and the top marginal estate and gift tax rates and the GST tax rates for the years 2001 to 2011, along with a few reminders of when various features of TRA 2001 are scheduled to become effective.

Year	Estate Tax Applicable Exclusion	Gift Tax Applicable Exclusion	GST Exemption	Top Marginal Estate & Gift Tax Rate and GST Tax Rate	
2001	$ 675,000	$ 675,000	$1,060,000	55%	Transfers after 12/31/00 are subject to automatic allocation of GST exemption.
2002	1,000,000	1,000,000	Increase indexed for inflation.	50%	5% estate and gift tax surtax repealed for estates of decedents dying after 12/31/01.
2003	1,000,000	1,000,000	Increase indexed for inflation.	49%	
2004	1,500,000	1,000,000	1,500,000	48%	Family-owned business deduction is repealed for estates of decedents dying after 12/31/03.
2005	1,500,000	1,000,000	1,500,000	47%	
2006	2,000,000	1,000,000	2,000,000	46%	
2007	2,000,000	1,000,000	2,000,000	45%	
2008	2,000,000	1,000,000	2,000,000	45%	
2009	3,500,000	1,000,000	3,500,000	45%	
2010	N/A	1,000,000	N/A	N/A for estate & GST taxes. 35% for gift taxes.	Estate tax and GST tax are repealed. Carryover basis is in effect. Any transfer to a trust other than a wholly owned grantor trust will be treated as a completed gift.
2011	1,000,000	1,000,000	2003 amount indexed for inflation.	55%	Current law springs back into effect.

Current Planning Implications. Wills that provide for formula funding of a credit shelter trust should be reexamined. As the estate tax applicable exclusion amount increases such wills could result in an unintentional reduction in spousal benefits and leave the spouse at the mercy of the right of election. Ideas for possible alternatives are discussed below.

Disclaimer wills are taking on increased importance because they permit the deferral of decisions to take into account facts that are not known at the time a will is executed, such as the amount of the applicable exclusion, the final size of the estate and the needs of the parties. But a disclaimer will may not be appropriate for everyone. For instance, a spouse may not be willing to disclaim, either because he or she is not able to understand the reasons for doing so, or simply does not wish to relinquish control. Because of the power given to personal representatives in New York Estates, Powers & Trusts Law (EPTL) 2-1.11 to disclaim on behalf of a decedent, in New York we do not have the problems caused by a surviving spouse dying before he or she can execute a disclaimer. Ideas for types of disclaimer wills abound. Following are some possibilities:

1. Simply provide that if the surviving spouse disclaims any part of the residuary estate the disclaimed interest will be paid to a credit shelter trust for the benefit of the surviving spouse (and possibly descendants as well).

2. For clients who are comfortable with the idea of funding a credit shelter trust for the benefit of their spouse and descendants with $1 million, provide that the mandatory funding of the credit shelter trust be capped at $1 million and if the surviving spouse disclaims any part of the residuary estate the disclaimed interest would be paid to a QTIP-able trust for the surviving spouse's benefit (which would presumably make the disclaimer more palatable to the surviving spouse). The executor would not elect QTIP treatment for all or a portion of the trust in order to take advantage of the applicable exclusion amount.

3. Provide that the entire estate is left to the surviving spouse and if the surviving spouse disclaims any interest the disclaimed interest will be paid to a QTIP trust. Then (under Treas. Regs. § 20.2056(d)(3)), provide further that if the surviving spouse disclaims any portion of the QTIP trust the disclaimed portion will be paid to a credit shelter trust for the benefit of the surviving spouse and descendants.

Once the estate tax repeal takes effect, if you believe that repeal will only be temporary you may wish to consider providing testamentary dynasty trusts for the testator's family (or subsets thereof). If the testator dies before the reinstatement of the estate tax, estate tax would presumably be avoided even if it is reintroduced. Gift tax will also be avoided on any distributions from the trust.

Currently Effective Provisions. Following is a list of additional changes in the law that are effective immediately and should be considered in our current estate planning advice to clients.

- **Deemed Allocation of Generation-Skipping Transfer (GST) Tax Exemption.** Effective with transfers made after December 31, 2000, the unused portion of a transferor's GST exemption will be deemed to be allocated to an "indirect skip" taxable transfer of property to a GST trust.[1] A GST trust is any trust from which a transfer subject to a GST tax *could* be made, *unless*: (1) more than 25% of the trust must be distributed to (or, under the requirements of the instrument is reasonably likely to be distributed to) or withdrawn by, a non-skip person before such person reaches age 46 (or, if such person dies before reaching age 46, then to his or her estate or is subject to his or her general power of appointment); (2) any portion of the trust would be included in the estate of a non-skip person if such person died immediately after the transfer to the trust; or (3) the trust is a charitable lead or charitable remainder trust. If the taxpayer does not want the automatic allocation rules to apply to any transfer, he or she must so indicate on a timely filed gift tax return.

  Comment: Trust property subject to a right of withdrawal is includable in the power holder's estate if he or she dies holding such power. However, if the right to withdraw does not exceed the Code § 2503(b) gift tax annual exclusion amount (currently $10,000) with respect to the transferor, that right will not cause the trust to be exempt from qualifying as a GST trust. As a result, *Crummey* powers limited to the annual exclusion amount will not prevent a deemed allocation of the transferor's GST exemption. We wonder what effect allowing *Crummey* powers to accumulate (if not exercised) would have on the GST trust status.

  Comment: In designing this rule, Congress was evidently trying to save taxpayers from the consequences of failure to properly allocate their GST exemptions in situations where the taxpayer would likely wish for the transfer to be GST exempt. Trusts and estates practitioners should review trusts currently in existence that have received or will receive transfers after December 31, 2000. If it is not desirable for the transferor's GST exemption to be deemed allocated

to the transfer, gift tax returns opting out of the deemed allocation must be filed by April 15 of the year following the transfer to the trust. At the same time, if desired, the taxpayer can elect to have Code § 2632(c) *not* apply to any or all future transfers made by the taxpayer to a particular trust.

- **Retroactive Allocation of GST Exemption Permitted in Cases of Unnatural Order of Death.** This is one area in which the practitioner's job is actually made easier by TRA 2001. If a grantor creates a trust for a non-skip person (his or her child, for instance) and no allocation of GST exemption is made because it is assumed that the trust assets will all be distributed out to the child, and the child dies before the grantor and while the trust is still in existence, it is now possible, under TRA 2001,[2] for the grantor to retroactively allocate GST exemption to transfers made to such trust on a gift tax return that is filed on or before April 15 of the year following the child's death. The value of the transfer is determined as if the allocation of GST exemption had been made on a timely filed gift tax return with respect to such transfer.

- **Severing Trusts for GST Purposes**. Under the old law, a trustee could not sever an existing trust that is subject to GST tax into two trusts, one with an inclusion ratio of one and one with an inclusion ratio of zero. Under Code § 2642(a)(3)(B)(ii) (as added by TRA 2001), a trust may be divided into two or more trusts (which is permitted under New York law for GST planning purposes by EPTL 7-1.13), if the trust is divided on a fractional basis and the terms of the new trusts provide, in the aggregate, for the same succession of interests of beneficiaries as the original trust. One trust receives a portion of the assets of the original trust equal to the applicable fraction of the original trust, and has an inclusion ratio of zero, and the balance of the assets of the original trust are distributed to a separate trust, which has an inclusion ratio of one.

- **Education Funding.** The benefits of Education IRAs and Qualified State Tuition Programs are enhanced under TRA 2001. The contribution limits to Education IRAs, and the limitations on their availability, have been eased somewhat. The annual contribution limit was increased from $500 to $2,000, and the maximum income that a married couple may have and still be eligible was effectively doubled (so that the eligibility is fully phased out at an income of $220,000). However, because of the contribution and income limitations, this program still does not represent a significant planning opportunity for many clients. Qualified State Tuition Programs, on the other hand, are worth a careful look. Substantial transfers may be made to such programs, free of gift taxes. The funds accumulate tax-free, like an IRA. Under TRA 2001, distributions from such programs to pay for certain kinds of higher education expenses will be tax-free. This is a simple and extremely tax-efficient means to provide for college education expenses for children, grandchildren and others. Also, as under current law, tuition payments made directly to schools and colleges, in any amount, are not subject to gift taxes.

- **Conservation Easements.** The geographic limits on qualifying property have been removed. Now the exclusion for conservation easements is available for otherwise qualifying property located anywhere in the United States or its possessions.

- **Installment Payment of Estate Tax for Estates With an Interest in a Closely-Held Business.** The Code § 6166 extension of time to pay has been expanded to include a decedent's interest in certain lending and finance businesses, but principal payment must commence immediately, rather than in five years, and the payments are permitted to be made over five years rather than ten annual installments. The number of allowable shareholders or partners in a closely-held business that qualifies for Code § 6166 treatment has been increased from 15 to 45.

  Comment: This increase in allowable shareholders still does not bring Code § 6166 into parity with the definition of a small business under Code § 1361, which permits qualification as a subchapter S corporation for businesses with up to 75 shareholders.

- **Waiver of Statute of Limitations for Certain Farm Valuations.** The Taxpayer Relief Act of 1997, which provided that a lineal descendant of the decedent (in addition to the surviving spouse) is not treated as failing to have used the property in a qualified manner solely because such person rents the property on a net cash basis to a member of such person's family was made retroactively effective to December 31, 1976. As a result, estates previously required to pay a recapture tax are now entitled to a refund. Under TRA 2001, the statute of limitations has effectively been extended for such refund claims until one year after the enactment of TRA 2001.

Highlights of Changes to Come. Unfortunately, paying attention only to those aspects of TRA 2001 that are immediately applicable is not sufficient. Advice to clients should also be informed, to the extent necessary, and address the changes scheduled to come.

- **Gift Tax Exclusion Amount.** After 2003 the gift tax and estate tax applicable exclusion amounts are no longer unified; the gift tax amount is frozen at $1 million. The apparent purpose of freezing the gift tax exclusion amount at $1 million, and of retaining the gift tax system after 2009, despite repeal of the estate tax, is to prevent the transfer of income-producing assets to beneficiaries in lower income tax brackets.

  Planning Implications: Wealth transfer techniques that do not constitute large gifts will assume an increased importance. Examples of such techniques are gifts to trusts with retained interests, such as a GRAT (which after the decision in *A.J. Walton*[3] can be "zeroed out"), sales to "grantor" trusts, "private split dollar" life insurance arrangements and split-interest charitable trusts. Gifts of property entitled to valuation discounts (such as minority interests in partnerships) also continue to be valuable planning tools. These techniques are not new, but are now of increased importance to clients who are not fully protected by the increasing exclusion amounts and who do not choose to believe that the estate tax will truly be repealed. Another alternative to avoid gifts in excess of the applicable exclusion amount would be to make long-term loans which could then be forgiven at death by will if the estate tax is not in existence.

- **State Death Tax Credit Phaseout.** Beginning in 2002, the credit against federal estate taxes allowed for death taxes paid to a state is being phased out. The amount of credit allowed is 75%, 50% and 25% of the amount formerly allowed, in 2002, 2003 and 2004 respectively. Starting in 2005, the credit is replaced by a deduction for such taxes which will be allowed in computing the federal taxable estate.

  Comment: These provisions cause a shift to the states of much of the cost of federal estate tax relief, since in most states the state tax merely "soaks up" the federal credit, and state tax revenues will decline as a result of a reduction in the federal credit. New Yorkers, however, will fare differently than residents of most other states. When New York adopted a "soak up" regime starting in February, 2000, the Legislature froze its reference to the federal credit at pre-2000 levels.[4] This means that New York's tax will be determined by the credit as it now stands, not as it will be reduced and eliminated under TRA 2001. A wealthy New Yorker dying in 2004, for example, will pay a 48% top marginal rate of federal tax and a 16% top marginal rate of New York tax (the top bracket of the credit before phaseout), reduced by only a 4% actual federal credit (25% of the top credit bracket). The end result is a 60% marginal bracket, a 5% increase above current law.

  New Yorkers must also be wary of another quirk in the New York "soak up" regime which is affected by TRA 2001. The New York estate tax must be computed as if the federal applicable exclusion amount is limited to $1 million even though the amount will be higher starting in 2004. This means, for example, that a New Yorker dying in 2004 with a taxable estate of $1.5 million will have no actual federal estate tax, but will have a New York estate tax of $64,400. The tax is computed by pretending that the federal applicable exclusion amount is only $1 million, thus causing a mythical federal tax ($210,000), then fixing the hypothetical state death tax credit against that mythical tax ($64,400), and then paying a real tax to New York equal to the hypothetical credit. This is no dream; this is a nightmare.

- **Qualified Domestic Trusts (QDOT).** Under Code § 2210(b)(1) (as added by TRA 2001), if the first spouse dies before January 1, 2010, then until December 31, 2020, there will continue to be estate tax assessed on distributions from the QDOT to the surviving non-citizen spouse during the surviving spouse's lifetime. If the surviving spouse dies after December 31, 2009, there will be no estate tax imposed on assets remaining in the QDOT as of the death of the surviving spouse.

- **Carryover Basis.** For persons dying before January 1, 2010, the income tax basis of property passing from a decedent is (with some exceptions) the fair market value of that property at the decedent's death. The result is a step up in basis, which means the reduction or elimination of capital gains taxes that would otherwise have been due when the property is sold. Under TRA 2001, when the estate tax is repealed this system is replaced, for persons dying after December 31, 2009, with carryover basis. This means that the recipient of the property will have the same basis as the decedent had, unless the property has declined in value, in which case the basis becomes the date-of-death value. (Note that the

decedent's $250,000 exclusion from capital gains tax on the sale of a principal residence will carry over to the estate and heirs.)

There are two significant exceptions. First, up to $3 million (indexed for inflation after 2010 in $250,000 increments) of property left to a spouse, outright or in a certain kind of trust, can receive a basis step up. Second, another $1.3 million (indexed for inflation in $100,000 increments) of property left to any person may receive a basis step up. If the amount of "gain" locked up in the estate's property exceeds these exceptions, the executor may decide how to allocate the step up among the beneficiaries receiving estate property.

Comment: The power of the executor to allocate the tax benefit of basis step up creates a potential for conflict among beneficiaries. Wills should be amended to provide specific guidance to the executor on this point.

The executor is subject to some constraints in how basis increases are allocated. For instance, basis may not be adjusted above the property's fair market value. Basis step up will be available for jointly-held property only for the share actually contributed by the decedent in the case of property owned jointly with a person other than a spouse and only for the one-half share deemed to be owned by the decedent in the case of property owned jointly with the surviving spouse. No basis increase is available for property acquired by the decedent by gift (from a person other than the spouse) within three years of death. No basis increase is available for property merely subject to decedent's general power of appointment.

Comment: Carryover basis will apply only if the estate tax is repealed. It may seem preferable to obtain relief from the estate tax even if capital gains taxes, at a much lesser rate, must still be paid. However, there are situations in which the actual result is a substantial increase in tax. For example:

1. If a decedent dies in 2009 with an estate of $3.5 million, there is no federal estate tax and a complete basis step up. If the same decedent dies in 2010, there is still no federal estate tax but a carryover basis, which means that the potential for capital gains taxes may have increased significantly.

2. If a decedent dies in 2009 and leaves his entire estate to his spouse, there is no federal estate tax and a complete basis step up. If the same decedent dies in 2010, there is no federal estate tax but an overall limit of $4.3 million on the amount of property entitled to basis step up.

- **Transfers in Trust.** Effective January 1, 2010, a transfer in trust will be treated as a taxable gift under Code § 2511 *unless* the trust is a grantor trust under §§ 671-679 of the Code. Apparently, Congress did not want a taxpayer to be able to shift the income tax to a taxpayer in a lower tax bracket without being treated as having made a gift of the property. Many questions and problems are raised by this provision of TRA 2001; hopefully, by 2010 it will not remain in existence in its current form.

The Future. What makes the temptation to sleep through all of these changes in the law so strong is the slim likelihood that TRA 2001 will remain in effect as currently enacted. A significant number of taxpayers with estates of over $1.3 million (the amount of exclusion to carryover basis available for distributions to descendants) and under $3.5 million (the size of estate that escapes estate taxation in 2009) will want to freeze the law as it will stand in 2009. The constituency of super wealthy who may favor total repeal of the estate tax, even in the face of carryover basis, is just too small. In 2009, the year before repeal is scheduled to take effect, a married couple will be able to shield a $7 million combined estate and enjoy all the benefits of income tax basis step up as provided in current law. Seen in that context, repeal will benefit only a small number of very wealthy families, and will be seen as a detriment by other taxpayers who will bear the cost, both directly (in the form of higher income taxes) and indirectly (in the form of the adverse effect of repeal on federal tax revenue). We believe it is unlikely that political and economic circumstances will develop in a way that a future President and Congress will allow such a thing to happen.

Endnotes

1. Code § 2632(c)(3)(A), added by TRA 2001.
2. Code § 2632(d)(1).
3. 105 TC 589, Dec. 54, 165.
4. *See* N.Y. Tax Law § 951(a).

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New U.S. Tax Act Has Dramatic Consequences on the Gift, Estate and Generation-Skipping Transfer Tax Regime in the Foreign Context

By Philip Marcovici, Teresa Lewis, Marnin J. Michaels, Victoria A. Dalmas and Christine Hsieh-Kammerlander

On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act (the "Act") of 2001. Although it primarily benefits U.S. citizens and residents, this new Act contains dramatic changes affecting, among other things, the U.S. Estate, Gift and Generation-Skipping Transfer (GST) Tax. While these changes are quite significant for U.S. citizens, they are *equally* significant for non-U.S. persons who invest in the U.S. or have U.S. family members. Notably, for many non-U.S. families that have U.S. citizens or residents in the younger generations, the new rules can have very negative tax results in the absence of careful advanced planning. Existing inbound grantor trusts will need special attention, as will a variety of other holding structures commonly employed by international families. We elaborate, in short order, upon the most significant changes.

> *"[F]or many non-U.S. families that have U.S. citizens or residents in the younger generations, the new rules can have very negative tax results in the absence of careful advanced planning."*

In this article, we will focus our attention on four areas, by discussing: (1) an overview of the changes; (2) a summary of the effect of the changes on non-U.S. persons; (3) the effect of the changes on trusts and banks operating in the offshore world; and, (4) the sunset provisions. In order to discuss the new Act in context, we begin with a brief summary of the current law.

I. The Current Law

A. The Estate and Gift Tax

The U.S. imposes a tax upon transfers of property during life (by gift) or at death (by bequest or devise). This tax is commonly known as the estate and gift tax. U.S. citizens and domiciliaries are subject to this tax on transfers of property wherever located throughout the world. Each U.S. citizen and domiciliary is granted an "applicable exclusion amount" or credit amount which exempts in 2001 US$675,000 worth of property from the U.S. estate and gift tax. U.S. estate and gift tax rates are very high and reach a tax rate of 55% on transfers above US$3,000,000. U.S. citizens and domiciliaries are able to take advantage of certain deductions. These deductions include: (1) the deduction for assets passing to a qualified charity; and, (2) the deduction for assets passing to a surviving spouse. This second deduction does not apply where the spouse of a donor is not a citizen of the U.S. unless a special trust is formed. However, gifts of up to US$100,000 to a foreign spouse can be made free of gift tax annually. This tax-free gift is currently indexed for inflation and in 2001 is US$106,000.

Persons who are neither U.S. citizens nor residents for estate tax purposes ("non-U.S. domiciliaries") are subject to U.S. estate and gift tax on transfers of U.S.-situs property. U.S.-situs property is generally limited to U.S. real estate, stock of U.S. corporations (for estate tax purposes only, not U.S. gift tax), mutual funds (including money market funds) organized in corporate form if incorporated in the U.S., certain types of debts of U.S. obligors (for estate tax purposes only, not U.S. gift tax purposes), and tangible personal property located in the U.S. This leaves broad categories of property that are not subject to U.S. estate and gift tax, such as foreign stocks, foreign bonds, foreign real estate, U.S. bank accounts and U.S. publicly traded bonds.

In the case of a non-U.S. domiciliary, the U.S. estate and gift tax can be eliminated by holding assets, which would otherwise be considered U.S.-situs, through a foreign corporation or through certain non-U.S. partnership structures. In the case of non-U.S. domiciliaries, the available credit is limited depending, in part, on whether a treaty between the U.S. and the individual's country of residence applies.

The question of domicile is not determined, for U.S. purposes, on the same basis as the question of residence for income tax purposes. The U.S. tax regulations provide that a person's domicile is one's permanent home (i.e., the place where an individual resides with no definite present intention of leaving). The IRS and the courts have further refined this definition by breaking down its requirements into a three

prong test: (1) an individual must have an intent to make the U.S. the place of his permanent home; (2) the individual must be physically present in the U.S. at a time when he holds an intent to remain permanently in the U.S.; and (3) the individual must have the ability to make an informed and intelligent decision as to his domicile. For most non-U.S. citizen taxpayers, the critical issue is whether the individual intends to make the U.S. his permanent home.

B. The GST Tax

In addition to the estate and gift transfer taxes, the U.S. imposes a GST tax on gifts that skip a generation (e.g., a grandparent makes a gift to a grandchild or other skip person). Although a detailed explanation of the application of the GST tax is beyond the scope of this article, we note that under guidance published by the U.S. tax authorities, it has been confirmed that the GST tax does not apply to a transfer of *non-U.S.* assets from a non-U.S. person (i.e., non-domiciliary) to a U.S. citizen or resident, even where such a transfer "skips" a generation. However, transfers of U.S.-situs assets by non-U.S. persons to a skip person are subject to GST tax, although lifetime transfers of $10,000 or less per donee are not subject to the GST tax. In addition, there is a GST exemption of $1 million for cumulative lifetime and death transfers to skip persons (currently inflation indexed at US$1,060,000), so whether a transfer is actually subject to the GST tax depends on whether and to what extent the donor/decedent's GST exemption is applied against the particular transfer.

C. Income Tax-Related Issues

Currently, the tax basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death (i.e., a so-called stepped-up basis). Stated alternatively, if a non-U.S. citizen and domiciliary buys shares of IBM for US$10 and dies holding the shares when they are worth US$100 and leaves them to a U.S. person and the U.S. person sells the shares when they are worth US$100, then there will be no capital gains tax as the assets are stepped-up to fair market value on the date of death or the alternate valuation date.

II. An Overview of the Changes

The changes in this Act can be divided into five segments: (1) estate tax changes; (2) GST tax changes; (3) gift tax changes; (4) basis step-up issues; and, (5) new reporting requirements.

A. Estate Tax Changes

1. Exemption Increase and Rate Reduction

As briefly discussed above, the U.S. estate tax is an extremely expensive tax. In order to provide some relief for estates of U.S. citizens and domiciliary decedents dying after 2001, the applicable exemption from the federal wealth transfer tax increases, in a graduated fashion from the current US$675,000 to US$3,500,000 in 2009. In the same years, the maximum marginal estate tax rate is reduced from a current rate of 55% to 45% in 2009. The changes are as follows:

Year	Exemption	Highest Marginal Rate
2001	US$675,000	55%
2002	US$1,000,000	50%
2003	US$1,000,000	49%
2004	US$1,500,000	48%
2005	US$1,500,000	47%
2006	US$2,000,000	46%
2007	US$2,000,000	45%
2008	US$2,000,000	45%
2009	US$3,5000,000	45%
2010	Repealed	Repealed
2011	US$1,000,000	55%

In addition, in 2002, the 5% surtax will be repealed on large estates. This surtax was imposed on cumulative taxable transfers between US$10 million and US$17,184,000, with the effect of phasing out the benefit of the graduated rates.

It should be noted that this increased exemption does not apply to non-U.S. citizens and domiciliaries as their exemption effectively excludes only *US$60,000* worth of U.S.-situs assets. Non-U.S. citizens and domiciliaries do, however, get to take advantage of the reduction in the estate tax rates.

In 2010, the U.S. estate tax will be repealed **but only for that year**. This relates to the sunset provisions contained in this Act which are elaborated upon below. However, absent legislation to the contrary prior to 2011, the highest marginal tax rate will return to 55% and the exemption for U.S. citizens and domiciliaries will return to US$1,000,000. Non-U.S. persons retain an exemption of US$60,000 if Congress does not vote to extend the estate tax repeal.

To summarize, the U.S. estate tax has only a one-year repeal in 2010, with a nine-year gradual phase-out.

2. Qualified Domestic Trust

As discussed above, the U.S. permits a deduction from the U.S. estate tax owing for property trans-

ferred to a U.S. citizen spouse. One exception to this rule is that property left for the benefit of a non-U.S. citizen spouse in a properly structured trust known as a Qualified Domestic Trust is permitted to take advantage of this deduction. The benefit of this Qualified Domestic Trust is that it allows the tax owed on assets for the benefit of a non-U.S. citizen spouse to be deferred until the later death of both spouses.

Notwithstanding repeal of the U.S. estate tax in 2010, the U.S. estate tax will continue to be imposed on any distribution prior to January 1, 2021 from a Qualified Domestic Trust.

3. Qualified Family-Owned Business Interests Deduction Repealed

In addition to the three most common estate deductions ((1) deductions for expenses of a decedent; (2) deductions for gifts to qualified charities; and (3) the marital deduction), there is a deduction available in certain limited circumstances for Qualified Family-Owned Businesses of U.S. citizens and residents. As part of this Act, in 2004, the qualified family-owned business interests deduction will be repealed.

4. State Death Tax Credit: Phaseout, Repeal and Replacement as a Deduction

Currently, the U.S. permits a credit for a certain amount of estate tax paid to a U.S. state. Beginning in 2002, the state death tax credit will be progressively reduced until its repeal in 2005. Beginning in 2005, the state death tax credit will be replaced by a deduction. The deduction will reduce a decedent's gross estate by the amount of any estate, inheritance, legacy or succession taxes actually paid to any state or the District of Columbia with respect to property included in the decedent's gross estate. The changes are as follows:

Year	Percentage of Reduction of State Death Tax Credit
2002	25%
2003	50%
2004	75%
2005	Replaced by a Deduction

While the state death tax credit is not available to non-U.S. persons, the state tax deduction will be available.

5. Qualified Conservation Easements

Under current law, a decedent's estate is eligible for an estate tax charitable deduction for a contribution of a qualified conservation easement provided that neither the decedent's estate nor the decedent's heirs received an income tax deduction for such easement. Beginning in 2001, the new law expands the availability of qualified conservation easements by repealing the distance requirements to national parks, wilderness areas and metropolitan areas of land that meet the definition of "land subject to a qualified conservation easement."

B. GST Tax Changes

Effective January 1, 2002, the GST tax exemption equals the exemption from wealth transfer taxes discussed above. Further, the maximum rate of the tax equals the rates discussed above. The GST tax is scheduled to be repealed for the year 2010. Absent Congressional influence, the tax returns to the 55% maximum rate in 2011 with an exemption of US$1,000,000 indexed for inflation.

C. Gift Tax Changes

The gift tax continues in its present form with the rates applicable to estate tax applying to the gift tax until 2010. An exemption of US$1,000,000 is applicable after December 31, 2001.

In 2010, the gift tax continues with the gift tax rate equaling the then highest marginal income tax rate (which is scheduled to decline to 35%), even though the estate tax has been repealed.

Again, this provision is subject to additional Congressional action, and, absent a vote to maintain this provision after 2010, the highest marginal gift tax rate will return to 55%.

D. Repeal of Basis Step Up and Replacement with a Modified Carryover Basis

1. In General

Once the estate tax is repealed on January 1, 2010, the current basis step up at death that occurs in certain circumstances will be repealed and replaced with a modified carryover basis. Generally, the basis of assets received from a decedent will retain the basis held by the decedent instead of being stepped up to fair market value at the date of death or the alternative valuation as is the current law. More specifically, the basis of assets received from a decedent will equal the lesser of:

- the adjusted basis of the property in the hands of the decedent; or
- the fair market value of the property on the date of the decedent's death.

2. Basis Increase

Notwithstanding this general rule, a basis increase is allowed on certain assets that are received from a decedent:

- If the decedent was a U.S. citizen or income tax resident, a general aggregate basis increase of US$1,300,000 (General Basis Increase) is allowed.
- Further increases in basis are allowed for the amount of a decedent's unused capital losses, net operating losses and certain built-in losses (Unused Losses Basis Increase).
- An additional US$3,000,000 of aggregate basis increase for outright transfer of property and qualified terminable interest property transferred to the surviving spouse (Spousal Property Basis Increase).
- If the decedent was a non-U.S. person, only an aggregate basis increase of US$60,000 is allowed. Note, that in addition to the US$60,000 limit, the estate of a non-U.S. person is not allowed the Unused Losses Basis Increase. We are, however, uncertain as to whether the Spousal Property Basis Increase will be allowed. At this stage the IRS has declined to provide guidance as to the new Act.

The basis increase is allocable on an asset-by-asset basis (i.e., allocated to a share of stock or a block of stock). Basis increase, however, is limited to the fair market value of the assets on the date of the decedent's death. For property to be eligible for a basis increase, the property must be owned, or is treated as owned, by the decedent at the time of the decedent's death.

3. No Basis Increase Allowed as to Certain Property

No basis increase is allowed as to certain property, which includes:

- Property that was acquired by a decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death;
- Property that constitutes a right to receive income in respect of decedent;
- Stock or securities of a foreign personal holding company;
- Stock of an international sales corporation (or former domestic international sales corporation);
- Stock of a foreign investment company; and
- Stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

4. Executor Allocates the Basis Increase

If the amount of basis increase is less than the fair market value of the eligible assets, the executor will determine which assets and to what extent each asset will receive a basis increase. Given that in most cases involving a decedent located outside of the U.S. the custodian of the assets (such as a bank) will be considered to be the executor (discussed in more detail below), potential lawsuits can be avoided by having all of the beneficiaries sign an agreement as to the eligible basis increase allocation to each of the eligible assets.

5. Planning

The basis step up loss is a major issue for non-U.S. persons who are leaving assets to U.S. persons.

Example 1. Mr. A, an Austrian, bought 10,000 shares of Novartis for US$10/share. He wants to leave his assets to his U.S. citizen son. Mr. A died when the value of the shares were worth US$100/share. Under current law, Mr. A could leave the shares to the U.S. citizen son with no U.S. tax or reporting obligations to Mr. A or his estate. Mr. A's son would, however, have to report (but not pay tax on) his receipt of the assets. When Mr. A's U.S. citizen son sells the shares, under current law his basis would be US$100/share, meaning that there would be no taxable gain. Under the new law, Mr. A's estate will have a reporting obligation (discussed below) and the U.S. citizen child's basis in the Novartis shares will be US$10/share. If the U.S. citizen child sells the Novartis shares upon receipt, he will pay capital gains tax on the US$900,000 gain.

In order to reduce the capital gains tax exposure of U.S. beneficiaries of foreign estates, consideration should be given to refreshing the basis of the assets owned by the foreign family member involved during such individual's lifetime. The consequences of refreshing the basis in the foreign person's home country will, however, need to be considered.

E. New Reporting Requirements

On January 1, 2010, when the modified carryover basis rules become effective, certain transfers at death and by gift must be reported. We will discuss each of these transfers in more detail below.

1. Certain Transfers Reported at Death

Certain transfers must be reported on death by a decedent's estate, namely, Large Transfers and 3-Year Transfers. These new reporting requirements are applicable to both the estates of U.S. citizen or resident decedents and non-U.S. person decedents, with some variations.

2. Large Transfers

Transfers at death of non-cash property are considered to be Large Transfers if a:

- **U.S. citizen or resident decedent** transfers property with a fair market value in excess of US$1,300,000.
- **Non-U.S. person decedent** transfers property with a fair market value in excess of US$60,000. For this decedent, this applies only to property that is: (1) U.S. tangible property; or (2) *any asset* (U.S.-situs or non-U.S.-situs) received by a U.S. person from a decedent.

3. 3-Year Transfers

3-Year Transfers apply to appreciated property received by a decedent within three years of death where the filing of a U.S. gift tax return was required. Where the decedent is a non-U.S. person, this applies only to property that is: (1) U.S. tangible property; or (2) *any asset* (U.S.-situs or non-U.S.-situs) received by a U.S. person from a decedent.

4. The U.S. Information Return

A U.S. Information Return must be filed with the IRS regarding Large Transfers and 3-Year Transfers. In addition, a Beneficiary Statement must be provided to the property recipient.

5. Executor Responsible for U.S. Reporting

Generally, the executor is responsible for filing a U.S. Information Return with the IRS for transfers at death that qualify as Large Transfers or 3-Year Transfers. In addition, generally, the executor is also responsible for providing the property recipient with a Beneficiary Statement. The term "executor" is defined such that if there is no executor or administrator appointed, qualified and acting in the U.S., then the obligation falls on those in actual or constructive possession of the property of the decedent. This means, in many instances, that foreign banks will be executors, a potential problem, particularly where bank secrecy rules apply.

The U.S. Information Return is due when the taxpayer would have ordinarily been required to file his income tax return if he was then living. The Beneficiary Statement must be provided to the property recipient no later than 30 days after the due date of the U.S. Information Return.

6. Penalties Apply for Failure to File

Penalties apply for failure to meet the filing requirements discussed above:

- US$10,000 if the U.S. Information Return as to Large Transfers is not filed with the IRS by the due date plus extensions;
- US$500 if the U.S. Information Return as to 3-Year Transfers is not filed with the IRS by the due date plus extensions;
- US$50 if the Beneficiary Statement was not provided to the property recipient by the due date;
- Reasonable cause exception for the US$10,000, US$500 and US$50 penalties; and
- If intentional disregard for filing, 5% of the fair market value of the property for which reporting was required, determined at the date of the decedent's death.

7. Certain Transfers Reported at the Time of Gift

A donor who is required to file a U.S. gift tax return must also send a Beneficiary Statement to the property recipient listed on the return. The Beneficiary Statement must be provided to the property recipient no later than 30 days after the U.S. gift tax return due date. Penalties apply for the failure to provide the Beneficiary Statement:

- US$50 for failure to provide a Beneficiary Statement to the property recipient by the due date; and
- If intentional disregard for such, 5% of the fair market value of the property for which reporting was required, determined at the time of the gift.

8. Example

The following example illustrates the operation of the filing obligations.

Example 2. Mr. G, a German citizen and resident, died owning a fully diversified portfolio held with a Swiss Bank, Big Swiss. Mr. G has two children, one of whom has a U.S. green card (GC). If Mr. G leaves any assets valued at more than US$60,000 on his death (i.e., even non-U.S.-situs assets) to GC, then an information return is due. Since Mr. G died in Germany, no U.S. executor was appointed. Therefore, Big Swiss is responsible for filing this Information Return. Since Big Swiss is governed by Swiss bank secrecy rules, it may only file the return with the consent of both children of Mr. G (the then owners of the account). If such a waiver is not obtained the IRS may impose a penalty equal to 5% of the value of the assets subject to the information return.

This information return places a significant obligation on private banks. Since a good portion of the clientele that use private banks (Latin American and Asian families in particular) have some U.S. connections, it is quite likely that many foreign banks will be in a position where they will be executors for the purposes of these new information reporting obligations. Further, a bank secrecy waiver from the current account holder does not permit a Swiss bank to file the U.S. return on behalf of the heirs since each heir is entitled to bank secrecy in his own right at the time the return is required to be filed. In addition, even if the account holder and all of the heirs waive bank secrecy at the time the account is established, such waiver may be revoked at any time.

F. Gain Recognized on Certain Death Transfers to Non-U.S. Persons

Beginning in 2010, a transfer by a U.S. person's estate (i.e., by a U.S. person at death) to a non-U.S. person will be treated as a sale or exchange for an amount equal to the fair market value of the transferred property. Gain must be recognized for any excess fair market value of property on the date of transfer over the U.S. transferor's adjusted basis.

G. The Sunset Provision

Due to federal budget constraints, Congress was unable to make permanent changes. As a compromise, Congress enacted changes that will sunset after December 31, 2010. Therefore, unless Congress extends these provisions with an additional legislative act, all of the changes mentioned above will be void *after December 31, 2010*, resulting in the 2001 tax rules springing back into place. While this makes tax planning difficult due to the uncertainty of the continuance of the new tax changes, it simply means that one must monitor any tax planning that is in place.

III. Summary of the Effect of Changes on Non-U.S. Persons

The new Act forces planners to have a two-pronged planning approach. Planning for non-U.S. persons with U.S. connections must be effectuated assuming the new law is effective after December 31, 2010 *and* assuming that the new law sunsets, leaving the law as it currently stands in place. As the authors see it, estate planning falls into two categories: (1) planning for families with non-U.S. connections, but that have U.S. assets; and (2) planning for families with U.S. connections. We briefly outline these possibilities below.

A. Planning for Families with Non-U.S. Connections, But with U.S. Assets

This example describes planning which has the same complexity as under the current law.

Example 3. Mr. H, a Hong Kong citizen and resident, has three children, none of whom are U.S. citizens or income tax residents. Mr. H has an affinity for U.S. technology company shares and holds more than US$20,000,000 in U.S. securities such a Qualcom, Cisco, and Microsoft.

Under current law, if Mr. H does no planning, then there will be a U.S. estate tax owing at Mr. H's death in excess of US$11,000,000. Under the new Act, there will be a U.S. estate tax that can be as high as US$11,000,000 in 2001, but reduced to US$9,000,000 in 2009. In order to minimize this tax Mr. H should hold his U.S. investments through a non-U.S. offshore corporation. This ensures that there is no U.S. estate tax exposure on Mr. H's assets either between 2001 to 2009, or, after 2010 if the Act sunsets. If the Act does not sunset, then there are no adverse consequences of this planning. If this is the case, then there are also no reporting obligations with this planning and the non-U.S. children would have no capital gains tax exposure.

B. Planning for Families with U.S. Connections

Planning for families with U.S. connections has become significantly more complicated. On the one hand, planning must assume that the new law comes into effect. On the other hand, planning must be effectuated to ensure that adequate planning is in place if a non-U.S. person with U.S. connections dies prior to January 1, 2009, or, after 2010, and the Act sunsets.

Example 4. Mr. S, a Swiss citizen, has three children, one of whom is a U.S. citizen. The other two are Swiss citizens and residents. Mr. S established, in 1999, a revocable grantor trust that allows his U.S. child to benefit from these assets on an income tax-free basis in the U.S. The trust consists of only non-U.S. investments. This trust, also, if properly structured, permits no U.S. estate tax exposures to Mr. S's estate or to the U.S. citizen child if Mr. S dies before 2010, or, after 2010, and the Act sunsets. It does not, however, provide for a step up in basis under the new Act. Mr. S must commence a process of stepping-up the basis of the assets in the trust to minimize taxes after his death.

Example 5. Ms. U, a U.S. citizen, wishes to leave certain U.S. property interests to her sister, a non-U.S. citizen and resident. Absent advance planning, a significant estate or capital gains tax could be owing.

IV. Effect of the Changes on Trust Companies and Banks Operating in the Offshore World

There are two significant issues that we believe each non-U.S. bank and trust company must address. The first is education of the customer. The second relates to dealing with the new modified basis rules.

A. Education of the Customer

There has been significant discussion in the press on the repeal of the estate tax. Very little, however, has been discussed about how and when the estate tax is repealed, if at all. The result is significant misinformation. All non-U.S. banks and trust companies must make affirmative efforts to educate their clients that: (1) the estate tax is not firmly repealed; (2) if it is repealed, it is not a permanent repeal unless a second vote occurs in 2009; and (3) if the U.S. estate tax is repealed, the need for planning has become even more acute if there are U.S. connections by way of U.S. assets or family members being involved.

B. Dealing with the New Basis Rules

Assuming the new Act is not permitted to sunset, then the new modified basis rules place significant burdens on non-U.S. banks and trust companies. In the first instance, all persons with U.S. connections will now wish to know the basis of their assets that they inherited, even if inherited from a non-U.S. person. The result is that all banks will now have to track basis. We understand that currently, most non-U.S. banks do not track basis.

Example 6. Ms. CH, a Swiss citizen and resident, has a mixed portfolio held with SMB, a small Swiss bank. Under Swiss tax law, a Swiss resident, as a general rule, is exempt from capital gains taxation on portfolio investments. As a result, SMB does not track basis. Ms. CH's daughter, BH, moves to the U.S. three years after Ms. CH's death. BH then sells shares in a Swiss company. As BH now takes over Ms. CH's original basis, BH requests the information from SMB. SMB does not keep this information. Furthermore, it has no obligations to keep records more than ten years old. The result is that BH will be forced to record a basis of nil in the property since she cannot establish her basis. SMB will face this problem going forward and, in order to avoid this issue, must start tracking the purchase price of shares.

The other major issue relates to the new reporting requirements, which we discuss in detail above. The reporting requirements place foreign banks located in bank secrecy jurisdictions in a very difficult situation: either comply with the new Act and be in violation of local bank secrecy law, or respect bank secrecy law and risk an intentional disregard penalty of 5% of the value of the assets on the date of the death of the decedent. Neither option is particularly pleasant.

"There are two significant issues that we believe each non-U.S. bank and trust company must address. The first is education of the customer. The second relates to dealing with the new modified basis rules."

V. Conclusion

While primarily benefiting U.S. citizens and residents, this new Act contains dramatic changes affecting, among other things, the U.S. Income, Estate, Gift and Generation-Skipping Transfer Tax. While these changes are quite significant for U.S. citizens, they are *equally* significant for non-U.S. persons investing in the U.S. or who have U.S. family members. Notably, for many non-U.S. families which have U.S. citizens or residents in the younger generations, the new rules can have very negative tax results in the absence of careful advanced planning. In addition, these new rules place significant burdens on non-U.S. banks and trust companies. We hope this article, which briefly outlines these new rules and concerns for non-U.S. persons and financial institutions, provides you with guidance in making plans to go forward.

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GST Changes Under EGTRRA (the Economic Growth and Tax Relief Reconciliation Act of 2001)

By Blanche Lark Christerson

The June 4th edition of *Tax Topics* had an overview of EGTRRA (the "Act"), which President Bush signed into law on June 7, 2001. This edition has a more technical discussion of the Act's changes to the generation-skipping transfer tax (GST). These changes are designed to save people from themselves and seem to reflect Congress's feeling that no one understands the GST anyway, so we may as well help these poor souls out.

Those familiar with the GST know that it is an additional transfer tax (the other two being the estate and gift tax), and applies to transfers to people such as grandchildren. The GST was created to thwart the Grandma and Grandpa Gotrocks of the world. It guaranteed that Mommi and Poppi could no longer lock their money into trust and benefit many generations of little Gotrocks—all for the price of ONE estate tax. In that respect, the GST has been very a successful tax, and ensures that transfer tax is collected at each generational level. It is also a very disliked tax, and is scheduled to be repealed in 2010, along with the estate tax. It's hard to keep a good tax down, though, and the GST (and all the other tax provisions that existed prior to June 7th) will be resurrected in 2011. That miraculous levitation occurs because the entire Act "sunsets" on December 31, 2010. Whether that will actually happen, of course, is a matter of conjecture. Nevertheless, we still must operate as if repeal is only going to last a year. And while the GST changes are largely of a technical nature, they are something with which planners, accountants and administrators need to be familiar, even if their clients' eyes may glaze over.

By way of review, the GST rate is equal to the top estate tax rate. As that top rate drops prior to repeal, so does the GST rate. Everyone has a "GST exemption"—or an amount that can be protected from GST. The exemption is $1 million, indexed for inflation (this year's exemption is $1,060,000). The exemption will still be indexed for inflation in 2002 and 2003; by 2004, it will track the estate tax exclusion (which will reach $3.5 million by 2009).

Here is a schedule of those rates and increased exemption amounts, pre- and post-repeal:

GST rates:

Year	Rate
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007, 2008, 2009	45%
2010	REPEALED
2011	55%

GST exemption:

Year		Exemption
2002	still indexed	$1,090,000 (?)
2003	still indexed	$1,120,000 (?)
2004 and 2005		$1,500,000
2006, 2007, 2008		$2,000,000
2009		$3,500,000
2010		REPEALED
2011	still indexed	$1,420,000 (?)

By way of further review, here is some essential GST terminology to keep in mind *before* we tackle the administrative GST changes:

Skip person: an individual who is two or more generations below the transferor's generation—

> **Example:** Grandchild is a skip person vis-à-vis Grandma
>
> or a trust, if all of the interests are held by skip persons.
>
> **Example:** a trust that is solely for grandchildren or more remote descendants

Non-skip person: any person who is not a skip person (really, that's what the Code says!).

> **Example:** A child is a non-skip person vis-à-vis parent; a generation-skipping trust for *children* and more remote descendants is a non-skip person as long as the children are still alive—once the last child is gone, the trust becomes a skip person.

Transferor: the individual making the transfer to the skip person.

Direct skip: a transfer to a skip person that is subject to estate or gift tax.

Example: Grandma leaves Grandson $100,000 under her will.

Example: Grandma and Grandpa transfer $2,060,000 into a trust for their grandchildren and more remote descendants.

Deemed allocation to "indirect skips" to "GST trusts." As if to protect all those people who may forget to allocate GST exemption when they should, the Act creates a new deemed allocation rule (one already exists for lifetime *direct* skips). Effective as of the beginning of this year, there is a deemed lifetime allocation to "indirect skips" to "GST trusts"—*unless* you opt out on a timely filed gift tax return.

"Indirect skip" means

- any lifetime transfer (other than a direct skip) subject to gift tax.
- made to a GST trust.

"GST trust" means a trust that *could* have a generation-skipping transfer with respect to the transferor *unless*—

Exception 1: The trust provides that more than 25% of the trust corpus must be distributed to, or may be withdrawn by, a non-skip person—

- before the non-skip person reaches age 46,
- on or before dates set forth in the trust that will occur before the non-skip person reaches age 46, or
- upon the occurrence of an event that (according to Treasury regulations) may reasonably be expected to occur before the non-skip person reaches age 46.

Example: Mom and Dad create a trust for Child, and fund it with annual exclusion gifts. The trust provides that Child will receive all the trust property by the time Child reaches age 45—or that Child may withdraw everything by the time he reaches age 45. This is NOT a GST trust.

Example: Mom and Dad create a trust for Child, and fund it with annual exclusion gifts. The trust provides that Child will receive 25% of the trust property by the time Child reaches age 45, 50% of the trust property at age 50, and the balance at age 55. Because Child is not receiving *more than* 25% of the property by the time Child reaches age 45, this IS a GST trust, subject to the deemed allocation rule unless Mom and Dad opt out.

Exception 2: The trust provides that more than 25% of the trust corpus must be distributed to, or may be withdrawn by, a non-skip person who's alive when another individual dies who's named in the trust (by name or by class) AND who's more than 10 years older than the non-skip person.

Example: Dad creates a lifetime credit shelter spray trust for Mom and their children. The trust provides that at Mom's death, the property will be distributed to Dad's then surviving issue, *per stirpes*. This is NOT a GST trust.

Example: Dad creates a lifetime credit shelter spray trust for Mom and their children. The trust provides that at Mom's death, the property will continue in trust for Dad's issue living from time to time, until the end of the perpetuities period. This IS a GST trust, subject to the deemed allocation rule.

Exception 3: The trust provides that if a non-skip person dies before what's described in Exceptions 1 or 2, more than 25% of the trust corpus either must be distributed to the non-skip person's estate or be subject to the non-skip person's general power of appointment.

Example: Mom and Dad create a trust for Child, and fund it with annual exclusion gifts. The trust provides that Child will receive all the trust property by the time Child reaches age 45—or that Child may withdraw everything by the time he reaches age 45. The trust also provides that if Child dies before the trust's complete termination, Child has a general power of appointment. This is NOT a GST trust because of the power (AND because the trust already fits within Exception 1). **Note:** this provision seems like overkill.

Exception 4: Any portion of the trust would be included in a non-skip person's gross estate (other than that of the transferor) if the non-skip person died immediately after the transfer.

Example: Mom and Dad create a trust for Child and fund it with their respective credit shelter amounts. The trust will last for Child's lifetime, but is payable to Child's estate (or is subject to Child's general power of appointment) at Child's death. This is NOT a GST trust.

Example: Dad creates an insurance trust that will hold second-to-die insurance on his and Mom's lives (i.e., the policy won't pay out until they're both gone). Dad's adult children and minor grandchildren are the current beneficiaries and all have *Crummey* withdrawal powers. When Mom and Dad are both gone, the trust will pay out to their then surviving issue, *per stirpes*, provided that if any child is then under age 50, his

or her share will be held in separate trust until age 50. This IS a GST trust because the children's *Crummey* powers don't count for purposes of having property immediately includible in their estate (see the special exception below) AND they don't receive more than 25% of the trust by the time they're 45. **Note:** this is a case where Mom and Dad might want to opt out of the deemed allocation.

Exception 5: The trust is a charitable lead annuity trust, a charitable remainder annuity trust or a charitable remainder unitrust.

Exception 6: The trust is a charitable lead unitrust and is required to pay principal to a non-skip person if such non-skip person is alive at the end of the charitable period.

Example: Grandma creates a charitable lead unitrust and provides that at the end of the charitable term, the property will be payable to her then surviving issue, *per stirpes*. This is NOT a GST trust.

Example: Grandma creates a charitable lead unitrust and provides that at the end of the charitable term, the property will continue in trust for her issue living from time to time, until the end of the perpetuities period. This IS a GST trust, subject to the deemed allocation rule. **Note:** most charitable lead unitrusts *are* intended as generation-skipping vehicles, since the trust can be fully protected from GST when you set it up (unlike the charitable lead annuity trust, where the GST result is uncertain until the close of the charitable period). The deemed allocation here would probably not be a bad thing, although careful planners would still take the affirmative step of allocating exemption to the trust on the relevant gift tax return.

Special exception re:* Crummey *powers and powers of appointment. If a non-skip person has a *Crummey* withdrawal power for the transferor's annual exclusion gift, the withdrawal amount won't be considered includible in the non-skip person's estate; if the non-skip person has a power of appointment, it is assumed that he will not exercise the power. **Note**: it's hard to see what this assumption is driving at, since if the non-skip person has a general power of appointment that's enough to make property includible in his estate—it doesn't matter whether or not he exercises the power. If he has a limited power, the property wouldn't be includible in his estate anyway.

Example: Dad and Mom create a generation-skipping trust for Children and Grandchildren, and more remote issue. They fund it with annual exclusion gifts. Each living beneficiary has a *Crummey* withdrawal power over the annual gifts. The Children's withdrawal power is ignored, and the trust is therefore a GST trust, subject to the deemed allocation rule.

Note: it is generally not a good idea to fund a generation-skipping trust with annual exclusion gifts, since the *Crummey* withdrawal holders can become transferors with respect to the additions. That is, unless the additions are limited to the greater of $5,000 or 5% of the trust principal (a "5 and 5 amount"), the beneficiaries must have "hanging powers" (the continuing right to withdraw annual contributions in excess of the "5 and 5 amount") so that the lapse of their withdrawal power is not a taxable gift. If the beneficiary dies with hanging powers outstanding, he has an includible asset in his estate and therefore becomes the transferor as to that amount—thereby wasting part of Mom and Dad's GST exemptions.

ETIP rule. If the grantor creates a trust in which he retains an interest (or the grantor's spouse has an interest) AND the trust assets are within the estate tax inclusion period (ETIP), the deemed allocation only occurs at the end of ETIP. The fair market value of the trust property is the FMV at the end of ETIP.

Example: Dad creates a trust for children and grandchildren, and makes Mom a discretionary beneficiary of the trust. Dad funds the trust with annual exclusion gifts. Dad's contributions for Mom exceed the "5 and 5 amount," and Mom has hanging powers (see above). The assets subject to those hanging powers are includible in her gross estate. The trust is therefore subject to ETIP. The kids' withdrawal powers are also ignored, and GST exemption is deemed allocated only when Mom's ETIP ends (either at her death, or when trust has sufficient assets to lapse out her hanging powers).

Opt out and opt in. Is there any way out of this deemed allocation? Yes. An individual—

- may elect out of the deemed allocation to an indirect skip or to any or all transfers to a particular trust.

Of course, if you want in, that's possible too, since an individual—

- may elect to treat any trust as a GST trust for purposes of the deemed allocation.

When do you make the election? On a timely filed gift tax return for the calendar year in which the transfer is made or deemed made (as

with the close of ETIP), or such later date as prescribed by the Secretary. If you're electing to treat a trust as a GST trust, you make the election on a timely filed gift tax return.

***Comment*:** As mentioned above, this new automatic allocation rule is designed to save practitioners from themselves. Yet sophisticated planners will have thought carefully about the GST consequences of their trusts, and will not want to rely on a "deemed" allocation to protect a trust that has been designed specifically for GST purposes; after all, without an actual allocation on a gift tax return, how will you keep track of how much exemption your client-transferor has used? Similarly, planners may not be happy with this deemed allocation rule if the trust is *not* designed for GST purposes. What the rule really requires, therefore, is that administrators and planners be thoroughly familiar with the trusts to which their clients make lifetime gifts—and if necessary, affirmatively opt out of this deemed allocation (or make an actual allocation, if that's what's desired). As an aside, it would seem that most life insurance trusts (if they're simply designed to provide for spouse and issue) would not be subject to this deemed allocation rule—obviously, however, the trust's provisions need to be carefully looked at to be sure of this result.

Retroactive allocations. The Act now permits a GST exemption "look-back." In other words, if there's an untimely death (such as a child dying sooner than you thought he would), the Act lets you make a retroactive allocation of GST exemption. Here's the rule: effective as of the beginning of this year, if a non-skip person has a present or future interest in a trust and:

- is a lineal descendant of the transferor's grandparent or of a grandparent of the transferor's spouse or former spouse AND
- is assigned to a generation below the transferor AND
- predeceases the transferor, then

the transferor may allocate GST exemption to previous transfers to the trust "on a chronological basis."

If the transferor makes a gift to the trust the year the non-skip person dies, he makes a retroactive allocation on his current gift tax return, AND

- the value of the transfer, for inclusion ratio purposes, shall be determined as if the allocation had been made on a timely filed gift tax return for *each* calendar year within which *each* transfer was made
- the allocation will be effective immediately before such death AND
- the amount of the transferor's available GST exemption will be determined immediately prior to the non-skip person's death.

What if there is no gift in the year the non-skip person dies? The transferor presumably would make the retroactive allocation on a current gift tax return, although this is not entirely clear from the statute. Perhaps regulations will shed some light on this.

Example: Mom and Dad create a trust for Child, and fund it with $20,000 annual exclusion gifts over ten years ($200,000 total funding). Although it's been some time since they've added to the trust, it's grown over the years, and is now worth $500,000. It will terminate when Child reaches age 35, but if Child dies before then, the trust property will pass to Child's then surviving issue, *per stirpes.* Child dies in November at age 30, and is survived by two children. Child's death triggers a taxable termination, which is subject to GST. Without a retroactive allocation, Mom and Dad will have to allocate $500,000 of exemption ($250,000 each) to the trust to protect it from GST. With the retroactive allocation, Mom and Dad only have to allocate $200,000 to the trust. They make the retroactive allocation on a gift tax return filed on April 15th following Child's death.

Severing trusts. What if someone's will doesn't create separate GST trusts, but has boilerplate that permits such trusts to be created? In other words, suppose you, as executor, don't want the future mess of having a trust that's partially subject to GST—you'd rather have one trust that's fully protected from it, and one that's fully subject to it. What are the rules regarding such a division? Under the Act, effective as of the beginning of this year, if a single trust is split in a "qualified severance," the resulting trusts will be treated as separate trusts for GST purposes.

"Qualified severance" means the division of a single trust and the creation (either under the governing instrument or local law) of two or more trusts if

- the single trust is divided on a fractional basis AND
- the terms of the new trusts, "in the aggregate," provide for the same succession of beneficial interests as the original trust.

If a trust is partially subject to GST and the division is made, the new trust must receive a fractional share of the total value of *all* trust assets

equal to the applicable fraction of the single trust immediately before the severance. In that case, the inclusion ratio for the new trust is zero and the inclusion ratio for the old trust is one.

A Qualified severance also includes any other severance permitted by regulations, and may be made at any time. The Service will issue regulations detailing the mechanics of this.

Example*:* At Dad's death, the bulk of his estate passes into a lifetime trust for Child (at Child's death, the property will pass to Child's then surviving issue, *per stirpes)*. The trust has property worth $3,180,000, or three times the amount of Dad's available GST exemption of $1,060,000. The trust's applicable fraction is 1,060,000/ 3,180,000, or 1/3. Its inclusion ratio is 2/3 (1 minus 1/3)—meaning that two-thirds of the trust is subject to GST. Dad's will permits his executor to divide trusts, so that one is fully protected from GST (i.e., has an inclusion ratio of zero), and one is fully subject to GST (i.e., has an inclusion ratio of one). The executor makes a qualified severance, and the new trust is funded with one-third of all of the original trust's assets. The new trust is fully protected from GST, and the original trust is fully subject to GST.

Modification of Certain Valuation Rules. Effective as of the beginning of this year, if GST exemption is allocated on a timely filed gift tax return (or a gift tax return that's deemed timely filed):

- the transfer's value shall be the value as finally determined for gift tax purposes, or if a deemed allocation occurs at the end of ETIP, the value will be determined then AND
- the allocation will be effective on or after the transfer date (or the close of ETIP).

Relief Provisions: *late elections.* What if you have totally blown it, and didn't allocate exemption when you should have? Regulations will set forth "such circumstances and procedures" under which extensions will be granted to make:

- an allocation of GST exemption for gifts for which a gift tax return was filed or deemed filed AND
- an election out of the deemed allocation for direct skips or indirect skips to GST trusts.

Regs will include procedures for requesting "comparable relief" for transfers made prior to enactment of this paragraph.

The Secretary will take into account

> all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.

Substantial compliance: if a transferor's GST allocation demonstrates an intent "to have the lowest possible inclusion ratio" regarding a trust transfer, then the allocation shall be deemed to allocate "so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio." The Service will take into account "all relevant circumstances . . . including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant."

Effective date: for late elections, the new law applies to requests pending on, or filed after, December 31, 2000; for substantial compliance, the new law applies to transfers after December 31, 2000 that are subject to estate or gift tax.

***Comment*:** As with the deemed allocation for indirect skips to GST trusts, these additional new rules are designed to ease the pain of the GST. How the mechanics of a retroactive allocation will work need clarification—particularly if the transferor doesn't make a gift to the non-skip person's trust the year the non-skip person dies. Similarly, the provisions regarding late elections and substantial compliance give the Service a lot of discretion to save hapless taxpayers (and attorneys and CPAs) from themselves. What will actually sway the Service if the taxpayer needs to throw himself on his sword? That remains to be seen. All that can be said is that the Service needs to issue new regulations to better explain some of these provisions. Even if the GST goes away in 2010, it's still supposed to come back in 2011!

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The 529 Plan: A Well-Kept Secret

By Antonia J. Martinez

In 1997, the Internal Revenue Code (I.R.C.) provided a mechanism for saving for higher education, while providing significant tax advantages. Section 529 of the I.R.C. allows any state to establish its own college tuition savings plan, and presently 48 states, including New York, have done so.[1]

Requirements and tax advantages vary from state to state. Some states allow an income tax deduction for contributions made to the plan. Others vary the annual amount that can be excluded from state income tax, along with state variations on age requirements and limits on investment amounts per beneficiary. Log onto www.collegesavings.org to find out the particulars of each state.

> *"Section 529 of the I.R.C. allows any state to establish its own college tuition savings plan, and presently 48 states, including New York, have done so."*

Account Owner Retains Control

Only the account owner can direct withdrawals. If the funds in a 529 plan are not going to be used for their intended purpose, the account owner may designate a different beneficiary, albeit limited to the immediate family of the original beneficiary. The account owner also has options if the beneficiary doesn't use the money for other reasons. For example, if the beneficiary dies, becomes disabled, or receives a scholarship, no penalty is assessed and the account owner may: (1) take the money back; (2) designate a new beneficiary within the immediate family of the previous beneficiary; or (3) leave the money in the account for another future beneficiary. From an estate planning perspective, it is unprecedented that one can gift assets, and then take them back if the beneficiary does not use the gift for its intended purpose.

Practice Tip: the account owner should designate a contingent account owner to control the use of these funds in the event the account owner dies or becomes incompetent. If no contingent account owner is listed, the account owner's estate executor may designate a new account owner.

Distinct from a Custodial Account

A 529 plan differs significantly from custodial accounts, which usually bear the designation Uniform Gift to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). Assets in such custodial accounts are available to their beneficiaries when they reach their age of majority, usually age 18 or 21. Thus, if the beneficiary, now sporting green hair or other non-organic color, decides college is a waste of time and decides instead to spend the money on a BMW or to save the world, the account owner is powerless to do anything. In contrast, the 529 plan can require the beneficiary to go to college or forfeit his or her benefits. It allows the account owner to guard against the use of his or her savings for frivolous expenditures (with no offense intended to those who own BMWs or want to save the world).

New federal legislation makes 529 plans even more appealing. Congress recently amended § 529 to make interest earned on these types of accounts after December 31, 2001, tax-free, as long as the money is used for qualified educational expenses. For the remainder of 2001, the tax imposed on the earned income is at the beneficiary's rate, usually lower than the account owner's taxable rate. Even if the designated beneficiary chooses not to go to school immediately, the money will be available for that purpose years later. Compare these benefits with a custodial account, where the income on a custodial account is taxed annually.[2]

A May 2001 article in the *Wall Street Journal*[3] gave 529 plans a lukewarm rating. But the conclusions from that article have been superseded by the new federal legislation. And T. Rowe Price, whose analysis was cited in the *Wall Street Journal* article, has since concluded, "529 performance likely will outpace alternative college-savings vehicles,"[4] in light of legislative changes in the tax laws.

A 529 plan account owner may have some investing limitations, depending both upon what a state offers and what some account owners want. A 529 plan may not be a suitable vehicle for someone who, for example, believes that commodities or rare coins are the best long-term investment. But for the majority of Americans who invest in stocks, bonds, and money market funds already, the 529 plan provides the financial benefits of those investment vehicles, while at the same time insuring that money invested for education will be used for its intended

purpose. Given its advantages, the 529 plan offers unique features that are otherwise unavailable.

Excellent Tax and Estate Planning Advantages

As an added bonus, in many states, the account owner (typically the parent or grandparent) will also save on state income taxes and may deduct contributions made to such plans from their state taxable income. Be sure to check the applicable provisions for the state in which you reside to determine what, if any, tax incentives exist in your state.

Gift taxes are another advantage. Aside from saving on income taxes, an account owner can give up to $50,000 at one time without paying a gift tax, and a married couple filing jointly, up to $100,000, which is then credited or "carried forward" for the next five years. The designated beneficiary of a 529 plan can start earning interest on an account owner's gift immediately without the imposition of a gift tax on the account owner. If the account owner dies before the five-year period, the *pro rata* portion of the $50,000 will be brought back into the account owner's estate.

> *"Anyone can set up a college savings account, no matter what his or her relationship is to the beneficiary: parents, grandparents, uncles, aunts. An account owner doesn't even have to be related to the beneficiary."*

Similarly, contributions to 529 plans are excluded from the account owner's estate. If your client has a taxable estate presently over $675,000,[5] the 529 plan provides a way to reduce his or her assets for estate tax purposes, while providing for the education of a loved one.

New York Version

The New York College Savings Program (NYCSP) is New York's version of the 529 plan.[6] Only now are people becoming familiar with the tax advantages it offers. NYCSP allows an account owner to:

- Receive an annual New York State tax deduction;
- Own the account and control the use of his or her savings;
- Set up a college savings account no matter what his or her relationship is to the beneficiary;
- Save for college on a tax-deferred basis and after January 1, 2002, on a tax-free basis.

The NYCSP even allows the account owner to set up an account for himself or herself. If such a person is or will be pursuing a degree in the future, he or she can name themselves as beneficiaries and deduct the amount contributed toward the plan for that taxable year from their New York State income tax bill (up to $5,000 per person; $10,000 if married and filing jointly).

Anyone can set up a college savings account, no matter what his or her relationship is to the beneficiary: parents, grandparents, uncles, aunts. An account owner doesn't even have to be related to the beneficiary.

Educational Options and Tax Benefits

The account owner's designated beneficiary has educational choices outside of New York State, even though the account owner receives New York State tax benefits. The beneficiary, for example, is not limited to attending New York State schools. Funds can be applied toward education in schools outside of New York State, including public or private, as well as graduate school, law school, medical school, part time studies, vocational school, and some international studies. Nor does the beneficiary of the account have to reside in New York. Even though the account owner is subject to New York State income taxes, he or she may choose to benefit a child residing in another state, and still take advantage of New York State tax benefits.

As an added bonus, the New York State account owner (typically the parent or grandparent) will also save on state income taxes. The account owner may deduct contributions up to $5,000, per person per calendar year on New York State income tax. A married couple filing jointly may deduct even more, up to $10,000.

If you live outside of New York State, check your particular state to determine what, if any, tax incentives exist in your state.

Investment Options

The NYCSP plan offers four investment options depending on the account owner's appetite for market risk. The funds, administered and managed by TIAA-CREF are: (1) Guaranteed Option, which pro-

vides a minimum rate of return of 3% and offers potential for greater return based on investment performance; (2) Managed Allocation Option, a blend of stock, bond and money market funds—the mix of funds changes with the age of the beneficiary; (3) Aggressive Managed Allocation Option, similar to the Managed Allocation Option, but with a greater exposure to equities; and (4) High Equity Option, which consists of 75% to 100% stock holdings.

Issues to Keep in Mind About the NYCSP

- There is a 10% penalty on money used for a purpose other than the beneficiary's higher education (a non-qualified withdrawal). Monies withdrawn in this manner are subject to a 10% tax on earnings, not contributions. For example, an account owner who contributed $50,000 and saw his or her account grow to $105,000, would pay 10% of $55,000, the amount earned, not contributed.
- The total amount contributed cannot exceed $100,000.
- Once the account owner chooses an investment plan for a 529 plan account, it cannot be changed. But the account owner can subsequently invest additional funds into different investment options for the same beneficiary. Example: an individual chooses the High Equity investment option for his or her child's account. Later when the child is older, the individual wants to diversify and invest funds into a more conservative fund. He or she may do so by investing additional funds into a different investment option.
- An account must be opened three years before a qualified withdrawal can be made. That means if the account owner expects the beneficiary to attend college at age 18, the account should be opened before the beneficiary is 15 years old. Any time after is not a good time to start, unless the account owner is planning to finance an advanced degree or wait to use the money toward the end of his or her child's educational career.
- Monies deposited in a NYCSP account are protected from creditors in bankruptcy proceedings, and creditors also are limited in their ability to satisfy judgments using NYCSP accounts, even outside of bankruptcy proceedings.

Individuals can open an account for as little as $15 and make periodic payroll contributions of $15 through an automatic investment plan such as a payroll deduction. More information is available at 877-NY-SAVES. Program representatives are knowledgeable and very helpful. Or log onto www.nysaves.org.

"Individuals can open an account for as little as $15 and make periodic payroll contributions of $15 through an automatic investment plan such as a payroll deduction."

Endnotes

1. Georgia and South Dakota presently have no such plan in operation, although Georgia will commence a college savings program in 2002.
2. The first $750 of income is not taxed, the next $750 of income is taxed at the child's rate, typically lower than the parents' rate. After the child reaches age 14, the income is taxed at the parents' rate.
3. Jonathan Clements, *Getting Going* Column, *Saving for College: Not as Easy as 5-2-9*, Wall St. J., May 22, 2001.
4. Aaron Lucchetti, *Is Your Tuition Account Most Likely to Succeed?*, Wall St. J., June 15, 2001.
5. This amount will increase to $1 million in 2002.
6. State of New York, Program Brochure, *New York's College Savings Program* (Nov. 15, 2000); discussions with program representatives on various dates.

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Determination and Validity of Estate Debts and Claims in New York

By Judith E. Siegel-Baum and Donald J. Hayde

I. Introduction

Enforcing a claim against an estate in New York requires a careful review of Article 18 of the Surrogate's Court Procedure Act (SCPA). If done in accordance with the statutory requirements the procedures are simple and effective. If statutory law is ignored, attempting to enforce a claim may be impossible. This article provides an overview of Article 18 with guidelines for noticing, presenting and enforcing claims against estates in New York.

II. Notice of a Claim

To obtain court enforcement of a claim, a claimant must make a presentation in accordance with the requirements of SCPA 1803, or, alternatively, obtain a court-ordered judgment or decree based upon a validly preserved claim. Therefore, failure to properly initiate the process may result in a loss of the claim.

SCPA 1803 requires that all claims against an estate in New York other than claims for administration expenses, or claims by the United States Government or New York State must be (1) in writing; (2) provide a statement of the facts upon which the claim is based; and (3) set forth the amount of the claim (which may require proof by affidavit where requested by the fiduciary of the estate). A copy of the notice of claim must be served (1) personally upon the fiduciary; (2) by certified mail return receipt requested at the address stated in the designation; or (3) if notice is published at the place specified in the court order. If, after exercising due diligence, a fiduciary cannot be found or served within the state, the notice of claim must be served on the clerk of the court. A claimant cannot effectively serve a notice of claim on the attorney for the fiduciary unless the attorney is authorized to accept service on behalf of that fiduciary. Otherwise, service is not effected and the claim is not properly served.

As set forth in SCPA 1802, failure to present a notice of claim within seven months is not in itself a time bar. Under New York law, the notice can be presented until entry of a final accounting decree. Failure to serve the notice within the seven-month period merely limits the liability of the fiduciary. If the claim is properly made within seven months after issuance of letters, (including preliminary or temporary letters) on the date fixed in any notice of publication, the fiduciary will be chargeable for any assets he or she paid outright or distributed during that seven-month period. When the claim is presented after that seven-month period, the fiduciary will not be chargeable for any assets paid or distributed prior to receipt of the notice so long as the fiduciary acted in good faith and had no knowledge of the claim. Under New York case law if a fiduciary "knew or should have known"[1] about a claim, or if the fiduciary had knowledge of the claim and avoided its payment, the knowledge or the fact that he or she should have known about the claim will create fiduciary liability. Such liability exists, regardless of the fact that the claimant did not comply with the notice requirements in SCPA 1803. Furthermore, if the fiduciary has personal knowledge of the existence of the claim, even if such claim was not presented and obtains an accounting decree without citing the creditor, then he or she distributes estate assets at his or her own peril.

III. Preference of Claims

There is a statutory "pecking order" as to how claims against an estate are treated. This preference of claims under SCPA 1811 is as follows: (1) the exemptions of a surviving spouse or minor children pursuant to Estates, Powers & Trusts Law 5-3.1 (EPTL); (2) administration expenses, including executor's commissions, reasonable legal fees and all costs of administration including costs related to fiduciary income tax returns;[2] (3) funeral expenses; (4) all claims entitled to preference under federal and New York State law;[3] (5) taxes assessed on a decedent's property prior to death; (6) judgments docketed and decrees entered against a decedent in the order of priority; and (7) all other debts. Under this statutorily imposed hierarchy, a lien or a judgment against a decedent that does not fall into one of the itemized preference categories may never be collected, since nearly every other creditor has a preference, and a fiduciary may not arbitrarily pick or choose who will be paid.

IV. Fiduciaries' Claims

Claims by fiduciaries are disposed of under SCPA 1809. Where an executor or other fiduciary has a claim to fees for his or her services provided to an estate, court approval is required before such payment can be made. The application for these fees may be made in a final accounting proceeding or, if necessary, on an interim basis. The fiduciary has the authority under SCPA 1809 to bring a special pro-

ceeding in which he or she may seek court permission for payment of fees, on an interim or final basis.

V. Allowance or Rejection of Claims

A somewhat unusual process exists under New York law. SCPA 1806 permits a fiduciary to allow or to reject a claim, wholly or partially, in writing. However, in the event the fiduciary fails to act within 90 days from the date the claim is presented, the claim is deemed rejected. Therefore a fiduciary may merely ignore a claim in order to evidence its rejection. Thus, if a fiduciary rejects a claim, he or she has two options prior to the filing an accounting: (1) to do nothing; or (2) to give written notice of a claim presented. If the rejection is in writing, a notice of rejection must be served personally on the claimant or an attorney for the claimant, assuming the attorney is authorized to receive service. This notice of rejection must set forth the reasons the claim is rejected. Service of the notice of rejection creates a time limitation for a claimant, who must commence an action for payment within 60 days after service of the notice of rejection. If he or she fails to do so, the claim can only be determined in the final accounting proceeding.

In some instances, either as a litigation tactic or because the claimant believes he or she will fare better in another jurisdiction, a claimant may within the 60-day time period want to initiate a proceeding in state Supreme Court or may want to "forum shop" in another state. This occurred in *In re Goodson*,[4] where a will was probated in Surrogate's Court and a notice of rejection was served on a claimant. The fiduciary filed a proceeding in Surrogate's Court to determine the validity of the claim before the 60 days passed. On the same date that the fiduciary filed the claim in Surrogate's Court, the claimant filed a proceeding in California to enforce the claim. The Appellate Division determined that the Surrogate's Court proceeding should have been dismissed since 60 days had not elapsed and during that time period, only the claimant may decide where to initiate an action to enforce the claim. The fiduciary, by serving a notice of rejection, is barred from bringing any action during the 60-day period.

Under SCPA 1807 a claimant may require a fiduciary to show cause as to why a claim should not be paid, and the court may dismiss the petition or direct payment or satisfaction of such claim in whole or in part. The court may require the claimant to provide a refunding bond. If the claim is allowed on such application, its validity is established. Any party who is adversely affected can file objections on the grounds that the claim was improperly allowed or negligently or fraudulently paid. The burden of proof on disallowing a claim is on the objectant. If there is no basis for filing an objection and the claim is deemed frivolous, the objectant faces the risk of court-imposed sanctions or a surcharge.

Under SCPA 1809, a fiduciary is authorized to commence a proceeding to determine the validity of a claim and does not have to wait until the final accounting proceeding.[5] Use of this proceeding may be appropriate, expedient and economically beneficial in a large estate where a full accounting may be quite costly. In seeking such a determination, citation must issue on all persons who would be affected by the allowance of the claim where the claim exceeds $10,000 or is greater than 25% of the estimated value of the gross probate estate. The rules contained in SCPA 1809 are very specific. If a special proceeding is commenced, an answer must be served eight days from the return date. The fiduciary may, if he or she chooses, serve and file a reply within five days from the service of the answer and the claimant may file a reply within a very short period of time not specifically stated in the statute.

If a special proceeding is not commenced, the claimant must either wait until the final account is filed or petition the court to compel the fiduciary to account. In either instance, if the claim is rejected by the fiduciary in the accounting, the claimant will file objections to the account and the court will determine the claim.

SCPA 1812, when applied in conjunction with CPLR 5102 and 5208, authorizes a claimant to execute judgment against the decedent's real property if he or she prevails.

VI. Compromise and Settlement of Claims Under the SCPA

SCPA 1813 authorizes the compromise and settlement of claims and is extremely useful since a fiduciary should not settle claims without court approval and authorization. SCPA 1813 permits a fiduciary to make an application either *ex parte* or on notice to parties as the court may direct seeking to settle a claim. As a general rule, the court requires service of the application on all interested parties. If an interested party has not received notice he or she may argue that the debtor's claim was fraudulently compromised or compounded and thus can reopen the matter. The fiduciary is protected from liability provided he or she obtains court approval of the compromise and avoids the risk of surcharge.[6]

VII. Conclusion

When asserting or defending a claim against an estate, compliance with the statutory requirements serves as an assurance for counsel that a client's rights have been preserved. Although facts make a

successful claim, if the groundwork is not laid properly, the claim will never be determined.

Endnotes

1. Knew or should have known has been deemed to be actual or constructive knowledge. *In re Segall*, 287 N.Y.2d 52, 38 N.E.2d 126 (1941), (fiduciaries cannot distribute assets of a debtors' estate with knowledge that they are evading payment of a debt, although no claim has been filed); *In re Leopold*, (Sur. Ct., Suffolk Co. July 19, 1996) (Prudenti, J.) (when the estate representative and counsel are aware of a claim, the claimant's failure to comply with SCPA 1803 shall not preclude enforcement of the claim, and filing a petition for determination of the validity of the claim is deemed sufficient notice); *In re Goldberg*, 14 A.D.2d 294, 220 N.Y.S.2d 559 (1st Dep't 1961) (if a fiduciary has personal knowledge of the existence of a claim, even if not presented, and obtains an accounting decree without citing the creditor, he or she distributes at his or her own peril); *In re Vivas*, N.Y.L.J., May 5, 1998, at 27 (Sur. Ct., N.Y. Co.) (Roth, J.) (decedent and fiduciary failing to give notice to Department of Social Services of the settlement of a personal injury suit does not preclude Department of Social Services from seeking and recovering reimbursement of Medicaid benefits paid on behalf of decedent).
2. *In re Stone*, 108 Misc. 2d 235, 437 N.Y.S.2d 249 (Sur. Ct., N.Y. Co. 1981). State taxes due on a fiduciary income tax return are administration expenses and have priority over debts of any kind, including United States claims.
3. *In re Doran*, 107 Misc. 2d 797, 435 N.Y.S.2d 495 (Sur. Ct., Erie Co. 1981). After payment of all administrative expenses, including executor's commissions and attorney's fees, the IRS claim for decedent's unpaid federal income tax has priority over the claim of the city of Buffalo for demolition fees on decedent's real property which was consented to by all parties.
4. 231 A.D.2d. 66, 661 N.Y.S.2d 6 (1st Dep't 1997).
5. *In re Perry*, 123 Misc. 2d 273, 473 N.Y.S.2d 335 (Sur. Ct., Nassau Co. 1984).
6. *Estate of Helen Singer Kaplan Lazarus*, N.Y.L.J., March 19, 1998, at 29 (Sur. Ct., N.Y. Co.) (Roth, J.). The statute protects the fiduciary by permitting the fiduciary to obtain court approval of the compromise and avoid the risk of surcharge. *Estate of Helen Singer Kaplan Lazarus*, N.Y.L.J., March 19, 1998, at 29 (Sur. Ct., N.Y. Co.) (Roth, J.) (preliminary executor received judicial permission to compromise a multi-million dollar claim against decedent's estate by decedent's children since cost to the estate by not selling would exceed any gains achieved by pursuing litigation of claim). SCPA 1813 facilitates the administration of an estate by allowing claims to be resolved before an accounting procedure. *See also Estate of Helen Singer Kaplan Lazarus*, N.Y.L.J., June 21, 2000, at 30 (Sur. Ct., N.Y. Co.) (Roth, J.) (unsuccessful attempt to set aside compromise in an accounting proceeding).

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Answers by Jon L. Schumacher and Elizabeth A. Hartnett

Q If a trustee has an absolute power to invade principal for beneficiaries, EPTL 10-6.6(b) says it can amend the trust in any way, or pour it over into a wholly new or different trust, just so long as the beneficiaries of the succeeding trust are permissible objects of the original trust's invasion power. It can be done either on consent of all interested persons (with application of virtual representation), or by the court in a proceeding on due notice. The principal purpose of that 1992 enactment was to permit modification of a pre-9/26/85 irrevocable trust (i.e., a trust grandfathered against the generation-skipping transfer (GST) tax) to extend its tax-free life down to further generations. Last December, the Treasury issued final regulations under § 26.2601 announcing that an extending modification requiring either beneficiary consent or judicial action would cause the trust to lose its grandfather protection. My question: Is EPTL 10-6.6(b) now worthless?

A Not worthless. It can be used to modernize, add desirable provisions, fix problems, change trustees or succession rules, add or subtract powers of appointment, and even change beneficial interests. But for extension of a grandfathered trust GST tax-free to further generations? No can do. The regulation took unabashed dead aim at New York's enactment, and it scored a bull's-eye. Indeed, 10-6.6(b) may even be worse than worthless now, because it may prove to be a trap for the unwary. An uninformed trustee might amend a grandfathered trust, on consent, calling down a GST tax where none had existed. So thanks for the question: perhaps a reader will be tipped off to the existence and effect of this regulation in time to prevent a bad, bad mistake.

As this is written, the Section awaits action on its bill that would reinstate the possible use of the statute for GST tax purposes regarding grandfathered trusts. The bill, A.7699, removes the offending mandate of either consent or court, letting the trustee amend in its sole discretion, although it also provides voluntary access to the court if the trustee wants that comfort for a non-GST tax amendment. Watch out, though: if that bill becomes law, its GST tax use still requires knowledge. The regulation has a further requirement—that the trustee's authority to make such an amendment must have been the law at the time the trust was created or became irrevocable. A Bosch review would probably ask whether the Court of Appeals would find favorably on two questions: Can a limited power of appointment be exercised in further trust, rather than only outright, absent any indication of creator's intent? If so, is a power of invasion the functional equivalent of a limited power of appointment, and therefore also exercisable in further trust? Since we are concerned with use on trusts created before 9/26/85, it is nice but not determinative that EPTL 10-6.6(f) was added in 1995 to clarify statutorily that exercise of an absolute power of invasion is to be treated as the exercise of a limited power of appointment; it is also nice that EPTL 10-6.6(b) was added in 1992 to state that with consent or court action a trustee can amend under a power of invasion; and even nicer that EPTL 10-6.6(a)(2) was added in 1967 to clarify that a limited power can be exercised less extensively than outright. The trick here is that the Service can test the Legislature's claim that its work at these points "clarifies" existing law. When you wrestle through all the pre-'95 and pre-'67 cases on these points, you will find less than a perfect proof that the Court of Appeals would have held, from time to time before 9/26/85, that New York trustees had the requisite power. That's not a negative conclusion: it is, however, a warning that you have homework to do before using the statute, if amended, for GST tax amendment of grandfathered trusts.

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* * *

Q The will of a predeceased husband contained a nonmarital residuary trust for his wife which provided

> my said wife shall have the power, so long as she shall live, to direct my Trustee to pay over to her from the principal and accumulated income, if any, in each calendar year including the year in which my death occurs, an amount not in excess of the greater of Five Thousand Dollars ($5,000.00) or five percent (5%) of the aggregate value of the principal of the Residuary Trust on the first day of the calendar year for which payment may be directed, which amount may be so paid or distributed from time to time as my said wife shall direct.

On the subsequent death of the wife what are the tax implications of such a power?

A This so-called "5 and 5" power is a general power of appointment.[1] It is used in trusts where the testator wants to grant some withdrawal rights to the beneficiary without the adverse gift and estate tax implications of a general power of appointment that is not so limited.

The exercise or release of a general power during the holder's lifetime is subject to gift tax on the value of the property so released or appointed. The lapse of a power is considered a release of the power. I.R.C. § 2041(b)(2) exempts from characterization as a taxable release the value of any property subject to a power of appointment equal to the greater of (1) $5,000; or (2) 5% of the value of the assets out of which the power could have been satisfied. Thus, by limiting the power to 5 and 5, neither the exercise or release of the power by the holder nor any lapse by failure to exercise will constitute a taxable gift.

Property subject to a general power of appointment possessed at death is includable in the power holder's estate whether or not the power is exercised.[2] If the amounts of the annual withdrawal powers for each year prior to the date of death were not greater than the 5 and 5 power specified in I.R.C. § 2041(b)(2) and those powers lapsed, the property subject to those lapsed powers is not includable in the power holder's estate. Since I.R.C. § 2041(b)(2) treats a lapsed 5 and 5 power as a released power, the powers for calendar years prior to the power holder's death do not exist on the date of the power holder's death.

The estate tax treatment of a power which exists in the year of the power holder's death is different. Since the power to withdraw during the last year of the power holder's life has not lapsed at the power holder's death, the exception for the lapsing 5 and 5 power under I.R.C. § 2041(b)(2) is not available. The value of the property of the trust subject to the right of withdrawal for the final year of the power holder's life is subject to inclusion in the power holder's estate under the general rule of I.R.C. § 2041(a)(2).[3]

For purposes of the inclusion of property subject to a general power of appointment, Treas. Reg. § 20.2041-3(b) draws a distinction between (1) those powers which are subject to a precedent notice requirement or are effective only after a stated period of time after exercise; and (2) those powers which may be exercised only upon conditions precedent to the exercise. A power of appointment is considered to exist at the power holder's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the power holder's death notice has been given or the power has been exercised.[4] However, a power which by its terms is exercisable only upon the occurrence during the power holder's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence at the power holder's death.[5]

The power set forth in the question above is granted only "so long as she shall live." Can it be said that the withdrawal power was not in existence at the power holder's death because it was subject to this condition precedent? Probably not. This is the same language as was considered in *Estate of Dietz v. Commr., supra*, where the property subject to the right of withdrawal during the final year of the power holder's life was determined to be includable in the gross estate. Additionally, this specific language is not referred to in the regulation's examples for this exception. The regulations cite, as nontaxable powers, powers that are exercisable only after the power holder attained a certain age, only if he survived another person or only if he died without descendants, provided such conditions precedent to the exercise had not occurred as of the power holder's death.[6]

In summary, the gross estate of the power holder in the question above must include the greater of (1) 5% of the trust principal value as of the first day of the year of the power holder's death; or (2) $5,000. To limit the inclusion of the power in the power holder's estate, the power should be restricted to a $5,000 withdrawal anytime during the year and then additional withdrawals up to 5% of principal only if the power holder is living on the last day of the calendar year.[7] This limits the possibility of inclusion to the circumstance where the power holder dies on the last day of the calendar year.

The inclusion of this property in the power holder's estate will qualify the estate for the credit for tax on prior transfers under I.R.C. § 2013(a) since the right to withdraw is a beneficial interest in property.[8] The value for purposes of the credit is the actuarial value of the power holder's right of withdrawal determined as of the date of the prior death of the testator granting the power.[9]

The property subject to the power and includable in the gross estate would have income tax effects as well. Since the exercise of the power would draw out income of the trust a portion of the amount included in the gross estate would be Income in Respect of a Decedent (IRD).

A portion of the property subject to the power would have a new tax basis. In the case of a decedent dying after December 31, 1953, if property is acquired as the result of a nonexercise of a power of appointment held by the decedent, such property is considered to have been acquired from or to have passed from the decedent.[10] I.R.C. § 1014(a) provides for the step up in basis of such property acquired from or passed from the decedent. In the question above, the value of the portion of the property not deemed IRD would be allocable to all of the Residuary Trust assets which were subject to the power as of the date of the power holder's death. The basis adjustment would be allocated on a *pro rata* basis based on the unrealized appreciation of each and every asset.

The holding period of each asset would also be affected. The stepped-up basis allocation to each asset would have a holding period of one year.[11] A sale of each asset will result in that allocable portion of the basis obtaining long term capital gain treatment.

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Endnotes

1. I.R.C. § 2041(b)(1) defines a general power of appointment as "a power which is exercisable in favor of the decedent, his estate, his creditors, of the creditors of his estate." The power to consume the principal of the trust is a power of appointment. Treas. Reg. § 20.2041-1(b).
2. *Kurz v. Commr.*, 101 T.C. 44, 53 (1993) *supplemented and reconsideration denied*, T.C. Memo. 1994-221, *aff'd.*, 68 F.3d 1027 (7th Cir. 1995).
3. *Estate of Dietz v. Commr.,* T.C. Memo 1996-471; Treas. Reg. § 20.2041-3(d)(3).
4. I.R.C. § 2041(a)(2).
5. Treas. Reg. § 20.2041-3(b).
6. *Id.*
7. Practical Drafting, Will Provisions, U.S. Trust, p. 54.
8. I.R.C. § 2013(e) includes general powers of appointment in the definition of property eligible for the credit.
9. Rev. Rul. 79-211, 1979-2 C.B. 319.
10. Treas. Reg. § 1.1014-2(b).
11. I.R.C. § 1223(11).

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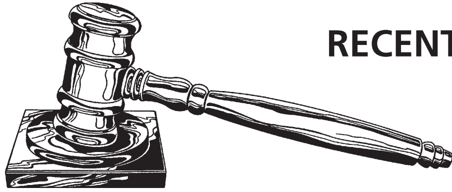

CASE NOTES— RECENT NEW YORK STATE SURROGATE'S AND SUPREME COURT DECISIONS

Arlene Harris and Donald S. Klein

After-Born Children

The testator executed a will in which he left his estate to his three children. Subsequently, he remarried and had two more children. The testator passed away in 1994, having not updated his will to include his additional children. The Surrogate ruled on EPTL 5-3.2, which states, "Whenever a testator, during his lifetime or after his death, has a child born after the execution of a last will, and dies leaving the after-born child unprovided for by any settlement, and neither provided for nor in any way mentioned in the will," such child shall receive "such share of the testator's estate . . . as he would have received had the testator included the after-born children with the children upon whom benefits were conferred under the will, and given an equal share of the estate to each such child." The court ruled that the after-born children were not entitled to share in the probate estate, because in fact they had been provided for by settlement: the testator had designated all five children as partial beneficiaries of his life insurance policy. The courts have uniformly held that the provision for payment of proceeds from life insurance policies constitutes a settlement. Thus, because EPTL 5-3.2 provides that "any" settlement is sufficient to satisfy the statute, no matter how small, Surrogate Feinberg found the after-born children were not entitled to a share of the probate estate. *In re Estate of Charles Merriwell Magrow*, N.Y.L.J., May 16, 2001, p. 20, col. 4 (Sur. Ct., Kings Co.) (Feinberg, Sur.).

Attachment of Assets

The administrator of a decedent's estate sought to recover estate funds which were distributed to the defendant, decedent's husband, on his representation that the decedent had died intestate. In fact, decedent had left a will in which numerous persons, but not the defendant, were named as beneficiaries. The administrator moved for an order of attachment against the defendant's New York assets. At the same time that the defendant was in the process of obtaining the approximately $350,000 from the decedent's estates, he was in the midst of filing for bankruptcy and had failed to disclose his interest in the decedent's estate.

The court pointed to CPLR 6201(3) which provides that an order of attachment may be granted in any action for a money judgment when "the defendant, with the intent to defraud his creditors or frustrate the enforcement of a judgment that might be rendered in plaintiff's favor, has . . . secreted property." In addition, the plaintiff must show a probability of success on the merits in the underlying action. The court ruled that the defendant clearly intended to defraud his creditors by concealing property. Defendant's fraudulent intent was evidenced by his failure to disclose requisite, material information about his assets during his bankruptcy proceedings. His denial of having a bank account or intending to open a bank account was false and could only have been made because he did not want the trustee or his creditors to know about the significant funds he was about to receive from the decedent's estate. As for the likelihood for success on the merits, the court found that it was fairly certain that the administrator would win his action to recover the assets from the defendant: it is well established that a distributee of an estate who has been paid monies to which he is not entitled will be required to return those assets in a lawsuit brought by either the administrator of the estate or a rightful distributee. Therefore, the court granted the administrator's petition and the defendant's assets were attached. *West v. Kastner*, N.Y.L.J., May 11, 2001, p. 20, col. 4 (Sup. Ct., N.Y. Co.) (Diamond, J.).

Attorney-Client Privilege

In an application to compel the production of documents in the estate of a decedent, the court ruled that an executrix may waive the decedent's attorney-client privilege. The executrix had sought the waiver in order to pursue an action for fraud in which the defendant had allegedly compelled the decedent, in his then diminished capacity, to sell his share in a closely-held corporation at a price estimated at $48 million below fair market value. The Surrogate went through a protracted analysis of the history of the attorney-client privilege. Specifically, she noted that the first statutory provisions on the attorney-client privilege, §§ 835 and 836 of the Code of

Remedial Justice, enacted in 1877, were merely meant to codify the common law, rather than to alter it. It was therefore important to note that prior to such codification, the decisions uniformly recognized that the personal representative of the client's estate succeeded to the right to waive the privilege in order to protect such property interests as were passed along by him. *Greenlaw v. King*, 1 Beav 137, 145 (holding that client's executor may waive privilege); *Doe v. Hertford*, 13 Jur 632 (holding that the fiduciary of client's estate or his heir may waive privilege). During the following century that led to the enactment of the current attorney-client privilege statute, CPLR 4503, there was no basis to conclude that the Legislature ever intended to narrow the category of persons who, under common law, had the right to waive the privilege when such a waiver would clearly benefit the client's interest. Therefore, the Surrogate ruled that because the client could have waived the privilege to protect himself or to promote his interests after his death, his personal representative could "stand in his shoes for the same purposes." *In re Estate of Nathaniel Colby*, N.Y.L.J., Apr. 3, 2001, p. 18, col. 6 (Sur. Ct., N.Y. Co.) (Roth, Sur.).

Commissions—Denial

As the executrix of an estate, the decedent's daughter filed an account of proceedings. The decedent's other two children filed objections to the final accounting. After reviewing the objections, the court found that the executrix had acted in bad faith; specifically, she had mismanaged the estate because she had engaged in self dealing and favored treatment of her son (the executrix had influenced her mother in turning over investment accounts valued at $135,000 over to her and her son). The main objections dealt with whether the executrix should be denied statutory commissions for her misconduct. The court noted the general rule cited in *In re Kramer,* 78 Misc. 2d 662 (N.Y. 1974), "[a]n executor may be denied commission for misconduct, breach of trust or mismanagement of the estate." If the fiduciary hopes to be compensated, she must take the job seriously and properly perform her functions. Statutory commissions constitute compensation for services well rendered; they are not a gift from a decedent to the fiduciary of his estate. The court then ruled that the executrix's misconduct, while falling short of that which would prevent her from receiving any compensation, justified the exercise of the court's discretion in denying the executrix 25% of her statutory commissions. *In re Estate of Ellen Palcic*, N.Y.L.J., May 18, 2001, p. 21, col. 1 (Sur. Ct., Richmond Co.) (Fusco, Sur.).

Construction—Anti-Lapse

In a construction proceeding the question was whether certain language in the will negated the application of the "anti-lapse" statute. Decedent died in November of 1999. She was survived by one of her two daughters, Beatrice, and predeceased by her spouse and her other daughter, Jeanne. The will left all real and personal property, "including lapsed legacies and devises, which is hereby defined as my residuary estate" to her husband. In the event that the husband predeceased the decedent, the entire residuary estate was left in equal thirds to Beatrice, Jeanne, and Beatrice's children. As Jeanne had predeceased, the question was to whom did Jeanne's share lapse. Pursuant to EPTL 3-3.3(a)(2)—the "anti-lapse" statute—unless the will provides otherwise, whenever a testator makes a disposition to his/her issue or sibling(s), and that beneficiary predeceases the testator, leaving issue who survive the testator, the bequest vests in the issue of the intended beneficiary, by representation. The statute is inapplicable where the will evidences a contrary intent, such as where the bequest is conditioned by words of limitation or survival. The court concluded that the "anti-lapse" statute applied to Jeanne's share of the residuary estate, because while the decedent used explicit language to impose a condition of survival upon her husband's bequest, she employed no such language upon the substitutionary bequests in the event that she was predeceased by her husband. *In re Estate of Virginia H. Scova*, N.Y.L.J., Apr. 16, 2001, p. 39, col. 5 (Sur. Ct., Westchester Co.) (Scarpino, Sur.).

Construction—Distribution Limits

Petitioners requested a construction of language that imposed limits on certain distributions from a residuary charitable trust. The decedent died in 1958. The will, executed in 1940, and a codicil, executed in 1941, did not authorize grants from the trust principal. The instrument directed that the trust income be applied to research for the prevention or cure of human disease. The trustee's choice of investment was such that, given the ratio of accounting income to principal, distribution of trust accounting income alone as directed in the will did not always satisfy the minimum distribution required by the Tax Reform Act of 1969. As mandated by EPTL 8-1.8(a)(1), the trustee had been making distributions from principal when necessary to comply with the federal minimum distribution requirements.

The Surrogate granted petitioner's request that percentage limitations imposed by the will on distributions to committee members or their medical

schools be construed as percentages of the minimum amount required to be distributed by law, and not as percentages of trust accounting income. The court viewed this as the best way to effectuate the intent of the testatrix. The Surrogate noted that by choosing to limit the grants in terms of a percentage rather than a specific dollar amount it was clear that the testatrix intended to restrict the proportionate share of a committee member or the member's medical school, not the amount the member or the school could receive. Therefore, it would be contrary to her intent to reduce the amounts available to them because of investment policies and statutory requirements adopted long after her death. *In re Estate of Alexandrine Sinsheimer*, N.Y.L.J., May 21, 2001, p. 25, col. 5 (Sur. Ct., N.Y. Co.) (Preminger, Sur.).

Domicile

The court had to determine, incident to a probate proceeding, whether the decedent had been domiciled in New York or Maine. The decedent had been born in New York and attended college and graduate school in New York. She was employed and lived in New York until her death. In addition, decedent had specifically expressed in two earlier wills that she was domiciled in New York. The only evidence that she was domiciled in Maine was the fact that she had built and maintained a vacation home there in 1994. However, the extent of decedent's contact with Maine was limited to the summer vacation home and her death there. The Surrogate explained that because the decedent was clearly domiciled in New York when she purchased the Maine property, her sister, who had been disinherited, had the burden of establishing that decedent had changed her domicile. The sister had failed to meet that burden, and the court concluded that decedent was domiciled in New York at the time of her death. *In re Estate of Ingrid Bareuther*, N.Y.L.J., Apr. 18, 2001, p. 20, col. 3 (Sur. Ct., N.Y. Co.) (Roth, Sur.).

Estate Management Fees

The Surrogate ruled that the fees sought by a trustee and his attorneys were unreasonable. The Surrogate pointed to five factors: (1) time spent; (2) the size of the estate; (3) the nature and extent of the services performed; (4) the legal complexities involved; and (5) the results achieved. *See In re Freeman*, 34 N.Y.2d 1 (1974). The court de-emphasized the importance of time spent, instead emphasizing the nature and extent of the actual services performed and the complexities involved. In the present matter, none of the services performed by any of the counsel, including the trustee as accountant, could truly be classified as involving complex legal questions, and the litigation itself did not proceed beyond its preliminary stages before it was settled. The court also pointed out that the size of the estate can operate as a limitation on the fees payable. In the present matter, the total fees amounted to over 10% of the trust. Relying on *In re Hughes*, N.Y.L.J., Feb. 27, 1995, p. 30, col. 5, the Surrogate stated that the fees sought should bear a reasonable relationship to the size of the estate. In addition, where more than one attorney is retained, the total fees to all attorneys should not exceed one reasonable attorney's fees. Therefore, the Surrogate reduced the fees and compensation for the trustee. In addition, in denying the trustee extra compensation, the court held that the statutory commissions constitute the only compensation allowed to a fiduciary for performance of the duties of his office. Additional compensation cannot be awarded out of the estate except for services entirely beyond the scope of those duties. *In re Estate of Claire Wynn Kelly*, N.Y.L.J., Apr. 24, 2001, p. 25, col. 1 (Sur. Ct., Suffolk Co.) (Riordan, Sur.).

Guardian Ad Litem Fees

A *guardian ad litem* was appointed in accordance with the SCPA 405 for the benefit of the surviving spouse. Pursuant to a court-approved stipulation of settlement between the spouse and the other surviving beneficiaries, the spouse was awarded one-third of the estate. The matter was before the court to resolve the question of who should pay the fee of the *guardian ad litem*, which amounted to $1,500. The court found that the executor and beneficiaries of the estate, as well as the spouse, benefited by the appointment of the guardian. Therefore, because the guardian was rendering statutory services (benefiting all), the fee would be payable in accordance with the *pro rata* distribution of the estate: two-thirds from estate assets, and one-third from the surviving spouse's funds. *In re Estate of Albert G. Stanton*, N.Y.L.J., Apr. 9, 2001, p. 35, col. 6 (Sur. Ct., Sullivan Co.) (LaBuda, Sur.).

Guardians

Petitioners sought, under Article 17 of the SCPA, to be appointed guardians of their 17-year-old daughter's unborn child. The sole purpose of the application was to get coverage for the baby under the grandfather's Blue Cross/Blue Shield health insurance policy. The mother had consented to the temporary guardianship, the 16-year-old father and his parents had consented, and the insurance company had agreed that it would enroll the baby as an eligible dependent if the grandparents were appointed guardians. The Surrogate relied on the decision in *In re Stuart*, 280 N.Y. 245 at 250 (1939), which stated that

a Surrogate has wide discretion in appointing a guardian for an infant and that "the paramount question is whether the interest of the infant will be promoted by the appointment made." It being clearly in the best interest of the child to have health insurance coverage, the Surrogate granted the grandparent's motion for temporary guardianship.

In addition, the Surrogate was asked to accept a Custody and Visitation Stipulation to be incorporated in the guardianship order issued by the court. Recognizing that such a custody order is ordinarily outside the jurisdiction of the Surrogate's Court and within the jurisdiction of Family Court, the Surrogate turned to stricture laid down by Judge Cardozo. In a case involving the Surrogate's Court, Judge Cardozo said, "To remit the claimant to another forum after all these advances and retreats, these reconnaissances and skirmishes, would be a postponement of justice equivalent to a denial. If anything is due him, he should get it in the forum whose aid he has invoked." *In re Raymond v. Davis*, 248 N.Y. 67 (1928). Therefore, the court approved the Custody and Visitation Stipulation and incorporated it into the guardianship order. *In re Baby K.*, N.Y.L.J., July 5, 2001, p. 24, col. 2 (Sur. Ct., Broome Co.) (Peckham, Sur.).

Guardian's Investments

The Surrogate denied a petition by the guardian of child's property to withdraw the child's funds from present depositories in order to invest funds with an investment advisory group without posting a bond. The child was almost nine years old and the guardian had the funds invested in certificates of deposit and savings accounts. The agreement with the investment advisory group proclaimed that the parties anticipated that the bank would have the investment onus as the delegee of the petitioner. Relying on EPTL 11-2.3(c)(D)(2) that "[a]n attempted exoneration of the delegee from liability for failure to meet such duty is contrary to public policy and void," the Surrogate found that many provisions in the proposed investment agreement constituted such an exoneration of the delegee and therefore needed to be stricken from the agreement in order for it to be valid. In addition, the agreement provided for final and binding arbitration to resolve any disputes. This provision was found to be directly in contradiction to the mandates of EPTL 11-2.3(c)(D)(3) that sets forth that the delegee in these arrangements automatically submits to the jurisdiction of the courts of New York. The Surrogate also indicated that upon receipt of an agreement omitting language contrary to the Act, he would grant the petition. *In re Christopher Corapi*, N.Y.L.J., July 13, 2001, p. 25, col. 6 Sur. Ct., (Onondaga Co.) (Wells, Sur.).

In another case, the Surrogate denied a petition to invest a 15-year-old ward's funds pursuant to an investment advisory agreement, which is permitted by SCPA 1708(2)(c), subject to the court's approval. Because the funds need to be invested in accordance with the Prudent Investor Act, the investment advisory fees must be reasonable. The court was left with the task of determining what is a reasonable rate. In making its determination, the court noted that an investment advisor does not assume the full responsibilities of the guardian, and so it is reasonable to assume that the investment advisor should not be permitted a higher compensation than a guardian. In rejecting the petition, the court found that the proposed fees to the investment advisor were excessive. It specifically noted that the investment advisor could not charge the investment advisory fee and also receive compensation from the mutual funds. It must elect to forgo one of the two fees. In addition, the court stated that the small size of the investment, $25,000, coupled with the short term of the investment meant that the risk of loss from investing in mutual funds that invest in the stock market was too great and therefore not in the best interests of the 15-year-old child who was the beneficiary of the account. *In re Derek W. Bryant*, N.Y.L.J., July 13, 2001, p. 25, col. 3 (Sur. Ct., Broome Co.) (Peckham, Sur.).

Power of Attorney—Gifts

The Second Circuit held that checks that were written to the decedent's family and friends prior to death but not paid until after death were not completed gifts and were, therefore, includible in her gross estate. The District Court held that the decedent did not part with dominion and control over the gifts, under New York law, because she had the ability to order that the payment on the checks be stopped. The Appellate Court affirmed this ruling and refused to apply the relation-back doctrine. The doctrine is generally applied in charitable gift cases and would treat the checks paid after death as completed on the date of delivery. The court indicated that as a matter of policy it did not want to extend the doctrine to a case where gifts were made to a noncharitable donee and the donor died prior to the date of payment. Finally, the court rejected the estate's argument that it was a violation of the Equal Protection Clause to treat charitable and noncharitable donees differently. *Rosano v. United States*, N.Y.L.J., Apr. 30, 2001, p. 30, col. 4 (2d Cir.).

Probate—Standing of Objectant

Prior to her death, decedent had executed a will in 1988 and the propounded instrument in 1991. Petitioner, the nominated executor, petitioned to probate the 1991 will. Objectant, the nephew of decedent's late husband, alleged lack of due execution, lack of testamentary capacity, fraud, and undue influence. Petitioner sought to dismiss the objections for lack of standing, claiming that the earlier will, in which objectant was named as a legatee, was presumed revoked, and since objectant was not a legatee in the 1991 will, he lacked standing to object to probate. The Surrogate ruled that objectant did, in fact, have standing because the alleged revocation of a prior will does not prevent a legatee under that will from contesting the probate of a later instrument, citing *In re Bayley*, 72 Misc. 2d 312 (N.Y. 1972). In addition, petitioner moved for summary judgment against the objectant. The Surrogate found that the document was executed properly, that the decedent did have testamentary capacity, and that there was no proof of fraud. Therefore, using the standard that summary judgment may be granted only where it is clear that no triable issue of fact exists, the Surrogate granted summary judgment on these issues.

However, in regard to the objectant's claim of undue influence, the Surrogate denied the petitioner's motion for summary judgment. The court noted that where a beneficiary has a confidential relationship with the testatrix and is involved in the preparation of the will, an inference of undue influence may be drawn. Petitioner was an accountant who had assumed a responsibility for the decedent's financial affairs beginning in 1990. He prepared checks for decedent's signature to pay expenses. He helped her manage her finances. The court found these facts sufficient to establish a confidential relationship. Given that undue influence is generally established by circumstantial evidence, the court found that there was a triable issue of fact, and therefore refused to grant summary judgment on the issue of undue influence. *In re Estate of Mina Werdinger*, N.Y.L.J., June 12, 2001, p. 21, col. 4 (Sur. Ct., King's Co.) (Feinberg, Sur.).

Reformation

The Surrogate accepted a petition for reformation of the decedent's will and a qualified personal residence trust (QPRT). The trust provided, "if neither Grantor is then living any cash in the trust held for the payment of expenses of the trust shall be distributed to the Grantor." The Surrogate pointed out that if neither Grantor is then living, then both are deceased and no payment could be payable to them:

> Where errors of draftsmanship have occurred, courts may save trusts which are contrary to technical requirements of law and it is immaterial if the mistake in the instrument is a mistake of fact or law or even a mistake in the tax consequences resulting from the method of creation of the trust.

In re Kander, 115 Misc. 2d 386, 388 (N.Y. 1982).

The Surrogate exercised his discretion to change and rearrange the words of the trust and the will so that the intentions of the testator and Grantors were carried out. *In re Estate of Alan C. Nelson*, N.Y.L.J., May 2, 2001, p. 24, col. 6 (Sur. Ct., Suffolk Co.) (Riordan, Sur.).

Revocation of Trust

The Downtown Athletic Club of New York City, Inc. executed a trust agreement in 1994 which transferred all the trademarks and licensing agreements relating to the Heisman Memorial Trophy to respondents, as trustees. One purpose of the trust was to secure the refinancing of a $9 million loan to the Downtown Athletic Club (DAC) from the Bank of New York. The trust provided that all revenues were to be distributed to the DAC. Upon the trust's termination, the assets were to revert back to the DAC. The loan was repaid and the Bank of New York acknowledged that it had no further interest in the trust. As a result, the DAC's Board of Governors passed a resolution consenting to and directing the termination of the trust. The trustees opposed the revocation, pointing to a provision in the trust agreement requiring the trustees to agree to any amendment to the trust agreement.

The Surrogate found the trustees' argument unpersuasive. Though the trust was to last for 25 years, EPTL 7-1.9 provides that

> upon the written consent . . . of all persons beneficially interested in a trust property . . . the creator of such trust may revoke or amend the whole or any part thereof by an instrument in writing . . . and thereupon the estate of the trustee ceases with respect to any part of such trust property.

In addition, when the loan was satisfied, the purpose of the trust ceased, and under EPTL 7-2.2, with the cessation of the trust's purpose, title in the trustees

also ceased. Therefore, the Surrogate held that the actions of the Board of Governors had terminated the trust. *In re Downtown Athletic Club of New York City, Inc.*, N.Y.L.J., May 22, 2001, p. 19, col. 3 (Sur. Ct., N.Y. Co.) (Preminger, Sur.).

Trusts—Remainder

At issue were two trust agreements that gave the trust remainders to decedent's heirs but which failed to specify the time for determining heirs. The Surrogate was asked to determine whether heirs were determined at the date of the death of the decedent or the death of the income beneficiary. The decedent had set up an *inter vivos* trust in 1923 and, at her death in 1925, a testamentary trust. Both were for the benefit of her son, Robert. The trusts provided income to Robert for life and upon his death, the remainder was to go to decedent's husband, but if he was not living, then the remainder was to pass to her "heirs at law." Decedent's spouse died in 1968. Her son died in 1999, survived by a daughter, decedent's sole grandchild. Decedent's other child died without issue in 1955. If heirs were determined at the death of the income beneficiary, there would be one issue who would take: decedent's granddaughter. However, if heirs were determined at the date of decedent's death, both her children would be heirs, and the trust remainder would be split in two, one part passing to each child's heirs. The Surrogate determined that it was decedent's intent to postpone a determination of her heirs until the death of the income beneficiary of the trust. In making this determination, the Surrogate pointed to four factors. First, a contingency was built into the provision disposing of the trust remainders: decedent intended the income beneficiary's death to be significant in determining who would take the remainder. Second, the specific language used in the remainder provisions indicated that the primary gift was to her husband, with heirs taking by substitution as a secondary disposition. Third, there was a certain incongruity in giving the remainders to those whom decedent favored with prior beneficial interests in the trusts. Thus, the implication here was that the decedent exclude her children from the heirs determination by creating prior estates in their favor. Fourth, the fact that decedent's overall testamentary plan revealed an exacting attention to her relatives supported the conclusion that "futurity is annexed" to the disposition of the trust remainders at issue. In the bequests to her extended family, heirs were to be determined at the death of the income beneficiaries. Therefore, the court perceived no reason why this same pattern should not apply for trusts set up for the benefit of her own son. Despite the fact that there was less evidence in the instant case than those cited to support the notion that the decedent had intended to postpone the heirs determination, the Surrogate ruled that the facts decidedly favored postponement of the heirs determination until the income beneficiary's death. *In re Estate of Emily Mayo Schell*, N.Y.L.J., May 2, 2001, p. 22, col. 3 (Sur. Ct., N.Y. Co.) (Roth, Sur.).

Trustee Contempt

Surrogate Preminger held a trustee in contempt for failure to comply with two orders. On May 21, 1998, the court signed an order directing the trustee to file an account of both trusts by June 15, 1998. The trustee failed to file the accounts until September 1999. The court found the trustee in civil contempt, noting that "the act of disobedience need not be deliberate; 'the mere act of disobedience, regardless of its motive, is sufficient to sustain a finding of civil contempt if such disobedience defeats, impairs, impedes or prejudices the rights of a party.'" *Gordon v. Janover*, 121 A.D.2d 599 (1986) (quoting *Great Neck Pennysaver, Inc. v. Central Nassau Pub., Inc.*, 65 A.D.2d 616 (1978)). The court found that the trustee was to pay the movant the costs and expenses, including attorneys' fees, incurred as a result of the contempt. The court ordered the trustee and his attorneys to refund to the trust all disbursements or legal fees paid after the issuance of a restraining order precluding such disbursements. The trustee failed to return $6,000 of the $49,000 that was to be reimbursed to the trust, and so the court found him to be in civil contempt. In addition, the court imposed on the offending party the other party's reasonable costs and expenses, including attorneys' fees. Because the movant did not provide sufficient documentation of the claimed $25,130 in legal fees, the court felt constrained to limit the facially excessive amount requested to the more reasonable sum of $15,000. The request for punitive damages was rejected. *In re Estate of Enrico Bonazzi*, N.Y.L.J., June 6, 2001, p. 21, col. 5 (Sur. Ct., N.Y. Co.) (Preminger, Sur.).

Virtual Representation

As a threshold issue to a petition seeking advice and direction pursuant to SCPA 2107 with respect to the sale of estate property, the Surrogate found that the petitioners had satisfied the requirements for virtual representation under SCPA 315. The criteria employed by the courts in applying virtual representation are as follows: (1) similarity of economic interest between representor and representee; (2) the absence of a conflict of interest; and (3) the adequacy of representation. *In re Holland*, 84 Misc. 2d 922 (1974). However, virtual representation does not apply to lateral or horizontal interests unless authorized by the will. SCPA 315(5). The interests in the

present matter were in fact horizontal, so the court needed to first determine whether the will satisfied SCPA 315(5). In Article 21, the will authorized horizontal virtual representation in accounting proceedings. The Surrogate did not interpret this as limiting virtual representation to accounting proceedings. First, the will clearly manifested an intent to dispense with service upon a person under a disability, where the interest of such person was the same as a party to the proceeding. Second, the Surrogate noted that the omnibus nature of an accounting proceeding must be considered, and that the petition in a voluntary accounting proceeding may include prayers for separate miscellaneous relief. Because the court found no reason to preclude a proceeding under SCPA 2107 from being subsumed in an accounting proceeding, the Surrogate held that "to rule that the testator's expressed intent in Article Twenty-First precludes horizontal virtual representation on these facts would be excessively technical." The petitioners had satisfied the requirements of SCPA 315, and only needed to file an affidavit as to the adequacy of representation of the proposed representors. The application for virtual representation was granted on the condition of the filing of that affidavit. *In re Estate of Louis Feil*, N.Y.L.J., May 23, 2001, p. 22, col. 6 (Sur. Ct., Nassau Co.) (Riordan, Sur.).

Voluntary Administrator

Petitioner, daughter of decedent, sought appointment to the office of voluntary administrator for administration of decedent's small estate, pursuant to SCPA Article 13. Decedent died seized of property not exceeding $20,000, and included in that property was a purchase money mortgage on real property. Because SCPA Article 13 only applies to personal property, the Surrogate was asked to determine whether the purchase money mortgage, as an asset of the deceased, constituted real or personal property. Pursuant to EPTL 13-1.1(a)(7), personal property passing to the personal representative of a deceased includes "debts secured by mortgages, moneys unpaid on contracts for the sale of lands." The Surrogate thus ruled that there was no question that the debt secured by the mortgage was personal property and that the voluntary administrator was authorized to collect this debt on behalf of the estate. However, the mortgage itself presented a problem to the court, because the lien of the mortgage was upon the land, and an instrument satisfying the lien of a mortgage is a recordable instrument affecting title to real property. The court then reviewed Real Property Law § 321(5)(a) which states that "the legislature has provided that a discharge of an unassigned mortgage shall be signed by the mortgagee or by his personal representative," which may include a voluntary administrator. However, because RPL § 321 does not address the authority of a voluntary administrator to assign a mortgage, and if legislative action was necessary to authorize the discharge of the supposed real property interest by a voluntary administrator, the same issue would intervene to prevent its assignment by such a representative. Therefore, the court filled in the "gap," and ruled that the interpretation of EPTL 13-1.1(a)(7) and RPL § 321(5) which granted authority to a voluntary administrator to collect and discharge a mortgage, implied legislative authority for a personal representative to assign a mortgage to a third party, should such an act be deemed advisable or necessary. *In re Estate of Verona J. Scheuer*, N.Y.L.J., May 11, 2001, p. 25, col. 5 (Sur. Ct., Greene Co.) (Lalor, Sur.).

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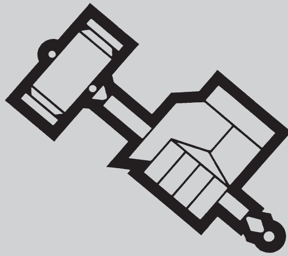

RECENT NEW YORK STATE DECISIONS

John C. Welsh

WILLS

CONSTRUCTION

Decedent's will directed that his female companion of 14 years have the right to continue to reside in his cooperative apartment "without payment of rent." The Appellate Division affirmed the Surrogate who concluded that "rent" was intended to include maintenance charges. Thus, the companion's continued residence would be without obligation relating to shelter. *In re Estate of Kovi*, __ A.D.2d __, 723 N.Y.S.2d 190 (1st Dep't 2001).

CONSTRUCTION

Decedent's will left his wife an amount equal to her elective share. In a subsequent divorce action, the parties stipulated in open court that certain cash payments were to be made by the husband to the wife. The judgment of divorce was to be based on these terms. A settlement date was fixed and the attorney for the wife filed with the court the findings of fact, conclusions of law and proposed judgment of divorce. The husband interposed no contrary documents but died on the settlement date before the judgment of divorce was signed. The Surrogate determined that signing the judgment of divorce was only a ministerial act under these circumstances and that for purposes of inheritance the parties should be treated as divorced. Therefore, the legacies to the wife are void under EPTL 5-1.4 and the wife's right of election would be barred by EPTL 5-1.2. Even if the parties were not divorced, the wife was deemed to have waived her rights to a share of the estate by the terms of the settlement. *In re Estate of Mirizzi*, 187 Misc. 2d 481, 723 N.Y.S.2d 623 (Sur. Ct., Richmond Co. 2001).

DESCENT AND DISTRIBUTION

Inheritance By Siblings Adopted Out

Decedent died intestate and was survived by three paternal first cousins and two maternal first cousins. Their claim to inheritance failed against the apparent rights of two brothers and one sister who had a common father with decedent but a different mother. Following the divorce of the siblings parents, the mother remarried and the three children were adopted in New Hampshire by her new husband. Under Domestic Relations Law § 117(1)(e), children with an adoptive father continue to inherit from their natural father when the adoptive father has married their maternal mother. The public administrator was directed to retain the assets of the estate for 90 days to allow the siblings of the half blood to provide proof of their entitlement. *In re Estate of Morrow*, __ Misc. 2d __, 724 N.Y.S.2d 286 (Sur. Ct., Bronx Co. 2001).

ADMINISTRATION OF ESTATES

Waiver of Elective Share

Nine months after their 1971 marriage, H and W executed mutual waivers of their rights to take an elective share in the estate of the other. Although they separated in 1984, they were still married when W died in 1987. W's will, which was not probated until almost ten years after she died, made no provisions for H. Shortly after the probate, H filed a notice of intent to elect against the will which was followed by a proceeding to determine the validity of the waiver executed by him 26 years earlier. The Appellate Division found that the cause of action for fraud in the inducement based upon a failure by W to disclose fully her existing assets accrued at the time the waiver was executed. Action was required within six years of the waiver or two years after the fraud could have reasonably been discovered. Since there was no showing that the extent of the assets could not have been discovered at the execution of the waiver or shortly thereafter, H's claim was time barred and should have been dismissed by the Surrogate. *In re Estate of Blake*, __ A.D.2d __, 723 N.Y.S.2d 563 (3d Dep't 2001).

Right of Election—Common Law Marriage

In a proceeding to determine the validity of a notice of election against the estate of decedent, the Appellate Division agreed with the Surrogate that

the alleged spouse failed to prove her common law status under the law of Pennsylvania. The alleged agreement to marry was made in New York where the parties cohabited for 26 years. The parties made several visits to a relative in Pennsylvania but there was no direct proof that they had even stayed overnight in that state. The alleged marriage vows were never repeated in Pennsylvania. Without an exchange of words intending to create a marital relationship, proof of constant cohabitation and a general reputation of marriage would suffice, but only when the alleged spouse is not able to testify. Although the alleged wife asserted that decedent and she had agreed to be husband and wife in 1971, she also testified that decedent had stated that he could not marry her because it would cause dissension in his family. Decedent's son had waived the Dead Man's Statute and the alleged spouse's claim was undercut by her own testimony that decedent did not intend to be married. In addition, proof of a general reputation of marriage was also lacking. Clear and convincing evidence required to show the existence of a common law marriage was found to be lacking as to both standards. *In re Estate of Landolfi*, __ A.D.2d __, 724 N.Y.S.2d 470 (2d Dep't 2001).

Spousal Elective Share

W died leaving a will which disinherited her estranged husband, H. When H filed an application to elect against the will, the Surrogate granted the motion of the estate to dismiss the application. The Appellate Division found that questions of fact existed as to whether H had abandoned W and whether H had the ability and means to support W during the period covered by the estate's non-support claim. The application to elect was reinstated. *In re Estate of Mancuso*, __ A.D.2d __, 722 N.Y.S.2d 651 (4th Dep't 2001).

Legal Fees

A co-executor who appointed himself as attorney to represent his co-executorship was not entitled to payment from the estate for supplemental legal fees based upon services rendered. Each co-executor prepared a final accounting which produced a duplication of services that was not allowed to increase the obligations of the estate. The differentiation between legal services and executorial duties was not adequately set forth. *In re Estate of Poulos*, 280 A.D.2d 336, 723 N.Y.S.2d 1 (1st Dep't 2001).

Accounting—Gifts Under Power of Attorney

The Appellate Division affirmed the Surrogate's decision requiring the return to decedent's estate of funds paid by her attorney-in-fact to herself and her son as intended gifts. No gift by an attorney-in-fact is valid unless it can be shown clearly that the principal intended to make a gift. No such intention was established and the attorney-in-fact was directed to restore $24,500 individually, plus $49,000 jointly, with her son. Interest was calculated from the date the checks were presented for payment. Bequests to the alleged donees in the amount of $25,000 each could be used to offset the money owed by them. *In re Estate of Roth*, __ A.D.2d __, 724 N.Y.S.2d 476 (2d Dep't 2001).

Accounting—Management of Assets

In an accounting proceeding, the executors successfully appealed from a Surrogate's decree disallowing certain expenses claimed and imposing a surcharge on them. Decedent's residence was the principal asset of the estate and was not sold promptly after decedent's death. Because the real estate market in the area was depressed, the executors elected to rent the premises but the tenant proved to be unsuitable. The delay in sale imposed no basis for liability. The expensive funeral arranged by the executors was in keeping with decedent's wishes. A portion of the funds claimed by the executors to have been used for mortgage payments was not substantiated. *In re Estate of Robinson*, __ A.D.2d __, 724 N.Y.S.2d 424 (2d Dep't 2001).

Accounting—Executorial Misconduct

Decedent's executor was removed from office after 5½ years for failure to file her final account. Thereafter, she ignored a court order to deliver the estate records to the public administrator as her successor until a contempt proceeding was brought against her. Although the original executor was not named as a legatee she transferred to herself a car valued at $4,700 together with cash of $1,900. Delay in filing federal and New York estate tax returns resulted in penalties and interest exceeding $31,000. Sale of four airplanes below value caused an additional loss of $133,000. Commissions were denied to the original executor with the full amount paid to her successor. Since no objections were filed, no surcharge was possible. The county attorney was entitled to be compensated for legal services rendered to the estate on behalf of the public administrator. These commissions and fees paid were to be turned over to the county as required by law. *In re Estate of Richmond*, __ Misc. 2d __, 724 N.Y.S.2d 566 (Sur. Ct., Broome Co. 2001).

TRUSTS

Constructive Trust

The children of decedent insured under a policy issued on his life unsuccessfully attempted to impose a constructive trust on the proceeds of the policy which named his brother as sole beneficiary. The children asserted that the designation of the brother

was based upon his promise to use the proceeds exclusively for their benefit. The complaint was dismissed when the lower court found that the plaintiffs would be unable to establish the necessary elements of a constructive trust. The brother denied making any promise to use the proceeds for the benefit of the children and asserted that he did not learn of the designation until shortly before the death of the insured. Decedent was a practicing attorney who was aware of the methods available for creating a binding obligation on the defendant if he chose to do so. *Kleinman v. Kleinman*, __ A.D.2d __, 721 N.Y.S.2d 674 (2d Dep't 2001).

Unilateral Diversion of Income Payments

Decedent's will created a trust which directed her husband and her daughter as co-trustees to pay the net income therefrom to her husband in quarterly installments. Without the consent of the husband, the daughter paid the income to herself in payments of the husband's alleged obligation to her resulting from the purchase of a boat. The Surrogate found that the trust was spendthrift and the husband had no right to make a voluntary assignment of the trust income. Consequently, the daughter had no right to withhold the income toward payment of the alleged debt either pursuant to an agreement or in the manner of an involuntary assignment. The common enforcement rights of creditors should have been utilized. *In re Margolis*, 187 Misc. 2d 600, 723 N.Y.S.2d 349 (Sur. Ct., Rockland Co. 2001).

Corporate Trustee Compensation

The surviving corporate trustee of two testamentary trusts sought reasonable compensation for services as provided in SCPA 2312. For the period in question, the amount claimed by petitioner exceeded compensation previously allowed by $83,423. The allowed amount was based upon the minimum standard provided by statute. Upon a rehearing as to reasonableness ordered by the Appellate Division, the Surrogate found that published fee rates of a corporate fiduciary were a significant factor reflecting the effect of the marketplace. Other factors deemed relevant were similar to the standards used in fixing the reasonableness of attorneys fees. The Surrogate limited the additional award to $60,000 after finding that the trustee kept inadequate contact with the income beneficiary to provide its special expertise in dealing with her unique concerns. Although adequate time records were not maintained, this omission was not found to be important. Use of common trust funds made the investments almost risk-free. The court noted that in uncontested proceedings, the published fee schedules will be deemed reasonable compensation except where the court has "legitimate cause" to scrutinize the actions of the corporate trustee. *In re Estate of Prankard*, 187 Misc. 2d 566, 723 N.Y.S.2d 315 (Sur. Ct., Westchester Co. 2000).

MISCELLANEOUS

Enforcement of Conditions on Charitable Gift

In 1971, H, a recovering alcoholic, announced his intention to give L Hospital $10 million over time to establish an alcoholism treatment center. Money was to be supplied as needed with the donor retaining the right to approve certain plans and appointments. In 1978, after paying slightly more than $5 million to L, H notified L that no additional payments would be made because L had failed to comply with the terms of H's letter of intent. In 1983, after two years of negotiation, H agreed to complete the funding of the gift under conditions accepted by L. Until his death in 1994, H was active periodically in raising money for the alcoholism center that had been named for him. One year after H's death, L announced that it was planning to sell the freestanding building housing the center and that care would be transferred into a hospital ward. Investigation by W, widow of H, and the Attorney General disclosed that endowment funds created by H as part of the gift for the center had been improperly transferred by L to its general account. Upon demand of the Attorney General, L restored the principal improperly removed but without interest. For three years, W, L and the Attorney General were in negotiation as to how H's wishes would be carried out. In 1998, L and the Attorney General entered into an Assurance of Discontinuance pursuant to Executive Law § 63, but the required court approval was not obtained. Dissatisfied with the agreement between L and the Attorney General, W, as special administratrix of H's estate, brought suit against both parties to enforce the conditions of the gift and for an accounting of the funds given. The Appellate Division found that W had standing to enforce the terms of the gift despite the non-exclusive authority given to the Attorney General under EPTL 8-1.1(f). In this situation, W was more vigilant than the Attorney General and might have interests in details of compliance that the Attorney General did not share. *Smithers v. St. Luke's-Roosevelt Hospital Center*, __ A.D.2d __, 723 N.Y.S.2d 426 (1st Dep't 2001).

Undue Influence

Within three weeks prior to his death from cancer, decedent changed the beneficiary on his four individual retirement accounts from his second wife to his son by his first marriage. About one month before the change, decedent had made a tape recording for his wife outlining his assets, including the IRAs naming her as beneficiary. The wife claimed that her husband's attitude toward her became more

hostile after she returned from a two-week visit to her ailing father in China. She blamed this change on undue influence exerted by the son during her absence and after her return. The son asserted that his father became upset with the wife because she persisted in giving him Chinese herbal remedies procured by her at the time of her visit. The son also claimed to have no knowledge of his father's financial affairs. The Appellate Division found that the wife failed to offer any proof of undue influence to support a temporary restraining order preventing withdrawal from the IRAs. The son was awarded summary judgment and the temporary restraining order issued by the Surrogate was vacated. *In re Estate of Branovacki*, 278 A.D.2d 791, 723 N.Y.S.2d 575 (4th Dep't 2000).

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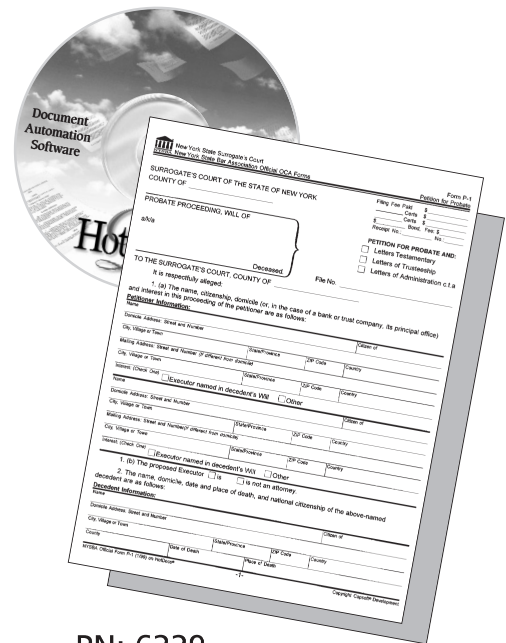

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