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Trusts and Estates Law Section Newsletter

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A Message from the Section Chair

As we reflect on the events of this year, we are reminded of the old cliché that nothing is certain except death and taxes. It may be time to take exception to those exceptions. In an age when human beings can be resuscitated after having been pronounced dead by a physician, or possibly cloned from a single cell, or cured of an incurable disease, or given birth posthumously using a decedent's frozen sperm or the couple's pre-embryo, it may be time to revisit some of our trusts and estates laws as they are impacted by these evolving sciences and technologies.

The article by New York Law School student Gail Goldfarb in the Summer issue of the *Newsletter*, entitled "Posthumous Conception and Inheritance Rights," has prompted Association President Thomas Levin to urge our Section to consider changes in our state's laws. Quoting the author, "As science races ahead, it leaves in its trail mind-numbing ethical and legal questions. The law, whether statutory or decisional, has been evolving more slowly and cautiously." If my mind were not already numb from the vicissitudes in pace from piña coladas on the beach in Cancun to the frenetic schedule of a modern law practice, it might have been numbed by some of these ethical dilemmas. As a result of this challenge, we are forming a new committee on biotechnology to study and recommend new laws or amendments to address these issues.

As for the second exception, taxes, the implication of the cliché is that we will always have taxes. This is true enough in a general sense. However, with respect to the federal estate tax, if the President can secure a few more votes, we may actually see the death of the estate tax in the year 2010. Most experts believe that long before that date we will see a compromise which will result in a permanent exemption equivalent of approximately $5 million. Regardless of

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whether the sunset provision is allowed to remain in the law, which will resurrect in 2011 the $1 million exemption equivalent which existed in the year 2001, there will be multiple tax laws challenging our practices—federal gift taxes, capital gains taxes, including the limited step-up for assets passing from an estate, and, very importantly, state death taxes. As we all know, in less than a few months New York will be out of conformity with the federal estate tax. It is beyond irony, bordering on insanity, that it took a decade to achieve conformity in New York only to see that conformity erased by one signature at the federal level.

Lest we be concerned that our practices will be repealed with the stroke of a pen, I am reminded of another cliché—"The more things change, the more they remain the same."

As of this writing, we are preparing to depart to the fair city of Victoria, British Columbia, for our Fall Meeting beginning on September 10th.

Since this issue is likely to be distributed after the Fall Meeting has been held, I would like to thank Program Co-chairs Colleen Carew, Esq. of Schram & Carew, and Charles Gibbs, Esq. of Holland & Knight, for putting together such a comprehensive and timely program, and for serving as panelists, as well as the following participants for contributing their considerable time and effort to produce a most enjoyable and informative program:

Ilene S. Cooper, Esq. of Farrell Fritz, P. C. and Amy Beller of Holland and Knight for their work as Course Book Editors; Georgiana Slade, Esq. of Milbank Tweed; Honorable Anthony A. Scarpino, Jr., Westchester County Surrogate, Professor Kenneth F. Joyce, Esq., SUNY Buffalo Law School; Honorable John M. Czygier, Jr., Suffolk County Surrogate; Gail E. Cohen, Esq. of Fiduciary Trust International; Michael J. A. Smith of Deutsche Bank and G. Warren Whitaker, Esq. of Day, Berry & Howard, LLP.

Many thanks also to our Tennis Chair, Bob Taisey, to our Golf Chair, Magdalen Gaynor, to our Tennis Sponsor, Fiduciary Trust International, and to our Golf Sponsor, Brown Brothers Harriman & Co. We also thank Mellon for sponsoring our cocktail reception on September 10 and our vendors: Christie's, Doyle New York, Fiduciary Trust International, Management Planning, Inc. and Sotheby's.

In the event that I fall off the whale-watching boat and become a "heavy hors d'oeuvres" for one of the seventy orcas in Victoria Bay, I leave the agenda and my 'sporran to Warren' (only because it rhymes, not that he'll find anything in it besides crumpled napkins with shrimp tails and cocktail sauce) and I direct that I am **not** to be used for the Committee's experiment in some new posthumous technology.

Timothy B. Thornton

Did You Know?

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Editor's Message

As the fall arrived, this Section held its meeting in the lovely location of Victoria. The meeting covered myriad issues facing the fiduciary in exercising discretionary investment administration powers. The speakers included well-known practitioners—two Surrogate's Court judges and a law professor. It was a wonderful program covering timely issues. For those who could not attend, some of the outlines will be reproduced in the next *Newsletter*.

This edition contains a variety of subjects for your perusal. The important topic of avoiding New York's nonresident tax is discussed by Jocelyn D. Margolin. Many suggestions are included in this timely article. Jonathan Blattmachr and Tracy Bentley point out the problems that result from the recent regulations that do not permit interest payments paid to certain beneficiaries to carry out distributable net income. Amy Beller has written a thoughtful article on the difficulty of removing hostile trustees and questions whether New York needs legislation. Michael J. Amoruso and Susan Taxin Baer have collaborated on an article regarding drafting documents in the post-2001 Tax Act era. Pamela Mann has written on the structural issues of operating a not-for-profit organization in New York. The final articles are offered by Robert Moshman. His past contributions have been well received and these two articles are no exception.

Gail Goldfarb's article entitled "Posthumous Conception and Inheritance Rights" appeared in the last issue of the *Newsletter* and has been well received. Professor Fried of Syracuse University College of Law has suggested that an additional authority should be added to the article. He wrote that the Restatement (Third) of Property: Wills and Other Donative Transfers (1999) takes the position that, "to inherit from a decedent, a child produced from genetic material of the decedent by assisted reproductive technology must be born within a reasonable time after the decedent's death in circumstances indicating that the decedent would have approved of the child's right to inherit." (See Section 2.5, Comment 1.) The comment goes on to say that "a clear case would be that of a child produced by artificial insemination of the decedent's widow with his frozen sperm. If the AIH procedure occurs after the husband's death, and if the child is born within a reasonable time after the husband's death, the child should be treated as the husband's child for purposes of inheritance *from the husband*." (Emphasis in original).

Magdalen Gaynor

Upcoming Meetings of Interest

January 28, 2004	New York State Bar Trusts and Estates Law Section. Annual Meeting. New York Marriott Marquis.
April 22-23, 2004	New York State Bar Trusts and Estates Law Section. Spring Meeting. Wyndham Syracuse.
October 14-17, 2004	New York State Bar Trusts and Estates Law Section. Fall Meeting. Savannah, Georgia.
September 29-October 2, 2005	New York State Bar Trusts and Estates Law Section. Fall Meeting. New Orleans, Louisiana.

New York's Nonresident Estate Tax: Options for Avoiding It

By Jocelyn D. Margolin

The changes brought about by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) create a frightening scenario: a nonresident of New York who owns New York-situated real property (or tangible personal property) could be subject to New York's nonresident estate tax in an amount exceeding the value of the property.[1] This article focuses on planning techniques designed to avoid New York's nonresident estate tax on the New York-situated property of nonresidents.

I. Transfer to a Limited Liability Company

The nonresident estate tax, set forth below, expressly refers to New York-based property that is either real property or tangible personal property:

> A tax is hereby imposed on the transfer, from any deceased individual who at his death was not a resident of New York state, of *real and tangible personal property* having an actual situs in New York state and either (i) includible in his federal gross estate or (ii) which would be includible in his New York gross estate pursuant to section nine hundred fifty-seven (relating to certain limited powers of appointment) if he were a resident of New York state.[2] (emphasis added)

With the express reference to "tangible personal property" and "real property" in mind, a promising technique is to transfer New York real property[3] to a limited liability company.[4] The client will receive in exchange an ownership interest in the limited liability company, which is intangible property. Only tangible personal property and real property located in New York, not intangible property, is expressly subject to New York's nonresident estate tax.[5] The omission of intangible property from the nonresident estate tax is intentional since intangible personal property of a nonresident is constitutionally exempt from taxation, provided that it is not used in carrying on a business in New York.[6]

The State of New York Department of Taxation and Finance ("Tax Department") clearly recognizes that the constitutional exemption from *estate* tax for nonresidents applies even if the intangible property is employed in "carrying on a business" in New York.[7] In TSB-M-92, the Tax Department cites the provisions of a few different New York taxing statutes, including the New York personal income tax, the New York gift tax (which was then in effect) and the New York generation-skipping transfer tax, all of which expressly subject to taxation intangible property employed in a business carried on in New York. By comparison, the New York estate tax provisions do not contain any such express language with respect to intangible property owned by a nonresident.[8] This fact is highlighted in TSB-M-92: "*except in the case of the estate tax* . . . the taxability of a nonresident's intangible personal property, including the income derived therefrom, is dependent upon whether the property is employed in a business, trade, profession or occupation carried on in New York State."[9] Thus, a limited liability company's ownership of New York real estate (even rental real estate) should not subject the nonresident member's interest to New York's nonresident estate tax.

In deciding whether to transfer real property to a limited liability company, consideration should be given to possible application of the real estate transfer tax. The real estate transfer tax applies to "conveyances" of New York-situated real estate where the consideration received is greater than $500.[10] There is an additional tax on "conveyances" of residential real estate when the consideration for the conveyance is $1 million or more.[11] There may be a further property transfer tax imposed by the county, depending upon where the property is located. For example, property situated in New York City is subject to the New York City real property transfer tax.[12]

An exception to the real estate transfer tax exists where the transfer is a mere change in identity.[13] Transfers to partnerships are expressly exempt from the real estate transfer tax where there is no beneficial change in ownership. The real estate transfer tax regulations state in pertinent part as follows:

> (a) the conveyance by tenants-in-common of their interest in real property to a partnership or a corporation, the partnership or corporation interests being in the same pro rata shares as the tenants-in-common held prior to conveyances. Such conveyance is not taxable as there is no change in beneficial ownership . . .
>
> (d) the conveyance by a person to a partnership in exchange for an interest in the partnership. Such conveyance is not taxable to the extent of

the grantor's interest in the partnership.[14]

The same result obtains with a transfer to a limited liability company where there is no beneficial change in ownership.[15]

Assume, for example, a husband and wife who own property jointly and want to transfer the property to a limited liability company. Provided that each spouse receives a 50% interest in the limited liability company, this transfer is almost identical to the transfer by tenants in common described in the above regulations. Even if the conveyance is treated as a gift by one spouse to the other (because of the severance of the joint tenancy), gifts of real property are not subject to the transfer tax.[16]

In a similar vein, the subsequent transfer by the husband and wife of their ownership interests in the limited liability company to other family members does not trigger the real estate transfer tax because a transfer by gift is not subject to the real estate transfer tax.[17] Even if the gift is of a majority interest the real estate transfer tax should not apply.[18] Whether the client plans to make gifts of interests in the limited liability company or not, it is imperative that no interest in the property is retained by the client that could be characterized under Internal Revenue Code § 2036 as a retained interest, as will be explained below in the section on irrevocable transfers in trust.

II. Sale of Property

In a typical situation where the client wants to keep property, such as a house, in the family but does not want to incur gift tax, the parents could sell the property to the children in exchange for a promissory note. A promissory note is clearly not subject to New York's nonresident estate tax, which defines "tangible personal property" so as to exclude notes and debt.[19]

Such a sale runs the risk of being re-characterized as a gift if the parents plan to forgive the loan at the outset. That is what happened in *Maxwell v. Commissioner*.[20] However, *Maxwell* involved facts that more blatantly suggested a gift than is recommended here. In that case, a parent sold her home to her son. Part of the principal was forgiven each year, and the rent paid by the parent to the son was approximately equal to the interest due from the son to the parent. The transaction conceived of here is for the promissory note to require interest at the applicable federal rate. Whether the principal is amortized over the term of the loan or repaid in one balloon payment at the end of the term would vary with the circumstances.

For some, however, paying back the principal makes this option unpalatable. The principal repayment problem could possibly be ameliorated by having the parents forgive the loan in their wills.

Another drawback of a sale is the real estate transfer tax and potential income tax applicable to the sale of property. Furthermore, the parents would have taxable income from the interest payments.

An alternative type of sale that alleviates some of the tax burden is to have the parents transfer their real property to a limited liability company, and then sell their company interests to an irrevocable grantor trust in exchange for a promissory note. The income[21] tax on the sale of the company interests and on the interest payments received from the trust would be nullified because of the grantor trust rules.[22] However, the real estate transfer tax would apply since the sale to the trust would change the beneficial ownership of the real estate. As a practical matter, the property or other trust assets would have to generate enough income to fulfill the payment obligations of the promissory note.[23]

As in the case of a sale to the children, when the property is transferred to a limited liability company and sold to a grantor trust, if done properly, the client would own a debt instrument at the end of the transaction. A debt instrument is not subject to the nonresident estate tax.

III. Irrevocable Transfers in Trust

It would seem obvious that transferring New York real property or tangible personal property to an irrevocable trust will avoid taxation of such property under New York's nonresident estate tax. This is generally so[24] except in limited circumstances where the grantor retains a "taxable interest" in the trust at death. A "taxable interest" is essentially a retained interest that would cause the trust assets to be included in a decedent's gross estate for federal estate tax purposes under Internal Revenue Code §§ 2036 or 2038. If the decedent retains a taxable interest in an irrevocable trust at death, then the trust property is treated as though it is still owned by the decedent for purposes of the nonresident estate tax.[25] In Advisory Opinion TSB-A-00(1)M, the decedent, a nonresident, created a qualified personal residence trust and a grantor retained income trust each for a term of 10 years but had the misfortune of dying prior to the end of the term. Since trust assets were included in her gross estate for federal estate tax purposes, the Advisory Opinion concludes that the New York real property[26] owned by the trusts was subject to the nonresident estate tax.[27] The rationale expressed in the Advisory Opinion is that if the decedent's interest in the trust property is so significant that it causes the trust property to be included in the decedent's gross estate for federal estate tax purposes, it should be treated for nonresident estate tax purposes as though the decedent owned it and transferred it at death.[28]

IV. Revocable Transfers in Trust

A revocable transfer in trust is not an effective technique to avoid New York's nonresident estate tax. The New York nonresident estate tax applies literally to the "transfer from any deceased individual" of real property or tangible personal property located in New York state.[29] The statutory phrase "transfer from any deceased individual" raises a question of statutory interpretation: Can real property (or tangible personal property) owned in trust escape the reach of this section, since property held in trust is not literally transferred from an individual at death? Under the rationale of the Advisory Opinion discussed above (TSB-A-00(1)M), the answer is "no." Since a revocable trust is a trust in which the decedent retains a "taxable interest" at death, the New York-based trust property will be treated by the Tax Department as passing directly from the decedent for purposes of the nonresident estate tax.

Conclusion

In summary, there are a few options for nonresident clients owning New York real property (or tangible personal property): sell the property, give it away or transfer it to a pass-through entity such as a limited liability company. Transferring the property to a limited liability company is the most promising technique for avoiding the nonresident estate tax. In addition to avoiding the nonresident estate tax, the initial transfer to the limited liability company is tax-free, and the client would maintain control over the property through majority ownership of the limited liability company. Selling the property or giving the property away are effective alternatives to avoiding the nonresident estate tax if the client does not object to relinquishing control of the property or the tax associated with the transaction. Regardless of the technique chosen, it should be implemented as soon as possible since the potential tax in excess of the value of the New York-situated property will be most severe during 2003 and 2004.

Endnotes

1. Philip L. Burke, NYSBA Trusts and Estates Law Section Newsletter, Winter 2002, Vol. 35, No. 4 at 40.
2. N.Y. Tax Law § 960(a).
3. This article was written with dispositions of real estate in mind even though the nonresident estate tax also applies to tangible personal property located in New York.
4. New York Tax Law provisions applicable to partnerships will apply in the same fashion to limited liability companies taxed as partnerships for federal tax purposes. Technical Services Bulletin Memorandum, TSB-M-94, 1994 N.Y. Tax LEXIS 614, *2 (Oct. 25, 1994).
5. N.Y. Tax Law § 960(a).
6. N.Y. Const., art. XVI, § 3.
7. TSB-M-92, 1992 N.Y. Tax LEXIS 551, *6 (Oct. 9, 1992).
8. TSB-M-92, 1992 N.Y. Tax LEXIS 551, *1-5 (Oct. 9, 1992).
9. TSB-M-92, 1992 N.Y. Tax LEXIS 551, *6 (Oct. 9, 1992) (emphasis added).
10. N.Y. Tax Law § 1402(a).
11. N.Y. Tax Law § 1402-a(a).
12. Tit. 11, ch. 21, New York City Admin. Code.
13. N.Y. Tax Law § 1405(b)(6).
14. Tit. 20, Official Compilation of Codes, Rules and Regulations of the State of New York, ch. III(K), § 575.10 (N.Y.C.R.R.).
15. Technical Services Bulletin Advisory Opinion, TSB-A-98(5)R, 1998 N.Y. Tax LEXIS 441, *3 (December 30, 1998).
16. 20 N.Y.C.R.R. ch. III(K), § 575.9(c)(4).
17. *Id.*
18. *Id.*
19. N.Y. Tax Law § 951-a(c) ("tangible personal property" is defined to exclude "deposits in banks, mortgages, debts, receivables, shares of stock, bonds, notes, credits, evidences of an interest in property, evidences of debt, or choses in action generally").
20. *Maxwell v. Comm'r*, 3 F.3d 591 (2d Cir. 1993).
21. New York personal income tax is derived from federal adjusted gross income, plus certain additions thereto, none of which include income excluded under federal law pursuant to the grantor trust rules. N.Y. Tax Law § 612.
22. Rev. Rul. 85-13, 1985-1 C.B.; PLR 9535026 (Feb. 10, 1995).
23. There are several articles discussing the advantages and disadvantages of the sale to an irrevocable grantor trust in greater detail. *E.g.*, Louis A. Mezzullo, *Freezing Techniques: Installment Sales to Grantor Trusts*, Probate & Property, Jan./Feb. 2000 at 17; Alan S. Gassman & James F. Gulecas, *Comparing the GRAT to the Installment Sale to a Defective Grantor Trust, and Who's Afraid of the Exhaustion Test?*, The Practical Tax Lawyer, Fall 1999 at 43; Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT,* Estate Planning, Jan. 1996 at 3.
24. The Tax Department notes that the transfer of an interest in a trust is the transfer of intangible property, which is not generally taxed by New York where the decedent is a nonresident of New York. Technical Services Bulletin Advisory Opinion, TSB-A-00(1)M, 2000 N.Y. Tax LEXIS 193, *2 (June 5, 2000). Although not mentioned in TSB-A-00(1)M, a more persuasive rationale for the nonresident estate tax not applying to an irrevocable trust is that the decedent does not own it at death.
25. TSB-A-00(1)M, 2000 N.Y. Tax LEXIS 193, *2 (June 5, 2000).
26. TSB-A-00(1)M states that the nonresident estate tax applies to the New York real property held in the trusts and does not discuss whether the New York tangible personal property held in the trusts would also be subject to the nonresident estate tax, although such a result is implied. No property other than real property and tangible personal property situated in New York was held in the trusts.
27. TSB-A-00(1)M, 2000 N.Y. Tax LEXIS 193, *2 (June 5, 2000).
28. *Id.*
29. "A tax is hereby imposed on *the transfer, from any deceased individual* who at his death was not a resident of New York state, of real and tangible personal property having an actual situs in New York state and either (i) includible in his federal gross estate or (ii) which would be includible in his New York gross estate pursuant to section nine hundred fifty-seven (relating to certain limited powers of appointment) if he were a resident of New York state." N.Y. Tax Law § 960(a) (emphasis added).

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A Potential New Problem in Estate and Trust Administration

By Jonathan G. Blattmachr and Tracy L. Bentley

Introduction

This article addresses one aspect of the recent regulations promulgated under section 663 of the Internal Revenue Code of 1986 as amended (IRC or "Code"), specifically Treas. Reg. § 1.663(c)-5. Example 7 of the regulation provides that amounts paid pursuant to a state law requirement (such as the elective share or as an interest payment on a dollar or pecuniary bequest) to a beneficiary who is not entitled to any of the accounting income of the trust or estate do not carry out the distributable net income (DNI) of the estate or trust. The Example concludes, therefore, that the estate or trust is not permitted an income tax deduction under IRC § 661(a) for the amounts paid to that beneficiary. The Example also concludes that the estate or trust also is not entitled to an interest deduction, because these amounts are treated as a non-deductible personal interest expense under IRC § 163(h).

> *"New York courts have ruled that a beneficiary of a testamentary disposition could be entitled to interest on a bequest that was not paid out within seven months from the time letters testamentary or letters of administration are granted even if the beneficiary did not commence a proceeding to compel payment."*

The Example has at least three negative effects. First, it may create gross income for federal income tax purposes where none previously existed; second, it disturbs the symmetry of the pass-through income tax treatment accorded trusts and estates to their beneficiaries under subchapter J of the Code; and third, it could possibly reduce the amounts eventually passing to charity where charity is a residuary beneficiary of an estate or trust. These consequences are so harsh that it seems that the regulations should be revised in order to eliminate those effects, by providing that (1) a trust or estate is entitled to an income tax deduction under IRC § 163 for amounts paid as interest to a beneficiary on the beneficiary's interest in an estate or trust pursuant to the requirements of local law or the governing instrument, (2) the interest is treated as a distribution for purposes of IRC §§ 661 and 662, or (3) the interest paid is a management expense within the meaning for Treas. Reg. § 20.2056(b)-4(2)-(4) (the so-called anti-*Hubert* Regulations). However, unless and until that occurs, practitioners will have to cope with the unfair consequences this new regulation produces.

The laws of many states (including New York) provide that a beneficiary who receives a general pecuniary bequest (i.e., a fixed-dollar amount) under a will or trust becomes entitled to interest on that bequest if the bequest is not paid out within a certain period of time (typically, several months or a year) after the testator's or grantor's death.[1] Therefore, the effect of Example 7 is potentially broad-reaching.

There may be many legitimate reasons why a beneficiary's bequest might not get funded within the time prescribed before interest on the bequest commences to accrue (e.g., one year after death). For example, the fiduciary might retain all assets to insure income and estate taxes can be paid in full, or there might be litigation over the estate, or the trust terms might be ambiguous, requiring a construction proceeding in state court.

The Regulation's Adverse Effects

First, the regulation generates income among family members where none previously existed and requires a trust to pay out assets it does not necessarily have. For example, a New Yorker dies with an estate consisting of $1,000,000 of unproductive real estate. Her will leaves a bequest of $100,000 to her son and the residue (or balance) to her husband. New York Estates, Powers and Trusts Law (EPTL) 11-1.5 provides that if a personal representative has not paid out testamentary dispositions or distributive shares within seven months from the date letters testamentary or letters of administration are granted, the person entitled to such disposition or distributive share may maintain an appropriate action against such representative. In any action to compel payment of a disposition, the interest thereon shall be at the rate fixed in the will or, if none is so fixed, at the rate of 6% per annum commencing seven months from the time letters are granted.[2] New York courts have ruled that a beneficiary of a testamentary disposition

could be entitled to interest on a bequest that was not paid out within seven months from the time letters testamentary or letters of administration are granted even if the beneficiary did not commence a proceeding to compel payment.[3] Therefore, under EPTL 11-1.5, 6% annual interest probably must be paid on the son's bequest if it is not funded within seven months. The executor subdivides the property and, 19 months after letters testamentary are issued, sells a parcel consisting of and equal in value to 10 percent of the whole tract of land for $106,000 cash which the executor distributes in satisfaction of the son's bequest (plus 6% interest for twelve months). The estate experienced a $6,000 profit which will be taxed to it without any deduction for the interest paid to the son and yet, under the regulations, the son also will have to report $6,000 of gross income. Even though a beneficiary might not have been entitled to any income from a trust or estate under the terms of the trust or will, the beneficiary will nonetheless become entitled to a certain amount of interest paid out of accounting income (and, perhaps, out of principal if the accounting income of the trust or estate is insufficient to satisfy the required interest payments) of the trust or estate during each year that the bequest is not paid out. Although the son will be required to include these amounts in his income, Example 7 indicates the estate will not be entitled to an offsetting deduction, thereby resulting in "extra" income to that family member.

In addition, grantors usually structure trusts in such a way that the principal of the trust will be sufficient to satisfy any bequests that the grantor has made. In the foregoing illustration, the return on the principal of the trust likely will be insufficient to satisfy the required interest payments. For example, the New York EPTL 11-1.5 provides for the bequest to earn interest at a rate of 6% per year beginning seven months after letters testamentary or of administration are granted. It is virtually impossible in today's market to find an investment that will guarantee a rate of return of 6% per year. Although it might be possible to purchase a low-grade corporate bond that would provide such a return, the interest would be taxable, and, therefore, the actual return could still be less than 6%. As a result, the interest rate mandated by state law may erode the principal of the estate or trust, decreasing the amount of income available to the income beneficiaries as well as the amount of corpus ultimately payable to the residuary beneficiaries. As discussed below, if all or a portion of the corpus of the trust is eventually payable to charity, this will result in a reduced payment to charity.

Second, the statute upsets the symmetry of the inclusion and deduction system. Subchapter J of the Code sets up a system of "pass-through" taxation for trusts and estates; that is, items which are not attributable to the estate or trust itself are attributable to the beneficiaries of the trust or estate (and vice versa). IRC §§ 661 and 662 are specifically crafted to ensure that, as a general rule, when a complex trust or a decedent's estate distributes amounts to a beneficiary, those amounts will be taxed to the trust or to the beneficiary, but not to both. In this case, however, even though the beneficiary is required to include the interest payments in his or her gross income, the trust will not be permitted an offsetting deduction, as is the result under the system of IRC §§ 661 and 662. Under the pass-through taxation scheme, which allows a deduction for the trust or estate when the beneficiary takes an amount into gross income, but no deduction when the beneficiary does not include an amount in gross income, the trust or estate should get a deduction for interest paid on a pecuniary bequest, because the beneficiary includes such payments in her income. Again, because the trust will not be permitted this offsetting deduction, the statute generates "extra" income and thereby upsets the symmetrical taxation system of subchapter J.

"[G]rantors usually structure trusts in such a way that the principal of the trust will be sufficient to satisfy any bequests that the grantor has made."

Third, in the case of trusts or estates the income or principal of which is to be currently or eventually distributed to charity, the regulation has the effect of reducing the amount passing to charity. As described above, in many cases, the trust will not be able to invest the trust assets in such a way that will guarantee a sufficient rate of return to cover the required interest payments out of the trust's net income. In those cases, the trust will be required to make up the shortfall out of the trust principal, resulting in a diminution of corpus. In the case of a charitable (or split-interest) residuary legatee, charity may receive less than the amount otherwise bequeathed to it.

The foregoing effects of Treas. Reg. § 1.663(c)-5 were, perhaps, unforeseeable and unintended. Nonetheless, the negative effects of this provision are so profound that, at a minimum, practitioners should take these effects into account in drafting and probably consider drafting alternatives that may avoid them. Alternatively, state legislatures should be urged to repeal their interest provisions and substitute statutes which will provide that, instead of being

entitled to interest, a beneficiary shall be entitled to an amount of income equal to the interest that would otherwise be due. That, of course, will take years at a minimum, disturb only standing state notions of fairness and greatly complicate the administration of estates and trusts, thereby increasing administration costs, a significant portion of which are effectively borne by the I.R.S. through income and estate tax deductions.

Although comments to the proposed regulations questioned the result now compelled in Example 7, the Treasury Decision accompanying the final regulations does not explain why the suggestion of treating interest on a pecuniary bequest as a distribution under IRC §§ 661 and 662 was rejected. It only addresses why the interest is not deductible under IRC § 163(h).

Possible New York Legislation

The Trusts and Estates Law Section of the New York State Bar Association is considering seeking legislation to provide as the state's "default" rule (which could be changed by the governing instrument) that pecuniary bequests share in income rather than become entitled to interest after a time.

Endnotes

1. *See generally* Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provision (United States Trust Co. of New York, 1984), 1996 Supplement, app. B.
2. *See* EPTL 11-1.5(d).
3. *See In re Schwartz*, 614 N.Y.S.2d 668 (Sur. Ct., N.Y. Co. 1994); *In re Park-Montgomery*, N.Y.L.J., May 19, 1997, at 33 (Sur. Ct., Nassau Co.).

A prior version of this article appeared at Jonathan G. Blattmachr, *A Potential New Problem in Estate and Trust Administration*, Prob. Prac. Rep., May 2003, at 1.

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New York Marriott Marquis

Removal of Trustees for Hostility: Does New York Need Legislation?

By Amy B. Beller

Most trusts and estates lawyers, preferring the peace and tranquillity of their usually non-adversarial practices, do not expect to be called upon to deal with irreconcilable hostility between a trustee and trust beneficiaries, or between co-trustees. But, occasionally, fractious relationships in trust administration do develop, and sometimes the level of antagonism between the parties can rival the worst divorce actions.

The genesis of the hostility is a variable. As between a trustee and beneficiary, hostility may arise from the trustee's refusal to accede to the beneficiary's wishes (i.e., refusal to make a principal distribution to a life income beneficiary), from the trustee's failure to communicate or to demonstrate an appropriate level of concern or interest in the beneficiary and his/her family, from a conflict unrelated to the trust, or simply because of a personality conflict. As between co-trustees, hostility most frequently arises from an inability to agree on decisions affecting trust administration.

Whatever the cause, insuperable hostility between trustee and beneficiary, or between co-trustees, can ultimately lead to a removal proceeding—with significant financial and emotional costs to everyone involved.

The standards governing removal proceedings are about as clear as a weekend in New York in the spring of 2003.[1] As a general rule, New York and other jurisdictions allow removal of a trustee, in the court's discretion, where hostility impairs or threatens to impair the proper administration of the trust. The decisions are fact-specific, and seem to require an intuitive finding by each court as to whether removal is warranted under the specific circumstances presented, precariously balanced with the court's deference to the grantor's or testator's choice of trustee. In short, although there is an articulated standard, the application of that standard, and thus the predictability of the result in a given case, is far from obvious.

In this article, we will examine the standards under New York law governing removal of trustees on the ground of hostility, we will provide a brief comparison of New York law with law in other jurisdictions, and we will discuss whether the New York standards are in need of legislative change.[2]

New York Statutes

Removal of trustees is governed by three statutory provisions: SCPA 711, SCPA 719, and EPTL 7-2.6. None of these provisions expressly cite hostility as a ground for removal, but they have been interpreted by New York courts as permitting removal for hostility under the rubric of general unfitness and want of understanding of a trustee's responsibilities under certain circumstances.

SCPA 711 governs removal of trustees by the Surrogate's Courts, and sets forth eleven grounds for removal of a fiduciary. SCPA 711(8) provides that a fiduciary may be removed: "Where he or she does not possess the qualifications required of a fiduciary by reason of substance abuse, dishonesty, improvidence, want of understanding, or . . . is otherwise unfit for the execution of the office." SCPA 711(10) provides: "In the case of a testamentary trustee, where he has violated or threatens to violate his trust . . . or is for any other cause deemed an unsuitable person to execute the trust."

SCPA 719 provides that a trustee's letters may be revoked by the court, without process, where, *inter alia*, "any of the facts provided in [SCPA] 711 are brought to the attention of the court." SCPA 719(10). SCPA 719 provides the court with authority to remove a trustee, sua sponte, or upon notice of facts requiring removal under SCPA 711 where notice is given the court by one who lacks standing to bring a removal proceeding under SCPA 711.

Proceedings for removal of trustees of inter vivos trusts may be brought in Supreme Court pursuant to Article 77 of the CPLR.[3] Standards for removal of trustees in a Supreme Court proceeding are governed by EPTL 7-2.6. Subsection (a)(2) of 7-2.6 provides a basis for removal where the trustee "has violated or threatens to violate his trust . . . [or] for any reason is a person unsuitable to execute the trust." In *In re Smithers*, N.Y.L.J., Aug. 17, 2000, p. 24, col. 1, the Supreme Court, New York County, relied on the grounds for removal in SCPA 711, and the case law interpreting that section, in dismissing the petitioner's application for removal of a trustee.

Thus, New York's statutory provisions allow removal where the trustee's hostility evidences a want of understanding, unfitness, unsuitability, or violation (or threat of violation) of his trust. Howev-

er, standing alone, the statutory standards give little guidance as to what circumstances will justify the drastic remedy of removal. We must examine New York case law for further instruction.

New York Case Law

New York courts, particularly in more recent decisions, have consistently adhered to the black letter principle that removal may be warranted where hostility impairs or threatens to impair administration of the trust. The application of this principle, however, has been less than uniform and has created some seemingly inconsistent results.

A Historical Perspective

Apparently hostility in the context of trust administration is not a creature of these stressful modern times: New York case law on the issue, ironically, dates back to at least the Civil War. In *Quackenboss v. Southwick*, 41 N.Y. 117 (1869), the New York Court of Appeals held that where differences of opinion and unfriendly personal relations between a trustee and his co-trustee made it unlikely they would cooperate in trust administration, removal of the trustee as an unsuitable person was warranted.[4] The threat of impairment of administration of the trust, rather than actual impairment, was sufficient to support removal.

And in *In re Morgan*, 63 Barb. 621, *aff'd*, 66 N.Y. 618 (1872), a trustee was removed on petition by his two co-trustees and a beneficiary of the trust on the ground of hostility without any showing of impairment of administration of the trust. The court held that relations between trustees and trust beneficiaries are necessarily intimate, and that "there should be full and perfect harmony between them." Although noting that the acts complained of by the trustee "are to be traced to a conscientious conviction that they were in the line of his duty," the court, awarding the beneficiary's wishes "great weight," affirmed removal of the trustee.

In *Deraismes v. Dunham*, 22 Hun. 86 (N.Y. 1880), the Appellate Division, Second Department, affirming the Supreme Court, Special Term's removal of a trustee for hostility toward his co-trustees, stated:

> It plainly appears that the relations sustained between this trustee and the other two are so unfriendly and hostile as to endanger the execution of the trust. They can neither consult in harmony, nor act in concert in relation to the estate, and it seems to be agreed that their differences are irreconcilable. These facts are sufficient of themselves to justify the removal of a trustee, without inquiry respecting the outgrowth of hostility. In this case, however, other reasons for the action of the court are found to exist. All the adult beneficiaries under the will join in the request for the removal of this trustee, and have stated many facts showing that his administration has been unfortunate and improvident. He has become inimical to all the beneficiaries except one, who has not been consulted by reason of absence, and one who is a minor. He is in open hostility to his wife, who has obtained an absolute divorce against him, and ought not to be compelled to endure him as her trustee, or to have any business relations with him respecting the estate. He has no interest in the estate except his annuity, and the remaining trustees are entirely competent to execute the trust, and they and the beneficiaries are in full harmony. There seems, therefore, to be ample reason for the removal of this trustee. . . .

In *Disbrow v. Disbrow*, 46 A.D. 111, 61 N.Y.S. 614 (1st Dep't 1899), the First Department held that the trial court's determination, after trial, that hostility between two trustees and the trust beneficiary, the mother of one of the trustees, endangered the welfare of the trust estate and was sufficient grounds for removal. The court described the actions of one of the trustees as "arbitrary and offensive" and stated the co-trustee failed to treat the beneficiary with the respect due her as his mother and the trust beneficiary. In addition, the court found that the trustee "took the entire management of the property into his own hands, and treated with contempt reasonable requests made by his cotrustee and the [beneficiary] in reference to what he was doing." In affirming removal of both trustees, the court held:

> There is no doubt that the Supreme Court has the power to remove, when a sufficient cause exists, trustees from the management of trust estates, and the exercise of this power does not necessarily depend upon proof of actual mismanagement, misconduct or dishonesty of the trustees. Whenever the court can see that inharmonious or unfriendly relations exist between the trustees, or between them and the cestui que trust, and that by reason of such

> inharmonious and unfriendly relations material injury may and is likely to result to the trust estate, it will exercise the power which it has, and to prevent that injury it will remove one, or, if the interest of the estate requires it, all of the trustees.
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> * * * * *
>
> The evidence introduced upon the trial discloses that hostility to a marked degree exists between [the co-trustees] and also between [a trustee and the beneficiary]; and it is apparent that this feeling is such as to prevent the hearty co-operation between the two trustees, which should be present in order that they may properly manage property committed to them. To permit them to act as trustees would tend in no small degree to jeopardize the trust estate, and to defeat the object of the trust.

46 A.D. 114-15.

By the mid-twentieth century, New York courts seemed to apply a stricter standard to removal proceedings, requiring not only irreconcilable differences and a threat of impairment of the trust, but actual interference in trust administration. In *In re Edwards*, 274 A.D.2d 244, 80 N.Y.S.2d 801 (4th Dep't 1948), the Appellate Division, Fourth Department, held that "normally, mere friction between a trustee and a beneficiary is not sufficient ground for removing a trustee, unless that friction interferes with the proper administration of the trust" (citing Restatement of Trusts, vol. I, sec. 107, comment C; Scott on Trusts, vol. I, sec. 107, p. 559), but that "where the hostility between cestui and the trustees seriously impedes the performance of the trust, especially if the trustee is at fault, the trustee may be removed."

Thus, in *In re Parker*, 27 Misc. 2d 652, 209 N.Y.S.2d 254 (Sup. Ct., Nassau County 1961), the fact that the beneficiaries were not satisfied with income yield and that there was friction between the beneficiaries and trustee was insufficient to sustain a petition for removal. *See also In re Miller's Estate*, 48 Misc. 2d 815, 265 N.Y.S.2d 999 (Sup. Ct., New York County 1965) (a proceeding to deny issuance of letters of trusteeship, holding that under EPTL 7-2.6 removal of a trustee for hostility requires proof that the hostility interferes with proper administration of the trust and some fault of trustee).

But in *In re Lipsit*, 50 Misc. 2d 289, 269 N.Y.S.2d 989 (Sup. Ct., Westchester County 1966), the court held that friction and hostility caused by the trustee's actions were sufficient grounds for denial of the issuance of letters of trusteeship to the trustee. The court held:

> Where friction between the trustee and beneficiary, or the trustee and his cotrustee, interferes with the proper administration of the trust, or if future cooperation between the trustees is improbable, or if the trustee's continuing to act as such would be detrimental to the interests of the beneficiary, said trustee may be removed (citations omitted).

50 Misc. 2d at 293, 269 N.Y.S.2d at 993.

The court cited two instances of the trustee's refusal to act in accord with the wishes of the beneficiary and his co-trustee which resulted in litigation.

And in *In re Grave's Estate*, 110 N.Y.S.2d 763 (Sur. Ct., Monroe County 1952), the petitioner trustee sought removal of his co-trustees, his sister and a bank. The parties agreed that acrimony between petitioner and respondents had impaired their relations to the point where "there is no likelihood that these trustees could ever again work as a unit for the good of the estate." Although holding that one faction or the other would have to be removed, the court refused the petitioner's motion for summary judgment revoking the letters of trusteeship of his co-trustees, holding that issues of fact required a trial. 110 N.Y.S.2d at 767.

Current New York Case Law

Current New York decisions are similarly difficult to reconcile.

In *In re Doerschuck*, May 31, 1990 N.Y.L.J. p. 25 col. 2 (Sur. Ct., N.Y. County), the court granted an application for removal of a trustee on the ground of hostility. In *Doerschuck*, the decedent's estranged wife, Georgiana, was the life income beneficiary and a co-trustee, along with her brother, of a testamentary trust under decedent's will. The trusts' remaindermen were the couple's three adult children. The "palpable animosity" arose, at least in part, from litigation in the decedent's estate in which Georgiana accused her children of theft of estate property, perjury, conspiracy and eavesdropping.

The court held:

> Where an application is brought for the removal of a trustee on the ground of hostility, the critical factor is whether the disharmony jeopardizes the interests of the beneficiaries

> and the proper administration of the trusts (*Quackenboss v. Southwick*, 41 N.Y. 117; *Matter of Edwards*, 274 App. Div. 244; Matter of Lipsit, 50 Misc. 2d 289). Here the proof clearly establishes that Georgiana lacks the ability to understand and discharge the duties of a trustee. She has demonstrated that she is unable to act impartially for the benefit of all trust beneficiaries and is instead determined to control the assets of both trusts for her own benefit. Indeed, Georgiana has shown that she is unable or unwilling to comprehend the fundamental responsibility of a fiduciary. Moreover, the record establishes that funds of the estate would be at risk if Georgiana continued to serve as trustee. Her animosity toward her children clearly impairs her ability.

Thus, under *Doerschuck*, a threat to the trust was sufficient to support removal of a trustee, but the court relied on numerous grounds—lack of understanding, unfitness, self-interest, and inability to act impartially, in justifying removal. The *Doerschuck* court also pointed to several instances where the trustee's misconduct, resulting from her hostility, caused the trust or the trust beneficiaries to incur additional taxes.

But in *In re Duell*, 258 A.D.2d 382, 685 N.Y.S.2d 686 (1st Dep't 1999), the Appellate Division, First Department, affirmed the Surrogate's Court, New York County's removal, after trial, of a trustee on the ground of hostility with his sister, a beneficiary, and his mother, a beneficiary and co-trustee, even though the trust had enjoyed substantial growth under the trustee's direction. The Surrogate's Court, New York County, cited the trustee's refusal to speak to his sister-beneficiary, his statement that he "would rather see everything burn down" than give her any money from the estate, his destruction of rent checks, and his abandonment of confidential estate property in a building lobby instead of delivering it to his mother-co-trustee. The court held that the trustee had failed his "duty of undivided and undiluted loyalty to those whose interest he protects," that his actions had endangered trust assets, and that removal was warranted because "the trustee's continuing hostility 'would be detrimental to the interests of the beneficiary.'" N.Y.L.J. 28, Sept. 22, 1997, col. 5 (Sur. Ct., N.Y. County 1997) (citations omitted).

On the other hand, in *In re Smithers*, *supra*, the Supreme Court, New York County, held that alleged hostility between a trustee and trust beneficiary resulting from a non-trust related family issue was an insufficient basis for a removal action without any allegation that the trustee's hostility had caused an impairment to the trust. The petitioner, the widow of R. Brinkley Smithers, founder of the Smithers Foundation for alcohol research and treatment, alleged that the trustee had been complicit in the publication of an article in which it was alleged that there was friction between petitioner and her son, and that the son had "fallen off the wagon." The respondent trustee disputed the allegations, and submitted conflicting evidence. On respondent's motion to dismiss (for which the allegations in the pleadings must be assumed true), the court held that

> [w]hat is most important is whether the trustee has the ability to carry out the duties of a fiduciary in an objective and reasonable manner. In this context, though, petitioner has failed to make out her prima facie case, as no facts have been put forth to suggest that the trustee had not carried out his duties in a proper manner. This is in sharp contract to the facts in *In re Duell*, where the trustee breached his fiduciary duty by refusing to distribute a portion of the estate to a rightful heir, provided for under the decedent's will.

Removal Standards in Other Jurisdictions

As a sampling of the law in other states, we researched the following jurisdictions: Massachusetts, Illinois, Florida, Texas, and California. State statutes and some of the leading cases we reviewed are summarized below.

1. **Massachusetts**: Massachusetts is the only jurisdiction we researched which arguably permits removal of a trustee based on hostility between the trustee and trust beneficiaries, without any showing of impairment or threat of administration of the trust. Massachusetts Gen'l Laws Ann., part II, title II, chapter 203, § 12 (Removal of trustee; successor; appointment), provides that a trustee may be removed if removal is "in the best interests of the beneficiaries of the trust" or the trustee is otherwise incapable or unsuitable.

In *Shear v. Gabovitch*, 43 Mass. App. Ct. 650 (1994), the appellate court held that although two trustees of family trusts had not breached their fiduciary duties, their removal was warranted in any event on the ground of hostility between the trustees and beneficiaries. In *Shear*, the beneficiary claimed hostility arising from the trustees' sale of the trusts' major asset without the beneficiaries' approval. The

trustees said the hostility arose later, when they refused the beneficiaries' request to resign so that the beneficiaries could invade the trust principal without restriction. Noting the importance of the fact that the beneficiary was not an income beneficiary but rather received distributions solely at the trustees' discretion, the court, citing *Wilson v. Wilson*, 145 Mass. 490, 14 N.E. 521 (1888), held that where hostility has arisen and is attributable in part to the fault of the trustee, and where the hostility "would naturally pervert [the trustee's] feelings and judgment," the court could remove the trustee without further proof of misconduct "upon the ground that the removal appears essential to the interests of the beneficiary." Here, the court held, the trustee had almost plenary discretion over distributions and could not be expected to exercise his powers with the desirable perspective and detachment when his motives and integrity were constantly impugned by the beneficiary and the parties "have been mired for years in a draining legal equivalent of total war."

However, the law in Massachusetts regarding removal of trustees may not be as liberal as indicated in *Shear*. In *Symmons v. O'Keeffe*, 419 Mass. 288, 644 N.E.2d 631 (1995), the court affirmed the grant of the trustee's motion for summary judgment dismissing the trust beneficiary's application for removal. The court held that a trustee can be removed on the basis of hostility, although the trustee need not be removed where, as in this case, "the hostile feeling does not interfere with the proper administration of the trust." The court found that the trustee had carried out his duty to distribute all of the trust's net income to the beneficiaries; that the hostility arose from institution of this lawsuit; that hostility resulting from the acts of the beneficiary, as opposed to the acts of the trustee, have been held insufficient grounds for removal; and that it would be a "poor rule indeed" to permit a beneficiary to remove a trustee for hostility the beneficiary engendered by demanding the trustee's resignation.

In *Edinburg v. Cavers*, 22 Mass. App. Ct. 212, 492 N.E.2d 1171 (1986), the appellate court affirmed denial of an application to remove a trustee. The court held that the trial court had not abused its discretion in deciding the trustee should not be removed on the ground of hostility toward the income beneficiary where the trustee could not fully perform his duty without incurring the hostility of some of the income beneficiaries, and there was no evidence that such hostility adversely affected the administration of the trust. *See also Hardiman v. Hardiman*, 11 Mass. App. Ct. 626, 418 N.E.2d 347 (1981) (appellate court affirmed denial of donor's petition for removal of trustees, who were partial income beneficiaries and remaindermen of trust, despite hostility between them).

2. **Illinois**: Illinois does not have a statute setting forth grounds for removal of trustees, and standards for removal are governed by case law. Illinois court decisions are in accord with New York law, and provide that a trustee may be removed on the ground of hostility to a trust beneficiary where the hostility interferes with administration of the trust.

In *Rennacker v. Rennacker*, 156 Ill. App. 3d 712, 509 N.E.2d 798 (1987), the appellate court held that hostility alone is not a ground for removal—there must be proof that hostility between a trustee and trust beneficiary interferes with the beneficial administration of the trust. However, the court held, hostility must be taken into consideration where the hostilities of the parties combine with other circumstances to render removal of the trustee essential to the interests of the beneficiary and the execution of the trust. In *Rennacker*, the court held, the hostility between the parties and their apparent unwillingness to communicate on a civil level indicated a deficiency in the trustee's ability to act as a fitting fiduciary. (The trustee also had sold a trust asset without the beneficiary's consent and invested property under his own social security number.)

In *Suffolk v. Leiter*, 261 Ill. App. 82 (1931), the court held that a court of equity has power to remove a trustee whenever such a state of mutual ill-will exists between the trustee and his co-trustees or beneficiaries that his continuation in office will be detrimental to the execution of the trust. The court held, however, that removal would be warranted only where removal is "clearly necessary" to safeguard the trust property, and that the wishes of the testator who placed great confidence in the selected trustee should not be lightly disregarded. The court held that the lower court did not abuse its discretion in refusing to remove the trustee where the relations between the beneficiary and trustee were not so hostile as to defeat the purpose of the trust.

In *Leman v. Sherman*, 117 Ill. 657, 6 N.E. 872 (1886), beneficiaries of a testamentary trust sought to remove the trustee on the ground of alleged "dislike and ill-feeling." The court held that although there is authority for removal where disagreements between a trustee and his cestui que trust make their transaction of business "unpleasant," removal on the ground of ill will was not warranted where the trustee managed the trust property with honesty and success. (The court removed the trustee on a different ground—that the trustee's appointment by the county court was invalid.)

3. **Florida**: Like Illinois, Florida does not have a statute governing removal of trustees. Like New York, under Florida case law, a trustee may be removed for hostility only where such hostility interferes or is likely to interfere with the proper administration of the trust.

In *Parr v. Cushing*, 507 So. 2d 1227 (Fl. Dist. Ct. App. 1987), the Florida Court of Appeals held that "[h]ostility and/or tension between a trustee and potential beneficiaries of the trust does not by itself constitute a ground for such removal." The court, without discussion of the source and degree of hostility, reversed the lower court's decision removing trustees on the ground of hostility because there was no showing of actual, not potential, mismanagement of the trust.

Similarly, in *Nickels v. Philips*, 18 Fla. 732 (1882), the Supreme Court of Florida held that the trustee could not be removed in the absence of any allegation of unfitness or want of care in management of the trust property. The court held:

> The only charge against [the trustee] is that he has denied to them social intercourse with himself and his family. While such a state of things is to be regretted, yet the uniform rule adopted by the courts is that unless the conduct, condition or omissions of the trustee are such as to endanger the property or disturb the enjoyment of it, or shall show a want of integrity, capacity or fidelity in the discharge of his duty as trustee, the court will not interfere. The mere existence of a family feud, not resulting in any damage whatever, nor threatening to impair or in any wise affect the rights of the parties, is not a sufficient ground upon which to demand the intervention of the court to displace the trustee.

18 Fla. at 735.

4. **Texas**: The Texas Trust Code, chapter 113, subchapter C, § 113.082 (Resignation or Removal of Trustee), seems to permit removal of a trustee for any reason. However, Texas case law provides that a trustee cannot be removed for hostility unless such hostility causes an independent breach of trust by the trustee.

In *Akin v. Dahl*, 661 S.W.2d 911 (Tex. 1983), the Supreme Court of Texas reaffirmed that state's rule that a trustee may not be removed for hostility or ill will between the trustee and a beneficiary unless it has affected the trustee's ability to properly serve in his capacity as a fiduciary. The beneficiary must prove that the hostility has or will affect the trustee's performance—proof that the trustee's performance will *probably* be affected is insufficient. Applying the rule to the facts of the case, and noting that the hostility was created by the beneficiaries, the court affirmed the lower court's denial of removal of the trustee.

5. **California**: California Probate Code § 15642 provides that the grounds for removal of a trustee include "hostility or lack of cooperation among cotrustees [which] impairs administration of the trust." There is no analogous provision for hostility between the trustee and beneficiaries, but a trustee may be removed where the trustee is "otherwise unfit to administer the trust."

The case law in California provides that a trustee may be removed on the ground of hostility between the trustee and beneficiary where such hostility causes impairment of administration of the trust. In *Copley v. Copley*, 126 Cal. App. 3d 248, 178 Cal. Rptr. 842 (1981), the Court of Appeal of California held that trustees—the second wife of the testator and her brother—could not be removed where there was no direct finding that the friction between the trustees and beneficiaries—the testator's adopted children from a prior marriage—impaired proper administration of the trust (citing *Estate of Gilmaker*, 57 Cal. 2d 627, 21 Cal. Rptr. 585, 371 P.2d 321 (1962)). The court also noted that the testator must have contemplated at least the potential for hostility and antagonism in the trust administration by appointing his second wife and her brother as trustees, and that only two of a number of beneficiaries claimed hostility.

In *Gilmaker v. Bank of Americal Nat'l Trust and Savings Ass'n*, 57 Cal. 2d 627, 371 P.2d 321, 21 Cal. Rptr. 585 (1962), the beneficiary of a testamentary trust sought removal of the bank-trustee based on hostility arising from the trustee's alleged failure to follow the beneficiary's instructions concerning the trust assets. The beneficiary was designated a "consultant" to the trustee in the testator's will. The court noted that "[t]he proper administration of the trust requires that there be no hostility between the trustee and the beneficiary-consultant." 57 Cal. 2d at 632. Noting that the hostility had been "constant and intense," the court held that the hostility between the trustee and beneficiary had impaired the proper administration of the trust and required removal of the bank as trustee.

In *Goto v. Goto*, 187 Cal. App. 2d 603, 10 Cal. Rptr. 20 (1960), the court held that antagonism alone between the mother trustee and the daughter benefi-

ciary was insufficient as a ground for removal of the mother as trustee. *But see Overell v. Overell*, 78 Cal. App. 251, 248 P. 310 (1926) (holding that where the trustee must exercise discretion over the trust assets, the mere existence of strong mutual ill feeling between the trustee and beneficiaries may justify removal).

Reconciling the Conflicting Cases

Can the apparently contradictory case decisions, even just among the New York cases, be reconciled? It seems that most recently, whether the court states the requirement as one of impairment of the trust or as a threat to trust administration, it must appear, to warrant removal, that the allegedly hostile trustee's acts have some connection or nexus to the trust. Thus, if, as in *Smithers*, the trustee may be personally hostile but does not allow that hostility to affect his or her actions as trustee, in any respect, then removal will not be granted. But where, as in *Duell* and *Doerschuck*, the trustee's hostility pervades some act of trust administration, even where the overall performance of the trust is successful as it was in *Duell*, removal may be warranted.

How much dissension is too much? What circumstances lead to a finding that the trust administration is jeopardized? To be sure, there seems to be an element of the courts' intuition involved in these removal decisions. However, it would be helpful, as practitioners, to have some points of reference in counseling our clients and assessing risk of litigation or likelihood of success. Factual analysis in the context of a framework is the best starting point.

Facts to Be Considered

In most cases, the courts deciding whether to remove a trustee on the ground of hostility focused, either expressly or impliedly, on the following factual issues:

(1) whether the trustee has any discretion regarding distributions to the beneficiary with whom he is at odds, and, if so, to what degree;

(2) the source and degree of the hostility, i.e., whether it arose from the beneficiary or the trustee's actions, whether the beneficiary would be hostile to any trustee, and whether the hostility has affected the trustee's actions;

(3) whether the trustee also has an interest in the trust; and

(4) whether the grantor or testator contemplated the type of friction.

To illustrate, one can imagine a situation, such as where a trust beneficiary is a playboy-variety son or grandson of the grantor, where just about any trustee who acts as the stopgap between the beneficiary and his unfettered spending of trust assets will evoke the hostility of the beneficiary toward the trustee. In that case, it is likely the hostility was anticipated by the grantor, who likely made his choice of a trustee based on his belief in the trustee's ability to resist the beneficiary's demands for excessive distributions. In that case, the courts should be loathe to remove the trustee at the playboy's behest.

The other extreme is a situation where the trustee seems unconcerned for the beneficiary's welfare, where the trustee is unresponsive (without basis) to the beneficiary's needs and requests, or where the trustee is hostile to the beneficiary as the result of some unrelated conflict such as a family conflict, unrelated litigation, or personal animus. In these cases it is less likely that the hostility would have been foreseen by the grantor, more probable that replacement of a new trustee will resolve the problem, and more likely that the courts will consider removal a viable option.

As to corporate trustees, the problems of personal animus and conflict are less likely to arise, and the situations of conflict with a corporate trustee are far more likely to fall into the first, playboy type of example. If it is the corporate trustee's imprudence or mismanagement of funds that has evoked the beneficiary's hostility, removal will more likely be based upon actual breach of fiduciary duty. However, there may arise a situation where the corporate trustee's alleged imprudence is not sustained, but the process of litigation between trustee and beneficiary has created hostility between the two such that a congenial relationship is no longer possible. Whether these situations permit removal is unclear, but in at least some cases the corporate trustee accused of hostility will agree to resign.

Do We Need Codification or Legislative Change?

Despite our analysis (or perhaps as a result), the standards for removal of trustees for hostility remain murky. Although perhaps desirable for clarity's sake, there does not seem to be anything to gain in terms of substantive change by adding hostility as an express ground for removal under SCPA 711, 791 or EPTL 7-2.6, without clarifying and codifying the factual predicates for removal.

However, as we have seen, removal cases are highly fact-sensitive. Delineating a factual standard for removal cases may be too onerous a task. How

are we to define actions which impair administration of a trust? Or actions which threaten to impair administration of a trust? How are we to rank the importance of various factors such as the genesis of the hostility?

Or, should we leave well enough alone? Perhaps the courts, especially our Surrogate's Courts, are best able to judge when hostility between a trustee and either a co-trustee or beneficiary warrants removal. After all, no one needed to ascertain precisely how many inches of rain fell last spring to know that it was a major wash-out.

We invite our colleagues' comments, thoughts and opinions. Please send any communications to the author, Amy B. Beller at: abbeller@hklaw.com.

Endnotes

1. CBS Evening News, "Record Rainfalls Continue Across the East Coast," June 21, 2003 (Russ Mitchell, anchor).
2. While the standards for removal of executors are also governed by SCPA 711 and SCPA 719, this article will focus specifically on removal of trustees which, because of the duration of trusts as compared with most estates, is a more prevalent problem.
3. CPLR 7701 provides, in pertinent part: "A special proceeding may be brought to determine a matter relating to any express trust except a voting trust, a mortgage, a trust for the benefit of creditors, a trust to carry out any plan of reorganization of real property acquired on foreclosure or otherwise of a mortgage or mortgages against which participation certificates have been issued and guaranteed by a corporation and for which the superintendent of insurance or the superintendent of banks has been or may hereafter be appointed rehabilitator or liquidator or conservator, a trust to carry out any plan of reorganization pursuant to sections one hundred nineteen through one hundred twenty-three of the real property law or pursuant to section seventy-seven B of the national bankruptcy act, and trusts for cemetery purposes, as provided for by sections 8-1.5 and 8-1.6 of the estates, powers and trusts law."
4. The Court held that it was proper to consult the beneficiaries as to which of the two trustees should be removed.

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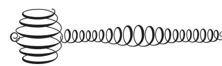

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Flexibility and Simplicity—The Drafting Keys After EGTRRA 2001

By Michael J. Amoruso and Susan Taxin Baer

Careful drafting and flexibility have always been important tools for solid estate planning. Since the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), however, an estate planner's need for precision drafting has never been greater. In the age of the upward spiraling applicable exclusion amount and its unification with the generation-skipping transfer (GST) exemption, replacement of stepped-up basis with carryover basis, repeal of the estate and GST taxes for one year (2010), reversion to pre-EGTRRA rates in 2011, phasing out of the state death tax credit and decoupling of New York State's estate tax in 2004, the days of merely providing a credit shelter trust in the will of the "wealthier spouse" with a taxable estate are over. In addition to each of the above ramifications, the estate planner must also consider the uncertainty of EGTRRA's survival. Given that the Republican-led Congress tried both in 2002 and 2003, as yet unsuccessfully, to make the one year estate and GST tax repeal permanent and that the Democrats continue to insist that we can no longer afford the tax cuts provided in EGTRRA, predictability in the law is eliminated from our planning process. The upshot is that, over the next eight years, our clients may finally understand the importance of reviewing their estate plans frequently.

This article will highlight certain aspects of estate planning that we must revisit with our clients in light of the changes contained in EGTRRA and the impact of New York State's decoupling estate tax. In addition, to help you plan for these uncertain times, we will discuss specific techniques that will add the power of flexibility and simplicity to your drafting.

I. Nuts and Bolts of EGTRRA

While the rhetoric that followed the debates and the enactment of EGTRRA focused on the supposed repeal of the estate and GST taxes, these taxes appear to remain alive and well. In fact, EGTRRA merely provides a temporary reprieve from the burdens (unjust or not) of the federal estate and GST tax system that comes in three forms. First, the applicable exclusion amount, which had been $675,000 in 2001 and slated to increase gradually to $1 million in 2006, was accelerated to that amount in 2002 and placed on a new time line, increasing to $3.5 million in 2009.[1] Second, pursuant to § 2010(c) of the Internal Revenue Code,[2] the applicable exclusion amount and the GST exemption will be unified on January 1, 2004,[3] and remain as such until the year 2011.

Finally, EGTRRA provides for repeal of the estate and GST taxes[4] *only* for the year 2010. In fact, P.L. 107-16 § 901(a)-(b) provides, in relevant part, as follows:

> **Sec. 901. SUNSET OF PROVISIONS OF ACT.**
>
> **(a)** IN GENERAL. All provisions of, and amendments made by, this Act shall not apply—
>
> **(1)** to taxable, plan, or limitation years beginning after December 31, 2010, or
>
> **(2)** in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.
>
> **(b)** APPLICATION OF CERTAIN LAWS. The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) *as if the provisions and amendments described in subsection (a) had never been enacted*. [5]

It is clear that the federal estate and GST taxes are not dead. Instead, despite an easing of the tax burden over the next seven years due to the rising exemption amounts and the one year repeal, the federal estate and GST taxes will re-emerge in 2011 in full force and effect under the pre-EGTRRA laws.

A. The price we pay for EGTRRA

The temporary relief under EGTRRA does not come without a hefty price: the demise of the state death tax credit and the replacement of stepped-up basis with carryover basis.

1. Phase-out of the state death tax credit

Prior to 2001, many states imposed a state estate tax that was equal to the state death tax credit allowed on the federal estate tax return.[6] Such states were often referred to as "pickup tax" states, since

they would receive estate tax revenue to the extent that the federal government shared such revenue by means of a credit. As a result of EGTRRA, however, the state death tax credit is being phased out through 2005. In particular, EGTRRA has reduced the state death tax credit by 25% in 2002, by 50% this year, and by 75% in 2004, and will repeal the state death tax credit for estates of decedents dying after December 31, 2004, replacing it with a deduction for state death taxes paid.[7] Many "pickup tax" states, however, have enacted legislation "decoupling" their estate taxes from the federal tax changes, thereby allowing them to retain estate tax revenue. New York, for example, applies a state exemption amount of $1 million, and calculates the estate tax on estates over this amount using Table B—Computation of Maximum Credit for State Death Tax, based on rates in effect in 2001,[8] despite the fact that that credit is being phased out. As a result, a taxable estate in New York and other such "pickup tax" jurisdictions that have decoupled will pay more in combined federal and state estate taxes due to the reduction in the state death tax credit.

> ***Example 1***: The estate of an unmarried New York decedent who died in 2001 with a taxable estate of $2.5 million would have paid federal estate tax of $664,450 (after taking into account the applicable federal estate tax exemption of $675,000 available in 2001 and a credit of $138,800 for death taxes paid to New York State).

> ***Example 2***: Given the same facts as in Example 1, except that death occurs in 2004, the estate would owe federal estate tax of $435,300 (after taking into account the federal estate tax exemption of $1.5 million then available and a state death tax credit of $34,700 (state death tax credit of $138,800 reduced by 75%). The estate would also owe New York State estate tax in the amount of $138,800, despite the fact that the allowable credit for federal estate tax purposes would only be $34,700.[9]

Unlike the examples above for New York, the cost of EGTRRA is significant for certain "pickup tax" states that calculate and collect the state estate tax based *solely* upon the federal credit allowable in the year of the decedent's death. While New York State will collect the full amount of its tax based upon pre-EGTRRA tables, those states that merely impose a tax based upon the post-EGTRRA federal credit for state death taxes will continue to lose tax revenues of 25% per year through 2004. In 2005, the estate tax in those states will be effectively repealed by EGTRRA if they are constitutionally prohibited from imposing an estate tax (e.g., Florida) or otherwise fail to adopt alternative legislation.

2. The loss of a step-up in basis in favor of carryover basis

For the year 2010, the one year the estate and GST taxes are repealed, EGTRRA terminates the step-up in basis for property acquired from a decedent and replaces it with a carryover basis.[10] Carryover basis is defined as the lesser of (i) the decedent's adjusted basis or (ii) the fair market value of the property at the decedent's date of death.[11] The decedent's executor can allocate a $1.3 million basis increase to any one or more assets for which carryover basis applies.[12] In addition to the $1.3 million basis increase, a spousal property basis increase of $3 million can be allocated to property transferred outright or in a qualified terminable interest property trust (QTIP).[13] Note, however, that the basis increase for any asset cannot exceed the fair market value of the asset at the decedent's date of death.

While at first blush this may not appear significant, consideration must be given to the potential income tax consequence to the beneficiaries of the decedent's estate when (i) the net appreciation of the decedent's assets is greater than $1.3 million and there is no surviving spouse and (ii) the net appreciation is more than $4.3 million and there is a surviving spouse.

> ***Example 3:*** A widower dies in 2010 with the following assets in his name alone:

	Adjusted Basis	Fair Market Value
House	$200,000	$1,500,000
Stock	100,000	500,000

> His will leaves his entire estate to his only child. If the decedent's executor allocates the $1.3 million basis increase entirely to the house ($1.3 million + $200,000 = $1.5 million), and if the child later sells the stock, the child will incur a long term capital gain of $400,000 and a capital gains tax of $80,000. ($500,000 - $100,000 = $400,000; $400,000 x 20% = $80,000).[14] Note that the one-year repeal of estate and GST taxes under EGTRRA comes with an attached

income tax liability. In addition, New York State will impose a state estate tax in the amount of $99,600.

Example 4: Compare the results in Example 3 to those that would occur if the same decedent were to die in 2006 when the federal applicable exclusion amount increases to $2 million. There would be no federal estate tax although New York would still collect its pickup estate tax of $99,600 and, since the child would receive an aggregate step-up in basis to $2 million in the house and the stock to their fair market value on date of death (or alternate valuation date), there would be no income tax liability.

Another drawback to the carryover basis system is the potential for fiduciary issues to arise when administering the estate of a decedent who dies in 2010. In particular, unless detailed and complete records regarding basis are maintained during the decedent's lifetime, the decedent's executor will have the overwhelming task of attempting to reconstruct the basis in order to satisfy the reporting requirements. Not only will this effort involve additional time and fees, but it will also expose the executor to an enhanced risk of being surcharged.[15] The executor may also be subject to claims by beneficiaries in different tax brackets that the allocation of the basis increase is neither fair nor reasonable.[16]

Many of these issues were previously addressed following the Tax Reform Act of 1976 when carryover basis was initially introduced. Plagued with problems then, it could not pass muster and, within a few years, was repealed retroactively. Given that the 1976 carryover provisions failed despite the fact that they provided a "fresh start" date for determining basis (rather than requiring one to make that determination from old and/or incomplete records), as well as the fact that carryover basis under EGTRRA is staged for only a one-year comeback, it is particularly difficult to expect clients to pay legal fees for provisions that may never take effect. Nonetheless, as we get closer to the year 2010, we must assess with our clients—particularly those who are frail or who may not remain competent over the next few years to draw a new will—the appropriateness of including provisions to take advantage of the $1.3 million basis increase and the $3 million spousal property basis increase. For those circumstances where a provision is advisable, suggested language follows:

Basis Increase. (A) If my Spouse survives me and if at the time of my death § 1022 of the Code is in effect, it is my wish that both the aggregate basis increase and the spousal property basis increase will be utilized to the extent available. To this end:

(1) I direct my Executors to give to my Trustees, to hold in the Family Trust, those assets to which my aggregate basis increase can be allocated.

(2) I further direct my Executors to give to my Trustees, to hold in the Marital Trust, as a minimum, such property as my Independent Executors, in their absolute discretion, shall provide for the aggregate spousal property basis increase after taking into account any other property to which spousal property basis increase has been allocated by my Executors. My Executors shall fund the Marital Trust with assets having the lowest aggregate fair market value to utilize such basis increase, unless my Independent Executors, in their absolute discretion, determine not to do so (because, for example, it appears that another asset is more likely to be sold sooner), in which event my Executors may fund the Marital Trust with such other asset.

(B) For purposes of this Article:

(1) My Independent Executors, in their absolute discretion, shall determine which property shall receive basis increases pursuant to § 1022(b) and (c) of the Code as well as the amount of such increases and shall make such determinations without regard to any duty of impartiality among the beneficiaries.

(2) My Independent Executors shall not be liable to any beneficiary of my estate for the selection of any assets made in accordance with the provisions in this Article, unless such selection is made in bad faith.

(3) The terms "aggregate basis increase," "aggregate spousal property basis increase," and "spousal property basis increase" shall have

the same meanings as those ascribed to them in § 1022(b) and (c) of the Code.

(4) The term "my Independent Executors" shall mean my Executors other than (i) the beneficiaries of the Family Trust as to distributions to that Trust and (ii) my Spouse as to distributions to the Marital Trust.

B. Decoupling of New York's exemption amount

As is noted above, the exemption amount in New York for the years 2002-2003 has been interpreted as matching the federal estate tax applicable exclusion amount of $1 million.[17] While New York's exemption amount will remain at $1 million, beginning in January 2004, the federal exemption amount will increase to $1.5 million.[18] Thus, New York will again be in a situation similar to that which existed prior to January 1, 2000 when the amount exempt from the state estate tax was less than the federal estate tax exemption. Now, as then, the executor may well be required to file a New York State estate tax return and even pay a New York State estate tax, although no federal estate tax is due and, perhaps, no federal estate tax return must be filed.

Likewise, in 2004, New York State's GST amount will decouple from the GST exemption under § 2631(c)[19]; however, New York State will continue to "pick up" its GST tax for New York property passing to a skip person based upon the federal GST credit of five percent (5%) as it existed under the 1986 Code, as amended on July 22, 1998.[20] In New York, this mirrors the phase-out of the state death tax credit. Note, however, that while the state death tax credit will be replaced with a deduction, there will not be a corresponding deduction for state GST taxes when the credit for those taxes terminates.

Example 5: In 2006, father created a Trust for child with remainder to grandchild on child's death. Prior to creating the Trust, father had already used his GST exemption. Child dies several years later, at which time there is a taxable termination. The Trust consists solely of New York property having a value of $3 million dollars at child's death. Based upon the federal law in effect prior to EGTRRA, the GST tax due New York State would be $82,500, computed as follows:

Federal tax imposed under § 2601 of the Code based on rate in effect prior EGTRRA:

$3,000,000 at 55% = $1,650,000

Credit for certain state taxes under § 2604 of the Code in effect prior to EGTRRA:

5% of $1,650,000 = $82,500

For illustration, the chart below depicts the state of the applicable exclusions where the federal applicable exclusion increases and unifies with the federal GST exemption while the New York State applicable exclusion and GST exemption remain static and tied to the law pre-EGTRRA.

Year	Federal Applicable Exclusion	NYS Applicable Exclusion	Federal GST Exemption	NYS GST Exemption
2003	$1,000,000	$1,000,000	$1,100,000	$1,100,000
2004–2005	$1,500,000	$1,000,000	$1,500,000	$1,100,000 indexed for inflation
2006–2008	$2,000,000	$1,000,000	$2,000,000	$1,100,000 indexed for inflation
2009	$3,500,000	$1,000,000	$3,500,000	$1,100,000 indexed for inflation
2010	N/A–No Tax	$1,000,000	N/A–No Tax	$1,100,000 indexed for inflation
2011	$1,000,000	$1,000,000	$1,100,000 indexed for inflation	$1,100,000 indexed for inflation

The table above clearly demonstrates the dilemma facing estate planning attorneys in New York. As you will note below, the estate planning techniques routinely selected under prior law may no longer be appropriate for your clients.

II. Estate Planning—What Must Be Considered for Each Estate

In light of the vast, yet temporary, changes that EGTRRA makes to the estate, GST and gift taxes, it is imperative that attorneys reevaluate their clients' estate plans. For instance, if a client's will was executed prior to 2001, when the federal applicable exclusion amount was $675,000, the planning choice reflected in that will may no longer be appropriate or produce the desired result for the client. Thus, the threshold question under EGTRRA is what type of clients need sophisticated tax planning in their wills?

A. Which clients need tax planning for their wills?

We are all too cognizant of the planning difficulties due to the sunset provision of EGTRRA and the uncertainty of whether Congress will permanently repeal the estate and GST taxes. We also have many concerns regarding carryover basis (despite the fact that it was introduced in a slightly different form in 1976 and failed within a few years) and the phase-out of the state death tax credit (which is creating revenue problems for the states). In addition, we cannot ignore the fact that many of our clients currently face estate, GST and gift taxes at substantial rates. Therefore, estate planning remains a necessary consideration for these clients. For other clients, however, the focus may shift from tax planning to other planning concerns such as spendthrift, long-term care or other disabilities, minor children, education, and small business succession. Whether you are advising a client whose estate requires tax planning or a client whose estate does not, it is imperative that both plans are capable of adapting to unforeseen changes in the tax laws.

1. An estate under $1 million no longer needs tax planning

In the face of uncertainty therein lies a scintilla of predictability. Assuming the availability of the full federal and New York applicable exclusion amounts (even after the sunset of EGTRRA), an unmarried person or a married couple, in either case with an estate value of under $1 million (and no taxable gifts), does not need tax planning. This is because New York's applicable exclusion amount is $1 million and the federal applicable exclusion amount will not be less than $1 million after EGTRRA's scheduled sunset.[21]

Of course, this does not mean that a simple "I love you" will is the most prudent approach. Although an estate under $1 million will not need sophisticated tax planning, your clients may have concerns that should be addressed in their estate plans. For example, an outright disposition could jeopardize children should the surviving spouse remarry without entering into a prenuptial agreement. Other issues, such as long-term care or a spendthrift beneficiary, may also require specific provisions. It is important to note, however, that if a surviving spouse is the sole beneficiary and is intending to invest aggressively the assets acquired under the marital deduction, then the need for advanced tax planning may be necessary to shelter any amount that is expected to appreciate above the surviving spouse's applicable exclusion amount.

For those clients whose assets exceed $1 million in value, tax planning options should be considered. The authors suggest that such planning strive for flexibility and simplicity to provide a mechanism that can adapt to the various changes under EGTRRA as well as the effect of New York State's decoupling estate tax.

2. Estates over $1 million must have flexible plans

For those estates over the $1 million threshold, we urge estate planners to review your clients' existing wills to determine the impact, if any, of the disparity between the federal and state applicable exclusion amounts. In particular, careful attention must be paid to the formula clauses that determine the amount of assets passing under the marital deduction and those directed into a credit shelter (or "by-pass") trust. Without such analysis, an unintended consequence may occur such as an overfunded credit shelter trust that may result in either the effective disinheritance of the surviving spouse (i.e., where the spouse is not a beneficiary of the credit shelter trust) and/or the triggering of a state estate tax.

For example, a standard "reduce to zero" formula may provide as follows:

> If my Spouse survives me, I give [to my Spouse absolutely] [to my Trustees to hold in trust for my Spouse] the minimum amount necessary to reduce the federal estate tax on my estate to the smallest possible amount (including zero) after taking into account the credit allowable against such tax under § 2010 of the Code and the credit allowable under § 2011 of the Code (provided use of this credit does not require an

increase in the state death taxes paid), but no other credit. I recognize that this amount may be affected by the action of my Executors in exercising certain tax elections, and that it may be zero. In determining this amount, property shall be valued as finally determined for federal estate tax purposes in my estate.

Such a commonly used formula is intended to reduce the aggregate estate taxes by minimizing assets passing to the surviving spouse, and thereby maximizing the credit shelter trust. From an estate tax savings perspective, the formula also ensures that any appreciation during the period of administration is allocated to the credit shelter trust.[22]

With the increasing federal applicable exclusion amounts under EGTRRA, however, such a "reduce to zero" approach may have the unintended consequence of either binding the surviving spouse to the terms of a credit shelter trust where one may not have been necessary for estate tax savings purposes or, in some cases, effectively disinheriting the surviving spouse.

Example 6: Assume a decedent in 2003 who has a taxable estate of $1.5 million, all passing under the terms of her will. Use of the above formula will cause $500,000 to be set aside for the surviving spouse (outright or in a marital trust), and the remaining $1 million to be allocated to a credit shelter trust.

Example 7: If, given the facts in Example 6, that same decedent were to die in 2004 (when the federal applicable exclusion amount increases to $1.5 million), the entire $1.5 million estate would be allocated to the credit shelter trust and nothing would pass outright to or in a marital trust for the surviving spouse.

This may not be a major concern if the surviving spouse is the sole beneficiary of the credit shelter trust during his lifetime since the surviving spouse may enjoy the income and certain distributions of principal. On the other hand, if the surviving spouse is a discretionary beneficiary, and particularly if one of several discretionary beneficiaries (the others being the decedent's children from a prior marriage), disputes may arise regarding the proper distributions from the credit shelter trust.

Consider also the testator who is concerned that distributions to her surviving spouse from the credit shelter trust might be accumulated, thereby causing her surviving spouse's estate to be taxable at his death. If, as a result, the credit shelter trust has several discretionary beneficiaries with no priority stated for the spouse, or if the surviving spouse is not included in the class of beneficiaries, then, under Example 6, the surviving spouse would be effectively disinherited.[23]

An additional concern regarding the commonly used "reduce to zero" formula is that it fails to accomplish a reduction of the combined federal and state estate tax to zero when the applicable exclusion amount for a state decouples with the federal amount. The applicable exclusion amount in New York, for example, is capped at $1 million. Therefore, if the credit shelter bequest at the first spouse's death is maximized based upon EGTRRA's increasing exemption, a tax will be imposed on the estate of a decedent who dies after 2003, a resident of New York State. The significance of this point is highlighted by the following chart:

Year	Federal Applicable Exclusion	NYS Applicable Exclusion	Maximizing Credit Shelter Trust to Federal Exclusion	NYS Tax on Maximized Credit Shelter
2003	$1,000,000	$1,000,000	$1,000,000	$0
2004–2005	$1,500,000	$1,000,000	$1,500,000	$64,400
2006–2008	$2,000,000	$1,000,000	$2,000,000	$99,600
2009	$3,500,000	$1,000,000	$3,500,000	$229,200
2010	N/A–No Tax & No Marital Deduction	$1,000,000	Unlimited	Based on Unlimited Credit Shelter Amount
2011	$1,000,000	$1,000,000	$1,000,000	$0

This chart lends firm support to the need to incorporate more flexibility into an estate plan. The commonly used "reduce to zero" approach limits a fiduciary's ability to engage in post-mortem tax planning because the formula is inherently inflexible.

It is therefore important that we help our clients avoid the harsh imposition of the New York State estate tax by modifying the formula language to impose a limit on the size of the credit shelter. Such a modification might include the sentence: "In no event shall this amount be more than the largest amount necessary to eliminate any New York estate taxes."[24] While this approach may eliminate the imposition of New York State estate tax, it may very well subject the surviving spouse's estate to federal and state estate taxes since more assets will be held in a marital trust or distributed to the surviving spouse. Therefore, it is also important that we draft for more flexibility utilizing post-mortem planning so that an estate will more readily adjust to the tax laws at the date of death.

B. Planning for flexibility

Given the evolution that EGTRRA will bring over the next eight years, it seems prudent to empower the surviving spouse and/or executor to engage in post-mortem tax planning by adopting a formula clause that incorporates a "wait and see" approach. We often hear investment advisors claim that someone cannot time the market. In our planning process, an analogous thought applies—we cannot plan on the year of death (and the year of death can bring different consequences under EGTRRA). Thus, in light of the current tax laws, it is sound reasoning to permit the executor to look at the applicable exclusion amount and the tax rates in effect at the death of the first spouse, and to determine *at that point in time* the extent to which assets will pass under the marital deduction rather than the credit shelter trust. In addition, at the death of the first spouse, the executor might be better able to forecast the tax laws that may be in effect in the anticipated year of the surviving spouse's death.

Estate planners might consider a variety of alternatives to the inflexible standard "reduce to zero" formula. Three examples of flexible planning include (i) the disclaimer trust, (ii) the divisible QTIP trust, and (iii) the contingent QTIP trust (or "Clayton QTIP").[25] The selection will depend, among other things, upon the size of the marital estate, intricacies of the family relationships, money management skills, and whether the surviving spouse may be susceptible to long-term illness. Each of these scenarios will provide a mechanism for the surviving spouse and/or the executor to engage in post-mortem tax planning utilizing a sliding scale approach when making allocations to the marital and non-marital shares. It is also important to note that each of these methods will qualify for the $3 million spousal carry-over basis increase in 2010.[26]

1. The disclaimer trust

When planning for a client with a small or modest estate, disclaimer planning may be a viable option. In essence, such a plan leaves the testator's entire estate outright to the surviving spouse with a further provision for any property disclaimed by the spouse to funnel into a non-marital trust. For example, a disclaimer provision may provide in relevant part:

> If my Spouse renounces any interest in property otherwise passing to my Spouse under this will, I give the property so renounced to my Trustee, to hold in trust (hereinafter, the "Disclaimer Trust") [*add provisions for non-marital trust for the benefit of spouse or spouse and others, making sure not to give spouse a power of appointment other than a $5,000 x 5% withdrawal power*].

This approach provides flexibility and gives the surviving spouse maximum control of the decedent's assets. From the control standpoint, the initial provision for outright distribution to the surviving spouse is similar to the simple "I love you" will; however, the disclaimer provision adds post-mortem tax planning flexibility by enabling the surviving spouse to shelter, in a non-marital trust, assets having a value equal to the exemption equivalent amount (or a lesser amount). Although, the surviving spouse makes this decision when more facts are known, it is based upon his willingness to forgo outright distribution of assets in favor of sheltering them from inclusion in his taxable estate.

Disclaimer planning, however, may not be appropriate in every small or modest sized estate. The federal disclaimer statute defines a "qualified disclaimer" as an irrevocable and unqualified refusal to accept an interest in property if (i) the refusal is in writing; (ii) it is given to the executor within nine months of the date of death; (iii) the person has not accepted the interest or any of its benefits; and (iv) the disclaimed interest passes without any direction on the part of the person making the disclaimer and passes to the decedent's spouse or a person other than the person making the disclaimer.[27] Herein lie two pitfalls for the surviving spouse who may not be guided by counsel.

First, if after the death of a decedent, the surviving spouse accepts any benefit of the decedent's property (i.e., house, money, etc.), then with but a few exceptions, a subsequent disclaimer will not be a "qualified disclaimer" under § 2518(b) of the Code, thereby frustrating the testator's intent to provide post-mortem tax planning flexibility with respect to those assets. For example, although an asset is titled solely in the name of a decedent, the surviving spouse may view it as belonging to both of them, and continue to benefit from the asset as a matter of "entitlement" after the decedent's death. Such an act would disallow the benefits of the disclaimer under § 2518(b) of the Code, causing the asset to pass as marital property in the decedent's estate and ultimately be included for estate tax purposes in the estate of the surviving spouse. Second, even if the surviving spouse does not accept the benefits of the decedent's property, a disclaimer would not be "qualified" if not executed by the surviving spouse and delivered within nine months of the decedent's death.

In addition, disclaimer planning may not be appropriate where the client has children from a prior marriage. Assuming that the decedent's children are sole beneficiaries, discretionary beneficiaries with the surviving spouse or even just the remainder beneficiaries of the disclaimer trust, irrespective of subsequent tax implications, the surviving spouse may not have the incentive to disclaim any interest that will ultimately benefit the decedent's children. Rather, preferring to control the ultimate disposition of such property, the surviving spouse may accept it outright at the decedent's death. Finally, the surviving spouse may simply refuse (i.e., due to fear of losing control, vulnerability, or no reason at all) to disclaim an interest. These examples demonstrate certain instances where the flexibility and control given by disclaimer planning may create an intolerable risk, thereby rendering this post-mortem tax planning vehicle inappropriate.

Nonetheless, in the appropriate situation, a disclaimer trust can be a particularly effective tool for the estate planner to utilize since EGTRRA.

2. The divisible QTIP

In those situations where the disclaimer trust is not appropriate, but the testator still wants the surviving spouse to benefit from the entire estate, a divisible QTIP trust may be the solution.[28] Under this concept, an executor can divide a QTIP trust into three shares, namely, (i) an estate tax exemption share, (ii) a marital share,[29] and, to the extent the decedent's GST exemption has not been fully used, (iii) a GST exempt marital share, making a QTIP election for the latter two shares and a reverse GST election for the last share. The Treasury Regulations demonstrate clearly the power and administration of the divisible QTIP:

> ***Example 8. Severance of QTIP trust.*** D's will established a trust funded with the residue of D's estate. Trust income is to be paid annually to S for life, and the principal is to be distributed to D's children upon S's death. S has the power to require that all of the trust property be made productive. There is no power to distribute trust property during S's lifetime to any person other than S. D's will authorizes the executor to make the election under § 2056(b)(7) only with respect to the minimum amount of property necessary to reduce estate taxes on D's estate to zero, authorizes the executor to divide the residuary estate into two separate trusts to reflect the election, and authorizes the executor to charge any payment of principal to S to the qualified terminable interest trust. S is the sole beneficiary of both trusts during S's lifetime. The authorizations in the will do not adversely affect the allowance of the marital deduction. Only the property remaining in the marital deduction trust, after payment of principal to S, is subject to inclusion in S's gross estate under § 2044 or subject to gift tax under § 2519.[30]

Most importantly from the standpoint of flexibility, unlike disclaimer planning where the surviving spouse is given only nine months to disclaim, with a QTIP trust the executor has up to fifteen months after the decedent's date of death to make a full or partial QTIP election.[31] With an additional six months,[32] the executor can more readily determine what portion of the trust should qualify for the marital deduction and what portion should be held as a non-marital trust, minimizing the impact of taxes at the surviving spouse's death.[33] Although the executor on the estate tax return must express intent to divide the trust, the actual division of assets need not be accomplished until the end of the estate's administration. If a partial election is made, it must be with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in applying code §§ 2044 and 2519.[34]

In addition, under the divisible QTIP, the executor can create a second marital trust (a GST exempt marital trust), and make a reverse QTIP election to take advantage of the decedent's GST exemption to the extent (if at all) that such exemption has not been used. A sample provision follows:

> If my Spouse survives me, I give my residuary estate to my Trustee to hold in as many separate Trusts, each for the benefit of my Spouse, as my Executors, in their absolute discretion, shall determine. In the event my Executors make an election under § 2056(b)(7)(B)(v) of the Code to treat a portion of my residuary estate as qualified terminable interest property, such portion shall be referred to as the "Marital Share," and the remaining portion of my residuary estate shall be referred to as the "Nonmarital Share." In the event that my Executors make a further election under § 2652(a)(3) of the Code to allocate my unused GST exemption, if any, to a portion of the Marital Share, my Marital Share shall be divided into two separate parts, one to which my unused GST exemption is allocated (the "Reverse Marital Share"), and the other being the remaining part of the Marital Share. The Nonmarital Share shall be held by my Trustees under Article [*Article setting forth terms of Family Trust*], and shall be known as the "[*testator's surname*] Family Trust." The Marital Share shall be held by my Trustees under Article [*Article setting forth terms of Marital Trust*], and shall be known as the "[*Spouse's name*] Marital Trust." The Reverse Marital Share, if any, shall be held by my Trustees under Article [*Article setting forth terms of GST Exempt Marital Trust*], and shall be known as the "[*Spouse's name*] GST Exempt Marital Trust."

With the unification of the estate tax applicable exclusion amount and the GST exemption in 2004, there will not be too many situations where the unused GST exemption will exceed the amount applied to the non-marital trust. One such situation, however, will occur where a testator who is a resident of a state that has decoupled (e.g., New York), limits the non-marital trust to the state's applicable exclusion amount.

> ***Example 9:*** Decedent, a resident of New York State, dies in 2004 when the federal applicable exclusion amount is $1.5 million and New York State's exemption is only $1 million. Decedent's taxable estate is $2 million. Decedent's will provides for a formula credit shelter trust, as limited to New York State's exemption amount. Decedent's residuary estate is to be held in one or more QTIP trusts for her husband. The executors will fund the credit shelter trust with $1 million. In order to take advantage of decedent's $1.1 million GST exemption (none of which was used during decedent's lifetime), the executors will allocate $1 million to the credit shelter trust. In addition, they will divide the QTIP trust into two separate trusts: one shall be determined by a fraction, the numerator of which will be $100,000 (decedent's remaining unused GST exemption) and the denominator of which shall be the value of the residuary estate (the "GST Exempt Marital Trust"), and the other shall be the remaining fractional share. Decedent's executor will make an election under § 2652(a)(3) of the Code to allocate her remaining $100,000 GST exemption to the GST Exempt Marital Trust. These provisions and transactions will (i) avoid payment of New York State estate tax in the amount of $64,400 at the decedent's death (though it risks the possibility of increased estate tax at her husband's death), (ii) take advantage of decedent's full GST exemption, and, if death were to occur in 2010, take advantage of both aggregate basis increase and spousal property basis increase.

Another such situation would occur where a client has made gifts during life which did not require allocation of the GST exemption, but used a portion of her applicable exclusion amount. As a result, the reverse QTIP election at death would be a viable planning tool since there would be a spread between the GST exemption and the applicable exclusion amount.

> ***Example 10***: Decedent dies in 2003 with a taxable estate of $2 million. Decedent made lifetime gifts of $100,000, leaving up to $900,000 (her remaining applicable exclusion amount) to fund a credit shelter trust. Decedent's will calls for a pecuniary credit shelter trust, with the residuary estate to be held in one or more QTIP trusts for the surviving spouse. Since decedent has not used any of her $1.1 million GST exemption, decedent's executor will allocate $900,000 to the credit shelter trust, causing it to be fully exempt, and will create two QTIP trusts, one being a fractional share of the residuary estate (the numerator of which is $200,000, and the denominator of which is the value of the residuary estate), for which a reverse QTIP election will be made.

Another potential feature of the divisible QTIP is that if the executor makes a partial QTIP election (which may trigger the payment of some tax at the first spouse's death) and the surviving spouse dies within ten years of the first spouse's death, the surviving spouse's estate may be entitled to a credit for taxes paid on prior transfers ("TPT Credit").[35] This trust may be an attractive planning tool for the estates of more mature couples where it is anticipated that both spouses will pass away within a relatively short time of each other.

Although the divisible QTIP may provide a powerful tool for post-mortem planning flexibility, it may not be appropriate when the value of the surviving spouse's estate exceeds the federal and/or state applicable exclusion amount and the surviving spouse is or will be in a high income tax bracket with adequate independent monthly cash flow to maintain an accustomed standard of living. The influx of required income distributions from the non-marital share of the divisible QTIP may further inflate the surviving spouse's estate, running the risk of increasing estate taxes at his subsequent death. In addition, should the surviving spouse require long-term nursing care, the divisible QTIP does not take advantage of key asset protection strategies that might otherwise allow one to qualify for Medicaid. In these circumstances, the "Clayton QTIP" may be a better option.

3. The "Clayton QTIP"

While the "Clayton QTIP" derived its name from the U.S. Court of Appeals, Fifth Circuit case *Estate of Clayton v. Commissioner*,[36] a review of the Treasury Regulations reveals that it may be more aptly named the "contingent QTIP."[37] The Treasury Regulations state, in pertinent part:

> *Contingent income interests.*—(i) An income interest for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g. remarriage), is not a qualifying income interest for life. However, a qualifying income interest for life that is contingent upon the executor's election under § 2056(b)(7)(B)(v) will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse . . .[38]

As the Treasury Regulations explain, the contingent income interest provides a powerful addition to the divisible QTIP approach. The contingent QTIP permits the executor to make a partial QTIP election and allocate the non-elected property to a non-marital trust that does not necessarily provide a lifetime income interest to the surviving spouse. By utilizing this approach, the testator is hedging against increasing the size of the surviving spouse's taxable estate since the surviving spouse will not necessarily be the recipient of income distributions from the non-marital trust.[39] This approach may also take advantage of the disparity in income tax rates between the surviving spouse and the testator's children. For instance, if the surviving spouse is in the 35% income tax bracket, income distributions to him from the non-marital trust would be taxed at that rate. If, however, the surviving spouse does not need part or all of the income from the non-marital trust, use of a contingent QTIP would allow the trustees to distribute such income to the testator's children whose income tax bracket is presumably lower (i.e., 28%) than that of the surviving spouse. Thus, the contingent QTIP plan also has an income tax savings component.

The contingent QTIP might be carved out of the residuary estate as follows:

> If my wife survives me, my residuary estate shall be disposed of as follows:
>
> a) I authorize my Independent Executors to make an election under § 2056(b)(7)(B)(v) of the Code to treat

> a portion of my residuary estate as qualified terminable interest property. In the event such an election is made, such elected portion shall be referred to as the "Marital Share," and the remaining portion shall be referred to as the "Nonmarital Share."
>
> b) My Trustees shall hold the Marital Share in as many separate Trusts as my Executors, in their absolute discretion, shall determine, each for the benefit of my Spouse, the dispositive terms of which are set forth in Article [*Article setting forth provisions for QTIP Trust*]. My Trustees shall hold the Nonmarital Share in as many separate Trusts as my Executors, in their absolute discretion, shall determine, the dispositive terms of which are set forth in Article [*Article setting forth provisions for Contingent QTIP Trust: a discretionary trust for issue or for surviving spouse and issue*].

Equally important, if the surviving spouse requires long-term skilled nursing care but does not have private long-term care insurance, the contingent QTIP may provide a superior means for protecting assets and therefore maximizing the trust remainder for the testator's children. For example, the executor might be directed to funnel the QTIP trust assets, to the extent QTIP treatment is not elected, into a contingent QTIP that is in the form of a supplemental needs trust (SNT) for the surviving spouse. This action may prevent the trust assets from being exhausted due to the surviving spouse's long-term illness. Note, however, that the contingent QTIP does not come without potential challenges. The surviving spouse's interest (if one exists at all) in a contingent QTIP (whether an SNT or otherwise) cannot compare to the interest he would have had in the non-marital share of a divisible QTIP, and certainly does not compare to the outright disposition he would have received (but for a disclaimer) in an "I love you" will. It is not surprising then that an estate plan relying upon a contingent QTIP may face a spousal elective share problem. In fact, unlike a disclaimer based plan, the New York elective share statute is not satisfied by any form of QTIP trust distributions.[40] Thus, in cases where a waiver of the elective share is not obtained, the surviving spouse may defeat a flexible estate tax savings plan by taking the elective share. This right of election may be exercised for emotional or financial reasons (i.e., the surviving spouse's feeling that he is being disinherited or his refusal to permit the decedent's children by a prior marriage to inherit the entire non-marital trust). Another disadvantage to the contingent QTIP plan is that the surviving spouse does not have a fixed and ascertainable interest in that trust as he would in a divisible non-marital QTIP trust. Therefore, if he dies within ten years after the decedent, the benefit to his estate of the TPT credit will be considerably less (if at all) than it would otherwise be if he were the beneficiary of a divisible non-marital QTIP trust.

Finally, when selecting fiduciaries for a contingent QTIP plan, it is essential that there be an independent executor. Neither the surviving spouse nor any of the beneficiaries of the non-marital trust should serve as the sole executor. Since the surviving spouse is the only person entitled to benefit from the marital share, there is an inherent conflict of interests between the surviving spouse and the beneficiaries of the non-marital share (whether or not the surviving spouse is one of the beneficiaries). This conflict is an invitation for litigation if the beneficiaries of the non-marital share believe that the surviving spouse is acting only in the best interest of the marital share rather than of both shares. On the other hand, if the surviving spouse is the sole executor, and makes the QTIP election over only a small portion of the Trust, the surviving spouse can be deemed to have made a taxable gift to the beneficiaries of the contingent QTIP Trust. Similarly, if one of the other beneficiaries is sole executor and makes the QTIP election over a significant portion of the Trust, he could be deemed to have made a gift to the surviving spouse by virtue of the fact that his interest in the contingent QTIP Trust has been reduced. Given this issue, it is prudent for the testator to appoint an independent executor for purposes of making the partial QTIP election.

C. Do not forget simplicity

When planning for flexibility to deal with the temporary effects of EGTRRA it is important not to lose sight of simplicity. Clients often come to an attorney's office with previously drafted estate planning documents and no understanding as to how the estate plan works. Sometimes, as we strive zealously to represent our clients and reduce the impact of estate taxes, simplicity is overlooked. When choosing a flexible plan to address the temporal nature of the current tax laws, a simple plan along with other techniques may produce a superior and more understandable result for the client.

1. Maximize each client's state applicable exclusion amount

The drafting concepts discussed above are important, but if the clients' assets are not properly

allocated and titled, the plan will not work. Since each New York resident can transfer up to $1 million at death, it is also necessary to maximize the assets of *each* spouse to the extent possible so that each will have at least $1 million in his or her name alone. This can be accomplishing by transferring assets between spouses (which are tax-free transfers) while both spouses are living.

> ***Example 11:*** Wife has assets valued at $1.8 million in her name and husband has $200,000 in his name. They have reciprocal wills with credit shelter trusts benefiting the other. Husband dies in 2000. Since wife had not transferred any of her assets to husband, only $200,000 can be sheltered in the trust under his will, with $800,000 of husband's exemption having been wasted. When wife dies in 2005, her assets remain valued at $1.8 million and the federal exemption is then $1.5 million. Wife's estate will pay $198,900 in taxes (federal: $113,700; NYS: $85,200).

> ***Example 12:*** Same facts as in Example 10, except that wife transfers $800,000 to husband in conjunction with their new wills. When husband dies in 2000, $1 million can be placed in the credit shelter trust under his will. When wife dies in 2005, her assets are now reduced to a value of $1 million, and neither Federal nor New York State estate taxes are required.

2. Don't forget the power of lifetime gifting

For those estates that are on the borderline for tax planning, lifetime gifting may be the prescription (assuming the client has liquidity to carry out such a plan). In 2003, each individual can give up to $11,000 annually, free of federal gift taxes, to an unlimited number of people (and they *do not* have to be related to the donor). If one spouse has the lion's share of the assets, both spouses can elect to utilize gift splitting, and make gifts of $22,000 annually. For clients who have a high net worth and are not "fearful" of becoming "impoverished," this is a powerful estate reduction technique.

> ***Example 13:*** A married couple with two children can make gifts (federal gift tax free) of up to $44,000 a year, in aggregate, to their children. Making such annual exclusion gifts over a five-year period would remove $220,000 from the couple's estate. If each child were married and had four children, annual exclusion gifts to each child, in-law, and grandchild, using split-gifts over a five-year period would remove $1,320,000 from the couple's estate.

3. The irrevocable life insurance trust still has value

To some, the increasing federal exemption amounts over the next eight years may alter their willingness to create an irrevocable life insurance trust. In contrast, the irrevocable life insurance trust may remain an excellent source of liquidity for those who live in states, like New York, that have decoupled from the federal exemption levels. Planning with life insurance may be a mechanism to complement a marital deduction formula that maximizes the credit shelter trust to the federal exemption level since it provides the necessary liquidity to pay the state estate tax cost for that increase. Alternatively, if the credit shelter trust is limited to the state exemption amount, thereby increasing the value of the surviving spouse's estate, liquidity will be needed at that spouse's subsequent death. In addition, if carryover basis is not repealed, additional funds may well be needed to replace funds used to pay capital gains taxes. Of course, the estate planner must crunch the numbers for each client by comparing the cost of premiums that will sustain the insurance with the potential savings that should result from the instant liquidity that will be obtained.

4. Moving may be an option

There are certain states, like Florida, where the state constitution prohibits the imposition of an estate tax. So long as the federal statute provides credit for death taxes paid to a state, Florida can "pick up" this credit as a state death tax. Once the federal statute phases out this credit, however, Florida will no longer be able to impose a death tax. Clearly, for certain clients, it may be worth considering a change in domicile to a state like Florida.

III. Conclusion

The federal estate and GST taxes are not permanently repealed by EGTRRA. In fact, EGTRRA raises important challenges for estate planners to address over the next eight years. When facing these challenges, simple techniques should be analyzed first to solve a potential tax problem. At the same time, where tax planning must be accomplished, estate planners should consider the power of flexibility to address the evolving effects of EGTRRA. A combina-

tion of both simplicity and flexibility will provide your clients with the tools needed to contend with the uncertain state of our current federal and state estate and GST tax laws.

Endnotes

1. I.R.C. § 2010(c). In addition, EGTRRA provides that the top marginal estate and gift tax rate will decrease from 55% in 2001 to 45% in 2009, but the top marginal estate and gift tax rate will return to 55% in 2011. In the year 2010, when the estate tax is repealed, the gift tax will be retained at the top income tax rate.
2. Unless otherwise indicated, references to "§" and "§§" are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), and references to "Treas. Reg. §" are to the Regulations under the Code.
3. § 2631(c). It is at this point in time that the estate tax and gift tax will be "de-unified" (although they will share a common tax rate from 2002-2009).
4. It is important to note that this repeal does *not* include the federal gift tax. The federal gift tax applicable exclusion amount will remain at $1,000,000 with a maximum tax rate in 2010 of 35%.
5. P.L. 107-16, § 901(a)-(b) (emphasis added).
6. § 2011(a).
7. §§ 2011(b)(2)(B), 2058.
8. Technical Services Bulletin Memorandum, TSB-M-02(2)M (Mar. 21, 2002), which allows New York to take advantage of the federal estate tax exemption of $1 million for decedents dying in 2002 and 2003, despite the fact that § 951 of the New York Tax Law might otherwise be interpreted as limiting the exemption to $700,000 for the years 2002 and 2003; *see also* NYS Estate Tax Return, Form ET-706 (3/02).
9. For an excellent discussion of the effect of EGTRRA on New York estate tax calculations, *see* NYSBA Trusts and Estates Law Section Newsletter: Philip L. Burke, *The Effect of Recent Federal Estate Tax Legislation on the New York Estate Tax: Part II*, Winter 2002, vol. 35, no. 4, at 40.
10. § 1014(a), (f).
11. § 1022(a)(2).
12. § 1022(b)(2)(B). In addition, § 1022(b)(2)(C) provides that the basis increase shall be further increased by unused built-in losses and capital loss carryovers.
13. § 1022(c)(2)(B).
14. This example does not take into account the recent decrease in the capital gains tax rates before the new carryover basis rules under EGTRRA take effect.
15. Frank S. Berall, Ellen K. Harrison, Jonathan G. Blattmachr & Lauren V. Detzel, *Planning for Carryover Basis That Can Be/Should Be/Must be Done Now*, WG&L Estate Planning Journal (Mar. 2002).
16. *Id.*
17. *See supra* note 8.
18. N.Y. Tax Law § 951(a).
19. The federal exemption unifies with the I.R.C. § 2010(c) amount.
20. N.Y. Tax Law § 1020(a). *See also* § 2604(a), (b).
21. This assumes that neither Congress nor the New York State Legislature will act aggressively to reduce the applicable exclusion amount to an amount below $1 million.
22. It should be mentioned that if the assets depreciate in value during the period of administration, the credit shelter will bear the burden of the decrease in value.
23. Surely, in this scenario, the surviving spouse would exercise the right of election under EPTL 5-1.1-A if a waiver of said right had not been executed.
24. Harold D. Klipstein & Ira Mark Bloom, Drafting New York Wills, Law and Forms, § 7.26 Form 3, at 7-278 (Matthew Bender & Co. 2003).
25. For an excellent synopsis of the advantages and disadvantages of each of these techniques, *see* Howard M. Zaritsky, Practical Estate Planning and Drafting after the Economic Growth and Tax Relief Act of 2001, ¶ 2.02[6] (Warren Gorham & Lamont 2001).
26. § 1022(c)(2)(B).
27. § 2518(b).
28. Zaritsky, *supra* note 25, at ¶ 2.02[6][b].
29. § 2056(b)(7); Treas. Reg. §§ 20.2056(b)-7(b)(2)-(4),-7(h), Ex. 9; *see also* EPTL 7-1.13(a)(1) (which permits the division of a QTIP trust).
30. Treas. Reg. § 20.2056(b)-7(h), Ex. 9.
31. § 6081(a); Treas. Reg. § 20.6081-1(b) (granting an automatic extension of time to file if an executor requests it within nine months of the decedent's date of death).
32. When a determination has to be made regarding a QTIP election, it is prudent post-mortem tax planning to obtain a six-month extension of time to file.
33. Treas. Reg. § 20.2056(b)-7(b)(2)(i)-(ii).
34. Treas. Reg. § 20.2056(b)-7(b)(2)(i). The separate trusts, however, do not have to be funded with a pro rata portion of each asset held by the individual trust. Treas. Reg. § 20.2056(b)-7(b)(2)(ii)(B).
35. § 2013.
36. 976 F.2d 1486 (5th Cir. 1992).
37. Treas. Reg. § 20.2056(b)-7(d)(3)(i).
38. *Id.*
39. If, however, the surviving spouse is a discretionary beneficiary of the non-marital trust, distributions can be made to him should he need additional funds. On the other hand, if he enters into a long-term care facility, funds from the trust can be used to supplement any governmental benefits to which he may be entitled.
40. Klipstein & Bloom, *supra* note 24, § 7.27[2], at 7-303.

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Operating the New York Not-For-Profit Organization: Structural Issues

By Pamela A. Mann

I. Introduction

A. The Not-for-Profit Corporation Law (N-PCL) provisions governing structural and operational changes made by New York not-for-profit organizations reflect the law's treatment of nonprofit assets generally. *See* Bjorklund, Fishman and Kurtz, *New York Nonprofit Law and Practice* (1997) ("*New York Nonprofit Law*"), Section 8-1. While the particular requirements for achieving each type of change will vary, there are three common elements.

1. The change is typically approved by the board of directors and, in the case of a membership organization, by the members.
2. In addition, fundamental changes by charitable not-for-profit organizations also require judicial approval on notice to the Attorney General. This requirement is based on the notion that, consistent with the public purposes which not-for-profit organizations serve, the real "owner" of the organization, *viz.*, a representative of the public interest, must approve the change.
3. The doctrine of *quasi cy pres* often applies to the question of whether the proposed change is appropriate. This doctrine is applied because the organization's assets are considered to be held in trust for the purposes for which the organization was formed and operated. As discussed below, any fundamental changes in the organization's operations must bear a close relationship to the original tax-exempt purpose. *Id.*

B. The doctrine of *quasi cy pres* plays a critical role in the process of making fundamental changes in a not-for-profit organization's structure or operations.

1. The doctrine of *quasi cy pres* is a variant of the common law doctrine of *cy pres*. Pursuant to this common law doctrine (which means "as near as possible" in archaic Anglo-French), a court will have the power to modify a charitable gift if a showing is made that, in light of changed circumstances, administration of the gift in a manner consistent with its original purpose will be impossible or impracticable. In that event, the court may modify the gift to effectuate its general charitable intent, adhering as closely as possible to the original purpose. *St. Joseph's Hospital v. Bennett*, 281 N.Y. 115 (1939) (*cy pres* doctrine applies to gifts to charitable corporations). *See also* EPTL 8-1.1, codifying the common law doctrine, with respect to charitable trusts.
2. The N-PCL codification of the *cy pres* doctrine in the corporate context resulted in the less restrictive *quasi cy pres* standard. *New York Nonprofit Law*, Section 8-1(a). Rather than requiring that the assets be used for the purpose for which the assets were initially held, the N-PCL allows the assets of the not-for-profit organization to be used for "substantially similar" activities. *See, e.g.*, N-PCL § 1005(a)(3)(A) (governing assets of dissolving organizations).
3. In *Alco Gravure, Inc. v. Knapp Foundation*, 64 N.Y.2d 458, 490 N.Y.S.2d 116 (1985), the New York Court of Appeals held that the *quasi cy pres* standard would be applied to any change in the manner of administration of not-for-profit assets, citing the provisions of the N-PCL addressing restricted gifts and dissolution. Because the Court viewed the corporate change at issue in the proceeding before it—an amendment of the purposes clause of the organization's certificate of incorporation—as a surreptitious method of dissolving the corporation, it applied the standard to the amendment of the corporation's purposes.
4. *In re Multiple Sclerosis Service Organization of New York*, 68 N.Y.2d 861, 505 N.Y.S.2d 841 (1986) clarified the issue of how the *quasi cy pres* standard was to be

applied. In that case, the Court of Appeals indicated that the activities of the corporation, not the purposes of the organization as expressed in its certificate of incorporation, were the starting point of the analysis. It stressed that the parameters of this standard were broader than the traditional *cy pres* standard, and that substantial deference should be accorded to the disposition of the assets proposed by the board of directors in determining whether the proposed disposition met the standard.

II. Amendment of Certificate of Incorporation

A. If a not-for-profit corporation has a broadly drafted certificate of incorporation, most changes in governance structure, program, and manner of operation may be accomplished by an amendment of the bylaws, at most. However, where the certificate contains a great deal of detail and/or a very specific "purposes" clause, amendment of the certificate may be necessary.

B. A not-for-profit corporation has the right to amend its certificate of incorporation as often as it wishes, provided that the amendment contains only such provisions as might be lawful in an original certificate of incorporation. N-PCL § 801.

1. Among the aspects of the certificate that may be amended are the name, purposes, duration, corporate powers, location of corporate offices, rights and powers of directors, members, and officers, and the authority to issue capital certificates.

2. A certificate of amendment does not replace the corporation's certificate of incorporation: the date of incorporation of a not-for-profit whose certificate has been amended remains the date of *initial* incorporation.

C. The amendment must be authorized by the governing body of the organization.

1. In the case of an organization with no members, the amendment must be approved by a majority of the board of directors. N-PCL § 802(a).

2. In the case of a membership organization, amendment other than those specified in section 802(c) must be approved by a majority of the members. *Id.*

3. Amendments of "housekeeping" provisions in the certificate of a membership organization may be approved by the board alone. N-PCL § 802(c). These include changing the location of the office of the corporation and changing the designation or address of the registered agent. Alternatively, these changes may be made by filing a certificate of change. N-PCL § 803-A.

D. The typical amendment of a certificate of incorporation is accomplished by filing a certificate of amendment with the Secretary of State and paying a filing fee of $30. N-PCL §§ 803, 104-A(f).

1. The certificate must be signed and verified in accordance with N-PCL § 104(d).

2. The certificate of amendment must contain certain provisions set forth in N-PCL § 803.

E. Particular types of amendments, however, require governmental approval. A certificate of amendment that adds, changes, or eliminates a purpose, power, or provision which required governmental approval at the time of incorporation must be approved or consented to by that governmental body at the time of amendment. N-PCL 804(a)(i).

F. In addition, the certificate of amendment of a Type B or C corporation that seeks to change or eliminate a purpose or power enumerated in the corporation's certificate or to add a power or purpose not enumerated in the certificate of incorporation must be approved by a justice of the Supreme Court on notice to the Attorney General. N-PCL 804(a)(ii).

1. As explained in *Alco Gravure, Inc. v. Knapp Foundation*, discussed at Section I above, the purpose of court approval is to assure that funds raised for an organization's initial purposes remain dedicated to those purposes, or otherwise expended consistent with the provisions of the *quasi cy pres* doctrine.

2. As a practical matter, a charitable not-for-profit which amends its purposes will generally be allowed to expend monies raised after approval of the amendment on the amended purposes, but it will not be authorized to expend

monies raised for its initial purposes on its amended purposes.

G. It is not clear whether changes in a not-for-profit's certificate of incorporation that leave the "purposes" clause of the certificate intact but that may work a *de facto* change in the organization's operations or purposes will require court approval.

1. In *Nathan Littauer Hospital Association v. Spitzer*, 287 A.D.2d 202, 734 N.Y.S.2d 671 (3d Dep't 2001), *leave to appeal denied*, 2002 N.Y. LEXIS 940 (N.Y. Apr. 30, 2002), two hospitals entered into an operating agreement to govern their effective merger into a common parent corporation. Each had restated their certificates of incorporation to make the parent corporation their sole member, but had retained their original corporate purposes and powers. Focusing on the literal terms of the certificates rather than their practical effect, the Third Department affirmed a lower court ruling that court approval was not required.

2. *Herbert H. Lehman College Foundation v. Fernandez*, 292 A.D.2d 227, 739 N.Y.S.2d 375 (1st Dep't 2002), on the other hand, suggested that a change in the certificate provision addressing the make-up of the corporation's board of directors *would* require court approval, although neither the purposes nor the powers of the corporation would be directly amended. The change, made via an amendment to the bylaws, was held to alter the organization's fundamental purpose from an organization supporting (and controlled by) Lehman College to an independent entity.

III. Merger and Consolidation of Not-for-Profit Corporations

A. Both mergers and consolidations involve the combination of two or more not-for-profit corporations. In general, the same rules govern mergers and consolidations.

1. In a merger, one of the constituent corporations is the surviving entity. N-PCL § 910(a)(1).

2. In a consolidation, on the other hand, two or more not-for-profit corporations combine to create a new entity. N-PCL § 901(a)(2).

3. If both merger partners are not New York organizations, the merger must satisfy the applicable laws of both states of incorporation.

B. Procedural aspects of merger and consolidation.

1. The board of each corporation must adopt a plan of merger or consolidation which states the terms and conditions of the combination and contains the other provisions required by N-PCL § 902(a).

2. If any of the combining organizations are membership organizations, the plan must be submitted to the members for approval.

   a. Notice of the meeting at which the plan will be considered must be given to each member, whether or not that member is entitled to vote. N-PCL § 903(a)(1).

   b. The plan must be approved by a two-thirds vote of the members.

C. Approval of mergers and consolidations.

1. Consistent with the procedures for other structural changes, if the merged or consolidated organization which will result is one that would have required the approval or consent of any governmental body under section 404 of the N-PCL, the merger or consolidation will require approval of that governmental body.

2. When the two organizations which are combining are Type B or C organizations, the change must be approved by the Supreme Court on notice to the Attorney General.

   a. As discussed above, the merger or consolidation will be approved if it is demonstrated that "the interests of the constituent corporations and the public interest will not be adversely affected by the merger or consolidation." N-PCL § 907(e).

   b. The Attorney General and the court will also review the internal approval process to assure that appropriate notice and other procedural safeguards are observed.

D. Upon the filing of the certificate of merger or consolidation or upon the date specified in the certificate (within 30 days of filing the certificate), the merger or consolidation becomes effective. N-PCL § 905(a).

IV. Disposition of All or Substantially All Assets

A. Sections 510 and 511 of the N-PCL require that certain procedures be followed and approvals be obtained before a not-for-profit corporation disposes of all or substantially all of its assets.

1. Determination of what constitutes "substantially all" of the assets is sometimes difficult. The N-PCL does not define this term, but the legislative history indicates that it was intended to mean "not a majority of assets . . . but so large a proportion as to be nearly all the assets and so large that the character of the corporation's activities will necessarily be changed as a result . . ." Explanatory Memorandum of the Joint Legislative Commission accompanying L.1972, c.961, § 5, quoted in *New York Nonprofit Law*, p. 240.

2. On the other hand, the Attorney General's office has generally taken the position that a sale of more than 50% of the assets would require court approval pursuant to N-PCL § 511.

B. Approval of substantial sales, as in other significant corporate events, must be by two-thirds of the members of the organization or, if it is a non-membership organization, by two-thirds of the board of directors. The members and/or the board must approve a resolution which specifies the terms and conditions of the proposed transaction. N-PCL § 510.

C. In the case of a charitable or public benefit organization (Type B or C not-for-profit corporations), a disposition of all or substantially all of the organization's assets must be approved by a justice of the Supreme Court on notice to the Attorney General. N-PCL § 511. The required elements of a petition for approval of the disposition are set forth in N-PCL § 511. In determining whether to approve the transaction, the court and the Attorney General will consider two major factors.

1. First, the organization must demonstrate that the disposition will promote the interests of the members and the purposes of the corporation.

   a. In the case of an organization which intends to keep operating for an indefinite period after the transaction, it will need to show that the programs of organization will be operated more effectively because of the disposition or that the disposition will otherwise further the purposes of the organization. *See Manhattan Eye Ear & Throat Hospital v. Spitzer*, 715 N.Y.S.2d 575 (Sup. Ct., New York County Dec. 3, 1999).

   b. If, as is sometimes the case, the disposition is part of the process of dissolving the organization, the petition must contain a showing that the disposition will indirectly preserve the charitable mission, perhaps by allowing another organization to carry on work similar to that performed by the organization.

2. Second, the organization must show that the financial terms of the sale or other disposition are fair and reasonable to the organization. Most commonly, this will involve demonstrating that the terms of the proposed disposition are at fair market value. Where an outright sale is involved, it will generally be necessary to submit a professional and independent appraisal.

3. Dispositions of all or substantially all of the assets of a Type B or C corporation that do not receive court approval are voidable. *See Rose Ocko Foundation, Inc. v. Lebovits*, 259 A.D.2d 685, 686 N.Y.S.2d 861 (2d Dep't 1999).

V. Fiscal Sponsorship

A. Fiscal sponsorship is a structural alternative to the creation of a free-standing not-for-profit organization recognized as exempt from tax under section 501(c)(3) of the Internal Revenue Code.

B. As described by Elena M. Paul, Executive Director of Volunteer Lawyers for the Arts, a fiscal sponsorship is an agreement between a 501(c)(3) organization and a

newly formed organization or time-limited project for administration of funds. These arrangements provide a temporary or permanent way for organizations or individuals to receive tax-deductible contributions.

VI. Dissolution of a New York Not-for-Profit Corporation

A. Dissolution is the procedure mandated under the N-PCL for terminating the corporate existence of a New York not-for-profit. Although the procedure is a complicated one, it is the most advantageous course for an organization which faces a lack of funding, staffing, or motivation to continue to pursue the organization's mission.

B. Most not-for-profit organizations dissolve pursuant to the "non-judicial dissolution" procedures set out in Article 10 of the N-PCL. Despite the implication of the name, these procedures require at least one trip to court. In the case of dissolving organizations with assets, two court proceedings are required.

1. First, the board of directors must adopt a plan for the dissolution of the corporation and the distribution of its assets. N-PCL § 1001(a). If the corporation has voting members, the plan must be approved by two-thirds of the members. N-PCL § 1002(a)

2. All not-for-profits must obtain the consent of the State Tax Commission in order to dissolve. N-PCL § 1004.

3. Not-for-profit organizations whose incorporation was required to be approved by a government agency must obtain the approval of that agency to dissolve. N-PCL § 1002(c). Thus, a not-for-profit school, chartered by the New York Board of Regents, would be required to obtain the consent of the Board of Regents in order to dissolve.

4. Type B or Type C not-for-profit organizations, as well as any corporations holding assets to be used for a specific purpose, must obtain approval of the plan of dissolution from the Supreme Court on notice to the Attorney General's office. Type B or Type C organizations which have no assets to distribute, however, need not obtain approval of the plan itself. N-PCL § 1002(d).

C. In certain situations, dissolution of a not-for-profit organization will be initiated by court petition rather than by a plan of dissolution. This procedure, known as judicial dissolution, is governed by title 11 of the N-PCL.

1. If the organization is insolvent or dissolution will be beneficial to the members, the majority of directors or members may petition for judicial dissolution. N-PCL § 1102(a)(1).

2. If the directors or members are so divided respecting the management of the corporation's affairs that the organization cannot be effectively governed, 10% of the members or any director may petition for dissolution. N-PCL § 1102(a)(2).

3. In any judicial dissolution proceeding, the Attorney General is a necessary party. N-PCL 1102(b). In addition, the Attorney General has authority to commence an action to force the involuntary judicial dissolution of a corporation. The Attorney General must show that the corporation procured its formation through fraudulent misrepresentation or concealment of a material fact, exceeded its lawful authority to act, or engaged in persistent fraud and illegality. N-PCL § 1001.

D. Application of the *quasi cy pres* doctrine. In supervising the dissolution of Type B and Type C corporations, as well as the disposition of any restricted gifts held by a dissolving organization, the Attorney General and the Supreme Court must apply the doctrine of *quasi cy pres* to assure that any assets remaining after the payment of debts be distributed to organizations with "substantially similar activities." N-PCL 1005(a)(3)(A).

1. *In re Multiple Sclerosis Service Organization*, discussed above in Section I, the Court of Appeals distinguished the *quasi cy pres* standard from the more restrictive common law standard. It also defined the factors to be considered in evaluating whether a proposed distribution of a dissolving organization's assets met the *quasi cy pres* standard.

   a. The source of the assets to which the doctrine is to be applied was

held to be an important consideration in assessing the disposition of an organization's funds. The Court found expressions of donative intent in gift instruments or representations made by the organization in requests for funds to be significant in determining the appropriate recipients of the funds.

b. The corporation's powers and purposes, as expressed in its certificate of incorporation, are critical factors, especially since funds donated without restrictions or specific representations as to use will be considered to be donated for the organization's general corporate purposes.

c. The actual activities and charitable programs of the organization are of paramount importance, in view of the statutory language requiring distribution to organizations with substantially similar activities to the dissolving organization.

d. Similarly, the relationship of the activities and purposes of the proposed distributees to those of the dissolving corporation must be carefully considered in determining whether the *quasi cy pres* standard has been met.

e. The recommendation of the governing board of the organization and the reasons for that recommendation, as discussed above, should be given substantial deference, given the emphasis in the N-PCL on the critical importance of board management of not-for-profit corporations, both with respect to dissolution and in general.

2. This *quasi cy pres* doctrine is consistent with the federal tax law requiring that, upon dissolution of a 501(c)(3) organization, all assets be transferred to another 501(c)(3) organization. Indeed, certificates of incorporation of tax-exempt organizations must include a provision restricting the distribution of assets upon dissolution.

E. Effectuating the distribution of assets and dissolution

1. Once the plan of dissolution is authorized (and, where approval is required, approved) and all assets have been distributed in accordance with the plan, the organization must file a financial report (generally the Form 990) showing a "zero balance" with the Attorney General's Charities Bureau. This requirement is imposed administratively by the Attorney General's office and is not specifically mandated by the N-PCL.

2. Thereafter, a certificate of dissolution may be filed with the Secretary of State. In the case of a Type B or Type C organization, or an organization holding restricted assets, the filing of the certificate must be approved by the Supreme Court on notice to the Attorney General. N-PCL § 1003(b)(2)

3. The dissolution of the corporation is effective upon the filing of a certificate of dissolution with the Department of State. N-PCL § 1004.

4. After dissolution, the corporation may not carry on any activities except for the winding up of its affairs, chiefly the payment of its liabilities. N-PCL § 1005.

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Stolen Art

By Robert L. Moshman

A work of art may be the most valuable asset in an estate. Yet one who possesses an artwork may not have legal title to it. And for tax purposes, the beneficial use of stolen art can be included in an estate even if the stolen art has been reclaimed by the rightful owner. However, the few cases on point leave a great deal to be desired. Let's review some of the potential estate-planning issues raised by stolen property.[1]

The Stolen Art Epidemic

After narcotics and illegal arms trading, the stolen art market is the next largest illegal industry. Worldwide art losses range from $2 billion to $6 billion each year. Consider the quantity of art theft that a single prolific thief is capable of.

Stéphane Breitwieser, living in Strasbourg, France, recently confessed to stealing 239 pieces of art worth $1.4 billion from European museums over a six-year period. Upon Mr. Breitwieser's arrest, his mother dumped 109 stolen vases and musical instruments in a canal and cut the paintings into little pieces which she put into her sink disposal and the trash.

In recent years there have been many brazen thefts from public institutions. Two van Goghs and a Cezanne were taken from the National Gallery of Modern Art in Rome. Two more van Goghs were taken from the van Gogh museum in Amsterdam. In New York, a painting by Salvador Dali worth more than $175,000 was stolen from Riker's Island Prison. An entire group of paintings worth $200 million were taken from a Boston museum.

The Scream, by Edvard Munch, was stolen from the National Gallery of Norway. (It has since been recovered.) Other recent thefts took place in Switzerland, the Netherlands, Brazil, and Spain.

To counter an epidemic of Italian art thefts, Italy issued a catalog of 1,500 stolen art treasures: *L'Opera Da Ritrovare (Works to Recover)*. A central Web site, Provenance Internet Portal, is expected to link sites listing thousands of lost works.[2]

Nazi Art Seizures: A two-year study by a blue-ribbon panel resulted in a report that exceeds 300 pages but which can only scratch the surface of what is estimated to have been looted by the Nazis between 1933 and 1945. Over 600,000 important works of art were seized by the Germans. Between 10,000 and 100,000 museum-quality works of art remain unaccounted for.

"After narcotics and illegal arms trading, the stolen art market is the next largest illegal industry. "

Artwork seized by the Nazis can end up in litigation whenever it surfaces. Thus, paintings by Egon Schiele that were stolen by the Nazis were seized after being shown at a New York museum. A 400-year-old painting by a Dutch artist was allegedly looted by the Nazis from the family of a Polish prince, sold by an art dealer in the 1950s and inherited by a Cornell geology professor. When the painting was listed for auction by Sothebys, heirs of the Polish prince found out and sued the geology professor. The assumption of good title, even after 40 years, can be dangerous.

Antiquities: Ownership of antiquities has been challenged as nations try to recover artifacts that are illegally smuggled from archeological digs and sold to wealthy investors in other countries. In 2002, directors of 18 major museums issued a statement justifying the retention of art because they "have become part of the museums that have cared for them, and by extension part of the heritage of the nations which house them."

Nevertheless, Greece would like to reassemble the Parthenon, but many slabs of the marble were removed by Lord Elgin to the British Museum in 1801. Other pieces reside in the Louvre and several other museums. Egypt has demanded the return of objects taken from the pyramids. Turkish authorities battled billionaire William Koch, who allegedly paid $3 million for an ancient trove of coins including 12 of the 30 known silver decadrachmas. The coins had been buried for 2,400 years. (Peasants who found the coins with a brand-new metal detector tried to sell the coins. They ended up paying $80 fines and spending a year in jail.)

Heinrich Schlieman, a German archeologist, found 300 pieces of gold jewelry that he believed

were from ancient Troy. These were looted during the fall of Berlin at the end of World War II. The objects only recently have resurfaced in the Pushkin museum in Moscow.

The Meador Case

During the waning days of World War II, the priceless treasures stored at the church of Quedlinburg, Germany, were relocated to a mushroom cave outside of town. When the American army arrived, a soldier named Joe Meador "liberated" about a dozen religious art treasures and manuscripts.

Joe Meador passed away in Texas in 1980. In the years that followed, Meador's heirs sold a number of the ancient manuscripts, including one that was sold for $3 million. In 1990, the authorities in Quedlinburg caught up with the Meador heirs and paid them $2.75 million for some of the remaining artworks and manuscripts. Meador's brother and sister were charged with possession of $100 million of stolen property, but criminal charges were later dismissed.

No estate tax return was filed for Joe Meador's estate based on its small size. Was the stolen artwork taxable as part of his gross estate? Yes. The decedent possessed the use and economic benefits of the stolen property. Valuation under section 2031 was based on what any willing buyer, including buyers from the "illicit market," would have paid at the time of Meador's death. No estate tax deduction was permitted for claims subsequently made for the property because the estate had closed, the statute of limitations had run, and such claims resulted from the entrepreneurial activities of the heirs, not the decedent.[3]

Valuation Issues

An estate containing an extremely valuable work of art that is potentially stolen has several critical valuation issues. First, if the title to the stolen object is defective and is successfully challenged, the artwork may have no value. On the other hand, if a valuable work of art is included in an estate, transfer taxes may be triggered. Liquidity may also be a major factor if there is a limited market for the work of art. Equitable distribution of an estate among various heirs must allow for the range in an artwork's potential value.

From a tax perspective, section 2033 was applied by the IRS in *TAM 9152005* to include the value of stolen property in the owner's estate under a theory of use and benefit of the property. Specifically, under Texas law, the owner had a superior right to the property than anyone other than the party from whom the property was stolen.

Contraband: Similar reasoning was applied to the valuation of illicit drugs. A drug dealer was killed when he crashed a plane full of 662.5 pounds of marijuana into a tree. For purposes of the drug dealer's estate tax liability, the marijuana found on the plane was valued at its fair market value in the jurisdiction where the plane crashed. Forfeiture of the contraband did not qualify for an estate tax deduction.[4]

It is unusual to have a brace of TAMs arrive simultaneously for stolen and illegal assets. It is unusual that 12 years later, those two TAMs are the only official position that has been taken. But most unusual of all is the apparent weakness of both decisions.

In *TAM 9152005,* the IRS said the decedent's heirs use of the property for 10 years could be valued using standard valuation tables. As a term of years, the heirs enjoyed a value of 55.8% of the property's fair market value. But this analysis cannot withstand much scrutiny. At the time of the decedent's death, it was not known how long the heirs would retain the property before being caught—the ten years was only determined after the fact. More significantly, fair market value is what the market will bear for full ownership rights, so the limited right to use property should be valued far lower.

As for *TAM 9207004,* there is reason to base the value of the illicit goods on wholesale prices in the market where they would usually be sold. Thus, where a taxpayer purchased a large quantity of uncut gems at a low price, the Tax Court barred him from claiming a charitable deduction based on retail prices.[5]

Recovery of Stolen Objects

A thief can never convey good title. No amount of good-faith transfers can clear the tainted title. Nor are claims time-barred by statutes of limitations because courts are sympathetic to the difficulty of tracing stolen art.[6]

Certain courts have required those asserting ownership of a stolen object to exercise due diligence in attempting to locate the object. Yet the New York Guggenheim Museum's failure to report a theft or attempt to locate a painting for 20 years did not preclude a legal action to recover the painting. In jurisdictions that have a replevin law, a statute of limita-

tions may start to run once a stolen work of art has been (or should have been) located.

Collectibles Checklist

- **Inventory:** A list identifying all art objects in a collection.
- **Title:** Document ownership. Unlike assets governed by the Uniform Commercial Code or title insurance, the title of art and collectibles may be far less certain. Hidden ownership claims may result in liability to executors for defects in title. Executors, trustees and attorneys have a responsibility to assess the assets and liabilities of an estate. A reasonable investigation of an art object's title must be documented to demonstrate the owner/collector's good faith. Many registries of stolen art now exist and must be reviewed in establishing title.
- **Appraisal:** The value of the object must be established for insurance and tax purposes, not to mention marketing an asset and securing an appropriate sale price. Even if an asset is to be distributed by will to a family member, an appraisal is needed to establish an equitable basis for distribution of assets to other family members.
- **Insurance:** A collectible should be insured along with any other valuable assets.
- **Security:** Assets should be stored in a manner that prevents theft as well as environmental damage from light, temperature, dust, etc.
- **Disposition:** Collectors form extremely strong attachments to their prized possessions. Lifetime gifts or testamentary dispositions of such assets must be treated as one of the primary goals of an estate plan.
- **Tax Ramifications:** A planner should be aware of key tax strategies, such as a valuation discount for a large block of an artist's art that could depress market prices. Special planning is needed for an artist's estate.[7] Charitable giving alternatives and capital gains rules are also relevant.[8]
- **Marketing/Sale:** As opposed to stock holdings that can be sold on the open market, collectibles have a limited market of buyers. Selection of a dealer or auction house is an important consideration. The timing of when to offer items for sale and whether to keep collections together or sell individual pieces must also be evaluated.
- **Advisor:** Ideally, a financial plan should utilize an independent art advisor who receives a fee rather than a commission and who is not affiliated with museums, auction houses, dealers or artists.[9]

"In jurisdictions that have a replevin law, a statute of limitations may start to run once a stolen work of art has been (or should have been) located."

Endnotes

1. Basha, *Stolen art: What estate planners and trustee need to know,* 137 T&E 13, p. 60 (Dec. 1998) (this is a comprehensive treatment with 95 footnotes); Madden, *Steps to take when stolen art work is found in an estate,* 24 EP 10, p. 459 (Dec. 1997).
2. *See* Provenance Research Project under www.metmuseum.org/collections.
3. *TAM 9152005 (1991).*
4. *TAM 9207004 (1991).*
5. *Anselmo v. Comm'r,* 80 T.C. 872 (1983), *aff'd,* 757 F.2d 1208 (11th Cir. 1985), is compared to *TAM 9207004* by William Turnier in *Estate taxation of the fruits of crime,* Probate Practice Reporter (July 1994).
6. *De Weerth v. Baldinger,* 836 F.2d 103 (diligence required); *Guggenheim v. Lubell,* 77 N.Y.2d 311, 567 N.Y.S.2d 623 (1991).
7. Moshman, *The 21st century art estate,* The Estate Analyst (July 1999).
8. Rev. Proc. 96-15 requires charitable deductions of $50,000 or more for gifts of art to be reviewed by the Art Advisory Panel. A fee of $2,500 covers the first three artworks. A provenance must be submitted for each artwork.
9. Zale & Temple, *Donations of art: They are not just appropriate for museums,* 140 T&E 4, p. 41 (Apr. 2001).

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The Stradivarius Estate

By Robert L. Moshman

One of the most unique niches of the stolen art and collectible world revolves around a small universe of original violins made by Antonio Stradivari. Between 1666 and 1737, the master craftsman made as many as 1,116 stringed instruments. About 900 of these were violins. Of these violins, there is a known universe of at least 512 and as many as 540 which are believed to exist today.

An exact count is never certain because Strads are constantly going missing or turning up all over the world. Daniel Pearl, the reporter from *The Wall Street Journal* who was slain in Pakistan, covered several of these Stradivarius capers in an October 17, 1994 article. The 1735 "Ex-Zimbalist" Stradivarius, which had been missing for 30 years, has been recently photographed in Japan . . . but is still missing. In 1951, amidst the Korean War, a genuine Stradivarius turned up in the wall of a South Korean home. "The Colossus," a unique Stradivarius violin of slightly larger size, was stolen in Rome in 1998.

> *"Many of the Strads have been stolen and recovered multiple times over the past 266 years."*

The 1732 Duke of Alcantara Stradivarius is owned by UCLA. In 1967, a member of UCLA's string quartet performed with the University's Stradivarius. What happened next isn't certain . . . but it looks like the absent-minded professor set the $800,000 Duke of Alcantara on the roof of his car before he got in and drove home.

Flash forward 20 years. Enter, amateur violinist Teresa Salvato. She had gotten a violin in a divorce settlement. It had belonged to her husband's aunt, who supposedly had stopped when mistaking the canvas-wrapped case for a baby, lying by the on-ramp to a freeway. One day, Teresa's violin teacher showed the instrument to a violin dealer and in minutes it was identified as the Duke.

Lost in New York

Anyone who is fortunate enough to inherit or acquire a Stradivarius should probably avoid New York City. Apparently, any Strad not tied down in the Big Apple will vanish in a New York minute.

A Strad worth $1.75 million was stolen from a Rolls Royce parked in New York in 1994. In 1995, virtuoso violinist Erika Morini fell ill following her final concert in New York City. The $4 million violin she had inherited from her father was stolen as she lay dying. Her family concealed the theft from her, knowing how much the news would have hurt her. A $500,000 reward has been offered. Another Stradivarius worth $3.5 million was stolen from a New York residence in 1996.

And in 2002, a rare 1714 Stradivarius, "Le Maurien," was stolen from a violinmaker's workshop on the Upper West Side of Manhattan. It was valued at $1.6 million and a $100,000 reward was offered.

The Red Violin

Many of the Stradivarius instruments take on special names, often for a famous owner. For example, "the Taft" was once owned by the brother of President Taft. The Taft was auctioned at Christies for $1.32 million in 2000. The Kreutzer Strad was auctioned for $1.6 million in 1998. Other famous Strads include the 1677 "Sunrise," the 1704 "Betts," and the 1715 "Alard," which is considered his finest of all. The 1679 "Hellier" is the most famous of the 10 surviving decorated Strads. The "Tuscan" violin of 1690 was created for Cosimo D'Medici, Grand Duke of Tuscany. And the Messiah violin of 1716, which was not played for over a century, is considered the most pristine example of the master's work. It was appraised at 10 million pounds, which is currently worth $15.7 million.

Many of the Strads have been stolen and recovered multiple times over the past 266 years. For instance, the 1713 "Gibson" Stradivarius was twice stolen from Polish virtuoso Bronislaw Huberman. It was stolen from Huberman's hotel room in Vienna in 1919, but was soon recovered. It was stolen a second time from Huberman's dressing room during his only Carnegie Hall performance of 1936. He collected $30,000 from Lloyd's of London.

A 20-year-old thief kept the instrument for half a century and confessed on his deathbed. His wife received a $263,000 finder's fee from Lloyd's of London. In 1996, the Connecticut Supreme Court ruled

that the $263,000 should have been included in the thief's estate and inherited by his only heir, his daughter. By then, however, the thief's wife had exhausted all of the money. Lloyd's sold the Gibson Strad in 1988 for $1.2 million.

> *"There are literally tens of thousands of knockoffs and imitations of the Stradivarius violins that are in circulation."*

It was a case of life imitating art when the Gibson was recently purchased by a young superstar violinist, Joshua Bell, for $4 million. Bell had played the violin for the sound track of "The Red Violin," a movie following a violin through the lives that it touches. As the owner of one of these slippery violins, Mr. Bell would be wise to keep his violin close at hand . . . and steer clear of New York.

Don't Be Disappointed . . .

. . . when someday you get an excited call about someone finding a Stradivarius in an aunt's attic or a yard sale. It is very, very unlikely to be the real thing. There are literally tens of thousands of knockoffs and imitations of the Stradivarius violins that are in circulation. Not only have there been innumerable handcrafted forgeries over 266 years, but there have been unabashed mass productions with factories operating in several countries. The 1902 Sears catalogue even offered two Stradivarius models, one for $2.45 and one for $6.95.

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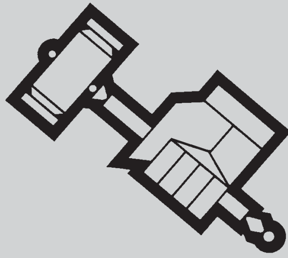

RECENT NEW YORK STATE DECISIONS

Ira Mark Bloom and William P. LaPiana

ATTORNEYS AND CLIENTS

Contingent Fees—Retainer Agreement Not Required; Increase in Value of Property Not Part of Recovery

Executor hired attorney to bring a legal malpractice action against former counsel for estate in connection with mortgage foreclosure actions brought on behalf of the estate. Attorney charged the executor $2,000 for an opinion letter and executor and attorney entered into a contingent fee arrangement under which the attorney's fee was to be one-third of any recovery, whether received in cash or property. The malpractice action settled. Attorney received one-third of the cash received in the settlement but also claimed one-third of the value of the property subject to the mortgages. Reversing the Surrogate, the Appellate Division held that there was no need to have filed a retainer statement under N.Y.C.R.R. 691.20(a)(1) because the legal malpractice claim was not one for personal injury, property damages or for death or loss of services resulting from personal injuries. However, the attorney was not entitled to any part of an increase in the value of property already in the possession of the estate; the property was not part of a "recovery." Cause remitted to Dutchess County Surrogate's Court for a determination of whether one-third of the cash proceeds is reasonable compensation under SCPA 2110. *In re Seigel*, 300 A.D.2d 668, 754 N.Y.S.2d 300 (2d Dep't 2002).

ADMINISTRATION OF ESTATES

Accounting—Filing of Estate Tax Return Does Not Start Limitations Period

Daughter brought an action to compel her mother to account as executor of her father's will, the gravamen of the action being the executor's failure to fund a residuary trust of which daughter was a remainder beneficiary. Mother as executor moved to dismiss the action alleging that the six-year statute of limitations on accounting actions had run (CPLR 213(1)) and that petitioner was barred by laches. The Surrogate dismissed the motion and the Appellate Division affirmed, holding that the filing of the federal estate tax return showing that there were no assets to distribute to the residuary trust was not an open repudiation of the executor's fiduciary obligation sufficient to start the running of the limitations period or to invoke laches. *In re Meyer*, 303 A.D.2d 682, 757 N.Y.S.2d 98 (2d Dep't 2003).

Distributees—Posthumous Proof of Paternity

Purported non-marital sons of decedent commenced proceeding to revoke letters of administration issued to decedent's daughter on the ground that she had not obtained jurisdiction over them in the administration proceeding. The sons moved to obtain alleged samples of the decedent's blood serum held by the New York Firefighters Skin Bank in connection with a donation of decedent's skin made shortly after death. Agreeing with *In re Bonanno*, 192 Misc. 2d 86, 745 N.Y.S.2d 813 (Sur. Ct., N.Y. Co. 2002), the Surrogate stated that posthumous genetic testing can be used to establish paternity under EPTL 4-1.2(a)(2)(C), indicating that the need to ascertain the decedent's heirs must be weighed against the need to maintain confidentiality of anatomical gifts. The motion was denied, however, pending resolution of issues pertaining to the chain of custody of the blood serum samples. The court also indicated that it would not rule on the admissibility of the genetic evidence until the petitioners could establish the first prong of the EPTL 4-1.2(a)(2)(C) test, that the decedent "openly and notoriously acknowledged" the petitioners as his children. *In re Seekins*, 194 Misc. 2d 422, 755 N.Y.S.2d 557 (Sur. Ct., Westchester Co. 2002).

PENSIONS

Waiver—QDRO Can Be Effective Waiver

In accord with the divorce decree, Dr. Robert Silber designated his ex-wife as a 50% beneficiary of his TIAA-CREF pension plan should he die before retirement. After he remarried, he named his new wife as the beneficiary of the remaining 50%. After his remarriage and at his ex-wife's insistence, Dr. Silber, his wife and his ex-wife entered into a QDRO assigning to first wife as her sole property a new annuity

created from a lump sum transfer of 45% of Dr. Silber's pension accumulations. All parties waived all other interests in each other's "estates." Silber never changed the beneficiary designation on file with TIAA-CREF so that when he died before retirement, his wife and ex-wife were still listed on the plan's records as 50% beneficiaries.

TIAA-CREF properly paid 50% of the funds to Silber's widow but withheld payment of the other 50% pending the outcome of this case. In an action by the widow-executor, the Court of Appeals held that federal common law determines whether the QDRO acted as a renunciation of the ex-wife's rights to the pension plan, that under federal common law her waiver was "explicit, voluntary and made in good faith," and that therefore it was an effective waiver. Thus, the widow was also entitled to the disputed 50%. *Silber v. Silber*, 99 N.Y.2d 395, 786 N.E.2d 1263, 757 N.Y.S.2d 227 (2003).

TRUSTS

Assets of Trust—Valid Assignment of Mortgage Bars Will Provision Forgiving the Debt

Decedent made a loan to her granddaughter to enable her to buy real property. Eventually granddaughter gave decedent a mortgage on the property. Decedent assigned the mortgage and the note secured by it to her revocable trust which became irrevocable by amendment a few weeks after granddaughter sold the property. According to its terms, the note became due and payable at the time of sale, but granddaughter did not repay the note nor did the trustees of decedent's trust demand payment. Decedent's will forgave any amount owed to her at death by the granddaughter. The Appellate Division affirmed the Surrogate's finding that the mortgage and note were assets of the trust, because the assignment was a valid assignment of both the note and the mortgage. Since neither the note nor the mortgage were probate property, the provisions of the will were not applicable to them. Thus, the granddaughter was held liable to discharge her debt due to the trust. *In re Stralem*, 303 A.D.2d 120, 758 N.Y.S.2d 345 (2d Dep't 2003).

WILLS

Contractual Wills—Required Writing Need Not Be in One Document

In a miscellaneous proceeding to determine the effect of a 1966 letter on decedent's 1983 will, the Surrogate imposed a constructive trust to benefit the beneficiaries of an oral agreement between decedent and her first husband in which she promised she would make a will under which the estate would eventually pass to their grandchildren. It also imposed a constructive trust in favor of the decedent's son.

After her husband died in 1963, the decedent executed a will in 1964 that carried out the terms of her oral agreement to dispose of property by will in favor of the couple's grandchildren. In 1966, decedent wrote a signed letter to her son that memorialized the agreement and also promised the son that she would not revoke the 1964 will. Decedent revoked her 1964 will by her 1983 will.

On appeal by the beneficiaries of the 1983 will, the Appellate Division affirmed, holding that the statutory requirement (Personal Property Law 31[7], now EPTL 13-2.1(a)(2)) that agreements regarding wills be in writing was satisfied by the 1964 will and the 1966 letter. There is no requirement that the terms of the agreement be set forth in a single writing. The court also noted that the decedent's renunciation of her freedom of testamentary disposition was "clearly and unambiguously delineated in the 1966 letter." *In re Urdang*, A.D.2d , 758 N.Y.S.2d 125 (2d Dep't 2003).

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Professors Bloom and LaPiana are the current authors of Bloom and Klipstein, *Drafting New York Wills* (Matthew Bender) (Bloom as principal author; LaPiana as contributing author).

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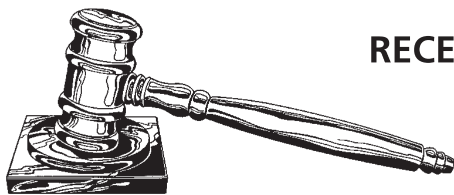

CASE NOTES— RECENT NEW YORK STATE SURROGATE'S AND SUPREME COURT DECISIONS

Ilene Sherwyn Cooper and Donald S. Klein

Application to Vacate Default Granted

In a contested probate proceeding, application was made by the decedent's daughter to vacate her default and file objections to specific provisions of the propounded will based upon fraud and undue influence. After a fact-finding hearing, the Court granted the petitioner's application.

To vacate a probate decree granted on default, a party must show: (1) a valid excuse for the default; (2) facts sufficient to afford a substantial basis for the contest and a reasonable probability of success on the merits; and (3) lack of prejudice to the opposing party.

Within this context, the Court found that the petitioner had presented a valid excuse for her failure to appear in the probate proceeding; specifically, that she did not understand the nature and/or import of the waiver and consent, citation and ultimate admission of the propounded will to probate. Additionally, the Court noted that the five-month period between the probate decree and the application for vacatur was relatively short.

Further, the Court concluded that the petitioner had demonstrated the existence of possible meritorious objections to probate, given the confidential relationship between the proponent and the decedent, the decedent's physical infirmities, and the proponent's involvement in the decedent's financial affairs.

Finally, the Court found that there would be no prejudice to the estate's administration by the vacatur of the probate decree. *In re Estate of Grillo*, N.Y.L.J., Apr. 9, 2003, p. 27 (Sur. Ct., Westchester Co., Surr. Scarpino)

Common Law Marriage

In a proceeding instituted for the revocation of letters of administration, the issue before the Court was whether the petitioner was the decedent's common law spouse. The petitioner alleged that he and the decedent had entered into a common law marriage in the state of Pennsylvania, and that they lived in both Pennsylvania and New York as husband and wife. Petitioner maintained that he and the decedent declared their intention to be married at a social gathering in the state of Pennsylvania, and thereafter, they held themselves out as husband and wife.

At the trial of the matter, the petitioner called two witnesses to the stand who each testified that while at a party in the state of Pennsylvania the decedent and petitioner stood amongst their friends and recited words to each other to the effect that they took each other as husband and wife. The Court found this testimony to be credible and persuasive of the existence of a common law marriage between the parties. The Court deduced that the reason that the decedent and the petitioner never discussed marriage subsequent to this event was because they in fact considered themselves married without the need for a formal ceremony.

Unlike other cases in which common law marriage was alleged, the case at bar presented the situation where the words of marriage exchanged between the parties were witnessed, and for several years thereafter until the decedent's death the parties held themselves as husband and wife.

Accordingly, the relief requested by the petitioner was granted. *In re Estate of Catapano*, N.Y.L.J., June 3, 2003, p. 23 (Sur. Ct., Suffolk Co., Surr. Czygier).

Construction of Will

In an uncontested proceeding, the executor under the decedent's will requested the Court to determine whether the disposition to her represented an administration expense or a bequest. Because the estate was insolvent, the character of the disposition would determine whether it was subject to abatement.

The provision in issue provided, in pertinent part, that if the named executor was employed by the decedent at the time of the decedent's death, that she be employed by the decedent's estate, in addition to her services as executor, to assist the estate in vacating her apartment, for a period of not less than eight weeks at a salary of not less than $2,000 per week.

The record revealed that the executor was in the decedent's employ at the time of her death, earning a weekly salary of $1,000.

The Court found that although a testator may prescribe compensation for an executor in excess of statutory commissions, that did not appear to be the case with respect to the will in issue. Rather, the Court determined that the $16,000 disposition was simply a gratuity for a faithful employee, subject to abatement. *In re Estate of Rapp*, N.Y.L.J., Feb. 26, 2003, p. 23 (Sur. Ct., N.Y. Co., Surr. Preminger).

Contract—Exercise of Option

At issue before the Court was the exercise of an option pursuant to a shareholder's agreement between the decedent and the petitioner. Specifically, the agreement granted the petitioner the option to purchase all of the shares of the decedent for $1,000, and stated that it would be binding on the heirs, successors, and assigns of the decedent.

At the time of the decedent's death, the option had not been exercised. One month after the decedent's death, the petitioner sought to exercise his option pursuant to the said agreement with the decedent. The decedent's estate maintained that the option could only be exercised during the decedent's lifetime, and therefore, the petitioner's untimely exercise was invalid.

The Court determined that the agreement was clear and unambiguous in its terms, and specifically indicated that it was binding upon heirs, executors, and assigns of each party. Further, the Court concluded that if the decedent intended for the option to be exercised only during his lifetime, there would have been included in the agreement language to the effect that the option terminated upon death.

Accordingly, the Court concluded that the petitioner's exercise of his option was valid. *In re Estate of Berman*, N.Y.L.J., Apr. 17, 2003, p. 25 (Sur. Ct., Richmond Co., Surr. Fusco).

Conveyance of Real Property Directed

By decision and Decree, the Court awarded title to four properties to The Carvel Foundation. The Decree expressly directed that within twenty days after service of the entry of the Decree, the respondent was to execute and deliver to the Foundation deeds and related documents conveying the premises, which were in New York and Florida. Respondent failed to deliver the deeds, thus provoking an application directing the Sheriff to convey the property. As to the New York property, the Court granted the application, pursuant to the provisions of CPLR 5107 and RPAPL 221, finding, in particular, that the Foundation had paid $270,000 in real estate taxes in order to protect the properties from foreclosure, and that the respondent had failed to advance any valid reason for its refusal to comply with its directives. As to the Florida properties, the Court directed that the appropriate application be made in the state of Florida to effectuate its rulings. *In re Estate of Carvel*, N.Y.L.J., Apr. 9, 2003, p. 27 (Sur. Ct., Westchester Co., Surr. Scarpino).

Due Execution

In an uncontested probate proceeding, the propounded will consisted of five pages. The attesting witnesses signed in pages three and four of the instrument; the testator signed on pages one, two, four and five. Subsequent to the testator's signature, there followed a disposition of two items of tangible personal property.

The Court admitted the first four pages of the will to probate as the will of the decedent, but denied probate to page five of the instrument on the grounds that the dispositions set forth thereon were not followed by the signature of the testator and the witnesses. *In re Estate of Morfogenis*, N.Y.L.J., June 9, 2003, p. 33 (Sur. Ct., Kings Co.).

Examination of Corporate Officers

In a discovery proceeding, the petitioner moved for an order granting leave to examine a corporate respondent by an employee and for an order compelling the production of documents.

The proceeding before the Court sought the return of assets allegedly converted from a brokerage account by an employee of the investment firm. Both the employee and the investment firm were respondents, the petitioner alleging, in particular, that the investment firm's supervision of its employees did not meet industry standards.

The corporation produced its chief investment officer for a deposition; however, the officer lacked knowledge of the corporation's supervision of its employees' personal financial transactions with clients. Consequently, the petitioner sought to depose an officer who had knowledge of the corporation's compliance procedures.

Although a corporation has the prerogative to initially select an employee for a deposition, the adverse party is entitled to depose additional employees if the witness lacks the requisite knowledge. Accordingly, the petitioner's motion to examine the corporation by an employee with knowledge was granted.

Further, the Court granted the petitioner's request to examine the internal compliance manuals of the corporation, finding that such manuals could be used to demonstrate that the corporation did not comply with its own standards. *In re Estate of Fergo*, Decision No. 331, June 26, 2003 (Sur. Ct., Nassau Co., Surr. Riordan).

In Terrorem Clauses

The income beneficiary of a trust sought the appointment of a fiduciary with limited and restricted letters to pursue proceedings against the trustee and her husband to recover estate assets or income rightfully belonging to the trust. In opposition, the trustee claimed, *inter alia*, that the petitioner lacked standing to seek the relief based upon the in terrorem clause contained in the decedent's will.

In support of her position, the trustee relied upon the decisions in *In re Cook*, 244 N.Y. 63, and *In re Ellis*, 252 A.D.2d 118, neither of which the Court found applicable. As compared to the case before it, the Court noted that each of these cases involved a situation in which objections to probate were filed or were sought to be filed. The petitioner in the case at bar was not seeking to contest the will, in fact, the will had long ago been probated, but instead, was seeking multiple relief against the fiduciary for breaches of fiduciary duty.

The Court found that under such circumstances the in terrorem clause would not be triggered. The Court concluded that it was disingenuous for the trustee to contend that the decedent intended that she serve as trustee even if she violated her obligations under the trust. Indeed, even if the decedent had such an intent, such a broad in terrorem clause would be void as against public policy of New York.

Accordingly, based upon the record, the Court determined that there was a need for the appointment of a fiduciary for the purposes set forth in the petition, and granted the relief sought by the petitioner. *In re Estate of Rimland*, N.Y.L.J., June 5, 2003, p. 25 (Sur. Ct., Bronx Co., Surr. Holzman).

Jurisdiction

Application was made by the decedent's surviving spouse for an order directing his former attorneys to turn over to him funds received by them on the spouse's behalf pursuant to an order of the Court. The monies distributed to counsel represented monies payable by the estate of the decedent to the surviving spouse. Upon receipt of the funds, counsel paid over a portion of the funds to their former client, but retained the balance, claiming that it constituted the balance of their legal fees. These fees were earned by counsel in representing the surviving spouse in a criminal matter. Counsel refused to relinquish the funds, maintaining that they had a common law possessory attorneys' retaining lien.

The Court determined that it lacked subject matter jurisdiction to determine the dispute between former counsel and the decedent's surviving spouse. Specifically, the Court opined that while it had plenary jurisdiction over all matters that relate to the affairs of a decedent, it had no power to supervise personal contracts made by an individual who is not a ward of the Court. In view thereof, the dispute between the decedent's surviving spouse and counsel was found to be a matter for a court of general jurisdiction to determine. *In re Estate of Kotsopoulos*, N.Y.L.J., Apr. 3, 2003 (Sur. Ct., Nassau Co., Surr. Riordan).

Res Judicata

Before the Court was a proceeding by the successor administrator of the estate for the apportionment of estate taxes pursuant to the provisions of EPTL 2-1.8. The record reflected that the tax liability in issue was in part attributable to a determination by the IRS that a $200,000 transfer from the decedent to the respondent was a gift. Petitioner sought apportionment of taxes against the respondent claiming the transfer to be a loan rather than a gift. Notably, a prior proceeding in Supreme Court by the former administrator of the estate against the respondent to collect the $200,000 "loan" was discontinued with prejudice.

The threshold issue before the Court was whether the discontinuance of the Supreme Court action barred petitioner from now pursuing her claim against the respondent under the doctrine of collateral estoppel.

The Court found that while petitioner correctly contended that she was not a party to the Supreme Court action, she was nevertheless in privity with her former fiduciary. This being the case, the Court concluded that principles of res judicata served to bind petitioner to the actions undertaken by her predecessor, most particularly, to a judgment on the merits by a court of competent jurisdiction.

The Court further concluded that the Supreme Court action and the action before it involved precisely the same issue; to wit, whether the transfer was a gift or a loan, and that all parties were afforded an opportunity to be heard as to this issue.

Finally, the Court held that the decision by the parties to discontinue the Supreme Court action with prejudice was a determination on the merits.

Based on the foregoing, the Court dismissed the petition. *In re Estate of Marcus*, N.Y.L.J., Apr. 16, 2003, p. 23 (Sur. Ct., Suffolk Co., Surr. Czygier).

Resignation of Fiduciary

Pending before the Court were two proceedings by the executor, the first, requesting permission to sell real property, and the second, requesting permission to resign. The Court authorized the sale of the real property. As to the application to resign, the petitioner claimed that one of the estate beneficiaries had subjected him to such abuse in the administration of the estate that it affected his health.

The Court opined that even where all the parties to the estate agree, a fiduciary will not be allowed to resign if it is not in the best interests of the estate. While the Court expressed sympathy to the plight of the executor, it found that because he was the most familiar with the facts and circumstances of the estate, and the estate was near conclusion, the appointment of a successor fiduciary would serve to further delay its administration. Accordingly, the request by the executor to resign was denied. *In re Estate of Ruddock*, N.Y.L.J., Mar. 25, 2003, p. 21 (Sur. Ct., Kings Co., Surr. Feinberg).

Right of Election

The decedent died leaving a will which left half of his estate in trust for the benefit of his wife. Prior to the decedent's death, his spouse had been diagnosed with severe dementia, resulting in her being placed in a nursing home where she remained until her death, which was one year after the decedent's. Her care was paid for by the Department of Social Services who asserted a claim against her estate in the sum of $124,000.

The decedent's will appointed his nephew, who was also a beneficiary of the estate, as the executor thereof and as trustee of the testamentary trust created thereunder. He did not seek to have it probated until two years after the decedent's death. The administrator of the estate of the decedent's post-deceased spouse thereafter petitioned to exercise her right of election against his estate, claiming that the decedent's nephew intentionally delayed offering the decedent's will for probate. The executor of the decedent's estate opposed the application on the grounds that the right of election was personal to the surviving spouse and thus could not be asserted after death.

The Court agreed with the executor, concluding that although the Legislature engaged in extensive revisions of the elective share statute in order to enhance the rights of a surviving spouse, it stopped short of making the spouse a forced heir. Indeed, the Court noted that while the Legislature afforded added protections to incompetent spouses so that their right of election could be preserved despite their incapacity, it emphasized that the right was personal to the spouse.

Nevertheless, in view of the allegations of fraudulent conduct made against the executor, whom the Court found "conflicted" in the fulfillment of his duties, the administrator of the surviving spouse's estate was afforded the opportunity to inquire as to whether he intentionally delayed probate of the will, and if so, to request imposition of a constructive trust upon the estate to the extent of the elective share. *In re Estate of Wurcel*, N.Y.L.J., June 3, 2003, p. 20 (Sur. Ct., N.Y. Co., Surr. Preminger).

Sealing of Court Records

Subsequent to the settlement of a miscellaneous and probate proceeding, counsel for certain parties moved to seal the court file and records on the basis of a settlement agreement and confidentiality agreement among the parties, and the overriding privacy interest of the litigants.

Citing the provisions of Rule 216.1, the Court noted that public policy favors the disclosure of court records. Confidentiality is the exception, rather than the rule, and the Court is required to make an independent judgment of whether "good cause" has been established for sealing records, even where the parties have entered into a confidentiality agreement.

Based upon the foregoing, the Court determined that the allegations set forth in the subject proceedings were not unique, either with respect to the parties or the decedent. Accordingly, the motion was denied. *In re Estate of Chambers*, N.Y.L.J., June 18, 2003, p. 25 (Sur. Ct., Suffolk Co., Surr. Czygier).

Three Year/Two Year Rule

Before the Court was a motion for an order compelling a witness to answer questions at an examination pursuant to SCPA 1404.

The decedent died with a will and a codicil. The codicil changed the named executor of the will to a corporate fiduciary as well as amended several dispositive provisions. Respondents alleged that the codicil was the product of undue influence.

At the SCPA 1404 examination of the named executor under the codicil, counsel instructed the witness not to answer questions concerning the history of litigation between his company and the decedent. Counsel argued that the questions were beyond

the scope of UCR 207.27. Respondents argued that the litigation between the named executor and the decedent spanned approximately 30 years, and that the decedent would never have selected the company to serve as executor but for possible undue influence.

Although the Court recognized that UCR 207.27 limits examinations conducted pursuant to SCPA 1404 to the period three years prior to the date of the instrument and two years thereafter or to the date of the decedent's death, whichever is shorter, it also noted that the rule can be extended in special circumstances most commonly where there is a scheme to defraud or a continuing course of conduct resulting in undue influence. Although respondents did not charge the named corporate fiduciary with undue influence in procuring the codicil, they did contend that the adverse relationship between the company and the decedent led to an inference that undue influence was perpetrated by a beneficiary under the propounded codicil. The proponents argued that respondents' contentions of undue influence were purely speculative.

The Court found that the propounded codicil was a departure from the decedent's prior testamentary instrument, that it was executed in close proximity to the decedent's death, and that the attorney-draftsman had no direct communication with the decedent regarding its contents. These circumstances, it held, created a suspicion of undue influence to warrant extension of the 3 year/2 year rule, the Court opining that "[d]iscovery should not be foreclosed because Respondents' argument rests upon the probability, not certainty, that the decedent would not have selected [the corporate fiduciary to serve.] Accordingly, the motion was granted. *In re Estate of Martin,* N.Y.L.J., Mar. 12, 2003, p. 21 (Sur. Ct., Nassau Co., Surr. Riordan).

Valuation of Life Estate

The decedent and her husband owned a home as tenants-in-common. The decedent left her husband a life estate in her share of the premises. A prior decision of the Court authorized the husband to sell the property. The house was sold and the proceeds placed in escrow. The issue before the Court was whether the life tenant was entitled to receive a sum in gross, i.e., the present value of the life estate upon the sale of the life tenant's and remaindermen's interest in the property, or whether the life tenant was entitled only to the income generated from the investment of the proceeds from the property sale.

Pursuant to section 968 of the Real Property Actions and Proceedings Law, the owner of a particular estate shall be entitled to receive a sum in gross unless the court finds that unreasonable hardship is likely to be caused thereby to the owner of some other interest in the affected real property.

The Court found, despite the paucity of case law on the subject, that payment of a gross sum will be allowed where the "withdrawal of the value of the life estate will leave a balance which, with accumulated interest over the period of the life tenant's expectancy, will restore the fund to its present corpus for the remaindermen." *Mosher v. Wright*, 200 Misc. 792; *Jermaine v. Sharpe*, 29 Misc. 258; *Wood v. Powell*, 3 A.D. 718. Thus, for example, if the remainderman showed that the payment of a gross sum would defeat the testator's intent, or that the life tenant would only survive for a short period, the application would be denied.

The Court concluded, based on the record, that the executrix had failed to show that unreasonable hardship by the granting of the relief sought. Accordingly, the Court directed that the life tenant be paid a sum in gross representing the value of his life estate. *In re Estate of Sauer*, N.Y.L.J., Mar. 25, 2003, p. 22 (Sur. Ct., Nassau Co., Surr. Riordan).

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