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Trusts and Estates Law Section Newsletter

A publication of the Trusts and Estates Law Section of the New York State Bar Association

A Message from the Section Chair

Greetings from New York State, your winter wonderland. Despite the wintry weather, our Section was warmly received at our Annual Meeting on January 22 at the Marriott Marquis in Times Square. Once again, our Section's attendance far exceeded that of all other Sections, which is a tribute to all of those persons who contributed to the program's success.

Eileen Caulfield Schwab chaired the program entitled "Estate Planning in a Low Interest Environment" and she assembled a panel from among the nation's leading experts including **Carlyn S. McCaffrey**, **of Weil, Gotshal & Manges, LLP**, President of the American College of Trust and Estate Counsel, who spoke on Charitable Lead Trusts; **Professor Pamela Champine of New York Law School**, who addressed GRATS, Private Annuities and Sales to Defective Grantor Trusts; **Edward Falk of Sabin, Berman & Gould, LLP** who explained the latest on split-dollar insurance; and **Kathryn Grant Madigan, of Levene, Gouldin & Thompson, LLP**, who presented an update on New York State laws enacted during 2002. Our luncheon speaker, **John F. Rausch, Estate and Gift Tax Manager for the Internal Revenue Service in its Albany District Office**, shared his observations from his unique perspective concerning recent developments in valuation discounts of interests in Family Limited Partnerships and similar entities. Thank you to all who participated for a superb program.

We also owe much gratitude to **Anne Tatlock, Chairman and CEO, Jim Goodfellow, Gail Cohen, Murray Stoltz** and **Ellen Kratzer** and everyone at **Fiduciary Trust International** for hosting a sumptu-

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ous and entertaining reception at its new headquarters at 600 Fifth Avenue.

Our Spring Meeting is scheduled to take place in Albany on Friday, April 25 at the Albany Marriott on Wolf Road. In addition to the regular program on Friday, which will focus on the pros and cons of probate versus testamentary substitutes, the officers have decided to offer a new feature on Thursday afternoon—a series of Discussion Tables in which experts in six general areas of our practice will lead discussions in small groups of members. Participants may come with specific questions and the moderators will also be prepared to discuss recent cases and trends. The topics are Accountings, Litigation, Surrogate's Court Practice, Will Drafting, Elder Law and Taxes. On Thursday evening we will be having a reception at the New York State Museum, which now includes the memorial exhibit for the victims of 9/11.

Our Fall Meeting this year will be at a beautiful and exciting location—the newly renovated Fairmont Empress Hotel in Victoria, British Columbia. Rated the world's second-most popular island destination by *Condé Nast* and often visited by the Royal Family, this capital city on picturesque Vancouver Island is home to the Royal British Museum, where we will be having a reception, and a pod of 70 orcas which, hopefully, will be visible but will not be hosting a reception. Please save the dates Wednesday, September 10 when we will have a reception for early arrivals through Sunday, September 14 and plan to come early and stay late to tour the beautiful Pacific Northwest.

Finally, I would like to thank our immediate **Past Chair, Arlene Harris**, not only for all of her many services to the Section during the last year and for many years, but also for being such a helpful mentor to me in preparing for the challenges which lie ahead. I hope to see you all in Albany on April 24 and 25.

Timothy B. Thornton

Editor's Message

As you know this Section is traveling to British Columbia for its Fall meeting. A summary of the topics which will be covered is included in this *Newsletter*. The topics in the program relate to current challenges of investing and administering trusts and estates. At this time two Surrogate's have agreed to be part of the program. This issue of the *Newsletter* includes articles on a similar theme. As an introduction to that theme, Georgiana J. Slade has provided a detailed article on challenges and rules for the Trustee in administering trusts in New York. Dick Rothberg discusses how to manage risks when investments are concentrated in one holding. Elizabeth Matheiu has complied a list of questions to ask when seeking investment advisors for clients.

A common part of our practice relates to proper listing of beneficiaries for IRA accounts. Seymour Goldberg has written on how to manage proper separation of accounts when there are multiple beneficiaries for IRA accounts.

Warren Whitaker has written on tax considerations of trusts created by non resident aliens for United States beneficiaries.

The problem of tax apportionment is a common one which sometimes is not recognized. The treatise included in this *Newsletter* by Michael Suprunowicz was part of the program at the Section's Fall meeting in Boston. There are many tax apportionment traps. This article should be kept as a reference.

"The problem of tax apportionment is a common one which sometimes is not recognized."

The IRS Web site now offers a section on estate and gift taxes. Besides a primer on basic taxation, it includes a "Frequently Asked Questions" area and downloadable forms for estate and gift taxes. This page can be located by going to the home page at <http://www.irs.gov>. Use the "Search IRS Site for" box and type "Estate and Gift."

As I write this column, the Section is preparing to travel to Albany for the Spring meeting. I hope to see many of you there.

Magdalen Gaynor

Upcoming Meetings of Interest

September 11-14, 2003	New York State Bar Trusts and Estates Law Section. Fall Meeting. Fairmont Empress (Inner Harbour), Victoria, British Columbia.
October 14-17, 2004	New York State Bar Trusts and Estates Law Section. Fall Meeting. Savannah, Georgia.
October 2005	New York State Bar Trusts and Estates Law Section. Fall Meeting. New Orleans, Louisiana

The Trustee in the New Millennium

By Georgiana J. Slade

A New York trustee in the new millennium is confronted with new rules governing the administration of trusts which will fundamentally change the trustee's approach to investing. The Prudent Investor Act, enacted July 26, 1994, adopts the modern portfolio theory, requiring diversification and consideration of alternative classes of investment such as private equity and hedge funds. Trustees have also traditionally been in the conflicting position of having to invest for total returns while providing accounting income. The enactment of the power-to-adjust and unitrust election have sought to help resolve this conflict for trustees. This article seeks to review some of the recent changes in New York law governing trustee administration and provide some practical guidance for trustees.

* * *

I. The Prudent Investor Act

A. Permissible Fiduciary Investments Before the Enactment of the Prudent Investor Act

1. *King v. Talbot* and New York's "Legal List"

King v. Talbot. In 1869, the New York Court of Appeals, in the landmark case of *King v. Talbot*, 40 N.Y. 76, 85-86 (1869), enunciated the standard for fiduciary investments as follows:

> . . . the trustee is bound to employ such diligence and such prudence in the care and management, as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs.
>
> This necessarily excludes all speculation, all investments for an uncertain and doubtful rise in the market and, of course, everything that does not take into view the nature and object of the trust, and the consequences of a mistake in the selection of the investment to be made.

Applying these principles to the facts of the case before it, the Court concluded that a trustee was permitted to invest *only* in government obligations and corporate or individual debt secured by a mortgage on real property. Investments in common stocks, for instance, were regarded as speculative and, accordingly, an improper investment for a fiduciary to make, unless specifically authorized by the governing instrument.

New York's Legal List. Beginning in the late 19th century and for many years thereafter, New York had a statute setting forth a "legal list" of permissible investments for a fiduciary. The list consisted of enumerated categories of debt instruments. Investments in common stocks were still prohibited unless, of course, the governing instrument explicitly allowed such investments. By the middle of the 20th century, the legal list statute had been amended to permit a designated percentage of a trust's assets to be invested in equity securities.

2. New York's Prudent Person Rule

In 1970, Section 11-2.2 of the New York Estates, Powers and Trusts Law (EPTL) was amended to replace the legal list statute with the Prudent Person Rule for all fiduciary investments. In general, the Prudent Person Rule provided that a fiduciary should invest assets in the manner that persons of prudence, discretion, and intelligence use in managing their own affairs, seeking "reasonable income and preservation of their capital."[1]

Subsequent to 1970, the New York courts have applied the Prudent Person Rule in numerous instances in deciding cases brought by beneficiaries against fiduciaries alleging improper investment decisions. One of the most noteworthy decisions is *In re Bank of New York* (*Spitzer*), 35 N.Y.2d 512, 364 N.Y.S.2d 164 (1974). In this case, the Court of Appeals enunciated a commonly accepted tenet under the Prudent Person Rule to the effect that the prudence of each investment in the portfolio must be justified independently despite the fact that the portfolio as a whole may have increased in value.

This traditional interpretation of the Prudent Person Rule (*i.e.*, judging each investment decision independently) led some courts and regulatory authorities to view certain types of investments or investment techniques as imprudent *per se*. The office of the Comptroller of the Currency, for instance, in a November 8, 1973 letter addressed to the presidents of all national banks with fiduciary powers took the position that because, in its view, all option transactions are speculative as a matter of law, such transactions by national bank trust departments would be deemed inappropriate *per se*.

Another significant decision applying the Prudent Person Rule is *Stark v. United States Trust Company of New York*, 445 F. Supp. 670 (S.D.N.Y. 1978), in which the Federal District Court, applying New York law, held that the corporate fiduciary did not act imprudently, notwithstanding substantial losses in the trust assets over a short period of time. The significance of the case is that the court emphasized the fiduciary's procedural care and attention in the *process* of its investment decisions, rather than emphasizing the merits of the investments selected. The case has been cited for the proposition that a fiduciary may satisfy the prudent person standard in making investment decisions if it utilizes a careful and well-managed process in making investment decisions (*e.g.*, senior and experienced officers of a corporate fiduciary conducting periodic reviews; rational system for evaluating securities, etc.), irrespective of the subsequent performance of the securities selected.

Moreover, because the Prudent Person Rule is expressed in terms of seeking production of income and preservation of capital, there was no definitive New York authority that held that a fiduciary had a duty to invest assets in such a manner as to protect the principal from erosion by inflation.

3. A Time for Change

During the past two or three decades, as the courts and regulatory authorities were considering issues of appropriate fiduciary investments, the financial markets were changing dramatically. Investors were presented with a wide range of new investment products and opportunities, including venture capital investments, foreign investments, special purpose funds, interests in real estate, interests in distressed corporations, interests in precious metals and other tangible property, etc. Furthermore, sophisticated investment strategies, involving the use of options, financial futures and derivatives, were devised to take advantage of investment opportunities in such a manner as to seek to manage the risks associated with such investments. The United States stock market enjoyed a sustained bull market which, even during some periods of high inflation, provided net gains for investors. During this period many fiduciaries were concerned that the law of fiduciary investments was not sufficiently developed or clear as to permit the commitment of fiduciary assets to certain types of these investments or the use of certain of these strategies. Some fiduciaries believed that greater clarity was required in order to take advantage of these emerging modern investment principles and concepts. Moreover, some of the leading commentators urged the enactment of laws which would explicitly provide fiduciaries with greater flexibility in making fiduciary investment decisions. Such thinking provided some of the major impetus for the adoption of section 227 of the Restatement (Third) by the American Law Institute in 1990 and the enactment of the Prudent Investor Rule in various states.

B. Permissible Fiduciary Investments After the Enactment of the Prudent Investor Act

1. Enactment of the Prudent Investor Act

On July 26, 1994, the Prudent Investor Act (the "Act"), which amended the EPTL, was signed into law. The Act became effective for all investments made or held by a trustee on or after January 1, 1995. EPTL 11-2.3 was added and codified the standard by which the performance of trustees is measured: the prudent investor rule.

2. Prudent Investor Standard Is a Standard of Conduct

The main principle of the prudent investor rule is contained in the definition of the prudent investor standard. The Act clearly states that prudence, for purposes of assessing a trustee's performance, is a *standard of conduct*, not of outcome or performance. Compliance is determined in light of facts and circumstances prevailing at the time of the decision or action by the trustee. EPTL 11-2.3(b)(1). Thus, it shifts the analysis of a trustee's performance away from day-to-day selection of individual stocks and towards the investment process or procedure, asset allocation, and overall portfolio performance. The prudent investor rule adopts the "modern portfolio theory" which approaches investment decision making from the vantage points of (1) risk analysis and (2) diversified asset allocation. In measuring risk, the modern portfolio theory looks at systematic risk (which is market risk) and unsystematic risk (which is the unique characteristics of the particular investment). The theory posits that these risks cause the deviation from the *expected* rate of return of an investment and its *actual* rate of return. Through diversification of the portfolio, the modern portfolio theory posits unsystematic risk may be eliminated.

The Act retains the traditional prudent person standard for trust investments; in other words, a trustee must "exercise reasonable care, skill and caution to make and implement investment management decisions as a prudent investor would for the entire portfolio." EPTL 11-2.3(b)(2).

Rather than judging propriety on an investment-by-investment basis, the Act requires a trustee to pursue an *overall* investment strategy which will enable the trustee to make appropriate present and future distributions to beneficiaries under the governing instrument and in accordance with risk and return objectives reasonably suited to the entire portfolio. EPTL 11-2.3(b)(3)(A). The trustee is required to consider, to the extent relevant to the decision or action, a non-exclusive list of factors in formulating an investment program, including:

- the size of the portfolio,
- the nature and likely duration of the trust,
- liquidity and distribution requirements,
- general economic conditions,
- possible effect of inflation or deflation,
- expected tax consequences of various investment and distribution decisions,
- the role of each investment in the overall portfolio,
- expected total return of the portfolio,
- the needs of the beneficiaries for present and future distributions. EPTL 11-2.3(b)(3)(B).

The Act clearly states that prudence for purposes of assessing a trustee's performance is a standard of conduct, not of outcome or performance. Compliance is determined in light of facts and circumstances prevailing at the time of the decision or action by the trustee. EPTL 11-2.3(b)(1). This latter concept is not really new, but has been a general rule developed under case law for quite some time. Nevertheless, this rule is strengthened by being written into the statute. Under this provision, a trustee's liability should not be determined by hindsight (that is, by the actual investment performance) but rather by the reasonableness of the processes and procedures which formed the basis on which the decision was made and the investment retained and the facts reasonably known about the investment to the trustee at that time. *See In re Bank of New York*, 35 N.Y.2d 512, 519 (1974) (finding no evidence to support that the losses in the trust fund resulted from imprudence or negligence and that it is not sufficient that hindsight might suggest that another course would have been more beneficial); *In re Chase Manhattan Bank*, N.Y.L.J., April 25, 2000, p. 27 (Surrogate's Court of New York County granting summary judgment motion in favor of trustee where guardian for the persons interested in principal of the common trust fund failed to produce any proof in support of his objections to the asset allocation chosen by the trustee and in the absence of any allegations that the trustee failed to follow its own guidelines or regulatory requirements, that the trustee engaged in acts of self-dealing or that the investment decisions were imprudent in light of the information available at the time the decisions were made); *In re Jakobson*, 173 Misc. 2d 539 (Surr. Ct., Nassau County, 1997) (stating that the test is prudence, not performance and mere inferior investment performance cannot be the basis for a finding of imprudence).

3. Higher Standards for Professional Trustees

In addition, the trustee which holds itself out as having investment expertise (such as the trust department of a bank or a professional investment advisor) is held to a higher standard and will be required to "exercise such diligence in investing and managing assets as would customarily be exercised by prudent investors of discretion and intelligence having special investment skills." EPTL 11-2.3(b)(5). *See In re Chase Manhattan Bank*, N.Y.L.J., April 25, 2000, p. 27 (stating that "a bank that serves as trustee is deemed to have special investment skills").

4. No Investment is *Per Se* Improper or Imprudent

The underlying concept of the prudent investor rule is that no type of investment or strategy is imprudent or prudent *per se*. EPTL 11-2.3(b)(4)(A). Consistent with the concept that a fiduciary should have flexibility to employ modern investment techniques, the provisions of the prudent investor rule do not seek to proscribe any types of investments or strategies. Instead, the fiduciary's conduct and overall performance will generally be judged by a standard of prudence applied to the fiduciary's development of an overall strategy for the account and the implementation of such a strategy.

Moreover, several recent cases suggest that under the prudent investment rule, because no investment or strategy is *per se* improper or imprudent, alternative investments are required to be looked at. For example, in *Levy v. Bessemer Trust Co., N.A.*, 1997 WL 431079 (S.D.N.Y. 1997), the plaintiff opened an Investment Management Account with Bessemer Trust Company in February 1995. The bulk of plaintiff's worth was restricted stock in Corning which he had received in the sale of his company (price at time account was opened was $31). The plaintiff advised the Trust Company that his chief concern was to protect against a downturn in Corning stock. The Trust Company advised that because stock was restricted for one year, plaintiff could not guard against downturn. Plaintiff later was advised by Paine Webber that he could enter into various hedging strategies for downward price protection, and in October 1995 plaintiff purchased a European option collar through Merrill Lynch (stock had reached $37 in May '95 but was at $27.75 at time of option collar). If the option collar had been purchased when the stock was at $37, the plaintiff could have purchased European options collar by purchasing a European put option at $33.33 and simultaneously selling a European call at $44. At $27 per share, plaintiff could only hedge with downside protection of $24.75 with the possible upside value of $31.90.

The court dismissed the Trust Company's motion to dismiss plaintiff's claims of negligence, gross negligence, negligent misrepresentation (with regard to the Trust Company's expertise in investment matters), breach of fiduciary duty, breach of duty to supervise, and fraud. (A breach of contract claim was also dismissed but plaintiff was granted leave to replead the claim.) Essentially, the court allowed the claims to stand because the Trust Company held itself out as having an expertise in providing investment advice; yet the Trust Company did not find out about possible hedge strategies to limit the plaintiff's downside, despite plaintiff's repeated requests for such advice.

In *Levy v. Bessemer Trust Co., N.A.*, 1999 WL 199027 (S.D.N.Y. 1999), on Bessemer's motion for summary judgment, the court held that plaintiff could not recover damages for lost profits on his claims for breach of fiduciary duty and negligence because such lost profits could not be proved with reasonable certainty. The damages on the other claims were left to be decided by a trier of fact.

In the case of *In re Chase Manhattan Bank*, N.Y.L.J., April 25, 2000, p. 27 (N.Y. Cty. Surr. Ct.), the objections of the principal guardian to Chase's investment allocation in its common trust fund were dismissed by the court. Along the lines of the holdings in the *Bessemer* case above, the court noted that under the Prudent Investor Act, "[a] fiduciary should consider modern investment theory, changing economic conditions and *newer investment vehicles and strategies* when making decisions." *Id.* (emphasis added).

C. To Which Trusts Does the Prudent Investor Act Apply?

1. General Application

The Prudent Investor Act applies to any investment made or held on or after January 1, 1995 by a trustee, regardless of the date of creation of the trust, except as otherwise provided by the express terms and conditions of the governing instrument. In addition, the statute applies to a trustee of any type of trust (revocable, irrevocable, *inter vivos*, or testamentary). That is, it should apply to any trust which provides that the laws of the state of New York govern its administration; to any trust created under the will of a New York decedent or by a New York grantor which is being administered in New York; and to any trust created by a non-New York domiciliary which is being administered in New York pursuant to the terms of the controlling instrument (EPTL 3-5.1(h); 7-1.10).

2. Determination of the Law Which Governs Matters of Administration

Under New York law "administration of a trust" includes those matters which relate to the management of the trust. Matters of administration include the powers and duties of the trustee, proper trust investments, commissions, indemnification, allocations as between income and principal and determination of principal and income.[2]

In general, all matters of administration are determined by the law of the situs of the trust. Courts take many factors into consideration in determining the situs of the trust, including:

(1) the intention of the settlor/testator, which can be express or implied from the language of the governing instrument or from other circumstances (*e.g.*, even if the trust instrument does not expressly provide that New York law is to govern, a court may find that the creator of the trust intended New York law to govern if the trustee is in New York and is administering the trust there or the instrument refers to New York law in some of its provisions and the settlor/testator had many contacts with New York),

(2) the place of business or domicile of the trustee,

(3) the location of the trust corpus, and

(4) the domicile of the settlor/testator.

See Erdheim v. Mabee, 305 N.Y. 307 (1953) (observing that the situs of a trust is determined by an interpretation of the words by which the trust is created and that while no rule of law can be laid down for the purpose of interpretation, courts usually look for the above-mentioned factors in determining the situs of the trust). *See also Scott on Trusts* (Fourth ed. 1989) § 591.

If the corpus of a trust consists of real property, generally, the law of the place where the real property is located governs the administration of the trust.[3] This rule applies whether the trust is of freehold interests in real property or of leasehold interests.[4] If by the terms of the trust the trustee is authorized to sell the real property and remit the proceeds to another state where the trust is to be administered, the law of the place of administration will apply to the administration of the trust of the proceeds.[5] Similarly, if the trustee is authorized to remit the rentals to another state where they are to be held and administered in trust, the law of the place of administration will apply to the administration of the trust of the rentals.[6]

The law of a state other than the state where the real property is located, however, will govern trust administration if the testator or settlor manifests an intention to have another state's law apply to the trust administration. This intention can be manifested either expressly, for instance, by specifically designating another state's law as the governing law, or by implication, for example, by referring to another state's law in many of the governing instrument's provisions. Moreover, if the trust also includes personal property which is located in another state, a court might apply the other state's law to the administration of the trust as a whole, for the sake of simplifying trust administration (the assumption being that the testator or settlor would also have intended to simplify the administration of the trust).[7]

Where a trust consists of personal property, if the trust is an *inter vivos* trust, as a general rule, questions of trust administration will be determined by law of the state where the settlor, the trustee and trust corpus are located, if the trust instrument is silent as to the applicable law.[8] Where the settlor names two or more trustees who are domiciled in different states, the courts will try to ascertain whether the settlor has manifested an intention that the trust should be administered at the domicile of one of the trustees. For instance, if one of the trustees is a corporate trustee and the other an individual, a court may find that the settlor has expressed the intention that the trust be administered at the place of business of the corporate trustee, because in most situations the corporate trustee is the trustee who is actively engaged in trust administration and will ordinarily administer its trust business at its principal trust office.[9] If the domicile of the settlor and the place of administration of the trust do not coincide, the express or clearly implied intent of the settlor usually controls. For example, if a settlor who is not domiciled in New York expressly provides that the trust, which is to be administered in New York, is to be governed by the law of his or her state of domicile, the courts of New York will respect that intention, provided the application of the other state's law does not violate the public policy of New York.[10]

Where the trust consists of personal property, if the trust is a testamentary trust, generally, the law of the testator's domicile will control the administration of the trust.[11] However, if a non-domiciliary of New York were to specifically provide that New York law is to govern the administration of a testamentary trust of personal property located in New York, New York courts would respect that intention. Even in the absence of express language designating New York's law as the law governing administration of the trust, a court might find that the testator intended New York law to apply if the testator has appointed a New York trustee to administer the trust assets in New York.[12]

If the administration of a trust is changed to another state (*e.g.*, the trustee moves to another state, a trustee resigns or is removed and the successor trustee is in another state), the question arises whether thereafter the administration of the trust is governed by the local law of the other state. The general rule is that the trust will be governed by the laws of the new place of administration, if this is in accordance with the settlor's or testator's intention, express or implied.[13] If the settlor has provided for the change in the place of administration, expressly or by implication (*e.g.*, such as when a will or trust instrument contains a power to appoint a co- or successor trustee located in another state), it may be presumed that the settlor intended the law of the state of the new trustee to govern administration.[14] On the other hand, if the settlor or testator expressly provides that the law of the original state is to govern, the fact that the trustee acquires a new domicile or a new trustee is appointed who is domiciled in another state will not cause a change in the law applicable to the administration of the trust.[15] *See In re Keeler's Estate*, 49 N.Y.S.2d 592 (1944) (where deceased died domiciled in New Jersey, the trustee was domiciled in New Jersey and the will was silent about governing law. The court held that New Jersey law would apply even though the trustee later moved to the state of New York and administered the trust there. The court reasoned that since the testator was domiciled in New Jersey when she executed the will and died there, she must be deemed to have intended that the trust will be administered under that state's laws. Moreover, a contrary law would permit trustees to make their own law for trust administration by the mere act of removing the trust assets and themselves to a jurisdiction whose laws best suit their ideas of trust administration). *Cf. In re Estate of Benedito*, 370 N.Y.S.2d 478 (1975) (where the decedent was domiciled in New York and the will was probated in New York, and the trust was originally administered and governed by New York law, the court permitted transfer of assets to Florida where all the beneficiaries and the individual co-trustee were domiciled in Florida and the other co-trustee (a New York bank) was being replaced by a Florida bank. The court also held that since there is no express provision in the will that only the laws of New York should govern trust administration, the administration of the trust should therefore be governed by the situs of the trust, which would be Florida upon transfer of the trust assets, even though compensation paid to trustees under Florida law might be greater than that permitted under New York law).

II. The Duty to Diversify

A. Duty to Diversify Prior to the Enactment of the Prudent Investor Act

Traditionally, under the prudent person rule, New York courts reversed the traditional Restatement rule which, in general, imposed a duty to diversify. In New York, it was initially believed that a fiduciary was under no duty to diversify investments unless, under the particular circumstances of a case, prudence required diversification. *In re Newhoff*, 107 Misc. 2d 589, 435 N.Y.S.2d 632 (1980), *aff'd*, 107 A.D.2d 417, 486 N.Y.S.2d 956 (1985). That is, prior to the Court of Appeals holding in *In re Janes*, 90 N.Y.2d 41 (1997), it was thought by many that a duty to diversify did not exist under New York law and a trustee would not be surcharged for mere concentration of trust assets absent other so-called "elements of hazard." However, in *Janes*, the Court held that, although a failure to diversify will not automatically result in liability, the lack of diversification itself may present an unreasonable risk to the assets of the estate or trust.

In *Janes*, the decedent, at the time of his death, owned 13,232 shares of common stock of Eastman Kodak Company, representing slightly in excess of 71% of the total value of the estate's portfolio. The decedent's will provided for the creation of three trusts for the benefit of his wife and/or charity. Shortly after the decedent's death, the investment officer of Lincoln Bank recommended that 1,232 shares of Kodak stock be sold and that the remaining 12,000 shares be retained. The retained Kodak stock constituted in excess of 60% of the portfolio. At trial, the investment officer testified that the surviving spouse (a co-executor) agreed with the recommendation, saying that she and her husband "loved Kodak." This was the only occasion where the retention of the Kodak stock or any other investment issues was discussed with the surviving spouse. About ten years later, the petitioner, Lincoln First Bank of Rochester ("Lincoln First Bank"), sought judicial settlement of its account as co-executor of the decedent's estate. Objections were filed to the account by the estate of the decedent's surviving spouse and by the Attorney General of the State of New York as representative of the ultimate indefinite charitable beneficiaries.

The Court in *Janes* stated that there is no absolute duty to diversify in all circumstances under the Prudent Person Rule. The court continued that, although a failure to diversify will not automatically result in liability, the lack of diversification itself may present an unreasonable risk to the assets of the estate or trust. The Court determined that given the fact that the ultimate beneficiaries were charities, Kodak's income yield of 1.1% was insufficient and unacceptable. The Court disagreed with the trustee's position that this income level in its broader form involved not only the actual dividend ratio to the price but also the growth nature of the stock and probabilities for future appreciation.

In *Janes*, New York State's highest court rejected arguments that under the Prudent Person Rule failure to diversify in and of itself could not constitute imprudence. Instead the Court adopted a facts-and-circumstances test stating:

> As the foregoing demonstrates, the very nature of the prudent person standard dictates against any absolute rule that a fiduciary's failure to diversify, in and of itself, constitutes imprudence, as well as against a rule invariably immunizing a fiduciary from its failure to diversify in the absence of some selective list of elements of hazard, such as those identified by Petitioner. Indeed, in various cases, Courts have determined that a fiduciary's retention of a high concentration of one asset in a trust or estate was imprudent without reference to those elements of hazard . . . The inquiry is simply whether, under all the facts and circumstances of a particular case, the fiduciary violated the prudent person standard in maintaining a concentration of a particular stock in the estate's portfolio investments.

The Court of Appeals affirmed the findings of imprudence on the part of the trustee, denied the trustee's commissions, established the methodology to calculate damages and imposed a surcharge. *See also William v. J.P. Morgan & Co., Inc.*, 199 F. Supp. 2d 189 (S.D.N.Y. 2002) (following *Janes* in holding that appropriate damages for failure to diversify or negligent retention of assets is the value of capital lost (measured in the difference between value of asset on date on which it should have been sold and value at time of the accounting [or court decision]) and not lost profits which may be awarded if there is an allegation of self-dealing or bad faith).

Another example of the duty to diversify under the prudent person rule is *In re Rowe*, 712 N.Y.S.2d 602, *appeal denied*, 96 N.Y.2d 707. In *Rowe*, the decedent created a charitable lead trust (CLT) under her will to be funded with 30,000 shares of IBM stock. The decedent's will did not mandate that the trustee retain the IBM shares. The trustee of the CLT was directed, in each taxable year of the trust, to pay out to qualified charities an amount equal to 8% of the value of the trust assets as finally determined in the federal estate tax proceeding. After 15 years, the remaining assets of the trust were directed to be paid over to the decedent's nieces or their issue. Upon the trustee's failure to provide the nieces with a voluntary accounting, the trustee was ordered by the court to file an intermediate accounting. The accounting revealed that the trustee still held 19,398 shares of IBM. The nieces filed objections to the account alleging that the bank's failure to diversify the trust was imprudent under the prudent person rule in that it violated the bank's own stated policy requiring diversification, the policy of the Comptroller of Currency and regulations of the Federal Reserve Bank. On appeal, testimony of trustee-bank officials revealed that they had a certain department-wide position with respect to IBM, which over the years had an excellent performance record, and paid no particular attention to IBM as an investment in the subject trust's portfolio and the unique needs of the subject trust.

The Surrogate's Court ruled that the trustee was negligent, that it had violated its own policy manual, and that it should have diversified 90% of the CLT's holdings in IBM. The court ultimately revoked the trustee's letters of trusteeship, appointed successor trustees, and ordered the trustee to refund its commission to the CLT and to pay damages to the CLT, finding that the trustee's failure to diversify amounted to gross negligence.

In 2000, the Appellate Division of the Third Department affirmed the removal, the denial of commissions and the surcharge. As to the Surrogate's Court finding that the trustee acted imprudently in retaining the IBM stock, the Appellate Division relied on the testimony of experts and noted that neither adverse tax consequences nor any provision of the CLT restricted the trustee's freedom to sell the IBM stock and diversify the CLT's investments. *See also In re Strong*, 289 A.D.2d 798 (3d Dep't 2001); *In re Saxton*, 274 A.D.2d 110 (3d Dep't 2000).

B. Duty to Diversify After the Enactment of the Prudent Investor Act

As discussed above, rather than judging the propriety of an investment on an investment-by-investment basis, the Prudent Investor Act requires a trustee to pursue an *overall* investment strategy which will enable the trustee to make appropriate present and future distributions to beneficiaries under the governing instrument and in accordance with risk and return objectives reasonably suited to the entire portfolio. EPTL 11-2.3(b)(3)(A). Under the concept of the so-called modern portfolio theory, upon which the fundamental principles of the Prudent Investor Act are based, this overall investment strategy requires risk analysis and diversification.

Thus, the Prudent Investor Act requires a trustee to diversify assets "unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument." EPTL 11-2.3(b)(3)(C). This mandate represents a significant change to prior New York law under the Prudent Person Rule where a trustee had no absolute duty to diversify.

The statute gives no guidance as to what "diversify" means. Is diversity among asset classes required? Neither the legislative history nor the commentary in the Restatement (Third) of Trusts provides helpful guidance except in the most general manner. The commentary provides:

> There is no defined set of asset categories to be considered by fiduciary investors. Nor does a trustee's general duty to diversify investments assume that all basic categories are to be represented in a trust's portfolio. In fact, given the variety of defensible investment strategies and the wide variations in trust purposes, terms, obligations, and other circumstances, diversification concerns do not necessarily preclude an asset allocation plan that emphasizes a single category of investments as long as the requirements of both caution and impartiality are accommodated in a manner suitable to the objectives of the particular trust. *Restatement (Third) of Trusts* § 227 at 26 (1990).

In addition, the statute gives no guidance as to what concentrations are permitted without violating the duty to diversify. By analogy, some limited guidance may be derived from other sources. For example, section 9.18(b)(9)(ii) of the Regulations of the Comptroller of the Currency provides (with some exceptions) that:

> No investment for a collective investment fund shall be made in stocks, bonds, or other obligations of any one person, firm or corporation if as a result of such investment the total amount invested in stocks, bonds, or other obligations issued or guaranteed by such persons, firm or corporation would aggregate in excess of 10 percent of the then market value of the fund. . . .[16]

Another potential source of guidance is the Employee Retirement Income Security Act (ERISA), which has been in effect since the mid 1970s and also contains a diversification requirement for fiduciaries. Specifically, the ERISA statute provides that a fiduciary subject to its provisions should diversify the investments of the plan "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." 29 U.S.C. § 1104(a)(1)(C). However, even in the ERISA context, after two decades, there are no precise mathematical guidelines that can be relied upon for general application. The legislative history of the statute is somewhat helpful in that it lists factors to be considered in determining whether there is diversification, including:

- the purposes of the plan;
- the amount of plan assets;
- financial and industrial conditions;
- the type of investment (i.e., mortgages, bonds, shares of stock or otherwise);
- geographic distribution of investments;
- industrial distribution of investments; and
- dates of maturity.

1974 U.S.C.C.A.N. 5038, 5084-85. Nonetheless, the foregoing list and the language of the legislative history make it clear that the test is based on the facts and circumstances of each case—not on prescribed mathematical formulas that can be generally applied.

III. Alternative Investments and Strategies

As discussed above, with the enactment of The Prudent Investor Act no investment becomes *per se* prudent or imprudent, which gives trustees the ability (and perhaps even the obligation) to consider investments which might not have traditionally been part of a trust's portfolio. This article will focus on three types of these alternative investments: private equity, hedge funds, and derivatives.

A. Private Equity

1. What Is Private Equity?

As a general description, private equity includes any investment in unregistered securities of public or private companies in different sectors such as venture capital, leveraged buyouts and mezzanine financing. Private equity funds are managed by a team of professional managers who (a) raise the capital from potential investors, (b) identify businesses in a particular sector with potential for growth or profitability, (c) structure investments in a handful of companies in a manner that gives the fund influence over the companies' management, (d) provide leadership and management advice to the companies and (e) at the end sell the fund's interest in the companies to maximize the return to the investors through a private placement or initial public offering, a sale of the company to another company, the repurchase of the fund's interest by the company or a secondary purchase of the equities by a third party.

In order to protect their investments, private equity funds will typically enter into contracts with the management of companies in which they invest to ensure control over the companies. These contracts often will include (a) board representation, (b) restrictive covenants which prevent managerial self-dealing and abuse of corporate opportunities, limit management compensation, require detailed financial disclosure, restrict issuance of new shares and restrict debt, (c) staged financing and (d) rights to discharge managers. *See* Douglas G. Smith, *The Venture Capital Company*, 65 Tenn. L. Rev. 79 (Fall, 1997).

Several examples of private equity funds types include:

Venture capital funds provide capital to investors in start-up companies (that is, new companies who are in the early stages of developing products and services) or companies who are in the expansion stage of the companies' evolution (that is, companies which need capital for new equipment or new lines of business or for an IPO).

Buy-out funds raise capital to purchase mature businesses. The buy-out fund then sells the acquired company's non-core holdings and seeks to improve the company's operating efficiency. Many buy-out funds specialize in leveraged buy-outs, leveraged recapitalizations or turnaround investments in financially distressed companies.

Mezzanine financing funds refer to funds which raise capital for companies which seek financing before an IPO. The financing is usually structured as a mixture of preferred stock, convertible bonds or subordinate debt. There may also be an equity component associated with such financing in the form of warrants (which are contracts that allow for the purchase of the company's stock at an agreed-upon price).

Because private equity funds require the active role of management in monitoring and advising the companies invested in, most funds will limit their investments to a particular sector such as health, technology, insurance, etc.

Most private equity funds are structured as limited partnership or limited liability companies. If structured as a limited partnership, typically the general partner interest will be owned by a management company. The management company will be experienced in raising investment capital, identifying the businesses to be invested in and providing the capital and investment management skills to the companies in which equity has been purchased. The management company will typically have a significant ownership position in the fund. The balance of the ownership position in the fund comes from outside investors who are the limited partners.

The managers of a private equity fund are typically compensated in two ways. First, the management company or manager receives an annual *management fee* in the range of 1% to 2.5% of capital commitments for the life of the fund. (Buy-out fund management fees usually decrease or are eliminated over a period of time.) In addition, the management company or manager will be entitled to receive a *performance fee,* which fee will depend on a variety of factors including the capability and experience of management, the type of fund and the investment the fund plans to make. It is not uncommon for the performance fee to be a 20% carried interest. Sometimes, the performance fee will be structured as a preferred return, which return will be 100% of the profit to the investors until the fund attains a specified internal rate of return and then the profits above that level are allocated based on a formula between the investors and management.

Private equity is distinguishable from traditional asset classes in several ways:

a. There is greater potential return but there is also greater risk. Within the private equity funds, "early stage" venture capital probably has the highest risk, LBO funds a lower risk profile but with more modest returns and mezzanine financing the lowest risk with a greater focus on capital preservation and current cost flow.

b. Private equity almost always necessitates a long-term holding period. Although the exact duration of a private equity investment will depend upon the type of investments being made by the fund, the term of a private equity fund typically ranges from 10 to 13 years, with each company's investment ranging from three to seven years. For example, if it is a venture capital fund, the investments need to wait until the companies invested in become successful to start receiving a return on their investment.

c. Private equity funds are not publicly traded, often have restrictions on transferability and have limitations on an investor's ability to withdraw or redeem interests.

d. Private equity funds may have capital calls. That is, if an investment is made in a private equity fund, the investor may have to commit to make additional investments on demand if called to do so in the future.

e. In order to avoid the SEC and Investment Company Act of 1940 registration and reporting requirements, most private equity funds limit their investors to accredited investors or qualified purchasers, which have minimum income and net worths.

f. Most private equity funds have investment minimums.

2. Determining the Prudence of an Investment in a Private Equity Fund

a. *Review of Governing Instrument*. In analyzing whether an investment is prudent, the starting point will be to review the governing instrument to determine whether the trustee is authorized to make the investment. If there are restrictions or limitations on the investments which may be made by the trustee, the trustee should seek court approval of the investment. There have been favorable New York cases which have removed restrictions from investments as a result of changing economic circumstances. *See, e.g., In re Aberlin*, 264 A.D.2d 775, 695 N.Y.S.2d 383 (2d Dep't 1999); *In re Siegel*, 174 Misc. 2d 698, 665 N.Y.S.2d 813 (N.Y. Co. 1997).

b. *Review of Partnership or Limited Liability Agreement*. The partnership or other agreement which establishes a private equity fund must be reviewed carefully by the trustee. In particular, the trustee should consider the following:

(1) *Are there any restrictions on the investor's ability to withdraw from the fund or transfer interests in the fund?* As discussed above, private equity funds typically limit an investor's ability to withdraw from the fund or sell or transfer an interest in the fund. Because the life of a typical private equity fund may be as long as 10 to 13 years, the illiquid nature of the fund should be considered carefully before investment in the fund.

(2) *What is the minimum investment required?* The partnership or other agreement should be reviewed to determine whether there is a minimum investment required. If a minimum investment is required, the trustee should consider the impact of that minimum investment on the overall asset allocation for the trust and whether that is an appropriate allocation to the alternative investment sectors of the portfolio.

(3) *Are there any "accredited investor" or "qualified purchaser" requirements?* As noted above, most private equity funds only permit investors who satisfy the requirements of "accredited investors" or "qualified purchasers" in order to avoid the SEC and Investment Company Act of 1940 registration and reporting requirements. The trustee should confirm that the trust satisfies any such requirements.

(4) *What are the fees charged by the private equity fund?* The agreement should be reviewed to determine what the management and performance fees are.

(5) *What are the restrictions, if any, on the private equity fund's ability to use the invested capital?* The agreement should be carefully reviewed to determine what are the permitted uses by the fund of committed capital. For example, are there limitations on the amount of capital which may be committed to any one investment? Are there provisions in the agreement precluding investments in ventures which deviate from the fund's stated purpose and focus? Are there limitations on the ability of the management company to reuse capital previously invested and returned? Are there provisions which mandate the immediate disbursements of funds on receipt?

c. *Liquidity Needs*. Before investing in a private equity fund, the trustee should review the trust's liquidity needs. Private equity almost always necessitates a long-term holding. For example, in a venture capital fund, the investors need to wait until the companies become successful to start receiving a return on their investment. The trustee should confirm that the illiquid nature of the private equity fund investment is consistent with the trust's liquidity needs (*i.e.*, distribution to beneficiaries, tax obligations, etc). In addition, an investor in a private equity fund usually makes a capital commitment to the fund. The trustee will need to keep in reserve the amount of that capital commitment so that it can meet any capital calls of the fund. Finally, the trustee should recognize that private equity funds are illiquid and non-marketable.

d. *Risk Analysis of Private Equity Funds*. Risk analysis for a private equity fund is very difficult since private equity funds are unregulated investments on which it is very difficult to obtain performance information. Thus, a risk analysis of a private equity fund investment will require a trustee to develop a prudent process by which to evaluate the following:

(1) *To what type of companies does the private equity fund propose to give financing?* A private equity fund which proposes to provide "seed" or start-up financing for new companies has a higher degree of illiquidity and risk since new companies do not have established track records and have longer time horizons for a return on an investment. A private equity fund which provides financing to later-stage companies which need funds for expansion, development of new products or the acquisition of a new business has a lower degree of risk since these later-stage companies usually have established products or markets and a history of growth, earnings and cash flow.

(2) *In what sector does the private equity fund propose to invest?* Most private equity funds will limit their investments to a particular sector of the market such as health or technology. The prospect for growth in that sector should be evaluated.

(3) *How do the managers propose to structure their investments to gain control over the companies in which they invest?* As noted above, management's ability to control, advise and monitor the portfolio's companies is important to potential success of the fund.

(4) *What is the experience and expertise of the managers?* The key component of every private equity fund is a management team which takes an active role in monitoring and advising the companies in which the fund is invested. The prior performance and experience of that management team is critical to evaluate and assess their ability to be successful in the private equity fund proposed to be invested in. Unfortunately, assessing prior performance can be very difficult as performance data on private equity funds is not public.

3. Income Tax Consequences[17]

As a general rule, private equity investments are structured for tax purposes as partnerships. As partnerships, the income, short-term capital gain and losses, long-term capital gain and losses, credits and deductions of the partnership flow through to its partners in proportion to their interests in the "partnership." The character of that income will depend upon the underlying investments in the "partnership." For example, if the private equity fund is a venture capital fund, a lot of the income from the fund is likely to be long-term capital gain as well as some ordinary income if dividends are declared by any of the companies within the venture capital fund.

B. Hedge Funds

1. What Is a Hedge Fund?

The hedge fund evolved out of a technique which was known as "statistical arbitrage," which was first developed in the 1950s. "Statistical arbitrage," was based upon the premise that a portfolio could be constructed which balanced the holdings so as to neutralize the impact of market risk. The balancing of a portfolio's exposures against each other created the "hedge." In constructing the portfolio, the portfolio manager would rely on basic capital market theory that held (1) asset price changes are determined by a security's sensitivity to one or more factors and (2) a security may be "mispriced" if the market does not correctly price each of these factors. The portfolio manager of a hedge fund will try to identify these mispriced securities and then create the return to the investor as the hedge portfolio corrects these mispricings.

In a traditional long-short hedge fund, the hedge fund manager will evaluate securities to identify stocks that are relatively overvalued or undervalued. Those stocks that are undervalued would be considered for purchase by the hedge fund manager (the long position) and the stocks that are overvalued would be "sold short." To sell short means that the portfolio manager would borrow the stock from another institution and then sell the stock for cash. Since in theory the fund manager has sold "overvalued securities," when the price of those securities declines, the manager pays back the stock loan by buying those securities cheaply. This creates a profit for the fund. The cash which the fund manager had received from his or her initial sale of the borrowed securities would be invested in the stocks which the fund manager had identified as undervalued. The hedge fund manager also seeks excess returns through the greater-than-market appreciation from the portfolio's long positions (the stocks which the manager has identified as "undervalued") and the difference between the performance of the portfolio's long positions and short positions. In theory, if the long and short positions are balanced, the portfolio should be "market neutral" and have minimal market risk.

Although historically hedge funds are structured to hedge the risk in equity markets, many new forms of hedge funds have developed including hedge funds which have investments in commodities, futures, options, private equity, leverage buyouts, distressed securities, third party debt and event driven arbitrage (merger and acquisition funds). There are also global macro funds which make investment decisions based on anticipated price movements in global currency, equity, bond and commodity markets. Unlike private equity funds, hedge funds do not seek, as a general rule, substantial or controlling positions in the companies in which they invest so as to advise and influence the companies' management.

Hedge Fund Structure—Hedge funds are generally structured as a limited partnership or limited liability company with the investment manager serving as a general partner or managing member and the investors as the limited partners or members. Hedge funds are also sometimes structured as offshore corporations. These partnerships or companies are generally unregulated by the Securities and Exchange Commission and therefore are operated without federal supervision. The fund expenses usually include a 1% *asset management fee* and a *profit incentive fee* that typically pays the manager approximately 20% of the fund profits. Sometimes, this profit incentive fee requires a hedge fund manager to make up prior unrecouped losses before earning a fee on current profits or requires the fund to exceed a certain minimum rate of return before the fee is assumed. In order to avoid SEC and Investment Company Act of 1940 registration and reporting requirements, investments in a hedge fund are generally restricted to accredited investors and qualified purchasers which require a minimum level of income and net worth for the investor. In addition, minimum initial contributions of $1 million or more are common to participate in a hedge fund. Hedge funds often also limit the redemption of partnership shares. Often investors may be locked up for a year or more initially and afterwards might have to give advance notice and then wait until the end of the quarter or year to redeem their partnership units. In addition, most hedge funds have restrictions on the transferability of interests.

To deal with some concerns raised by investors regarding the unregulated nature of hedge funds, some investment firms have recently formed and marketed "registered hedge funds." Registered hedge funds are hybrids between mutual funds and traditional unregistered hedge funds. These hedge funds register with the SEC in conformance with the terms of the Investment Company Act of 1940 and thus are subject to regulatory oversight. These funds are typically sold to an unlimited number of investors at relatively low investment minimums which can start as low as $25,000. However, similar to unregistered hedge funds, registered hedge funds do not list their daily net asset values, are not listed on Exchanges, are generally only available to investors who meet a minimum net worth requirement and typically permit redemption of shares in the fund just twice a year.

To address the lack of diversity and the increased market risk that some hedge funds may have, fund of funds have been created. A fund of funds is a hedge fund which invests in other hedge funds and thereby seeks to diversify the hedge funds as well as the risks of exposure to a single manager. A fund of funds manager is also well-positioned to conduct due diligence in the various funds in which the fund may invest. A fund of funds will generally have higher fees since there are fees both at the underlying hedge fund level as well as at the parent fund level.

2. Determining Whether a Hedge Fund Is a Prudent Investment

As previously described, under the prudent investor rule, there is no investment that is *per se* proper or improper but rather the Prudent Investor Act requires the trustee to pursue an overall investment strategy and looks to the trustee's standard of conduct in constructing that strategy. In determining whether a trust's portfolio should include an investment in hedge funds or in a particular hedge fund, the trustee may wish to consider the following:

a. Review governing instrument. Prior to investing in hedge funds, the governing instrument should be reviewed to determine if there is any restriction on the assets in which the trust may be invested. If there are such restrictions, the trustee may wish to seek court approval to allow investment of trust assets in this alternative investment. The New York courts on occasion have broadened the investment discretion of a trustee as a result of changes in economic conditions since the trust was originally created. *See, e.g., In re Aberlin*, 264 A.D.2d 775, 695

N.Y.S.2d 383 (2d Dep't 1999); *In re Siegel*, 174 Misc. 2d 698, 665 N.Y.S.2d 813 (N.Y. Co. 1997).

b. Review of the partnership or limited liability company agreement. The partnership or other agreement which establishes the hedge fund must be reviewed carefully by the trustee. In particular, the trustee should consider the following:

(1) *Are there any restrictions on the redemption of partnership units?* As mentioned above, many hedge funds limit the ability of investors to redeem partnership units in the first year and thereafter allow redemptions only on written notice and on a limited basis (*i.e.*, quarterly, semi-annually or annually). In determining whether an investment in a particular hedge fund is appropriate and the amount of the trust assets that should be invested in any particular hedge fund, these redemption restrictions will need to be considered in light of liquidity needs of the trust (*i.e.*, distributions to beneficiaries).

(2) *What is the minimum investment required?* The agreement also should be reviewed to determine whether there is a minimum investment required. If there is a minimum investment required (*i.e.*, $1 million), the trustee should consider the effect of that minimum investment on the overall asset allocation for the trust and whether that is an appropriate allocation to the alternative investment sector of the portfolio.

(3) *Are there any accredited investor or qualified purchaser requirements?* Also, as mentioned above, most hedge funds only permit accredited investors or qualified purchasers to make investments in the funds so as to avoid SEC and Investment Company Act of 1940 registration and reporting requirements. The trustee should confirm that the trust meets the necessary requirements.

(4) *What are the fees charged by the hedge fund?* The agreement should also be reviewed to determine what the asset management fee and the profit incentive fees are.

c. Risk analysis of hedge fund.

Because hedge funds as a general rule are not regulated, one of the greatest difficulties for a trustee will be to assess the prudence of the investment from a "risk" perspective. It is very difficult for most trustees to obtain information regarding a hedge fund's particular investment strategy. As a general rule, fund managers only provide limited and vague statements regarding their investment strategy and their holdings. In addition, fund managers can and do change strategies often without any disclosure to investors. This lack of transparency can often be very troublesome to trustees.

In addition, historically there have been a lack of objective standards for evaluating the performance of hedge fund managers. First, comprehensive performance result studies of fund managers are limited. In addition, fund managers employ different methodologies to measure their returns, which makes it very difficult to compare funds. There are no benchmarks *per se* by which to measure hedge fund performance.

To address the difficulties in evaluating the prudence of an investment in a hedge fund, some institutions offer hedge fund risk profiles, investment position analysis and risk evaluation systems to help evaluate hedge fund performance. If consultants are hired to evaluate hedge fund investments, it is important to determine whether that consultant has any conflicts of interest. Is the consultant in any way serving any of the hedge funds that are being evaluated? Is the consultant associated with a firm which offers and sells interests in any of the hedge funds being promoted?

If a trustee desires to invest in a particular hedge fund, it will be important for the trustee to develop a prudent process by which to obtain necessary information regarding the hedge fund's investment strategy and the assets to be held by the hedge fund. One of the most important factors will be the experience, expertise and past performance of the particular hedge fund manager(s) and the strategy to be employed by the manager in the particular fund to be invested in. In addition, the trustee will need to evaluate the level of risk to be employed in the investment strategy of the particular hedge fund. For example, to enhance returns, many hedge funds use leverage. Such leverage can increase the risk of the hedge fund, especially if the hedge fund holds illiquid and non-traditional assets. Where a hedge fund holds illiquid, non-traditional assets, it may become difficult for the hedge fund to meet margin requirements if there is a market price decline.

3. Income Tax Consequences

As a general rule, hedge funds were structured for tax purposes as partnerships. As partnerships, the ordinary income, the short-term capital gain and losses, the long-term capital gain and losses, credits and deductions of the partnership will flow through to its individual partners in proportion to their interest in the partnership. The character of the underlying income of the partnership will depend upon the nature of the investments within the hedge fund.

C. Derivatives

1. What Is a Derivative?

A derivative is a financial instrument, the value of which is based on the value of some other asset. Strictly speaking, that definition includes options and futures. The Uniform Principal and Income Act, recently promulgated by the National Conference of Commissioners on Uniform State Law, defines a derivative as "a contract or financial instrument or a combination of contracts and financial instruments that gives the trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or a group of assets." Uniform Principal and Income Act § 414(a). For the purpose of this article, the discussion of derivatives will focus on puts, calls and collars.

A put is a contract that gives the purchaser the right (but not the obligation) to *sell* an underlying instrument at a specific price for a fixed period of time. Typically, puts are used to protect against downside risk.

> **Example**: The trust owns stock trading at $100 per share. To protect its downside, the trust buys a put with a strike price of $85 per share. The trust can, at any time during the life of the contract, demand that counterparty buy its shares at the strike price ($85).[18] The trust would do so at some time after the stock price drops below $85 per share. If the stock price remains above the strike price, the trust will not exercise its option. When the exercise period expires, the trust is out the cost of the put.

A call is a contract giving a right (but not the obligation) to *buy* an underlying instrument at a specific price for a fixed period of time. Individuals will usually buy calls if they think the stock will increase in value.

> **Example**: The trust sells a call with a strike price of $115 for a stock trading at $100. If the share price were to stay at $100 for the entire life of the contract, the trust will not exercise its option and let it expire, and is out the cost to have bought the call. If, however, the stock price goes to $120, the trust could exercise the option and earn a $5 profit.

A collar is typically a combination of contracts involving the purchase of a put and sale of a call. A collar limits the individual's downside risk with respect to the asset, at the sacrifice of a certain amount of its upside. A "cashless" collar is a collar for which the purchase price of the put exactly offsets the sale proceeds of the call.

> **Example**: Using the examples from above, the trust, holding stock worth $100 per share may create a cashless collar by buying a put with a strike price of $85 and selling, or "writing," a call with a strike price of $115. If the stock price stays within the collar, both the put and the call will expire, and the trust will be out nothing, having protected his downside while sacrificing the upside. If the stock drops below the put strike price, the trust should exercise the put. If the stock price increases above the call strike price, the owner of the call will exercise, and the trust will lose some of the upside.

2. Determining Whether Derivatives Are "Prudent" Investments

Should a trustee acquire or retain a derivative within a trust? The most common types of derivatives which a trustee may wish to acquire are a put or a collar. Usually, a trustee considers these alternative investments when the trustee has a concentrated equity position. The issues that the trustee may wish to address in determining whether the purchase of a derivative in this circumstance is prudent include:

a. *Derivative vs. Sale*. As noted above, most commonly a trustee will consider acquiring or retaining a derivative to protect a concentrated equity position. As discussed earlier, under the Prudent Investor Act, a trustee has an absolute duty to diversify unless the trustee reasonably determines that it is in the interests of the beneficiaries not to do so, taking into account the terms of the governing instrument. Accordingly, prior to acquiring a derivative to protect the downside risk in a concentrated equity position, the trustee shall determine whether sale of the equity position to achieve diversification is not a referable alternative. The sale of the equity position may not be the better alternative for one of a variety of reasons such as: (1) the stock may have a low income tax basis and sale may result in a significant capital gain, (2) the stock may be thinly traded and diversification may not be feasible except over a long period of time, without adversely affecting the price at which the stock is sold, (3) the stock may be subject to SEC or other restrictions that restrict the ability of the trustee to sell the stock, or (4) the stock may be stock in a family company and the family may not want to dispose of the stock because of the family relationship or control of the company.

b. *Governing Instrument*. If the trustee has determined that the sale of the concentrated stock position is not feasible or appropriate, the trustee needs to determine that the purchase of the derivative is authorized by the governing instrument. If the Prudent Investor Act applies to the trust, the purchase of the derivative is not *per se* imprudent or improper so long as a prudent process of evaluating the advisability of purchasing the derivative if followed by the trustee. However, if the governing instrument specifically prohibits the purchase of "derivative instruments," the trustee should not invest in a derivative without a court order construing the governing instrument to allow the purchase of the "put" or "collar." *See In re Aberlin*, 264 A.D.2d 775, 695 N.Y.S.2d 383 (2d Dep't 1999); *In re Siegel*, 174 Misc.2d 698, 665 NYS2d 813 (N.Y. Co. 1977).

c. *Evaluating the Derivative Contract*. It is beyond the scope of this article to review all the issues which need to be negotiated with the counterparty through whom the derivative will be placed. It is imperative that the trustee retain corporate counsel to review the documentation on behalf of the trust. Some of the issues which a trustee should consider include:

   (1) Determining the appropriate strike prices.

   (2) Determining the appropriate duration of the derivative.

   (3) Understanding the pricing on termination of the derivative.

   (4) Determining the events of default that could cause earlier termination of the contract.

   (5) Determining the effect of the death of the income beneficiary during the contract.

   (6) Determining whether the contract can be cash-settled or physically settled.

   (7) Determining and understanding the income tax consequences of creation of the contract and termination of the contract (see discussion below).

   (8) Negotiating the best strike prices for the derivative and having a competitive bidding process.

The prudence of a derivative transaction also mandates that the trustee continually monitor the derivative to determine if unwinding the transaction prior to maturation is advisable at any particular point during the contract. For collars, for example, a key consideration is not just whether the collar is in the money, but also whether the fair market value of the underlying asset has changed in relationship to the strike prices. In this context, it is important to keep in mind that a critical variable is the breadth of the collar itself. In collars with a wide difference between strike prices, there is potential for wide swings that can affect the pricing of the put and call.

Risk is also a large factor in any decision about holding, and trustees should be aware that they should have a risk management procedure and numerical models to guide them.

3. Income Tax Considerations

A detailed analysis of income tax treatment of derivatives is also beyond the scope of this article. However, a general discussion of the income tax treatment of certain positions commonly used by taxpayers to hedge positions in securities (purchasing a put option, writing a call option and entering into a "collar") is briefly set forth below.

Put Options. As a general rule, the premium paid to purchase a put option is a nondeductible capital expenditure. *See* Rev. Rul. 78-182, 1978-1 C.B. 265 (citing Rev. Rul. 71-521, 1971-2 C.B. 313; Rev. Rul. 58-234, 1958-1 C.B. 279). Gain or loss recognized with respect to options generally is capital if the underlying security is a capital asset in the hands of the taxpayer. *See* I.R.C. § 1234(a). If the put option is sold, the premium (and any transaction expenses) is taken into account in determining gain or loss. If the put expires unexercised, the expiration is treated as a sale or exchange on the date of lapse resulting in a capital loss. The loss is short-term or long-term depending on the holding period of the option. If the put is exercised and physically settled, the premium reduces the amount realized on the sale of the underlying security and the gain or loss is short term or long term depending on the holding period for the underlying security. In certain cases, however, the acquisition of a put may be considered a short sale, resulting in gain being treated as short-term capital gain. *See* I.R.C. § 1233(b). The effect of the "straddle" rules must also be considered. *See* I.R.C. § 1092.

Call Options. The premium received for writing a call option is not included in income at the time of receipt. Upon lapse of the option, the writer of the option recognizes gain equal to the premium (net of transactions expenses). The gain is short-term capital gain. *See* I.R.C. § 1234(b)(1). If the call option is exercised and physically settled, the net premium increases the amount realized on the disposition of the underlying security. Gain or loss generally is short term or long term depending on the holding period for the underlying security. If the writer closes the call by paying the holder the value of the call, he or she recognizes short-term capital gain or loss in an amount equal to the difference between the premium received and the amount paid.

Collars. A collar generally is a combined position consisting of a purchased put option and a written call option. There may be tax consequences when entering into a collar transaction, or when settling or terminating the collar transaction.

Tax Consequences of Entering Into Collar-Constructive Sale. I.R.C. § 1259 of the Internal Revenue Code may treat the hedge of an underlying appreciated position in stock as a "constructive sale" of that position in certain circumstances. If treated as a constructive sale, the trusts would recognize any gain (but not any loss) inherent in the hedge shares as of the time the collar is entered into. In relevant part, the following transactions with respect to appreciated shares would result in a constructive sale: (1) short sales of the shares, (2) offsetting "notional principal contracts" with respect to the shares or substantially similar property, (3) forward sales of the shares or substantially similar property and (4) to the extent prescribed in regulations, any other transactions having "substantially the same effect."

Although it is not clear, it is possible that a collar may be treated as a notional principal contract with respect to the hedge shares for this purpose. However, regulations prescribing when transactions will have "substantially the same effect" have not been issued. Such regulations when issued may apply with retroactive effect to "abusive" transactions, which could include a collar where the ceiling price and floor price are too close to the market price when the collar is entered into. In the absence of regulations or other authority addressing when a partial hedge of appreciated stock results in a constructive sale, taxpayers generally rely on certain "rules of thumb" to determine whether the reduction in the risk of loss and opportunity for gain is so limited that the transaction is not a constructive sale. There is no "safe-harbor" as a matter of present law. Complying with these "rules of thumb" therefore provides no certainty that a constructive sale will not result. Taxpayers have, however, engaged in many such transactions in reliance on these "rules of thumb." The "rules of thumb" are:

- *Gross spread test*. The gross spread between the cap and floor price should be at least 20% of the market price of the hedged shares on the date the transaction is entered into ("Initial Price") and that Initial Price should be between the cap and floor price.
- *Option pricing test*. This test compares the combined value of a put and call that are "at the money" to the value of the put and call options in the collar. In general, the values (*i.e.*, premiums) should be determined for the put and call options in the collar and for hypothetical put and call options whose strike price is equal to the Initial Price based on market pricing. The risk/opportunity retained is computed by subtracting from one (1) a fraction whose numerator is the sum of the values of the embedded options and whose denominator is the sum of the values of the "at the money" options. This fraction should be at least 0.2. The analysis should appropriately take into account arrangements with respect to dividends.
- *Delta test*. This test measures the delta (*i.e.*, rate at which the value of one position changes with respect to changes in the other) of the collar in relation to the hedged shares. In absolute terms, this should not exceed 0.8.
- *Likelihood of lapse*. This test measures the indicative probability that the price of the hedged shares at termination will lie between the cap and floor price, *i.e.*, that the collar will lapse unexercised. Ideally, this should be 20% or greater.

In addition to the statutory constructive sale rule, it is also important that the taxpayer be viewed as continuing to own the hedged shares as a matter of substance to avoid the risk of gain recognition. Therefore, other factors that may be relevant in negotiating the terms of the collar include (1) the term of the collar (generally it should not exceed three years), (2) whether the taxpayer retains the economic benefit of any dividends declared on the hedged shares during the term of the collar and (3) whether the counterparty has the right to rehypothecate any hedged shares pledged to secure the taxpayer's obligations under the collar.

Tax Consequences of Settlement or Termination. The collar is subject to extremely complicated rules applicable to "straddles." A "straddle" generally includes a position in stock where the taxpayer also holds an offsetting position in stock or substantially similar property and holding one position substantially diminishes the risk of loss of the other. The straddle rules (1) require a loss from one position in the straddle to be deferred as long as there is any unrecognized gain in the offsetting position, (2) affect the holding period of property that is part of a straddle, (3) may alter the character of gain or loss from the straddle as long term or short term and (4) may require the interest on debt that is deemed to have been incurred to purchase or carry a position in the straddle and certain "carrying costs" related to the straddle to be capitalized rather than deducted.

Because of the straddle rules, the tax consequences upon settlement, lapse or termination of the collar will vary depending on whether (1) the collar is cash-settled or physically settled and (2) the collar is viewed as a single integrated contract or is instead viewed as a separate call option and put option (where the call option premium is used to purchase the separate put option). It is unclear under present law which of these approaches is correct. The following table briefly summarizes the rules under the different approaches.

Cash-Settlement of Collar		
	Single Financial Contract	**Two Separate Options**
Put exercised and call expires	Should be short-term capital gain.	Gain on put, net of premium deemed paid, is short-term capital gain, premium deemed received from call is short-term capital gain.
Call exercised and put expires	Should be long-term capital loss; straddle rules apply to defer losses.	Amount deemed paid for put is long-term capital loss; excess of cash paid on call over premium deemed received should be a long-term capital loss; straddle rules apply to defer losses.
Both put and call expire	Not a taxable event.	Premium deemed received from call is short-term capital gain; premium deemed paid for put is long-term capital loss; straddle rules apply to defer losses.
Physical Settlement of Collar		
	Single Financial Contract	**Two Separate Options**
Put exercised and call expires	Long-term capital gain equal to excess of put price over basis in underlying shares.	Long-term capital gain on put equal to excess of put price over sum of tax basis in underlying shares and amount deemed paid for put; premium deemed received from call is short-term capital gain.
Call exercised and put expires	Long-term capital gain equal to excess of call price over basis in underlying shares.	Amount deemed paid for put is long-term capital loss; long-term capital gain on call equal to excess of call price and amount deemed received for call over basis in underlying shares.
Both put and call expire	Same as if cash settled.	Same as if cash settled.

In particular, the straddle rules (1) may prevent deduction of losses on the collar until all of the hedged shares owned by the trust or persons related to the trust (possibly including any shares of that class even if not subject to the collar) have been sold, (2) may result in taxable income upon lapse of the collar equal to the premium deemed received for the call option (whereas a deduction for the premium deemed paid for the put option may be deferred, possibly indefinitely) and (3) may defer the deduction of interest on any borrowing incurred in connection with the hedged shares or the collar.

IV. Trustee's Power to Adjust

A. Legislative Purpose and Effective Date Provisions

1. Legislative Purpose

Under New York's Prudent Investor Act, the trustee of a trust is required to seek an investment strategy designed to make appropriate current and future trust distributions. Prior to the enactment of the new article 11-A and the power to adjust, trustees were in the conflicted position of having the authority to invest under the Prudent Investor Act for total return, but also having the obligation to produce trust accounting income for income distributions in accordance with New York's current Principal and Income Act.

EPTL 11-2.3(b)(5) has been added (and the current subparagraph 5 is being renumbered 6) to authorize a trustee of a trust [(i) to which article 11-A applies and (ii) the terms of which describe the amount that may or must be distributed to a beneficiary by referring to the trust's income] to adjust between principal and income (or income and principal) to the extent the trustee deems advisable to enable the trustee to make appropriate current and future distributions. The power to adjust is meant to enable trustees to make trust investments in accordance with the Prudent Investor Act and no longer be limited in their investment decisions by the trust accounting income rules contained in New York's current Principal and Income Act.

2. Effective Date Provisions

The power to adjust is effective as of January 1, 2002, regardless of the date of creation of the trust. The power to adjust and the application of article 11-A are default rules; the governing instrument may provide otherwise, and these rules would not apply if the unitrust regime is adopted (see below analysis of new EPTL 11-2.4).

Although the power to adjust is available to many trusts (see below section describing those trusts for which the power to adjust is not available), trustees are not obligated to make an adjustment. The trustee is merely authorized to do so in the exercise of the trustee's discretion.

B. Exercising the Power to Adjust

1. Application

The trustee's power to adjust applies to any trust to which the rules of article 11-A apply and the terms of which describe the amount a beneficiary is entitled to by reference to the trust's income. As a general rule, the effective date of article 11-A (and, therefore, the power to adjust provisions) is January 1, 2002. (EPTL 11-A-6.3). Unless otherwise provided in the governing instrument, article 11-A applies to any receipt or expense received or incurred on or after January 1, 2002 by any trust or estate, regardless of when the asset involved was acquired by the trust. Article 11-A also applies to any trust or estate established after January 1, 2002, unless the governing instrument provides otherwise or unless an election is made or court order entered applying the unitrust regime to the trust. (EPTL 11-A-6.4).

The language in EPTL 11-2.3(b)(5) does not state whether the power to adjust applies to estates. However, the power to adjust is only granted to a "trustee" (not a fiduciary). Thus, an executor does not have a power to adjust. Moreover, EPTL 11-2.3(b)(5)(A) provides that the power is meant to enable the trustee to make "appropriate present and future" distributions. However, EPTL 11-A-3.1(b)(2) states that an asset becomes subject to a trust on the date of a testator's death in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the testator's estate. Therefore, it is not clear whether the trustee of a testamentary trust may adjust for the period during the administration of the estate and before funding of the trust.

In addition, EPTL 11-2.3(b)(5) applies to any type of trust (revocable, irrevocable, *inter vivos*, or testamentary) to which the rules of article 11-A apply.[19] That is, EPTL 11-2.3(b)(5) should apply: (1) to any trust which provides Chapter 11-A applies; (2) to any trust which provides that the laws of the state of New York control its administration; (3) to any trust created under the will of a New York decedent or by a New York grantor which is being administered in New York; and (4) to any trust created by a non-New York domiciliary which is being administered in New York pursuant to the terms of the controlling instrument (EPTL 3-5.1(h); 7-1.10). Depending upon the provisions of the controlling instrument and the factual circumstances surrounding the current and prior administration of a particular trust, EPTL 11-2.3(b)(5) also may apply to a trust created by a non-New York domiciliary if the situs of the trust is in New York (which could occur as a result of the appointment of a New York trustee if the instrument is silent concerning the law controlling trust administration). [*See Bank of New York v. Shillito*, 14 N.Y.S.2d 458 (Westchester Co. 1939).]

2. Factors to Be Considered by Trustee in Determining Whether to Exercise Power

The new legislation permits the trustee to consider certain factors in determining whether to adjust between income and principal. Under EPTL 11-2.3(b)(5)(B)(i)-(iii), the trustee is permitted to take into account the following:

- the settlor's intent as expressed in the governing instrument;
- the assets held in the trust (including the extent to which they consist of financial assets, interests

in closely held enterprises, tangible and intangible personal property or real property);

- the extent to which an asset is used by a beneficiary;
- whether an asset was purchased by the trustee or contributed by the settlor;
- the net amount allocated to income under article 11-A (to determine whether an adjustment is necessary) and the increase or decrease in the value of the principal assets (to determine how the remaindermen will be affected); and
- whether the trustee has the power to invade principal or accumulate income, and the extent to which trustee has exercised such power.

EPTL 11-2.3(b)(5)(B) also notes that the trustee, in accordance with the Prudent Investor Act, may also consider related trusts, a beneficiary's income and resources, and an asset's special relationship or value to a beneficiary (EPTL 11-2.3(b)(4)(B)), and to the extent relevant to the decision or action, a non-exclusive list of factors, including:

- the size of the portfolio;
- the nature and likely duration of the trust;
- liquidity and distribution requirements;
- general economic conditions;
- possible effect of inflation or deflation;
- expected tax consequences of various investment and distribution decisions;
- the role of each investment in the overall portfolio;
- expected total return of the portfolio; and
- the needs of the beneficiaries for present and future distributions (EPTL 11-2.3(b)(3)(B)).

It should be noted that in deciding whether and to what extent to exercise the power to adjust, EPTL 11-2.3(b)(5)(B) provides that the trustee "may consider" the various factors set forth above. Thus, the trustee is not required to consider any of these factors.[20] Moreover, the trustee is not required to make an adjustment but is authorized to do so if the trustee determines that such an adjustment would be "fair and reasonable to all of the beneficiaries so that the current beneficiaries may be given such use of the trust property as is consistent with preservation of its value." EPTL 11-2.3(b)(5)(A).

3. When a Trustee May Not Adjust

There are nine situations listed in EPTL 11-2.3(b)(5)(C)(i)-(ix) when the power to adjust may not be utilized. A trustee may not make an adjustment:

(i) that diminishes the income interest in a marital deduction trust (*i.e.*, the adjustment cannot reduce the distributions to the spouse below the normal accounting income of the trust);

(ii) that reduces the "actuarial value" of an income interest intended to qualify for a gift tax annual exclusion;

(iii) that changes a fixed annuity or fixed fraction payable to a beneficiary;

(iv) from any amount "permanently set aside for charitable purposes" under a trust or will "unless the income therefrom is also permanently devoted to charitable purposes;"[21]

(v) if holding or exercising the power causes any individual to be treated as the owner of all or part of the trust for income tax purposes;

(vi) if holding or exercising the power causes all or part of the trust to be included for estate tax purposes in the estate of any individual who has the power to remove or appoint a trustee;

(vii) if the trustee is a current beneficiary or a presumptive remainderman of the trust;

(viii) if the trustee is not a current beneficiary or a presumptive remainderman, but the adjustment would benefit the trustee directly or indirectly; or

(ix) if the trust is an irrevocable lifetime trust which pays income to the grantor for life, and holding or exercising the power would cause any public benefit program to consider the adjusted principal or income to be an available resource.

In the case where co-trustees are serving and one trustee would be prohibited from holding or exercising the power under EPTL 11-2.3(b)(5)(C)(v)-(viii), the co-trustee(s) to whom the restriction does not apply may hold or exercise the power (unless the terms of the trust would otherwise prevent the trustee(s) from exercising the power). (EPTL 11-2.3(b)(5)(D).) Also, a trustee may release the power to adjust (from principal to income, income to principal, or both), either permanently or for a specified period, including a period measured by the life of an individual. Such release is allowed *only* if the trustee (a) is uncertain whether possessing or exercising the power will cause an adverse income, gift or estate tax consequence described in paragraphs (i) through (vi) and (viii) above or (b) determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described above. (EPTL 11-2.3(b)(5)(E).)

4. Determining the Appropriate Adjustment

The primary purpose for the enactment of the trustee's power to adjust was to provide a mechanism for a trustee to satisfy the trustee's duty of impartiality between the income beneficiaries and the remaindermen. Prior to the enactment of the power to adjust, to satisfy the income beneficiary and generate income, the trustee was required to purchase investments such as bonds which did not appreciate relative to other investments such as stocks. On the other hand, although stocks are expected to appreciate, the income return was often low. This problem caused friction between the income beneficiaries and the remaindermen. The enactment of the power to adjust allows a trustee to invest for the highest total return consistent with the risk profile for the account.

Within that framework, the question arises as to what is the appropriate return for an income beneficiary.

First, the return should ensure that the income beneficiary receives the appropriate level of beneficial enjoyment of the trust assets under New York law consistent with the beneficiary's income interest.

Second, it may be appropriate to base that return on a model which takes into account historical or projected future growth of trust assets (in terms of production of income and appreciation), as adjusted for inflation.

Third, the trustee should consider the factors set forth above in determining whether to make an adjustment with respect to a particular trust. For example, if the income beneficiary of a particular trust is elderly, has sufficient assets outside the trust, the trust is not subject to estate tax on the beneficiary's death and the beneficiary is satisfied with the income return from the trust, an adjustment may not be appropriate. However, if an income beneficiary has acute needs, a larger adjustment may be appropriate.

The legislative history to EPTL 11-2.3(b)(5) also indicates that trustees of multiple trusts may adopt a plan or formula which establishes a benchmark which is applied to a class of trusts. The New York State Assembly's Memorandum in Support of the EPTL 11-2.3(b)(5) provides:

> Trustees of multiple trusts, in determining whether to exercise the power of adjustment, would have the authority to decide as a matter of policy or with respect to individual trusts or classes of trusts whether and under what conditions they would exercise such power, and may decide from time to time to make an adjustment or may adopt a policy of making adjustments on the basis of a plan or formula. Such adjustments would be similar to the current practice by many trustees of making investments. For example, a trustee would be allowed to institute a policy that a group of trusts with a certain asset allocation would be adjusted in the same fashion.
>
> If such a benchmark is established, however, a trustee may expose itself to complaints from an income beneficiary if an adjustment on a particular trust is below the benchmark or from a remainderman if the adjustment on a particular trust is above the benchmark. The trustee can protect itself or minimize the liability in such circumstances by obtaining the consent of the income beneficiary or remainderman (SCPA 315(8)), by petitioning the court for a determination that the proposed exercise is not an abuse of discretion, or by accounting regularly.[22]
>
> The establishment of a benchmark might result in a negative adjustment to an income beneficiary (*i.e.*, an adjustment from income to principal). Although the statute appears to authorize a negative adjustment if such adjustment is fair and reasonable to all of the beneficiaries, as a practical matter, a trustee is likely to expose itself to complaints from an income beneficiary if there is a negative adjustment (unless the income beneficiary has agreed to such adjustment).

C. Standard for Judicial Review (EPTL 11-2.3-A)

1. Abuse of Discretion

The general rule in New York is that a court will not disturb a trustee's exercise of discretion with respect to distributions unless the court finds that there has been an abuse of discretion. *See Glenn v. Chase Lincoln First Bank, N.A.*, 607 N.Y.S.2d 802 (App. Div. 1994); *In re Will of Daubney*, 153 Misc. 2d 120 (Nassau County Sur. Ct. 1992); *Hoelzer v. Blum*, 93 A.D.2d 605 (App. Div. 1983). A trustee's exercise of the power to adjust is subject to the same standard: a court should not change a fiduciary's decision to exercise or not to exercise an adjustment power unless it determines that the decision was an abuse of the fiduciary's discretion. (EPTL 11-2.3-A(a).)[23] This standard applies to (i) a trustee's determination of whether and to what extent an amount should be transferred from income to principal or from principal to income, and (ii) a trustee's determination of the factors that are relevant to the trust and its beneficiaries and the weight given by the trustee to those factors in deciding whether and to what extent to adjust.

If a court determines that the fiduciary has abused his, her or its discretion, the court may restore the income beneficiary or remaindermen to the position they would occupy if there were no abuse of discretion. The court could require the fiduciary to make distributions to the beneficiary in cases where the fiduciary did not make an adjustment or where the adjustment was too small, or could require the fiduciary to withhold an amount from one or more future distributions to a beneficiary (or require the beneficiary to return some or all of a distribution) in those cases where the adjustment caused a distribution to the beneficiary which was too large. (EPTL 11-2.3-A(c)(1) and (2).)

If the court is unable to restore the beneficiaries, the trust or both to the position they would have occupied absent the abuse of discretion, *and* the court finds that the fiduciary was dishonest *or* arbitrary and capricious in the exercise of his, her or its discretion, the court can surcharge the fiduciary. (EPTL 11-2.3-A(c)(3).) Therefore, there are two thresholds of scrutiny under the statute. First, a finding that an abuse of discretion has occurred can lead to a direction by the court to make an adjustment or readjustment. Second, if such a direction by the court cannot restore the beneficiaries and a trust to their just positions and the court finds that the fiduciary was dishonest or arbitrary and capricious, the fiduciary can be required to contribute its own funds in order to restore the beneficiaries and/or the trust to their just positions.

2. Protection from Liability

EPTL 11-2.3-A(d) permits the fiduciary to petition the court for a determination of whether a proposed exercise or non-exercise of the power to adjust by the fiduciary will result in an abuse of discretion. The petition should describe the proposed exercise or non-exercise and contain sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the beneficiaries and remaindermen will be affected. A beneficiary who challenges the proposal has the burden of establishing that it will result in an abuse of discretion. Accordingly, if a trustee is concerned that a beneficiary may challenge a proposed adjustment or a determination not to adjust, the trustee may protect itself from liability by so petitioning the court.

A trustee may also be protected from future liability for a proposed exercise (or non-exercise) of the power to adjust if the proposal is specifically authorized by the unanimous informed consent of all beneficiaries, including contingent remaindermen. New York case law is clear that a beneficiary who has properly consented to an action of a trustee is estopped from later holding the trustee liable in connection with such action. *See Ere v. Lincoln Rochester Trust Co.*, 214 N.Y.S.2d 849, *appeal denied*, 217 N.Y.S.2d 576 (App. Div. 1961).

D. Miscellaneous Considerations Regarding Power to Adjust Statute

1. Duty to Inform Co-Trustees and Beneficiaries

Where a professional trustee is serving with one or more co-trustees, such trustee should contact the co-trustee(s) to inform them of the existence of the new legislation and its ramifications so that the co-trustee(s) can meaningfully participate in the decision whether to exercise the power to adjust. For example, in a recent New York case, the court held that "[a] trustee, 'particularly one empowered to exercise greater control, or having greater knowledge of trust affairs' is under a duty 'to inform each co-trustee of all material facts relative to the administration of the trust that have come to his attention.'" *Benedict v. Medici*, 1993 U.S. Dist. LEXIS 3556 (S.D.N.Y. 1993) (quoting Bogert's Trusts & Trustees, § 584, at 40 (Supp. Rev. 2d ed. 1992)). Moreover, where a trustee shares authority to make such decisions for the trust, a trustee is required to inform its co-trustee(s) under EPTL 10-10.7 as well, which states that such a power shall be jointly exercised by two trustees or by a majority if more than two trustees are serving (unless the governing instrument provides otherwise). Even if the governing instrument permits a trustee to make such decisions on its own, co-trustees should be informed of the new legislation and, at least in general terms, any changes a trustee anticipates making with respect to the investment and distribution guidelines for that type of trust.

There is no case law or statutory law expressly obligating a trustee to inform a beneficiary of changes in the law or decisions by the trustee regarding investments, distributions or administration.[24] Likewise, EPTL 11-2.3(b)(5) does not require notification to a beneficiary of the power to adjust or the exercise of that power by the trustee. However, the beneficiaries will have to be notified in cases where the trustee petitions the court for a ruling as to the appropriateness of a proposal to exercise or to not exercise the adjustment power.

2. Should a Trustee Exercise the Power to Adjust or Invade Principal?

If a beneficiary has a right to receive the trust's income, and article 11-A applies to the trust, the trustee will have to determine whether or not to exercise the powers granted under EPTL 11-2.3(b)(5). First, the trustee may wish to determine what the appropriate return to the income beneficiary should be based on the factors described above. Then, the trustee may wish to determine, depending on whether the current production of income is too low or too high, whether to adjust the income by shifting income to principal or principal to income based upon the circumstances of the particular beneficiaries and trust. Because the purpose of the power to adjust is to ensure, consistent with the grantor's intent, that the income beneficiary has the beneficial enjoyment of the trust property consistent with the beneficiary's income interest, a determination whether to exercise or not exercise the power to adjust probably should be made first, prior to and separate from any determination of whether to invade principal.

Where the trustee is the trustee of a trust which allows payments of income and/or principal to beneficiaries in the trustee's broad discretion (a true sprinkle trust), it should not be necessary for the trustee to adjust between principal and income, and it may be more in keeping with the settlor's intent if the trustee were to distribute (or accumulate) income and invade principal when necessary instead of using the power to adjust. Under the terms of such a trust, the trustee should already be able to invest in order to achieve a total return that benefits the current beneficiaries and remaindermen.

3. Can the Power to Adjust Be Exercised if Principal Invasions Are Prohibited?

Because the stated purpose of the enactment of the power to adjust is to ensure that an income beneficiary will receive an appropriate level of distributions from the trust in accordance with the beneficiary's income interest, the trustee should be permitted to exercise the power to adjust even if no power to invade principal exists. By exercising the power to adjust, the trustee is not invading principal or altering a person's beneficial interest in the trust, but is making sure that the income beneficiary is receiving appropriate distributions from the trust consistent with the beneficiary's interest. Therefore, the power to adjust is distinct from an invasion power in that the power to adjust only allows the trustee to increase the distribution amount to an amount which is an appropriate income return for the trust.

For the same reasons, although it is not as clear, the trustee should be permitted to exercise the power to adjust even if the governing instrument specifically prohibits such invasions. However, in the case of a trust where such invasions are specifically prohibited, it may be advisable for the trustee to seek court approval or seek consents from the interested parties before exercising the power to adjust since the power to adjust does involve an allocation of principal to the income beneficiary which otherwise would be prohibited under the terms of the governing instrument. It is possible that a court might find that such prohibition is a term "intended to deny the trustee the power of adjustment." EPTL 11-2.3(b)(5)(F). This would especially be the case if extrinsic evidence (*i.e.*, the testimony of the grantor of the trust or the attorney draftsman) indicates that the use of the power to adjust would be inconsistent with the prohibition on invasions of principal contained in the governing instrument.

4. Can an Adjustment Be Made Retroactively?

The statute does not expressly provide for retroactive adjustments to make up for years after the effective date when the power to adjust was not exercised. In addition, EPTL 11-2.3(b)(5)(A) states that the power is meant to enable the trustee to make "appropriate present and future distributions." Therefore, it appears that the trustee may use the power to adjust in determining appropriate distributions only on a "going forward" basis.

E. Optional Unitrust Provision

1. Summary of Unitrust Provision

Recently enacted EPTL 11-2.4 authorizes the net income of a trust to be defined as a four percent (4%) unitrust interest. This provision applies to a trust at the election of the trustee or pursuant to the terms of the governing instrument. This provision and article 11-A may not apply to a trust at the same time—one or the other may apply (and the governing instrument may provide that neither applies). The unitrust regime is meant to simplify the administration of the trust by replacing the concept of principal and income by defining a trust's "net income" as the "unitrust amount." For the first three years of a trust, the unitrust amount is equal to four percent (4%) of the net fair market value of the assets of the trust on the first business day of the current valuation year; and thereafter, the unitrust amount is equal to four percent (4%) of the average of the net fair market value of the assets of the trust on the first business day of the current valuation year and the two immediately preceding years.[25] In determining the value of a trust, certain assets set forth in EPTL 11-2.4(b)(6) are not to be included.[26]

2. Trusts to Which It Applies

Under EPTL 11-2.4(e), the unitrust regime applies to any trust if the governing instrument states that EPTL 11-2.4 applies. The trustee can also elect into the unitrust regime under EPTL 11-2.4(e)(1)(B). For trusts created before January 1, 2002, the trustee may elect to have this provision apply on or before December 31, 2005, and for trusts created on or after January 1, 2002, the trustee may make such an election on or before the last day of the second full year of the trust.

It also appears that a court may direct the payment of the unitrust amount retroactive to the first day of the year in which the petition directing the application of the unitrust amount is granted. *See In re St. Ives*, 197 Misc. 2d 479 (Surr. Ct. Broome Co. 2002).

The trustee's election may be made with the consent of or on behalf of all persons interested in the trust *or* in the trustee's discretion. The election is required to be made by an acknowledged written instrument delivered to the creator of the trust (if living), to all persons interested in the trust (or to their representatives), and the court, if any, having jurisdiction over the trust.[27]

In addition, at any time, the trustee may petition the appropriate court for a direction that article 11-A does apply and EPTL 11-2.4 does not apply to a trust (or vice versa) (EPTL 11-2.4(e)(2)). If a proceeding is so brought, there is a rebuttable presumption that EPTL 11-2.4 applies.

The term "trust" for purposes of EPTL 11-2.4 does not include any estate or any trust pursuant to the terms of which any amount is permanently set aside for charitable purposes unless the income therefrom is also permanently devoted to charitable purposes (*i.e.*, a charitable remainder trust). (EPTL 11-2.4(c)(9).)

3. Factors to Consider in Determining Whether to Elect Unitrust Payout

EPTL 11-2.4(e)(5) states that all factors relevant to the trust and its beneficiaries are required to be considered by the trustee in determining whether to elect the unitrust payment or apply article 11-A (*i.e.*, the power to adjust). The following non-exclusive list of factors to be considered are set forth in the statute:

- the nature, purpose and expected duration of the trust;
- the intent of the creator of the trust;
- the identity and circumstances of the beneficiaries;
- the needs for liquidity, regularity of payment, and preservation and appreciation of capital; and
- the assets held in the trust (including the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property or real property, the extent to which an asset is used by a beneficiary, and whether an asset was purchased by the trustee or received from the creator of the trust).

Unlike the trustee's power to adjust, the unitrust provision requires the trustee to take into consideration the circumstances of the beneficiaries and the trust in determining whether article 11-A or the unitrust provision should be applied to a particular trust.

In addition, in determining whether to direct that a unitrust be applied, a court determined that these five factors were also required to be considered by the court and, in that regard, the parties submitted an affidavit of the attorney-draftsman regarding the testator's intent, and affidavits from the income beneficiary and a remainderman regarding their financial circumstances. *See In re St. Ives*, 197 Misc. 2d 479 (Surr. Ct., Broome Co. 2002).

An additional factor a trustee may wish to consider is that once the unitrust election has been made, only the court may reverse the election (and direct that article 11-A thereafter applies). (EPTL 11-2.4(e)(2)(A).)

4. Should Trustee Elect In or Use Available Invasion Power?

Because, unlike the power to adjust, the unitrust election is "permanent," it is probably preferable not to elect in and instead use the power to adjust or an available principal invasion power to meet the needs of the current income beneficiaries.

5. Requirement to Notify Co-Trustees and Beneficiaries

EPTL 11-2.4 does not require that co-trustees be informed of the existence of the provision or the election into the unitrust regime. However, for the same reasons noted above with respect to the new power to adjust provision, a professional trustee should inform co-trustees of the unitrust provision and the election which may be made thereunder.

As stated above, in cases where an election is made to have the unitrust provision apply to a trust, the trustee is required to deliver the election instrument to (and thereby notify) the beneficiaries of the election. There is no additional requirement to notify the beneficiaries of the provision.

F. Some Differences Between the Optional Unitrust Provision and the Power to Adjust

1. Notification Provision

Unlike in the case where a trustee exercises the power to adjust (assuming no petition is made to the court), when the trustee elects the application of the unitrust provision, the trustee is required to notify the grantor, the beneficiaries and the appropriate court (otherwise the election will not be effective). In addition, if the trustee petitions the court to determine whether the unitrust provision should apply, all persons interested in the trust are required to receive notice of the petition.

2. Allocation of Commissions and Fees

Unless the governing instrument provides otherwise, the unitrust amount is not reduced by trustee commissions. The trustee commissions are allocated to principal. SCPA 2308(3), 2309(3) and 2312(5). Outside the unitrust regime, trustee commissions are allocated one-third to income and two-thirds to principal for non-charitable trusts. However, a trustee may consider the impact of commissions chargeable to income in determining the extent of its adjustment under the power to adjust.

3. Inability to Elect Out

As noted above, the unitrust regime cannot be elected into and out of in the trustee's discretion. Once the unitrust election is made, only the court may reverse that election and direct that article 11-A applies to the trust. This limits the trustee's flexibility to adjust distributions to the income beneficiary as economic circumstances change, making a four percent (4%) return to the income beneficiary in many cases not appropriate.

4. No Prohibition on Interested Trustee from Participating in Unitrust Election

While an interested trustee may not participate in a determination to exercise the power to adjust (EPTL 11-2.3(b)(5)(C)(vii)), an interested trustee is not precluded from participating in the determination to elect into the unitrust regime.

5. Application

As noted above, the optional unitrust provision does not apply to estates or to any assets while held in a testator's estate. (EPTL 11-2.4(c)(7) and (9).)

However, unlike the power-to-adjust provision, the unitrust regime is not precluded from applying to (i) a marital deduction trust regardless of whether such election will diminish the income interest, (ii) trust transfers which qualify for the gift tax annual exclusion, or (iii) any other trust (other than a charitable remainder trust). Before electing in, the trustee should ascertain that such an election will not deprive the trust of a tax benefit or impose a tax burden.

6. Consideration of Factors

Also as noted above, unlike with the power to adjust, the trustee is required to consider all relevant factors in determining whether to elect in to the unitrust regime.

In addition, EPTL 11-2.4(e)(5)(B) creates a rebuttable presumption that the unitrust regime should apply in any proceeding brought by an interested party for a determination that the unitrust regime should apply rather than article 11-A.

7. Liability Concerns

With regard to the power to adjust, the trustee would only be liable to the beneficiaries and/or the trusts if a court (a) found it had abused its discretion in exercising or deciding not to exercise the power to adjust, (b) determined that the abuse of discretion could not be remedied other than by payment of the trustee's separate funds and (c) found that the trustee acted dishonestly or arbitrarily and capriciously.

With respect to the unitrust regime, although there is no recitation of the standard of review which will be applied by the court to a trustee's determination of whether or not to elect that the unitrust regime apply, a trustee probably would not be held liable unless the court found that the trustee had abused its discretion. However, if a trustee is found to have abused its discretion, the statute does not preclude the court from finding the trustee liable regardless of whether a restoration could be effected through use of trust assets. *Cf*. EPTL 11-2.3-A(c). In addition, the requirement of an additional finding that the trustee acted dishonestly or arbitrarily and capriciously in exercising the power to adjust suggests that a higher standard than abuse of discretion alone may be required to hold a trustee individually liable. Although the terms "arbitrary and capricious" may be used in the context of finding that a trustee has abused its discretion, their separate use in EPTL 11-2.3-A(c)(3) suggests a higher standard.

8. Investment Considerations

If the unitrust regime applies (whether pursuant to the terms of the governing instrument or the election of the trustee or otherwise), the trustee will have to make investments which will enable the payment of the four percent (4%) unitrust interest without eroding the purchasing power of trust principal. Even with the three year "averaging" rule which will use the market values of trust assets over three years to determine the unitrust amount, it is possible that a four percent (4%) unitrust interest may not comport with the trustee's investment model.

The power to adjust, however, would allow the trustee to use the same investment philosophy as in the unitrust regime, but would offer flexibility in making distributions. For example, where a trust mandates annual distributions of income to the beneficiary, the trustee could invest for a total return in keeping with the Prudent Investor Act and could make gradual adjustments to the income interest depending on the growth the trust has experienced in any given year. If the trust instead were paying a four percent (4%) unitrust, the trustee would not be in as good a position to protect the purchasing power of trust principal should the market underperform for a period of years.

* * *

The Prudent Investor Act provides the trustee of the new millennium with greater investment flexibility, permitting investment for total return and permitting investment in asset classes not traditionally considered. As these new asset classes are considered, a trustee needs to consider the diversification of the trust's portfolio and develop a prudent process to determine the appropriateness of the investments since, under the Prudent Investor Act, prudence is determined based upon the trustee's standard of conduct. As the trustee structures a total return portfolio, the power to adjust and optional unitrust election will provide the trustee with the flexibility to make sure the investment strategy chosen does not adversely affect the interests of either the income beneficiary or remaindermen.

Endnotes

1. A provision was subsequently added to EPTL 11-2.2 that required fiduciaries with special investment skills to exercise those skills and indicated that their performance would be judged accordingly.
2. *See, e.g.*, EPTL 11-A-1.3(a)(3) which requires a fiduciary to "administer" a trust or estate in accordance with the terms of the Uniform Principal and Income Act provided the terms of the trust or will do not contain a contrary provision or do not give the fiduciary a discretionary power of administration; 106 N.Y. Jur. 2d, § 17 (stating that a trustee's duty of making allocations as between income and principal is a question of trust administration); *In re Waterbury's Trust*, 231 N.Y.S.2d 208 (1962) (holding that while the question of governing law for allocation of dividends is one of construction, the question of what receipts are allocable to income and what to principal is a question of trust administration).
3. *See* 106 N.Y. Jur 2d § 22; *see also Restatement (Second) Conflict of Laws* § 279 (stating that "the administration of a trust of an interest in land is determined by the law that would be applied by the courts of the situs as long as the land remains subject to the trust.") *See In re Turner's Will*, 90 N.Y.S.2d 481 (1949) (stating that administration of a trust of real property is governed by the law of the state where the real property is located, and can be supervised by courts of that state only).
4. *Restatement (Second) Conflict of Laws* § 279, comment b.
5. *Id*.
6. *Id*.
7. *Id*.
8. *See In re Waterbury's Trust*, 231 N.Y.S.2d 208 (1962).
9. *Restatement (Second) Conflict of Laws* § 267, comment c.
10. *Id*. at § 272 provides that the local law of the state designated by the settlor governs the administration of the trust. If there is no such designation, the local law of the state to which the administration of the trust is most substantially related applies.
11. *See In re Keeler's Estate*, 49 N.Y.S.2d 592 (1944).
12. *Id.*; *see also Restatement (Second) Conflict of Laws* § 271 (stating that "the administration of a trust of interests in movables created by will is governed as to matters which can be controlled by the terms of the trust (a) by the local law of the state designated by the testator to govern the administration of the trust, or (b) if there is no such designation, by the local law of the state of the testator's domicile at death, unless the trust is to be administered in some other state, in which case the local law of the latter state will govern").
13. *See Restatement (Second) Conflict of Laws* § 271, comment g, and § 272, comment e.
14. *Id*.
15. *Id*.
16. 12 CFR § 9.18. The regulation further provides that the limitation does not apply to investments in direct obligations of the U.S. or obligations fully guaranteed by the U.S.
17. The income tax treatment of financial instruments is an extremely complex area. The analysis in this outline sets forth a very basic introduction to these income tax rules. The applicable rules will vary with the particular facts and circumstances of each case. Fiduciaries should consult tax counsel prior to making any decisions to purchase, exercise, hold or close any financial instrument.
18. "American" options can be exercised at any time during the life of the contract. "European" options can be exercised only at maturity.
19. However, the application of the power to adjust is subject to the restrictions in EPTL 11-2.3(b)(5)(C).
20. It should be noted, however, as discussed later, that the optional unitrust provision (EPTL 11-2.4(e)(5)) states that in determining whether to elect the unitrust payment or article 11-A (*i.e.*, the power to adjust), the trustee is *required* to consider certain factors.
21. This section is intended to remove pooled income funds and charitable remainder trusts from the provision since the IRS indicated that they would not continue to qualify if they used the adjustment power.
22. As is noted later, although a benchmark is authorized for multiple trusts managed by a trustee, EPTL 11-2.4(e)(5) appears to require that a trustee consider the particular circumstances of each trust to determine whether article 11-A (and, therefore the power to adjust) or the optional unitrust provision should apply.
23. The statute provides that a court cannot find that a fiduciary abused its discretion merely because the court would have exercised the discretion in a different manner or not at all.
24. It should be noted that in a recent case involving a dispute between remaindermen and a trustee in connection with trust investments, the Broome County Surrogate stated that "[i]mplicit in [the] professional standard [imposed on corporate trustees] is the responsibility on the part of the trustee to consistently counsel trust beneficiaries to assume an investment strategy that is in their own best interest." *In re Estate of Saxton*, 179 Misc. 2d 681, 690 (Broome Co. Sur. Ct. 1998). It is not clear, however, that this duty would include notifying the beneficiaries of changes in the law.
25. The trustee's determination of net fair market value is conclusive on all persons interested in the trust if made reasonably and in good faith. Such determination is conclusively presumed to be made reasonably and in good faith unless proven otherwise in a proceeding commenced within three years of the date the determination is made.
26. The assets which are not included in calculating the trust's fair market value include residential property or tangible personal property which trust beneficiaries have the right to occupy, possess or control, assets specifically given to a beneficiary and assets while held in a testator's estate.
27. For purposes of EPTL 11-2.4, the term "all persons interested in the trust" is defined to include all persons upon whom service of process would be required in a judicial accounting proceeding, taking into account SCPA 315. EPTL 11-2.4(e)(3). In addition, where a person interested in a trust has the same interest as a person under disability (horizontal representation), EPTL 11-2.4(e)(3) does not require the consent of or the notification of the person under disability.

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New York State Bar Association
Trusts and Estates Law Section

2003 Fall Meeting

"The New Millennium: Investment and Administration Challenges Facing the Trustee and Executor"

The premise of this two-day program for the Fall 2003 meeting is to provide a guide as to the most effective means of addressing issues, pre-litigation, and, if unresolved, to obtain relief in the Surrogate's Court.

The panel will seek to integrate new technology into the program, for example, involving registrants with operations technology which allows them to indicate a position on the issues presented.

In the context of the showcase topic, "Investment Before and After the Prudent Investor Act," the panel will address numerous issues for the trustee and executor, such as the distribution of assets, the funding of trust, the allocation of interests among beneficiaries, the "standard of impartiality," the effect of global assets including conflicts, jurisdiction in cyberspace and fiduciaries in multiple jurisdictions.

I. Investment Issues

A. What to do when your client is an unhappy beneficiary because:

1. The trustee has incurred substantial investment losses:

   a. Under Prudent Person Rule

      i) Imprudent investments

      ii) The no-offset rule—Bank of New York

      iii) Terms of instruments

      iv) Delegation

      v) Professional and non-professional fiduciaries

      vi) Burden of proof

   b. After Prudent Investor Act

      i) Different than Prudent Person?

         (a) No imprudent investments

         (b) A change in perspective—the no-offset rule

         (c) Terms of instruments

         (d) Delegation

         (e) Professional and non-professional fiduciaries

   c. Measure of Damages

      i) When does prudence become imprudence?

      ii) The impact of intermediate accounts—Are fiduciaries measured by unrealized gains?

2. The trustee achieved a high current yield for the income beneficiary but little or no growth in corpus for your client, or no growth in corpus for your client, or the trustee achieved substantial corpus appreciation, but low current yield for your client.

   a. Under Prudent Person Rule

      i) The preservation of principal dogma

      ii) The duty of impartiality

      iii) The beneficiaries' consent—Hunter, Saxton

      iv) The underproductive rule—EPTL 11-2.1(k)

      v) Terms of instruments

   b. Under Prudent Investor Act

      i) Terms of instruments

      ii) Powers of adjustment

      iii) The unitrust option

II. Administration

A. Funding trusts

1. Selection of assets and standard of impartiality

2. Use of business or partnership interests, transfer of control

3. Effect of funding on non-trust beneficiaries

4. Discharge of executor/trustee

B. Allocation of shares among beneficiaries where trustee has full discretion

1. Distribution, only in equal shares? What is the trustee's responsibility?

2. Terms of instrument as guidance

C. What does the beneficiary or co-trustee do when:

1. Two co-trustees, co-executors, are at an impasse.

   a. May the attorney continue to represent the co-fiduciaries?

2. A co-trustee or co-executor fails to respond to recommendations from her co-trustee or co-executor.

3. An executor, trustee or co-trustee appears to be incapacitated by reason of senility or other infirmity.

4. The trustee, or executor, fails to respond to your client's questions and refuses to comply with your client's request for information.

   a. Rule of reason/harassment/abstinence

   b. Remedies—SCPA 2102

5. The fiduciary refuses to comply with the beneficiaries' requests/directions.

   a. Terms of instruments

   b. A reasonableness standard?

   c. AHammer" powers

   d. Conflicts among beneficiaries

6. Your client regards the expenses of the executor or trustee as excessive.

   a. The fair and reasonable standard

      i) How to measure

   b. Burden of proof

D. Fiduciary: Maintaining records—how detailed?

E. Assets in multiple jurisdictions

1. Authority to administer

2. Resolving issues of conflicts, duties and liabilities

3. Determining when a non-New York fiduciary is required

III. Remedies: If Negotiation Fails and Court Intervention Is Required

A. Remedies available to beneficiaries

1. Removal

2. Surcharge

3. Disqualification of attorney

B. Pleadings:

1. What must the beneficiary, or fiduciary, allege in:

   a. The petition?

   b. The answer? (Admit, deny, deny knowledge, affirmative defenses, counterclaims)

C. What defenses are to be expected from trustees/executor/exoneration provisions?

D. How to satisfy burden of proof

1. Beneficiaries

2. Fiduciaries

3. Application of inferences and presumptions

E. What strategies are available to each party?

1. Discovery

2. Motions

Special Report on the Separate Account Rule for Beneficiaries of IRA Accounts

By Seymour Goldberg

Many IRA owners have multiple nonspouse beneficiaries of their IRA accounts. It is important that attorneys, accountants and financial planners become aware of the IRS distribution rules that apply after the IRA owner passes away.

It is important that the nonspouse beneficiaries act in a timely manner in order to satisfy the separate account rules that are reflected in the final regulations at 1.401(a)(9)-8, Q & A-2 and Q & A-3.

The reason that the separate account rule is important is the fact that each beneficiary after the death of the IRA owner may then use his or her life expectancy in determining the required minimum distributions from his or her pro rata share of the decedent's IRA account.

According to the preamble to the final regulations, the separate accounts with different beneficiaries of the IRA can be established at any time, either before or after the IRA owner's required beginning date. However, according to the IRS final regulations at 1.401(a)(9)-8, Q & A-2(a)(2), a separate account must be established no later than the last day of the year following the calendar year of the IRA owner's death in order for each beneficiary to use his or her respective life expectancy for minimum distribution purposes.

Practitioner tip:

If the separate accounts are established after the last day of the year following the IRA owner's death, then each beneficiary may not use his or her respective life expectancy for minimum distribution purposes. Instead, each beneficiary must receive required minimum distributions based upon the oldest beneficiary's life expectancy. This can create serious problems if one of the beneficiaries is a charity or the IRA owner's estate.

The IRS final regulations at 1.401(a)(9)-8, Q & A-2(a)(2) further provide in relevant part as follows:

> If the [IRA owner's account] is [timely] divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts of the [IRA owner], for years subsequent to the calendar year containing the date on which the separate accounts were established, or date of death if later, such separate account [of the IRA owner] is not aggregated with the other separate accounts [of the IRA owner] in order to determine whether the distributions from such separate account under the [IRA] satisfy section 401(a)(9). Instead, the rules in section 401(a)(9) separately apply to such separate account under the [IRA]. However, the applicable distribution period for each separate account is determined disregarding the other beneficiaries of the [IRA owner] only if the separate account is established on a date no later than the last day of the year following the calendar year of the [IRA owner's] death.

According to the IRS, the separate account rules become operative in the calendar year after the separate accounts are established. However, the separate accounts must be timely established in order to implement the separate account rule.

The author of this report was involved in obtaining two IRS letter rulings with respect to the implementation of the separate account rules under the IRS final regulations. See IRS letter rulings 200248030 and 200248031, both dated September 3, 2002.

In order to implement the separate account rule described in this special report, the following steps should be taken:

1. Upon the death of the IRA owner, the advisor should determine whether or not there are multiple beneficiaries of the deceased IRA owner's account.
2. If there are multiple beneficiaries of the IRA owner's account, then someone should be given the responsibility with respect to implementing the separate account rule.

Practitioner tip:

Often the beneficiaries are not advised as to the mechanics of timely implementing the separate account rule. Since an IRA generally is not a probate asset, the attorney for the estate may assume that the decedent's financial consultant will correctly handle the post-death retirement distribution issues. This may or may not be the case. There are currently a number of civil disputes pending against financial planners who have given the beneficiaries improper post-death retirement distribution advice.

3. If the beneficiaries of the decedent's IRA decide to implement the separate account rule, then a competent professional advisor should give the beneficiaries specific instructions on what the beneficiaries should do and when.

4. The following approach should be considered in implementing the separate account rule:

   a. The attorney or financial planner should meet with the beneficiaries and advise them to establish separate accounts with respect to the deceased IRA owner's account. If a meeting is not possible, then written instructions should be given to each beneficiary as to what should be done and when.

   b. Each nonspouse beneficiary of the IRA should be told that a nonspouse beneficiary may not roll over an inherited IRA into his or her name.

Practitioner tip:

Each nonspouse beneficiary should be told that a nonspouse beneficiary must have the IRA maintained in the deceased IRA owner's name for the beneficiary's respective benefit.

If the IRA is erroneously retitled in the name of a nonspouse beneficiary, then this improper IRA account is considered to be fully and immediately taxable to the nonspouse beneficiary and is also subject to a 6% nondeductible excise tax under IRC Sec. 4973 (excess contribution) to the nonspouse beneficiary. This excise tax is a cumulative excise tax and accrues each year until corrected. There are a number of IRS letter rulings on this issue. Unfortunately, this issue can happen when the beneficiaries deal with a consultant who is not aware of the IRS distribution rules and the IRS letter rulings.

5. In addition to the proper titling of the decedent's IRA, another IRS rule must be satisfied with respect to the separate account rule if the decedent had multiple beneficiaries of his or her IRA account. The final regulations at 1.401(a)(9)-8, Q & A-3 discuss the pro rata rule. This final regulation provides in essence as follows:

> The separate accounting must allocate all post-death investment gains and losses . . . for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner among the separate accounts. However, once the separate accounts are actually established, the separate accounting can provide for separate investments for each separate account under which gains and losses from the investment of the account are only allocated to that account, or investment gains or losses can continue to be allocated among the separate accounts on a pro rata basis. A separate accounting must allocate any post-death distribution to the separate account of the beneficiary receiving that distribution.

Practitioner tip:

If a partial distribution is made after the death of the IRA owner and prior to implementing the separate account rule, then any post-death distributions must also satisfy the pro rata rule.

Application of the Separate Account Rule

The best way to illustrate the separate account rules is to use examples.

The following examples should help you in implementing the separate account rule:

Example 1

Assume that John, age 75, dies on March 1, 2003. His required minimum distribution for the calendar year 2003 is $20,000. John failed to receive this amount prior to the date of his death. The beneficiaries of his IRA are Jack, age 20 in the calendar year 2003 and Jill, age 30 in the calendar year 2003. Both Jack and Jill are equal beneficiaries of John's IRA.

Question: Who should receive the $20,000 required minimum distribution from John's IRA for the calendar year 2003?

Answer: Jack should receive $10,000 and Jill should receive $10,000 in order to satisfy the pro rata rule if the distribution is made prior to the implementation of the separate account rule.

Example 2

Assume the facts in Example 1. Further assume that Jack would like to receive $15,000 in July 2003 prior to the implementation of the separate account rule. However, Jill would only like to receive $10,000 prior to the implementation of the separate account rule.

Question: Will this discrepancy create a problem in implementing the separate account rule at a later date?

Answer: In the absence of an IRS letter ruling to the contrary, it appears that the separate account rule will be violated since the pro rata rule is breached.

Example 3

Assume the facts in Example 1. Further assume that each beneficiary receives $10,000 during August 2003.

Question: By what date should the separate account rule be implemented?

Answer: The separate account rule should be implemented by December 31, 2003, if possible. However, in no event may it be implemented after December 31, 2004.

Example 4

Assume the facts in Example 3. Further assume that the beneficiaries would like to implement the separate account rule by December 31, 2003.

Question: How is the separate account rule implemented?

Answer: The beneficiaries should give written instructions to the financial institution to divide Jack's IRA into two equal inherited IRAs which should read as follows:

John deceased IRA f/b/o Jack (Jack's SS # should be used on the account)	John deceased IRA f/b/o Jill (Jill's SS # should be used on the account)

Example 5

Assume the facts in Example 4. Further assume that the separate account rule was implemented on December 15, 2003. Further assume that each separate IRA account had a balance of $500,000 as of December 31, 2003.

Question: What is the amount of the required minimum distribution that Jack and Jill must receive from each separate IRA account during the calendar year 2004?

Answer: Jack must receive a required minimum distribution of $8,051.53 in 2004 from John's deceased IRA f/b/o Jack. This is based upon the following calculation:

(1) John's deceased IRA account balance as of December 31, 2003.	$500,000
(2) Divided by Jack's single life expectancy of 62.1 as determined in the year after John's death. In 2004, Jack is age 21.	62.1
(3) Result (1 + 2)	$ 8,051.53

In the year after John's death, Jack is age 21. The single life expectancy of an individual age 21 is 62.1 years.

Jill must receive a required minimum distribution of $9,541.98 in 2004 from John's deceased IRA f/b/o Jill. This is based upon the following calculation:

(1) John's deceased IRA account balance as of December 31, 2003.	$ 500,000
(2) Divided by Jill's single life expectancy determined in the year of John's death. In 2004, Jill is age 31.	52.4
(3) Result (1 + 2)	$ 9,541.98

In the year after John's death, Jill is age 31. The single life expectancy of an individual age 31 is 52.4 years.

Example 6

Assume the facts in Example 5.

Question: In determining the required minimum distribution for the calendar year 2005, what calculation formula must Jack and Jill use?

Answer: Jack will determine the account balance of John's deceased IRA f/b/o Jack as of December 31, 2004 and divide that amount by 61.1 years in order to determine his required minimum distribution for the calendar year 2005. Jill will determine the account balance of John's deceased IRA f/b/o Jill as of December 31, 2004 and divide that amount by 51.4 years in order to determine her required minimum distribution for the calendar year 2005.

Practitioner tip:

Jack and Jill will reduce the term-certain period that is allocable to each of them by one for each year after 2005 as well.

Example 7

Assume the facts in Example 3. Further assume that the separate account rule was implemented in February 2004. Further assume that John's deceased IRA account as of December 31, 2003 amounted to $1,000,000.

Question: What is the amount of the required minimum distribution that Jack and Jill must each receive during the calendar year 2004?

Answer: Jack and Jill must each receive a required minimum distribution of $9,541.98 for the calendar year 2004. This is calculated as follows:

(1)	John's deceased IRA account balance as of December 31, 2003.	$ 1,000,000
(2)	Divided by Jill's single life expectancy determined in the year after John's death.	<u>52.4</u>
(3)	Result (1) 2)	$ 19,083.96

Jack and Jill will each receive 50% of $19,083.96 or $9,541.98 as his or her required minimum distribution for the calendar year 2004. Since the separate account rule was not implemented by December 31, 2003, then the life expectancy that must be used in determining the required minimum distributions for the calendar year 2004 is based upon the life expectancy of the oldest beneficiary. The life expectancy of the oldest beneficiary is determined in the calendar year after John's year of death. In the calendar year 2004, Jill is age 31 and her life expectancy is 52.4 years.

Example 8

Assume the facts in Example 7.

Question: In determining the required minimum distribution for the calendar year 2005, what calculation formula must Jack and Jill use?

Answer: Jack will determine the account balance of John's deceased IRA f/b/o Jack as of December 31, 2004 and divide that amount by 61.1 years in order to determine his required minimum distribution for the calendar year 2005. Jill will determine the account balance of John's deceased IRA f/b/o Jill as of December 31, 2004 and divide that amount by 51.4 years in order to determine her required minimum distribution for the calendar year 2005.

Practitioner tip:

Jack and Jill will reduce the term-certain period that is allocable to each of them by one for each year after 2005 as well.

Example 9

Assume the facts in Example 8 except that the separate accounts are established in June 2005.

Question: Has the separate account rule been timely implemented?

Answer: No. According to the final regulations under 1.401(a)(9)-8, Q & A-2(a)(2), the separate account rule must be timely implemented by no later than the last day of the year following the calendar year of the IRA owner's death. Therefore, the separate account rule must be timely implemented by December 31, 2004 since John died in 2003.

Example 10

Assume the facts in Example 9.

Question: In determining the required minimum distribution for the calendar year 2005, what calculation formula must Jack and Jill use?

Answer: The account balance of John's deceased IRA is determined as of December 31, 2004 and is divided by 51.4 years. That amount is the aggregate amount of the required minimum distribution for the calendar year 2005. Jack and Jill would each receive 50% of that amount as their respective share of the aggregate distribution.

Practitioner tip:

Since the separate account rule was not timely implemented by December 31, 2004, the required minimum distributions from John's deceased IRA must always be based upon the life expectancy of the oldest beneficiary of John's IRA. Since Jill is the oldest beneficiary and had a life expectancy of 52.4 years in the calendar year 2004, then that life expectancy is reduced by one for each year thereafter for both Jack and Jill. In 2005, the remaining life expectancy used by both Jack and Jill is therefore 51.4 years. They may, of course, accelerate distributions from time to time. This result would not change even if Jack and Jill separate John's IRA at a later date. Any action taken by Jack and Jill after December 31, 2004 will not help Jack since he must use Jill's life expectancy.

Letter Ruling 200248030
Dated September 3, 2002

(Selected portions of the ruling are provided below)

By Seymour Goldberg

This ruling indicates how the separate account rule applies when there are multiple beneficiaries of an IRA account.

According to the facts, A, whose date of birth was Date 1, died on Date 2 in 1999 after having attained his required beginning date.

At his death, A maintained an individual retirement account (IRA) with Company Y. A named B, C and D as equal beneficiaries of his IRA X. B and C are A's children. D, whose date of birth was Date 5, 1943 is older than both B and C.

C requested this letter ruling. C's date of birth was Date 4, 1952.

During Month 7, 1999, C arranged for her pro rata (1/3) interest in A's IRA X to be separated from the interests of B and D and to be maintained as a separate IRA in the name of A for the benefit of C. The division and segregation occurred during Month 7, 1999 and Month 8, 2000. Since the date of separation, the IRA maintained for the benefit of C has had its gains and losses (to the extent applicable) allocated without regard to the allocations made to any IRA(s) set up and maintained for the benefit of B and D. Furthermore, any expenses associated with the maintenance of the IRA benefitting C have been debited against said IRA without regard to any IRA(s) maintained for the benefit of B and D.

Taxpayer C requested a number of rulings including the following:

* * *

3. That with respect to calendar years beginning with calendar year 2002, minimum required distributions from the IRA set up in A's name for the benefit of C may be based on the IRS final regulations under 1.401(a)(9) issued on April 17, 2002;
4. That with respect to calendar years beginning with the 2002 calendar year, minimum required distributions from the IRA set up in A's name for the benefit of C may be based on the single life expectancy table found in the IRS final regulations;
5. That with respect to calendar year 2002 and subsequent calendar years, the required minimum distributions that must be paid to C from the IRA set up and maintained in the name of A for C's benefit may be based on her remaining life expectancy of 34.0 years reduced by one for each calendar year subsequent to 2002. The determination of 34.0 is arrived at by determining the life expectancy of C during the calendar year 2000, the calendar year following the calendar year of A's death and reducing said life expectancy by one for each subsequent year.

The IRS stated in part as follows:

a. The preamble to the final regulations indicates that the regulations apply for determining required minimum distributions for calendar years beginning on or after January 1, 2003. However, with respect to calendar year 2002 distributions, a taxpayer may rely upon the final regulations published during 2002. This letter ruling is based on the IRS 2002 final regulations.

b. In general, if an IRA owner dies on or after his required beginning date, the applicable distribution period for calendar years after the distribution calendar year containing the IRA owner's date of death is the longer of (1) the remaining life expectancy of the IRA owner's designated beneficiary or (2) the remaining life expectancy of the IRA owner.

c. The final regulations provide that with respect to a nonspouse beneficiary, the applicable distribution period measured by the beneficiary's remaining life expectancy is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the calendar year of the IRA owner's death. In subsequent calendar years, the applicable distribution period is reduced by one for each calendar year that has elapsed after the calendar year immediately following the calendar year of the IRA owner's death.

d. In order to be a designated beneficiary, an individual must be a beneficiary as of the date of the IRA owner's death. Generally, the IRA owner's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of death.

e. In general, if an IRA owner has designated more than one beneficiary as of the applicable date for determining the designated beneficiary, the beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the distribution period.

f. The final regulations provide rules governing the establishment of separate accounts for purposes of computing the minimum required distributions. These rules provide in part that a separate account is a portion of an IRA owner's benefit determined by an acceptable separate accounting including allocating investment gains and losses on a pro rata basis in a reasonable and consistent manner.

g. The separate account must be established no later than the last day of the year following the calendar year of the IRA owner's death. The separate account rules are effective for years subsequent to the calendar year containing the date on which the separate accounts were established or the date of death of the IRA owner, if later.

According to the IRS, A died during the calendar year 1999. As of the date of his death, A maintained IRA X. A named B, C and D as equal (1/3) beneficiaries of his IRA X.

During the latter part of calendar year 1999 and the first half of calendar year 2000, C segregated her 1/3 interest in A's IRA X from the interests of B and D. C's interest in A's IRA X has been maintained for the benefit of C without regard to any IRA(s) set up and maintained for the benefit of B and D.

C's date of birth was Date 4, 1952. Thus, C attained age 48 during calendar year 2000, the calendar year following A's date of death. The single life expectancy table of the final regulations indicates that the remaining life expectancy for an individual age 48 is 36.0 years. Reducing 36.0 by two produces a life expectancy of 34.0.

Based upon the facts in this case, the IRS granted all of C's ruling requests.

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Tax Apportionment Traps

By Michael R. Suprunowicz, Lawrence A. DeAngelus, Richard A. Fuerst and Angela Martucci

I. Statutory Apportionment (Equitable Apportionment EPTL 2-1.8)

A. Constitutionality of Apportionment Statutes

Twelve years after the enactment of New York's first statutory tax apportionment statute (Decedent's Estate Law § 124), the Supreme Court of the United States held the statute to be constitutional, thereby requiring the payment of estate taxes to be apportioned under New York's tax apportionment statute in the absence of a tax clause in decedent's will. *See Riggs v. Del Drago*, 317 U.S. 95, 63 S. Ct. 109 (1942).

In *Riggs v. Del Drago*, beneficiaries under a will not containing a tax apportionment clause argued that the estate tax should not be apportioned according to the New York State law in effect at that time (DEL § 124), but should be paid entirely from the residue in accordance with federal law (§ 826(B) of the 1916 Code). *Riggs v. Del Drago*, 317 U.S. 95, 63 S. Ct. 109 (1942). The Court rejected their argument and stated that the New York statute was not in conflict with the federal statute. The Court reasoned, based upon Congressional intent, that the federal statute does not state "who shall bear the ultimate burden of the tax." *Id.* at 100. Rather, "[the] legislative history indicates clearly . . . that Congress intended that state law should determine the ultimate thrust of the tax." *Id.* at 100; *see generally, Estate Tax Apportionment and Nonprobate Assets: Picking the Right Pocket*, 21 Cumb. L. Rev. 1, 1990/1991, pages 5-7.

B. EPTL 2-1.8—The Text of New York's Equitable Apportionment Statute

§ 2-1.8. Apportionment of federal and state estate or other death taxes; fiduciary to collect taxes from property taxed and transferees thereof

(a) Whenever it appears in any appropriate action or proceeding that a fiduciary has paid or may be required to pay an estate or other death tax, under the law of this state or of any other jurisdiction, with respect to any property required to be included in the gross tax estate of a decedent under the provisions of any such law (hereinafter called "the tax"), the amount of the tax, except in a case where a testator otherwise directs in his will, and except where by any instrument other than a will (a "nontestamentary instrument") direction is given for apportionment within the fund of taxes assessed upon the specific fund dealt with in such nontestamentary instrument, shall be equitably apportioned among the persons interested in the gross tax estate, whether residents or non-residents of this state, to whom such property is disposed of or to whom any benefit therein accrues (hereinafter called "the persons benefited") in accordance with the rules of apportionment herein set forth, and the persons benefited shall contribute the amounts apportioned against them.

(b) Unless otherwise provided, when a disposition is made by which any person is given an interest in income or an estate for years or for life or other temporary interest in any property or fund, the tax apportionable against such temporary interest and the remainder limited thereon is chargeable against and payable out of the principal of such property or fund without apportionment between such temporary interest and remainder. The provisions of this paragraph apply although the holder of the temporary interest has rights in the principal, but do not apply to a common law annuity.

(c) Unless otherwise provided in the will or nontestamentary instrument, and subject to paragraph (d-1) of this section:

(1) The tax shall be apportioned among the persons benefited in the proportion that the value of the property or interest received by each such person benefited bears to the total value of the property and interest received by all persons benefited, the values as finally determined in the respective tax proceedings being the values to be used as the basis for apportionment of the respective taxes.

(2) Any exemption or deduction allowed under the law imposing the tax by reason of the relationship of any person to the decedent, the fact that the property consists of life insurance proceeds or the charitable purposes of the gift shall inure to the benefit of the person bearing such relationship or receiving such insurance proceeds or charitable gift, as the case may be.

(3) Any deductions for property previously taxed and any credit for gift taxes paid by the decedent shall inure to the benefit of all persons benefited and the tax to be apportioned shall be the tax after allowance of such deduction or credit.

(4) Any interest resulting from the late payment of the tax shall be apportioned in the same manner as the tax and shall be charged wholly to principal.

(5) Any discount allowed for prepayment of the tax shall be credited wholly to the principal of the funds contributing the moneys used for prepayment in proportion to the contribution made.

(d) Subject to subparagraphs (1), (2) and (3) of this paragraph, any direction as to apportionment or nonapportionment of the tax, whether contained in a will or a nontestamentary instrument, relates only to the property passing thereunder, unless such will or instrument provides otherwise.

(1) Any such direction in a will which is later in date than a prior nontestamentary instrument and which contains a contrary direction shall govern provided that the later will specifically refers to the direction in such prior instrument.

(2) Any such direction in a nontestamentary instrument which is later in date than a prior will or nontestamentary instrument and which contains a contrary direction shall govern provided that the later instrument specifically refers to the direction in such prior will or instrument.

(3) Any such direction provided in a nontestamentary instrument only relates to the payment of the tax from the property passing thereunder and such direction shall not serve to exonerate such nontestamentary property from the payment of its proportionate share of the tax, even if otherwise directed in that nontestamentary instrument.

(d-1) (1) (A) If any part of the gross tax estate consists of property the value of which is includible in the gross tax estate by reason of § 2044 of the Internal Revenue Code of 1986 as from time to time amended, the decedent's estate shall be entitled to recover from the person receiving the property the amount by which the total tax under article twenty-six of the tax law which has been paid exceeds the total tax under such article which would have been payable if the value of such property had not been included in the gross tax estate.

(B) Clause (A) of this subparagraph shall not apply if the decedent specifically directs otherwise by will.

(2) For the purposes of this paragraph, if there is more than one person receiving the property, the right of recovery shall be against each such person.

(3) In the case of penalties and interest attributable to additional taxes described in subparagraph (1) of this paragraph, rules similar to subparagraphs (1) and (2) of this paragraph shall apply.

(e) In all cases in which any property required to be included in the gross tax estate does not come into the possession of the fiduciary, he is authorized to, and shall recover from the persons benefited or from any person in possession of such property the ratable amounts of the tax and any interest payable by the person benefited. The surrogate may direct the payment thereof to the fiduciary and may charge such payments against the interests of the persons benefited in any assets in the possession of the fiduciary or any other person. If the fiduciary cannot recover the amount of the tax and interest apportioned against a person benefited, such amount may be charged in such manner as the surrogate determines.

(f) No fiduciary is required to pay over or distribute to any person other than the fiduciary charged with the duty to collect and pay the tax any fund or property with respect to which the tax is or may be imposed until the amount of the tax apportioned or which may be apportioned against such fund or property and any interest due from the persons entitled thereto is paid or, where the tax has not been determined or apportionment made, unless and until adequate security for such payment is furnished to the fiduciary making such payment or distribution.

(g) The surrogate shall make such preliminary, intermediate or final decrees or orders in the proceeding, as he shall deem advisable, tentatively or finally apportioning the tax and any interest, directing the fiduciary to collect the apportioned amounts from the property or interests in his possession of any persons against whom such apportionment has been made and directing all other persons against whom the tax and any interest are apportioned or from whom any part of the tax and any interest may be recovered to make payment of such apportioned amounts to such fiduciary; and if it is ascertained in such proceeding that the property in the possession of the fiduciary, otherwise payable to a person liable for any part of the tax and interest, is insufficient to discharge the liability of such person, the surrogate may direct that the balance of the apportioned amount due shall be paid to the fiduciary by such other person. If, in the course of the proceeding, it is ascertained that more than the ratable amount of the tax and interest due from any person has been paid by him or in his behalf the surrogate may direct an appropriate reimbursement of the overpayment.

(h) If the surrogate apportions any part of the tax against any person interested in nontestamentary property or apportions the tax among the respective interests created by any nontestamentary instrument, he may, in his discretion, assess against such property or interests, an equitable share of the expense in connection with the determination of the tax and the apportionment thereof. Whenever an attorney renders services to the estate or to its personal representative resulting in the exclusion from the gross taxable estate of any nontestamentary property or interests created by any nontestamentary instrument, the surrogate may, in his discretion, assess against such property or interests an equitable share of the compensation for such legal services rendered to the estate or to its personal representative in proportion to the benefit received by such property or interests from such services, unless the decedent's will or the nontestamentary instrument contains a direction that no portion of the tax shall be apportioned against such nontestamentary property or against interests created by any nontestamentary instrument. The surrogate may retain jurisdiction of any proceeding until the purposes of this section have been accomplished.

C. Common Law Rule

Under common law, *unless otherwise provided* by the testator, all taxes due by reason of testator's death were paid from the residuary estate. *See In re Edwards' Estate,* 114 Misc. 2d 703, 452 N.Y.S.2d 293 (Sur. Ct. Onondaga Co. 1982); *In re Metzler,* 176 A.D.2d 15, 579 N.Y.S.2d 288 (4th Dep't 1992); *see also Bemis v. Converse,* 246 Mass. 131, 134, 140 N.E. 686 (1923) ("Where no other provision is made, taxes must be paid out of the residue of the estate."); *Estate Tax Apportionment and Nonprobate Assets: Picking the Right Pocket,* 21 Cumb. L. Rev. 1, 1990/1991. EPTL 2-1.8 is New York's current tax apportionment statute, which applies if the testator does not provide otherwise.

D. State Law Governs Apportionment of Federal and State Estate and Gift Taxes

One question that may arise when determining whether or not apportionment of taxes is applicable is, if the federal and state law are different, should federal and state taxes be apportioned pursuant to state law, or should the federal law control apportionment of federal taxes and state law control apportionment of state taxes? In *Riggs v. Del Drago,* the Supreme Court of the United States explained that state law governing apportionment of federal taxes does not conflict with the provisions of the IRC and therefore the New York statute requiring apportionment was constitutional. The Court went further to explain that "federal estate tax should be paid out of the estate as a whole, and that the applicable state law as to the devolution of property at death should govern the distribution of the remainder and the ultimate impact of the federal tax." *Riggs v. Del Drago,* 317 U.S. 95, 97-98, 63 S. Ct. 109, 110 (1942).

The fact that state law governs apportionment of federal estate taxes has been mentioned in cases and secondary sources. For example, in *In re Owen's Estate,* the court stated that "[d]istribution of the impact of the tax among beneficiaries is a matter of State law." *In re Owen's Estate,* 71 Misc. 2d 179, 184, 335 N.Y.S.2d 882 (Sur. Ct. N.Y. Co., 1972). Therefore, although the federal taxes must be paid by the executor, how the tax will be apportioned is controlled by state law. 16 A.L.R.2d 1282 (1951).

E. How Decedent's Domicile Affects Tax Apportionment

When assessing payment of estate taxes, New York has adopted the "decedent's domicile" rule, which explains that the laws of the decedent's domicile are controlling with regard to tax apportionment. *In re Edwards' Estate,* 114 Misc. 2d 703, 705-706, 452 N.Y.S.2d 293 (Sur. Ct. Onondaga Co., 1982). This rule applies where the decedent lives in one state while also possessing assets located outside the state that are includable in decedent's gross tax estate. *In re Adams' Estate,* 37 N.Y.S.2d 587 (N.Y. Sur. 1940). For example, in *In re Adams' Estate* the decedent was a domiciliary of New York but owned real property in New Hampshire which contributed to federal estate taxes. *Id*. The court explained that the state in which the testator was domiciled has the power to apportion federal estate taxes, and that includes taxes generated from assets from within the state as well as those outside the state. *Id.* One purpose for this rule is to ensure that all beneficiaries are treated consistently and, therefore, fairly. If a decedent has assets in several states and each asset is subjected to the apportionment laws of the state where it is located, then some beneficiaries may be required to contribute more or less than beneficiaries in other states, or more or less than their aliquot portion of estate tax. *In re Will of Hallinan,* 74 Misc. 2d 1034, 347 N.Y.S.2d 157 (Sur. Ct. Kings Co., 1973).

A non-domiciliary of the state of New York can circumvent the law of the decedent's domicile by drafting a provision in the will that expresses his intent for his New York property to be governed by the laws of New York. *In re Dow's Estate*, 81 Misc. 2d 506, 366 N.Y.S.2d 831 (Sur. Ct. Monroe Co., 1975). In *Dow* the court expressed that simply "requesting a New York court to take jurisdiction of the matter" is an insufficient direction to allow New York law to govern. *Id*. The court added that the appointment of a New York trustee by a non-domiciliary shows his intention that the assets "should be administered in New York in accordance with the laws of New York. *Id*. However in *In re Will of Hallinan,* the court did not follow that idea because there, even though a Kansas domiciliary appointed New York trustees to handle her New York assets, the court held that Kansas law ruled over the New York property because New York had "no significant interest in the method of apportionment of estate taxes." *In re Will of Hallinan,* 74 Misc. 2d 1034, 1036, 347 N.Y.S.2d 157, 160 (Sur. Ct. Kings Co., 1973).

The law of the decedent's domicile also applies where a testator has his domicile in one state but enjoys a separate residence in another country, where he spends winters and/or vacations. *In re Strebeigh's Estate,* 176 Misc. 381, 27 N.Y.S.2d 569 (Sur. Ct. New York Co., 1941). In *In re Strebeigh's Estate* the decedent was originally domiciled in New York but was more often physically present at his house in the Bahama Islands, especially during the winter months. However, during the time he was in the Bahamas he filed non-resident New York State income taxes, kept his banking connections in New York, and derived most of his income from real property located in New York. The court explained that determining one's domicile depends mainly on the facts of each case, but one should look at whether the decedent established his home in another place with the intention of making that place his permanent home. The court held that there is a heavy burden to prove that the decedent changed his domicile from his home country to another country and mere winter residence does not meet that burden. *Id.*

Furthermore, if the decedent is a domiciliary of another country but owns assets in New York, the court may be reluctant to interpret foreign law regarding the apportionment of taxes. *In re Edwards' Estate,* 114 Misc. 2d 703, 452 N.Y.S.2d 293 (Sur. Ct. Onondaga Co., 1982). In *In re Edwards' Estate* a domiciliary of Mexico had an *inter vivos* trust in New York and the question in the case was if and how the estate taxes would be apportioned. After recognizing the law of the decedent's domicile applies to "inter vivos trusts no matter where the transfer has taken place," the court held that because it was reluctant to interpret Mexican law regarding tax apportionment, it would look to New York law as a default. *Id.*

F. Methods Used by Various States to Apportion Federal Estate Taxes

Generally, unless otherwise provided in the decedent's will or other nontestamentary instrument, state statutes direct how federal estate tax is apportioned. It appears that state statutes provide for some different methods directing how to apportion the federal estate tax in the absence of a direction by the decedent. *See generally Estate Tax Apportionment and Non Probate Assets: Picking the Right Pocket*, 21 Cumb. L. Rev. 1, 1990/1991, page 5 and footnote 29.

New York is among the majority of states that have adopted "equitable apportionment" statutes under which the residue will only bear the portion of the tax that it generates. *See, e.g.,* N.Y. [EPTL] § 2-1.8 (McKinney 2000); Alaska Stat. § 13.16.610 (1973); Ark. Code Ann. § 26-59-115 (1987); Cal. [Probate] § 20111 (1991); Colo. Rev. Stat. Ann. § 15-12-916 (West 2002); Conn. Gen. Stat. Ann. § 12-401; Del. Code Ann. tit. 12, § 2901; D.C. Code Ann. § 47-3714 (1997); Haw. Rev. Stat. Ann. § 560:3-916; Idaho Code § 15-3-916; Ind. Code Ann. § 29-2-12-2; La. Rev. Stat. Ann. § 9:2432; Me. Rev. Stat. Ann. tit. 18-A, § 3-916; Md. Code Ann., [Tax] § 7-308; Minn. Stat. § 524.3-916; Mont. Code Ann. § 72-16-603; Nev. Rev. Stat. § 150.310; N.H. Rev. Stat. Ann. § 88-A:2; N.M. Stat. Ann. § 45-3-916; N.C. Gen. Stat. § 28A-27-2; N.D. Cent. Code § 30.1-20-16; Or. Rev. Stat. § 116.313; R.I. Gen. Laws § 44-23.1-2; S.C. Code Ann. § 62-3-916; S.D. Codified Laws § 29A-3-916; Tenn. Code Ann. § 30-2-614; Tex. [Probate] Code Ann. § 322A; Utah Code Ann. § 75-3-916; Vt. Stat. Ann. tit. 32, § 7302; Va. Code Ann. § 64.1-161; Wash. Rev. Code Ann. § 83.110.020; W. Va. Code § 44-2-16a; Wyo. Stat. Ann. § 2-10-103.

A couple of states have adopted statutes that charge the decedent's residuary estate with the burden of paying the estate tax, similar to the common law rule. *See, e.g.,* Ala. Code § 40-15-18; Ga. Code Ann. § 53-2-101.

There are a few states that have passed statutes under which the residue will only bear the portion of tax generated by the probate assets (and the residue of *inter vivos* trusts will bear the portion of tax generated by the trust) and then certain other nonprobate assets will generally bear the portion of the tax that they generate. *See, e.g.,* Ohio Rev. Code Ann. § 2113.86.

II. Exonerating the Estate from Statutory (Equitable) Apportionment

A. Necessity of a "Clear and Unambiguous Direction" from the Testator

EPTL 2-1.8(a) requires that all estate and death taxes imposed on the transfer of a decedent's property shall be equitably apportioned "except in a case where a testator *otherwise directs in his will*, and except whereby any instrument other than a will . . . *direction is given* for apportionment within the fund of taxes assessed upon the specific fund dealt with in such nontestamentary instrument. . . ." (emphasis added.)

Prior to equitable apportionment's adoption in 1930, New York State imposed the burden of death taxes on the decedent's residuary estate. The tax payable from probate as well as non-probate property was deducted from the residue. Since the people closest to the testator were more likely to be the residuary beneficiaries of his will, the depletion of their inheritance under the prior law was considered unjust by the Legislature, and contrary to the testator's intent in most cases. Combined Reports of the Decedent Estate Commission, Reprint, p. 309-310, as cited in *In re Mills,* 189 Misc. 136, 140, 64 N.Y.S.2d 105 (Sur. Ct. New York Co., 1946), *aff'd*, 272 A.D. 229, 70 N.Y.S.2d 746 (1st Dep't 1947), *aff'd*, 297 N.Y. 1012, 80 N.E.2d 535 (1948). Thus, there is a strong policy in favor of equitable apportionment, and judges have been vigilant in enforcing it. *In re Shubert's Will,* 10 N.Y.2d 461, 471, 225 N.Y.S.2d 13 (1962).

B. Rules of Construction—*In re Mills*—Courts Will Generally Not Look to the Will as a Whole to Determine Testator's Intent on the Question of Whether the Testator Has "Directed Otherwise"

However, courts have stated in accordance with the statute that "a testator may by clearly expressed intention" exonerate his estate from apportioning taxes "equitably." *In re Duryea*, 277 N.Y. 310, 14 N.E.2d 369 (1938); *In re Pepper,* 307 N.Y. 242, 120 N.E.2d 807 (1954). The guiding principle in cases involving supposed exoneration clauses is that "in the absence of a *clear, unambiguous direction* to the contrary in the will, apportionment pursuant to statute will be directed." *In re Shubert's Will*, 10 N.Y.2d 461, 471, 225 N.Y.S.2d 13 (1962) (emphasis added) (also, *In re Mills,* 189 Misc. 136, 141, 64 N.Y.S.2d 105 (Sur. Ct. New York Co. 1946)—"*In case of doubt as to what the will means on the subject of taxes the statutory direction to apportion is absolute.*") (emphasis provided). As such, the typical inquiry in these cases is whether there is a clear and unambiguous direction to exonerate the testator's estate, or portions thereof, from the statute, and the burden of proof will be on the party arguing against apportionment. *In re Shubert's Will, supra.*

In determining whether a testator has evidenced a clear intent not to apportion, the typical canons of construction do not apply. Particularly, a court typically may not consider the will or trust instrument as a whole to determine the testator's intent on this matter if an explicit direction against apportionment is not readily apparent. "The question of allocation should not be approached as would a construction question where at all events the meaning of the text must be determined from the content of the will. In a tax allocation problem the text of the will is to be scanned only to see if there is a clear direction not to apportion; and if such explicit direction is not found, construction of the text ceases because the statutes state the rule." *In re Mills,* 189 Misc. 136, 142. The same rule holds true where there *is* an explicit direction against apportionment—the direction will be followed by the courts, and arguments professing to explain the true intent of the testator will be ignored as irrelevant. *In re Bruce,* 131 A.D.2d 670, 516 N.Y.S.2d 748 (2d Dep't 1987).

The courts will rarely dismiss an exoneration clause in a will, or allow reformation thereof, when the tax clause effects an outcome that may be contrary to the testator's intent, because to do so would generally require consideration of the will as a whole. This rule against looking at the will as a whole seems to be relaxed, however, when there is an explicit direction in the will not to apportion, but the direction is contradicted by other terms in the will. In that circumstance, application of the usual rules of construction is appropriate.

In *In re Pepper,* the testator had an explicit exoneration clause providing that the trusts set up in his will would be free from taxes, and that all taxes shall be paid from the residue. Read by itself, the provision was clear and unambiguous. However, in later paragraphs the testator created the supposed tax-free trusts out of his residuary estate from where he had directed the taxes be paid. Addressing the issue of "whether ambiguity results when the will is read in its entirety," the court held that since the contrary directions canceled each other out, "the net result is that this will does not contain a direction against statutory apportionment." *In re Pepper*, 307 N.Y. 242, 120 N.E.2d 807 (1954).

In *In re Hynard,* the testator's exoneration clause directed that "all [death] taxes shall be paid . . . from my residuary estate prior to distribution and treated as an expense of administering my estate," which the court found to be a clear and unambiguous direction not to apportion. *In re Hynard,* 10/01/98 N.Y.L.J. 33 (col. 3) (Sur. Ct. Suffolk Co.). However, the testator also directed in the same paragraph that "there *shall be apportionment* among the persons beneficially interested." Because there was a clear direction against apportionment followed by an inconsistent direction in favor of apportionment, the *Mills* prohibition against searching the document for the testator's intent did not control, and the court could resolve the ambiguity by reference to the canons.

The *Hynard* court used two rationales for holding that the exoneration clause would be enforced. First, it noted that where language is ambiguous, it will be considered subordinate to the testator's "primary purpose" as shown by reading the will in its entirety. Hynard left his residuary estate 75% to his sons, and 25% for charity. The court weighed these two purposes (one, to benefit family, and two, to benefit charity) and found that Hynard's "primary purpose" was to benefit his sons. Since apportionment would be less beneficial to the sons than non-apportionment, the exoneration clause would stand and the contradictory language disregarded as "an inadvertent oversight."

Second, the court noted that if a will contains inconsistent clauses, the last one generally nullifies previous clauses unless a reading of the whole will would indicate otherwise. Under this rule of construction, the exoneration clause would stand.

C. Burden of Proof

When a court is asked to determine whether or not a decedent's estate taxes should be apportioned, the party asserting nonapportionment has the burden of proof. *In re Shubert's Will,* 10 N.Y.2d 461, 471, 225 N.Y.S.2d 13 (1962). One main reason for the party opposing apportionment to bear the burden is because there is a "strong policy in favor of statutory apportionment." *Id.* EPTL 2-1.8 is a "self-executing" statute, unless there is a clear direction against apportionment. *In re Spencer's Estate,* 95 Misc. 2d 512, 515, 406 N.Y.S.2d 960 (Sur. Ct. Onondaga Co., 1978). Therefore, the party controverting apportionment bears the burden of showing that there is a clear and unambiguous direction against apportionment. *In re Pergament's Estate, infra.*

Where there is both a testamentary and a nontestamentary instrument, the party seeking to avoid tax apportionment bears the burden of proving clarity regarding apportionment direction for the specific instrument that the party does not want to be subject to apportionment. *In re Pergament's Estate,* 29 Misc. 2d 334, 218 N.Y.S.2d 831 (Sur. Ct. New York Co., 1961) *aff'd*, 19 A.D.2d 945 (1st Dep't 1963). In *Pergament,* the decedent made a direction in his will against apportionment; however the question arose as to whether the decedent had also intended the same be true for his *inter vivos* trust. *Id*. The court held that there was an ambiguity as to the fact of whether the decedent intended for the trust to be apportioned and since that was unclear, statutory apportionment must be decreed for taxes allocable to the trust property. *Id*.

D. The Different Tax Consequences of Directing Taxes Be Paid from the Residue vs. Taxes Paid as an Expense of Administration—Or, How to Cause Irreparable Damage to a Perfectly Good Deductible Bequest

1. In General

When drafting against equitable apportionment, testators and their attorneys commonly choose one of two directions for how taxes are to be paid—either from the residue or from the residue without apportionment (i.e., as an expense of administration). The goal either way is usually to exonerate pre-residuary and/or non-testamentary transfers from taxation, and to have the tax paid from the residue of the estate. While both will serve that purpose in most cases, these two directives operate differently and have profoundly different tax consequences which must be considered carefully in light of the testator's dispositive intent.

When directing that taxes be paid from the residue, various phrases have been held to accomplish the same result. A testator may shift the tax burden upon his "general estate," from the "rest of" his estate, from "my estate," or "from the funds of my estate," and courts have construed such phrases as referring to the residuary estate. 101 N.Y. Jur. 2d § 2142.

Similarly, payment of taxes as an expense of administration can be accomplished in ways other than explicitly stating so. If a testator makes a provision the operation of which results in treating the tax as an administration expense, then the taxes will be paid that way. *In re Moritz,* 48 Misc. 2d 323, 264 N.Y.S.2d 734 (Sur. Ct. Nassau Co., 1965). Also, if death taxes have been "grouped" with payment of the decedent's debts and administration expenses, courts have construed such provision to indicate the decedent's intent to treat taxes in the same manner. *In re Leonard,* 9 A.D.2d 1, 189 N.Y.S.2d 422 (3d Dep't 1959) (where the will directed the executors to "pay all of my just debts, funeral and administration expenses, including such estate and inheritance taxes as may be assessed against my estate."); *see also In re Cromwell,* 199 Misc. 143, 102 N.Y.S.2d 85 (Sur. Ct. New York Co., 1950), *aff'd*, 278 A.D. 649, 103 N.Y.S.2d 124 (1st Dep't), *aff'd*, 303 N.Y. 681, 102 N.E.2d 837 (1951) ("By thus grouping or bracketing estate taxes with debts, funeral and administration expenses, which debts and expenses are ordinarily payable out of the general estate, the testator . . . has directed that estate taxes . . . be deducted and paid out of the general estate without apportionment . . . so that the dispositive provisions would apply only to the net estate remaining after such payments or deductions.").

2. Operation and Tax Consequences

Although both directions operate to pay taxes from the residue, they differ as to whether equitable apportionment applies to taxes assessed on residuary property. If taxes are to be paid as an expense of administration, then they are deducted prior to the establishment of the residuary estate. *In re McTarnahan's Estate,* 130 N.Y.S.2d 752 (Sur. Ct. New York Co., 1954). The testator is considered to intend that no part of his estate shall be subject to apportionment, and that all shares of the residuary estate contribute ratably to the tax burden. This has a negative tax impact when part of the residue is bequeathed to a spouse or charity, and may also impair the testator's dispositive scheme by diminishing the amount intended for the charitable or marital beneficiary.

If, on the other hand, taxes are to be paid from the residue, then the tax on the residuary property is equitably apportioned within the residuary estate. *In re Shubert's Will,* 10 N.Y.2d 461, 225 N.Y.S.2d 13 (1962). While such a direction is an unambiguous direction to exonerate pre-residuary and/or non-testamentary bequests, it "is not the equivalent of a direction against proration within the residue itself nor a command that taxes be treated as administration expenses." *In re Shubert*, 10 N.Y.2d at 471.[1]

This distinction between the two directions is crucial for large estates because under equitable apportionment, transfers to spouses and charities are exonerated from paying any portion of the tax (EPTL 2-1.8(c)(2)). If a decedent dies with a taxable estate, provides for a residuary bequest to charity or to a spouse, and provides in the will that all taxes shall be treated as administration expenses, then all the estate tax on the entire estate will come off the top. Thus, if 50% of the residue goes to charity, then the charitable bequest will be reduced by 50% of the taxes, regardless of the fact that no taxes were assessed on that property due to the charitable deduction. The effect of this direction is to reduce the amount going to charity, thereby reducing the amount of the deduction available, thereby increasing the amount of estate tax due. The tax preparer must perform an interrelated computation to fix the tax due, which amount will be considerably greater than if the deductible bequests were fully exonerated from tax. The final result is that the charitable bequest will be unnecessarily decreased, while the tax will be increased correspondingly.

If the testator directs taxes to be paid from the residue, only the pre-residuary and non-testamentary dispositions are exonerated from tax. The taxes payable by reason of this property's inclusion in the gross estate are charged against the residuary estate prior to determination of the residuary beneficiaries' respective shares. *In re Shubert's Will*, 10 N.Y.2d at 472; *see also In re Coulter*, 11 Misc. 2d 851, 854, 173 N.Y.S.2d 425 (Sur. Ct. New York Co. 1957); *In re Campe*, 205 Misc. 699, 702, 129 N.Y.S.2d 362 (Sur. Ct. New York Co. 1954); *In re Slade*, 4 Misc. 2d 616, 620, 158 N.Y.S.2d 719 (Sur. Ct. New York Co. 1956). The rule is slightly more involved when part of the residue qualifies for the marital or charitable deduction. If the deductible residuary bequest is a pecuniary disposition in a *fixed sum*, the non-exonerated intra-residuary dispositions bear the burden of all estate taxes, including those on the exonerated pre-residuary and non-testamentary dispositions. In other words, these taxes do not come "off the top," but are fully apportioned according to the statute. However, if the deductible residuary bequest is a *fractional share* of the residue, the executor must compute the tax on the exonerated bequests and deduct that amount "off the top" of the residue. The beneficial share of each residuary beneficiary, even the charitable or marital, is reduced as a result, and only after this general reduction may the executor compute the residuary shares for each beneficiary. *In re Olson*, 77 Misc. 2d 515, 519, 353 N.Y.S.2d 347 (Sur. Ct. Kings Co., 1974).[2] What is left for the charity or spouse at this point is the amount of the deduction. Just as with a direction that the taxes be treated as administration expenses (or paid from the residue without apportionment), a direction that the tax be payable from the residue will require an interrelated computation to determine the proper amount of estate tax if there is a fractional deductible bequest. The taxes on the pre-residuary and non-testamentary assets will still come off the top and the residuary shares will be reduced accordingly. The only difference between these directions in this respect is how big a bite the interrelated computation will take from the deductible share if taxes are payable without apportionment, the deductible fractional share will bear (and be reduced by) a portion of all death taxes; if the residue is apportioned, then the deductible share is only burdened by taxes allocable to non-residuary bequests. Obviously, the deductible bequest will realize less evisceration when the residue is apportioned.

3. The Easy Fix

The interrelated computation can be completely taken out of play and the full deduction presumed, however, if the drafter provides in the tax clause that taxes shall be paid from the portion of the residuary estate not qualifying for the marital or charitable deductions. If the deductible residuary bequests are explicitly exonerated from sharing in the tax burden, then they will pass undiminished, as the testator intended.

Although directions in an exoneration clause either to pay taxes from the residue or to treat them as administration expenses will both result in a reduction of the residue by the amount of taxes, the difference between these two directions is very significant. If taxes are to be paid "from the residue," then the taxes on the residuary will be apportioned among the residuary beneficiaries. If they are paid as administration expenses, they come off the top before the residuary shares are computed, reducing the amount of each beneficiary's share. If the testator has made residuary bequests to a spouse or to charity, a direction to pay taxes as administration expenses (or "from the residue, without apportionment") will result in a significant reduction in the amount transferred to the intended beneficiary, and a corresponding increase in estate tax liability. A direction to pay taxes "from the residue" will ensure that more of the tax deduction inures to the benefit of the spouse or charity, but an interrelated computation will still be necessary because part of the estate's tax burden is coming from the residue without apportionment. If the testator does not intend this result, the drafting attorney must specifically exonerate the marital and/or charitable bequests.

E. With or Without Apportionment

Many times little, if any, thought is given to drafting the tax clause, which is often one of the most important provisions in the will. For example, drafters should understand the difference between stating in a will that all estate taxes shall be paid out of the testator's residuary estate versus out of the testator's residuary estate without apportionment and whether such language is even sufficient if a portion of the residuary qualifies for the marital or charitable deduction. Depending on the language, portions of the residuary that otherwise qualify for a full charitable or marital deduction and are thereby exempt from paying any portion of the estate tax under New York's apportionment statute, may have to contribute to the tax. In other words, a portion of the marital or charitable deduction may be decreased and the amount of tax thereby increased, which could lead to having to calculate the tax by using an interrelated mathematical computation. The use of an interrelated mathematical computation may be necessary since the charitable or marital deduction must be known before computing the estate tax, and the charitable or marital deduction can not be computed until the amount of taxes payable from the charitable or marital deduction is known. In addition, merely stating that all taxes shall be paid out of the residue can also lead to problems if a portion of the residue would otherwise receive a marital or charitable deduction and there are pre-residuary bequests. *See In re Shubert's Will,* 10 N.Y.2d 461, 225 N.Y.2d 13 (1962) (and cases cited therein); *Estate of Olson*, 77 Misc. 2d 515, 353 N.Y.S.2d 347 (Sur. Ct. Kings Co., 1974); *see also In re McKinney,* 101 A.D.2d 477, 477 N.Y.S.2d 367 (2d Dep't), *app. den. by,* 63 N.Y.2d 607, 482 N.Y.S.2d 1024 (1984); *Lewald v. U.S.,* 245 F. Supp 336 (S.D.N.Y. 1965).

Some of these "tax traps" are best illustrated by a leading New York Court of Appeals case, *In re Shubert's Will*, where the will stated that after some pre-residuary bequests to various individuals the residue was left in various shares to charity and to named individuals. Before we look at the case, you should understand that generally, New York's tax apportionment statute applies to apportion taxes equitably among persons benefited, exempting property qualifying for a marital or charitable deduction, unless the will or nontestamentary document provides otherwise in a very clear and unambiguous manner. N.Y. EPTL 2-1.8 (McKinney); *see In re Shubert's Will,* 10 N.Y.2d 461, 225 N.Y.S.2d 13 (1962).

The Court of Appeals in *In re Shubert's Will* held that the tax clause in a will which stated that all estate taxes shall be paid out of the testator's residuary estate only released the pre-residuary bequests and devises from New York's tax apportionment statute and did not exonerate the residuary bequests from New York's tax apportionment statute. *In re Shubert's Will,* 10 N.Y.2d 461, 225 N.Y.S.2d 13 (1962). The Court reiterated the strong public policy favoring apportionment and stated that the tax clause ". . . cannot be read as a mandate that the portion of the tax attributable to the residuary assets is not to be apportioned in an equitable manner among the recipients of the residuary gifts." *See id*. The Court also stated that ". . . the clause . . . standing alone does not constitute an unambiguous direction." *See id*. Moreover, the Court stated that the tax on the pre-residuary bequests had to be ". . . charged against the residuary estate before computation of the residuary shares of the respective legatees." *See id*.

As a result, the charitable residuary beneficiaries in *In re Shubert's Will* only had to contribute to the estate tax generated by the pre-residuary bequests. The estate tax generated by the pre-residuary bequests had to be paid off the top, which necessitated the use of an interrelated mathematical equation. But, the same charitable residuary beneficiaries did not have to contribute to the estate tax generated by the residue (because New York's tax apportionment statute applied to the residuary beneficiaries). Keep in mind that when the charitable (or, spousal) residuary beneficiaries are exonerated from paying tax generated by the residue, this generally has the effect of increasing the amount the residuary charitable (or, spousal) beneficiaries will receive, because the other residuary beneficiaries will bear the burden of the estate tax. In *In re Shubert's Will*, the charitable residuary beneficiaries would have received even more, if the tax on the pre-residuary bequests was not taken off the top (requiring an interrelated computation) before dividing up the residue.

Therefore, if it is the testator's intent to totally exonerate that portion of the residue that would otherwise receive a charitable or marital deduction, merely stating that all taxes should be paid out of the residue is insufficient, because it appears that any tax on pre-residuary bequests should be deducted off the top before dividing up the residue (requiring an interrelated mathematical equation). *See generally In re Shubert's Will,* 10 N.Y.2d 461, 225 N.Y.S.2d 13 (1962) (and numerous cases cited therein). Since *In re Shubert*, courts have developed this rule somewhat. *See generally Estate of Olson,* 77 Misc. 2d 515, 353 N.Y.S.2d 347 (Sur. Ct. Kings Co., 1974) (tax on pre-residuary bequests only taken off the top, thereby requiring the use of an interrelated computation, before calculating residue, if residue contains disposition in fractional shares to charity and/or a spouse, but not if the only dispositions to charity and/or spouse in the residue are pecuniary); *see also In re McKinney,* 101 A.D.2d 477, 477 N.Y.S.2d 367 (2d Dep't), *app. den. by,* 63 N.Y.2d 607, 482 N.Y.S.2d 1024 (1984) (after *citing In re Shubert* the Second Department affirmed the Surrogate's Court which held that tax on pre-residuary bequests should be taken off the top before calculating residue, thereby requiring an interrelated computation, which was the correct result, but then included in the opinion an odd statement that **non-charitable** residuary beneficiaries were charged with full burden of tax on both pre-residuary and residuary bequests). Consequently, drafters should add additional language so that the testator's intent is clearly and unambiguously set forth in order to avoid any confusion.

In addition, courts have held that a tax clause stating all tax shall be paid from the residuary "without apportionment" or as "an expense of administration" is clear and unambiguous language to negate having the taxes apportioned according to New York's tax apportionment statute. *See, e.g. Estate of Robbins,* 144 Misc. 2d 510, 544 N.Y.S.2d 427 (Sur. Ct. New York Co., 1989); *Estate of Beebe,* 268 A.D.2d 943, 702 N.Y.S.2d 683 (3d Dep't 2000); *Estate of Atkinson,* 148 A.D.2d 839, 539 N.Y.S.2d 112 (3d Dep't 1989). By stating that taxes shall be paid out of the residue without apportionment, if a portion of the residue would otherwise qualify for the charitable or marital deduction, that portion will not only have to bear the burden of the estate tax that they would have otherwise been exonerated from under New York's tax apportionment statute, but by having to pay a portion of the tax, that portion loses the deductible status and as a result the amount of estate tax due is increased.

F. Residuary Apportionment with an "Equal Share" Clause

Tax apportionment of the pre-residuary estate pursuant to EPTL 2-1.8 can be avoided by the use of a tax apportionment clause directing all taxes be paid out of the residuary. Although such a clause will exonerate the pre-residuary beneficiaries from paying estate taxes, statutory apportionment may be applied within the residue unless there is a clear and unambiguous direction against such apportionment. *In re Shubert's Will,* 10 N.Y.2d 461, 471, 225 N.Y.S.2d 13 (1962). When a testator divides his residuary estate between both taxable and non-taxable beneficiaries and leaves each beneficiary an equal share, apportionment of the residuary may alter the amount ultimately given to the beneficiaries, such that the shares will not be equal. *Id.* 10 N.Y.2d at 472. However, a will which contains an equality clause alone is insufficient to direct against statutory apportionment. *Id.* at 473.

Statutory apportionment will be applied in the absence of a direction against such apportionment. *In re Shubert's Will,* 10 N.Y.2d 461, 471, 225 N.Y.S.2d 13 (1962). In *Shubert* a testator devised that all taxes were to be paid out of the residuary estate, which was divided into "six equal shares," three of which, or one half of the residuary, were to be given to charity, while the other three were to make up three separate individual trusts. *Id.,* 10 N.Y.2d at 469. Appellants argued that the equality clause was a direction against apportionment because by using the word "*equal*" the testator intended each of the six shares be given the same amount. *Id.* at 472. If the residuary is apportioned this intention will be defeated because since the charity is exonerated from the residuary taxes, the three individual shares must bear the burden of said taxes, which will decrease their overall net gain. The three individual shares in effect receive less than 50% of the residue, therefore the six shares will not be "equal." *Id*. at 470.

However, the change in the proportions devised is an effect of apportionment when there is a deductible residuary bequest. *In re Shubert's Will,* 10 N.Y.2d 461, 473, 225 N.Y.S.2d 13 (1962). The *Shubert* court held that the equality clause was not a clear direction against apportionment, and without such direction the testator must have intended "'gross equality' or equality prior to taxes, rather than 'net equality' or equality after the tax impact." *In re Shubert's Will,* 10 N.Y.2d 461, 473, 225 N.Y.S.2d 13 (1962), *quoting Jerome v. Jerome,* 139 Conn. 285, 93 A.2d 139 (1952). Where a testator devises the residuary estate into equal shares, this alone is not a clear and unambiguous direction against tax apportionment and such a clause only refers to equality prior to taxation, because "an equal division of assets does not necessarily mean an equal tax burden." *In re Shubert's Will,* 10 N.Y.2d 461, 473, 225 N.Y.S.2d 13 (1962).

G. When Residuary Estate Is Insufficient to Pay All of the Estate Taxes

In New York, as set forth in EPTL 2-1.8, a tax apportionment clause can be drafted to avoid statutory apportionment of the preresiduary. EPTL 2-1.8(a) (McKinney). One way to do this is by expressly stating that all estate taxes should be paid out of the residuary estate; however, questions may arise if the residue is insufficient to pay all of the estate taxes. If the residuary is exhausted, the remaining estate taxes will be paid according to statutory apportionment. *In re Volckening's Will,* 70 Misc. 2d 129, 131, 332 N.Y.S.2d 538, 541 (Sur. Ct. Kings Co., 1972).

If this does not comport with the testator's wishes, he or she may direct that the taxes left unpaid after the residuary is exhausted should be paid out of a separate fund, such as a trust, with or without apportionment. *See generally In re Will of Collia,* 123 Misc. 2d 1014, 475 N.Y.S.2d 237 (Sur. Ct. Suffolk Co., 1984).

Where a clause has been drafted directing payment of estate taxes through the residuary estate and the residue is inadequate to pay the estate taxes, then the remaining balance of such taxes after the residue has been depleted "is required to be equitably allocated against all beneficiaries." *In re Hamilton's Will,* 69 Misc. 2d 246, 247, 329 N.Y.S.2d 698, 701 (Sur. Ct. Orange Co., 1972). In both *In re Hamilton's Will* and *In re Volckening's Will,* the testator directed all taxes to be paid out of the residuary estate and that there should be no apportionment of the pre-residuary gifts; however in both cases the residuary estate was insufficient. *In re Hamilton's Will,* 69 Misc. 2d at 247, 329 N.Y.S.2d at 700-701; *In re Volckening's Will*, 70 Misc. 2d at 131, 332 N.Y.S.2d at 541. Both courts held that although there was a direction against apportionment of the preresiduary, where the residuary estate is inadequate to pay the estate taxes, statutory apportionment is necessary.

1. Apportionment vs. Abatement

To avoid statutory apportionment of the preresiduary, a testator can direct the executor to pay estate taxes out of a separate fund if the residuary estate is insufficient to pay such taxes. *See generally In* *re Will of Collia,* 123 Misc. 2d 1014, 475 N.Y.S.2d 237 (Sur. Ct. Suffolk Co., 1984). In *In re Will of Collia* the testatrix directed taxes to be paid out of the residuary estate without apportionment and if the residuary was inadequate, then the remaining taxes were to be paid out of an *inter vivos* indenture trust which gave a small sum to her cousin and the balance to several charities. *In re Will of Collia,* 123 Misc. 2d at 1015-1016, 475 N.Y.S.2d at 239. Although there was no specification as to apportionment of the trust fund, the court held that express provision of the decedent's will against apportionment of the residuary estate sufficiently indicated her intention to pay estate taxes without apportionment; therefore the court did not allow apportionment of the trust estate.

However, it should be noted that statutory apportionment pursuant to EPTL 2-1.8 only applies to estate taxes or death taxes. EPTL 2-1.8 (McKinney). When there are funeral or administration expenses, or debts of the decedent, "interests in the decedent's estate abate for the purpose of paying such estate obligations" as set forth in EPTL 13-1.3. *In re Hamilton's Will,* 69 Misc. 2d at 248, 329 N.Y.S.2d at 701 (Sur. Ct. Orange Co., 1972). Order of abatement would be 1) distributive shares in property not disposed of by will, 2) residuary dispositions, 3) general dispositions, 4) specific dispositions. EPTL 13-1.3(c)(1)-(5) (McKinney). These expenses are abated prior to any statutory apportionment of the estate taxes. As is explained in *In re Beckmann,* "administrative expenses are the first charge against the residuary." *In re Beckmann,* 9/20/91 N.Y.L.J. 22 (col. 5). Therefore, abatement may have the effect of depleting the residuary estate which would leave the residuary funds insufficient to pay the estate taxes, and that is when statutory apportionment would apply even where the testator has directed no apportionment of the preresiduary.

H. Paying Taxes from the Marital or Charitable Share/Interrelated Computation

The amount of a charitable or marital deduction may need to be calculated using an interrelated mathematical calculation, whenever property otherwise qualifying for a marital or charitable deduction must contribute to the estate tax liability. (See II.E. above.) If estate taxes are paid from the marital or charitable share, then the taxes paid do not pass to the spouse or charity and the deduction must be reduced, thereby increasing the taxes, thereby further reducing the deduction, thereby further increasing the taxes, etc. Therefore, whenever you have property passing to either a charity or spouse that would otherwise qualify for a marital or charitable deduction, special attention should be given to the tax clause in the will.

As illustrated in earlier sections of the outline, a poorly drawn tax clause can result in requiring the spouse or charity to contribute to the estate tax, which may or may not have been the intent of the testator. *See generally In re Shubert's Will,* 10 N.Y.2d 461, 225 N.Y.S.2d 13 (1962) (and cases cited therein); *Estate of Olson,* 77 Misc. 2d 515, 353 N.Y.S.2d 347 (Sur. Ct. Kings Co., 1974); *see also In re McKinney,* 101 A.D.2d 477, 477 N.Y.S.2d 367 (2d Dep't 1984), *app. den. by,* 63 N.Y.2d 607 (1984); *Lewald v. U.S.,* 245 F. Supp 336 (S.D.N.Y. 1965); TAM 9140005, 1991 WL 778179 (IRS TAM); TAM 8027016, 1980 WL 133401 (IRS TAM). For instance, if the tax clause states that all estate taxes are payable out of the residuary estate and the will provides for pre-residuary bequests to individuals and a fractional portion of the residue passes to a spouse or charity, or if the tax clause states that all estate taxes are payable out of the residuary estate without apportionment and a portion of the residue passes to a spouse or charity, the portion of the property passing to the spouse or charity in the residue will be burdened with payment of some of the estate tax. In order to determine the amount of the charitable or marital deduction and the amount of estate tax due, a complex mathematical formula or a series of trial-and-error computations must be used. *See* 26 CFR § 20.2055-3(a)(2). There are also computer programs available that will compute the series of trial-and-error computations. However, if it is the testator's intent to have property not qualifying for the marital or charitable deduction in the residue bear the burden of any estate tax, in addition to stating the residue should bear the full burden of the tax, drafters should consider using a savings provision: "In no event shall taxes be paid from property otherwise qualifying for the Marital or Charitable Deduction." Also consider using a clause that says "pay all taxes out of that portion of the residue not qualifying for the marital or charitable deduction."

The reason the computation is considered circular and interrelated is because the charitable or marital deduction must be known before computing the estate tax, and the charitable or marital deduction can not be computed until the amount of taxes payable from the charitable or marital deduction is known. In other words, the amount of the charitable or marital deduction is reduced for every dollar of estate tax coming from the property that would otherwise go to a spouse or charity and at the same time the amount of estate tax increases, because there is tax due on the tax, which then has the effect of further reducing the marital or charitable deduction and therefore increasing the tax in a very circular and interrelated manner.

One formula that can be used to compute the interrelated computation, where the residue is burdened with paying all of the estate taxes without apportionment, is the "Andressen" formula. Although this formula needs to be tailored to the specific facts of a given estate (e.g., if there were any gift taxes paid within three years of death, if additional estate tax must be paid to the state, etc.), the basic formula is as follows:

"Andressen" Formula

T = Combined Federal and State Estate Taxes

T = (Initial Taxable Estate + [Charitable or Marital percentage of the residue] x **T** - Applicable taxable amount from Column A, unified rate schedule) H Applicable tax rate from Column D, unified rate schedule x Applicable amount of tax from Column C, unified rate schedule - Applicable credit amount)

Additional formulas that may be used to compute the interrelated computation include the "Greeley" formula and the trial-and-error method. There are also several computer programs available that will compute the interrelated computation by going through the series of trial-and-error computations. Also, the practitioner may refer to *Internal Revenue Service Publication 904,* which has various illustrations on how to compute the estate tax and the marital deduction or charitable deduction where the circular interrelated computation must be computed. *IRS Publication 904* (Rev. May 1985). This publication has been declared obsolete by the Internal Revenue Service. However, several secondary authorities have indicated that practitioners should, nevertheless, still be able to rely on the methods set forth in the publication, but would have to insert the updated unified credit amount and updated tax rates, etc. Along the same lines, the secondary authorities indicated that in all likelihood the Internal Revenue Service declared publication 904 obsolete due to the outdated unified credit amounts and tax rates.

In sum, whenever there is property in a will passing to either a charity or spouse that would otherwise qualify for a marital or charitable deduction, special attention should be given to the will's tax clause. The practitioner should also make the client aware of the various consequences of having property that would otherwise qualify for a marital or charitable deduction contribute to the estate tax liability.

I. Beneficiaries of Lifetime Gifts

The beneficiaries of lifetime gifts do not have to share in the estate tax liability if the lifetime gifts increase the estate tax liability by being added to the taxable estate as adjusted taxable gifts, because N.Y. EPTL 2-1.8 applies to apportionment of property included in the "gross tax estate." *See generally In re Metzler*, 176 A.D.2d 15, 579 N.Y.S.2d 288 (4th Dep't 1992); *Estate of Coven*, 148 Misc. 2d 132, 559, N.Y.S.2d 798 (Sur. Ct. N.Y. Co., 1990). The New York statute does not define "gross tax estate," but under the Internal Revenue Code, adjusted taxable gifts are not part of the gross estate but rather are added to the taxable estate in order to compute the estate tax due. *See id*.

However, it is still an open issue whether beneficiaries of lifetime gifts must contribute toward the estate tax attributable to the inclusion of gift tax paid on the gifts made within three years of decedent's death. In this case, such gift tax paid is included in the "gross tax estate" under IRC § 2035, if made within three years of decedent's death. It appears that this could have been raised in *In re Metzler*. However, the only issue raised dealt with the increase of estate tax attributable to the inclusion of adjusted taxable gifts to the taxable estate.

(a) The beneficiary of a lifetime gift does not have to share in the estate tax liability when the adjusted taxable gifts are added to the taxable estate and increase the tax liability, because adjusted taxable gifts are not considered part of the "gross tax estate" under N.Y. EPTL 2-1.8.

To illustrate, in *In re Metzler*, the decedent made *inter vivos* gifts within three years of death which were added back into her estate as adjusted taxable gifts in order to determine the final tax liability. *In re Metzler*, 176 A.D.2d 15, 579 N.Y.S.2d 288 (4th Dep't 1992). It is interesting to note that there was no federal gift tax paid (due to the federal unified credit), but there was state gift tax paid. The court looked to EPTL 2-1.8 in order to determine who was responsible for estate tax, since decedent did not have a tax apportionment clause in her will. The court pointed out that "the statute [EPTL 2-1.8] should not be read more broadly than its terms, and EPTL 2-1.8 authorizes apportionment only against property required to be included in the decedent's 'gross tax estate.'" *Id.*, 579 N.Y.S.2d at 290. As a result, the court reasoned, however inequitable, the beneficiaries of decedent's gross estate had to bear the burden of the estate tax and not the beneficiaries of lifetime gifts.

Moreover, it is interesting to note that parties in *In re Metzler* did not point out that, in fact, the state gift tax paid on the lifetime gifts was included back into the decedent's "gross tax estate" thereby increasing the amount of tax due. By not addressing the issue, it appears to be an open issue, when a decedent's will does not provide a sufficient and unambiguous tax apportionment clause.

(b) It is still an open issue as to whether the beneficiaries of lifetime gifts have to share in the tax burden due to the inclusion of the gift tax paid within three years of decedent's death under IRC § 2035 to the "gross tax estate."

For discussion purposes, assume decedent made lifetime gifts within three years of death and paid gift tax on the gifts. Thereafter, decedent died within three years of making taxable gifts with a gross estate of over $1 million (including gift tax paid on lifetime gifts) not including the adjusted taxable gifts. Decedent did not have a tax apportionment clause in his will, therefore N.Y. EPTL 2-1.8 is applicable.

Based on the foregoing discussion regarding the inclusion of adjusted taxable gifts in the taxable estate, we know that the beneficiaries of the lifetime gifts are not responsible for the estate tax attributable to inclusion of the adjusted taxable gifts. However, what results if gift taxes paid by the decedent are included in the decedent's gross estate under IRC § 2035? An interesting and apparently unresolved question.

Some commentators have applied a statutory interpretation to N.Y. EPTL 2-1.8 and have reasoned that the lifetime beneficiaries are the only persons who could possibly be said to benefit by the payment of the gift tax; therefore, the lifetime beneficiaries should have to pay the tax attributable to the inclusion of the gift tax in the gross estate.[3]

However, until this issue has been dealt with by the New York State courts, drafters should not rely on the New York State tax apportionment statute to provide the answer. This is yet one more reason to have a well drafted tax apportionment clause included in a will, thereby avoiding yet another tax apportionment trap.

Taxes attributable to gifts that are otherwise includible in the gross estate (such as transfers includible under IRC 2035, 2036, 2037 and 2038) would most likely be apportioned against those assets that generate the tax, absent a tax clause exonerating such transfers from tax payments. Note, however, that if the estate is entitled to a credit for gift taxes paid by the decedent or a credit for property previously taxed the credit is subtracted from the taxes before apportionment so that it benefits all beneficiaries of the estate (EPTL 2-1.8(c)(3).)

J. General Power of Appointment Apportionment (IRC § 2207) vs. QTIP Apportionment (IRC § 2207A) vs. Retained Life Estate Apportionment (IRC § 2207B)

A "general power of appointment" (GPA) is a power which is "exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." 26 U.S.C.A. § 2041(b)(1). Where a decedent dies possessed of a GPA, pursuant to IRC § 2207, decedent's executor is entitled to recover from the appointee (recipient of the property) of said GPA the pro rata taxes which the GPA generated in the decedent's taxable estate, unless the decedent directs otherwise. 26 U.S.C.A. § 2207. (*See also* EPTL 2-1.8(a), (b) and (c)).

Prior to the enactment of the IRC § 2056(b)(7) (QTIP), to qualify a trust for the marital deduction under IRC § 2056(b)(5), the testator would have had to pass the property interest in trust so that the surviving spouse would have the entire income interest from all, or a specific portion of the trust, as well as the general power to appoint the trust to herself or her estate, or use an "Estate Trust." 26 U.S.C.A. § 2056(b)(5).

However, in 1981 Congress enacted IRC § 2056(b)(7), which allowed for a qualified terminable interest trust to qualify for the martial deduction. 26 U.S.C.A. § 2056(b)(7). A qualified terminable interest (QTIP) trust allows the decedent to create an income interest in his surviving spouse, while retaining the right to designate the remainder beneficiaries. Pursuant to IRC § 2044, if the decedent's estate elected martial deduction treatment for a QTIP trust, then the entire QTIP interest, or the appropriate percentage elected, is includible in the surviving spouse's estate. 26 U.S.C.A. § 2044.

If a QTIP trust is included in the surviving spouse's estate, then unless he or she "specifically indicates an intent to waive any right of recovery" the spouse's estate is entitled to recover taxes generated by the trust from those receiving the property. 26 U.S.C.A. § 2077A. Generally, a specific reference to the QTIP trust will be sufficient. However, a general direction to pay taxes out of the residue of the estate is not specific enough, and therefore, such a direction will not waive decedent's right to recovery.

New York law regarding a decedent's right to recovery parallels the federal law and is set forth in EPTL 2-1.8(d-1)(B), which was enacted in February of 1999. EPTL 2-1.8(d-1)(B) (McKinney). The statute explains that the decedent's estate will be able to recover from the recipient of the QTIP trust unless the decedent "specifically directs otherwise." EPTL 2-1.8(d-1)(B) (McKinney). When determining whether there was in fact a specific direction otherwise, New York cases state that the decedent must "specifically" provide an alternative apportionment direction. *In re Estate of Gordon,* 134 Misc. 2d 247, 510 N.Y.S.2d 815 (Sur. Ct. New York Co., 1986); *In re Estate of Kramer,* 203 A.D.2d 78, 79, 610 N.Y.S.2d 31 (1st Dep't 1994). In *In re Estate of Kramer,* the court explained that the decedent's direction to pay all taxes out of her residuary estate, except for estate taxes resulting from Sections 2035, 2039, and 2041 of the IRC, was not a "specific direction otherwise" because the clause did not expressly mention the QTIP trust. *Id.* Therefore, the court held that the decedent's estate would be entitled to collect the taxes from the trust remaindermen. *In re Estate of Kramer,* 203 A.D.2d at 78, 610 N.Y.S.2d at 31 (1st Dep't 1994).

In both federal law and New York law, if the decedent's estate did not specifically direct otherwise, the decedent's estate can recover for the taxes generated from the QTIP pursuant to the formula set out in IRC § 2207A and EPTL 2-1.8(d-1)(A) respectively. 26 U.S.C.A. § 2207A; EPTL 2-1.8(d-1)(A) (McKinney). Both IRC § 2207A and EPTL 2-1.8(d-1)(A) explain that the recipient of the trust remainder must pay the difference between the total tax due and the tax which would have been due if the QTIP trust wasn't included in the decedent's estate. 26 U.S.C.A § 2207A; EPTL 2-1.8(d-1)(A) (McKinney).

However, in federal and New York law where the decedent retains an IRC § 2036 interest in property (relating to transfers with a retained life estate), the right of the decedent's estate to recover estate taxes is set forth in IRC § 2207B and EPTL 2-1.13 respectively. 26 U.S.C.A. § 2207B; EPTL 2-1.13 (McKinney). Both statutes explain that the decedent's estate is entitled to recover from the recipient "the amount which bears the same ratio to the total tax which has been paid as (A) the value of such property bears to (B) the taxable estate." 26 U.S.C.A. § 2207B(a)(1); EPTL 2-1.13(a)(1) (McKinney). Additionally, IRC § 2207B allows a decedent to override the statute if there is a specific indication to waive the decedent's right to recovery. 26 U.S.C.A. § 2207B(a)(2). Although now the statute only requires a "specific indication," prior to 1997, the statute stated that the decedent must "specifically reference" IRC § 2207B in order to waive the right of recovery. Conversely, New York's EPTL 2-1.13 continues to state that the statute will not apply if the decedent "otherwise directs . . . specifically referring to this section." EPTL 2-1.13(a)(2) (McKinney). Furthermore, the practice commentaries to EPTL 2-1.13 by Margaret Valentine Turano explain that New York requires the decedent to refer specifically to the section and "a general tax residuary tax clause will not prevent 2-1.13's application." EPTL 2-1.13(a)(2) (McKinney).

However, please note EPTL 2-1.8(c)(3) states, "any deduction for property previously taxed and any credit for gift taxes paid by the decedent shall inure to the benefit of all persons benefited and the tax to be apportioned shall be the tax after allowance of such deduction or credit." EPTL 2-1.8(c)(3) (McKinney).

III. The "Tax Clause"—One of the Most Important Clauses in the Estate Planning Document

A. Necessity of Describing Which Types of Transfer Taxes Are Affected by the Exoneration Clause

The typical exoneration clause will contain a litany of all the different taxes to which the clause applies—legacy taxes, succession taxes, inheritance taxes, estate taxes, and so on. Although a drafter may succeed in exonerating certain property from the burden of taxation by providing simply that all "death taxes" or "transfer taxes" or "estate taxes" are payable from a designated fund, it is far more prudent to explicitly state each possible kind of tax. The taxes payable from a decedent's estate are not direct taxes on the property he or she died owning, but are excise taxes on the change in ownership of this property occasioned by the event of death. Death taxes may differ based upon the type of property subject to each tax.

There are two ways the government can tax your property at death: 1) coming and 2) going. It must be remembered that death duties are not taxes on property, but on the transfer of property. In every transfer there is a giving and a receiving, and with death taxes this is described as the cessation of the decedent's interest in property, and subsequent commencement of the beneficiary's interest in that same property.

When the tax is imposed on the transfer *from the decedent*, it is generally referred to as an "estate tax." It is leviable upon all property interests of the decedent which cease at his death. The estate tax superseded the probate tax in 1894. The basic difference between the probate tax and the estate tax is their scope. The probate tax did not reach any property outside the jurisdiction of the probate court during administration. Real estate, for instance, was not subject to the probate tax in most cases. The estate tax covers all property interests of the decedent whether they are probate assets or testamentary substitutes. *Hanson on Death Duties,* p. 63, as cited in *Knowlton v. Moore,* 178 U.S. 41, 48-49, 20 S. Ct. 747 (1900). The important thing to remember, however, is that estate taxes and probate taxes are both taxes on the cessation of the decedent's property interests.

In contrast, the "inheritance tax" is "a tax on the privilege of receiving property on the death of another," and "is laid upon the transfer of particular property to a particular person." *In re Herz*, 85 N.Y.2d 715, 722, 628 N.Y.S.2d 232 (1995). (The Court's use of the word "privilege" here is telling. The ability to acquire property from one's parents was considered a natural right around the time of our nation's founding. *See, e.g.*, Edmund Burke, *Reflections on the Revolution in France*, p. 87 (1790). Indeed, the earliest form of inheritance tax imposed by the United States in 1797 specifically exempted from tax all property passing to the surviving spouse, children, and grandchildren of the decedent. 1 Stat. at L.527, chap. 11, as cited in *Knowlton v. Moore*, 178 U.S. at 49. The "legacy tax" was the first kind of inheritance tax imposed in the U.S., and was levied on the receipt of a decedent's personal property only. This was later complemented by the "succession tax" (or "real estate inheritance tax"), which covered real property and any personal property not subject to the legacy tax. *Id*.

Again, these are taxes on the commencement of the recipient's interest in property, whereas the estate taxes are on the decedent's interest that ceased.

During the 1890s, the United States imposed both of these taxes at the same time. This practice ended in 1916, when the U.S. settled on the estate tax as its sole death duty. Similarly, in 1930 the New York State legislature abolished inheritance taxes on New York estates and switched to an estate tax approach. The practical result of the federal and New York State changes (not to mention the increasing exclusion amounts) is that fewer estates need to be concerned with comprehensive exoneration clauses that clearly state all conceivable types of death duties. Further, at least one Surrogate has held that a testator's use of the term "inheritance tax" instead of "estate tax" in the exoneration clause did not defeat his attempt to have all estate taxes paid out of the residue. Where it is clear to the court that a testator really meant "estate tax" but did not actually use those words, the court may consider the terms synonymous. *In re Moritz*, 48 Misc. 2d 323, 264 N.Y.S.2d 734 (Sur. Ct. Nassau Co., 1965), *citing In re Randall*, 147 Misc. 358, 263 N.Y.S. 778 (Sur. Ct. New York Co., 1933) (where the court stated "[T]he word 'inheritance' is broad enough to cover an estate tax in the connotation in which it is used." The clause referred both to inheritance and transfer taxes, so it is curious that the court did not simply find that "transfer taxes" covered the estate taxes imposed). Both cases relied on *Farmers' Loan & Trust Co. v. Winthrop*, 238 N.Y. 488, 144 N.E. 769 (1924).

Care must still be taken when drafting these clauses, however, to make sure inheritance taxes are addressed. For example, when a testator has named beneficiaries in other states which may have some form of inheritance tax, the direction not to apportion these taxes must still be clear and unambiguous. Also, despite *Moritz, Randall,* and *Farmers' Loan & Trust,* whether or not a court will apply the technical definitions of estate and inheritance taxes depends on whether the testator has clearly shown his intent either way. Absent the clear showing of intent that the words used should not be construed in their technical sense, the courts still recognize that "the term 'inheritance taxes' had and has a special meaning." *In re Wise,* 20 A.D.2d 55, 244 N.Y.S.2d 960 (1st Dep't 1963), *aff'd*, 15 N.Y.2d 591, 255 N.Y.S.2d 259, 203 N.E.2d 648 (1964) (in which case the technical meaning was preserved). In either event, the testator's intent will control when it is unclear which taxes are affected by the tax clause. *In re Herz,* 85 N.Y.2d 715, 719, 628 N.Y.S.2d 232 (1995).

The reference to "inheritance taxes" is also important where the decedent leaves property to someone in another country. Germany, for example, imposes a tax called the *Erbschaftsteuergesetz*. In 1934, the Westchester County Surrogate dealt with an exoneration clause that directed payment of all inheritance taxes from the residue in connection with an estate subject to the German tax. The Surrogate, in dicta, considered the tax to be on the person receiving the gift rather than on the transfer, and described it as an "acquirer tax" and not in the nature of a true inheritance tax. *In re Gotthelf,* 152 Misc. 309, 273 N.Y.S 247 (Sur. Ct. Westchester Co., 1934). For 60 years, New York Surrogates used the dicta in this case to hold that foreign taxes charged to the recipients of property from New York estates cannot be paid from the general estate unless the foreign tax was specifically included within the list of non-apportioned taxes. In 1995, the Court of Appeals examined for the first time the propriety of characterizing the German tax as an acquirer tax. They found that the German tax was indeed in the nature of an inheritance tax, so that the testator's direction not to apportion inheritance taxes would effectively encompass the tax levied against her beneficiary in Germany. A specific reference to the German tax is no longer required in the tax clause. *In re Herz,* 85 N.Y.2d 715, 628 N.Y.S.2d 232 (1995). There is no indication yet whether the same will hold true with the tax laws of other foreign countries. *See, e.g., In re Williams,* 60 Misc. 2d 952, 304 N.Y.S.2d 180 (Sur. Ct. Westchester Co., 1969), dealing with Puerto Rican taxes.

There are different types of taxes imposed on the transfer of property occasioned by a person's death. In order that a clear and unambiguous direction to exonerate certain property from taxation be given effect, the testator ought to specify the kinds of taxes to which the exoneration clause applies. If there is ambiguity about whether the tax clause covers a given tax imposed, the court will search for the testator's intent.

B. Payment of Generation-skipping Transfer Taxes

Deciding which of the testator's assets should bear the burden of paying generation-skipping transfer taxes is another one of those issues over which the unwary estate planner could find himself with a more difficult administration and crippling the testator's intended plan in the process. It is important that the client's wishes be ascertained on this issue, and that the estate planner carefully think through the effects of the tax clause he is drafting.

1. Federal Law Preempts State Law, but Testator May Direct Otherwise

New York's apportionment statute does not pertain to generation skipping transfer taxes, because there is a federal statute specifically stating how these taxes are to be charged. *Estate of Monroe v. Commissioner,* 104 T.C. 352 (1995), followed by *In re Jobson,* 10/29/98 N.Y.L.J. 34, (col. 3) (Sur. Ct. Suffolk Co.). The rule is simply stated: "The tax imposed by this chapter [13] on a generation-skipping transfer shall be charged to the property constituting such transfer." IRC § 2603(b). As to who is liable for paying the tax and filing the return, the rules are found in Treas. Reg. § 26.2662-1(c)(1 and (2)(iii), and are as follows (subject to significant exceptions):

- Taxable distributions—the transferee;
- Taxable terminations—the trustee;
- Direct skips—in general, the executor.

The testator may elect out of this statute and charge other assets with the payment of GST tax, but the will or trust directing otherwise must make specific reference to the GST tax. IRC § 2603(b). The estate planner must make sure of the testator's intent before making provision for the GST taxes in an exoneration clause because the additional tax imposed by Chapter 13 is onerous, almost to the point of being punitive. The testator may not want to reduce other bequests by a second round of taxation imposed at the highest rate of tax for the individual's estate. If the testator does wish to apportion taxes in another way, the "specific reference" requirement in the statute must be satisfied. The tax clause must actually state the words "generation-skipping transfer taxes," or "the taxes imposed by Chapter 13 of the Internal Revenue Code," or even better, "generation-skipping transfer tax as defined in Chapter 13 of the Internal Revenue Code, as amended." *Harris' New York Estates Practice Guide*, example shown in § 1.71 (4th ed.). The usual references to estate, inheritance, transfer, legacy, succession, death and other similar taxes will not be an effective direction against the statute. *In re Monroe,* 104 T.C. 352, 364-5; *In re Jobson*, 10/29/98 N.Y.L.J. 34, (col. 3); IRS PLR 9731030.

2. Beware the Double Interrelated Computation

The estate planner must also be aware of how this tax is computed if the statutory scheme is not followed, and the effect it will have on administration and the value of other bequests. Specifically, if the tax clause is drafted so that all taxes, including GST taxes, are payable either as an administration expense or from the residue *without* apportionment, and a fractional share of the residue is a generation-skipping transfer, the attorney for the executor will have to do an interrelated computation to determine the GST tax due.

PLR 8830055 dealt with a situation where 1/3 of the residue was a direct skip to the decedent's grandchild, and the tax clause directed payment of taxes from the residue without apportionment. Since the tax is imposed on the value of property received by the skip person, it is impossible to know what that amount is until the residue has been reduced by the GST tax, but at the same time, it is impossible to know what the tax is until the skip person's share has been determined.

Step one in the Service's calculation was to reduce the gross residuary estate by all amounts charged to it (administration expenses, estate taxes, etc.) except for the GST tax. Step two was to perform the interrelated computation and solve for the GST tax payable on the skip person's 1/3 share of the trust. The third step was to reduce each share of the residue by its aliquot portion of the GST tax. (Note: If the residuary bequests include a fractional share going to charity or to a spouse, and a fractional share going to a skip person, and if the deductible bequest has not been completely exonerated from taxes, then the executor's attorney will have to perform two interrelated computations—once to fix estate taxes, and a second time to fix GST tax. The end result is a considerably reduced charitable or marital deduction, increased tax liability, and extra work for the attorney in preparing the 706.)

C. Operation of EPTL 2-1.8(d)(1), (2)—Contrary Tax Direction in a Later Instrument

If a decedent drafted a will which contains an exoneration clause contrary to a direction he made in a prior non-testamentary instrument, the later in time will governs if it "specifically refers to the direction in such prior instrument." Similarly, if the decedent executed a non-testamentary instrument that was later in time to another non-testamentary instrument or a will and contained a tax clause contrary to the earlier instrument, the later one will govern if it specifically refers to the earlier direction. EPTL 2-1.8(d)(1), (2). In either case, these rules only apply where (a) there are two separate directions in two separate instruments, one later in time than the other; (b) the later direction contradicts the earlier one as to how taxes are to be paid; and (c) the later direction makes specific reference to the earlier direction it contradicts.

This part of the statute was enacted by the legislature to overrule, in part, the Court of Appeals decision in *In re Cord,* 58 N.Y.2d 539, 462 N.Y.S.2d 622 (1983). In that case, the decedent had set up a trust providing an income interest to herself, remainder to her children from a prior marriage. The tax clause directed that any death taxes payable by reason of the trust's existence be paid by the trustees out of the corpus. Forty years later, the decedent drafted a will that provided for all death taxes imposed with respect to probate and non-probate property to be paid from the residue, without allocation to any person receiving non-probate property. The decedent's surviving husband petitioned to have the portion of taxes allocable to trust property paid from the trust. The Court held that the later provision superseded the earlier one, and that all taxes were to be paid from the residue according to the clear direction of the testator in her will. The Court specifically noted that the decedent's failure to mention the trust in the tax clause of her will "is of no moment." The testator's intent, they reasoned, is to be found within the four corners of the will, and extrinsic evidence such as the trust is not admissible to demonstrate a contrary intent from what is plainly stated in the will. This result is supposed to be prevented under the statute in its current form. The later direction must refer to the prior one in order to supersede it.

However, the "specifically refers to" test is not a strenuous one, as *In re Patouillet,* 158 Misc. 2d 473, 601 N.Y.S.2d 385 (Sur. Ct. Onondaga Co., 1993) demonstrates. The decedent made a will directing taxes to be paid from the residue. He later made a trust which provided "the Trustee shall pay out of the . . . trust fund . . . such sums as [the executor] shall state to be necessary for the payment of . . . federal estate taxes . . . and any state estate, inheritance and succession taxes . . . whether or not attributable to property subject to probate administration." The trustee refused to pay any taxes from the trust after the executor made written demand for same, on the ground that the trust did not specifically refer to the will. The court, finding that argument "unconvincing," held that the trust language was specific enough, so the later direction contained therein was controlling. "The specificity mandated by the statute refers to a specific direction in the instrument as to the apportionment or non-apportionment of the tax; not the date or other identifying language of the instrument." However, if that is the new rule, it seems that the language in *Cord* is also specific enough for the later direction to govern. But the court goes on to say that the detailed references in the trust's tax clause to matters involving administration of the probate estate are enough on their own to meet the specificity requirement. It seems that the statutory requirement is diluted by this decision, making a showing of the decedent's cognizance of an alternate source of payment and a general reference to it the true standard.

Just as the rule governing contrary directions does not apply when there is no specific reference, it also does not apply where the two instruments are executed concurrently. *In re Hoffman,* 165 Misc. 2d 146, 627 N.Y.S.2d 524 (Sur. Ct. New York Co., 1995). This holds true even where a trust was executed many years prior to the will, but was last ratified on the same day the will was executed, and the trust's tax clause had never been changed. All three elements must be present for operation of this part of the statute: (a) an earlier and later instrument; (b) each of which contains a tax clause contrary to each other; and (c) the later direction makes specific reference to the earlier direction.

IV. Executor's Ability to Recover Tax from Beneficiaries

A. Non-probate Beneficiaries

New York's tax apportionment statute, EPTL 2-1.8, allows for the executor of an estate to collect estate taxes from property that is included in the gross estate, but that does not pass through the hands of the executor. EPTL 2-1.8(e) (McKinney). The executor "is authorized to, and shall recover from the persons benefited or from any person in *possession of such property* the ratable amounts of the tax and any interest payable by the persons benefited." EPTL 2-1.8(e) (McKinney) (emphasis added). For example, In *Estate of Satnick* the court supported the executor's power by holding that the beneficiaries of United States savings bonds were obligated to reimburse the executor in the amount of their pro rata share of the estate taxes because the bonds were included in the decedent's gross estate. *Estate of Satnick,* 142 Misc. 2d 268, 270, 537 N.Y.S.2d 464, 465 (Sur. Ct. Bronx Co., 1989). Furthermore, the court added that if necessary, the executor may withhold from the beneficiary any property in his possession, which would otherwise go to the beneficiary, as security for the taxes owed by that beneficiary. *Id.*

The executor has a statutorily granted ability to recover estate taxes from beneficiaries of nontestamentary assets that were included in the total taxable estate. Such assets include reimbursement from insurance proceeds. *In re Zahn's Estate,* 300 N.Y. 1, 87 N.E.2d 558 (1949). However, a problem may arise when considering who exactly is going to pay the taxes, specifically when dealing with a life insurance policy. In *In re Zahn's Estate* the decedent's insurance carrier gave all of the proceeds of the policy to the designated beneficiary, who spent the money and later died. *In re Zahn's Estate,* 300 N.Y. 1, 87 N.E.2d 558 (1949). In order to recover the taxes, the executor attempted to sue the insurance carrier; however the Court held that the insurance carrier cannot be included within the statutory meaning of "possession." *In re Zahn's Estate,* 300 N.Y. 1, 87 N.E.2d 558 (1949). Although the holder was at one time in "possession" of the policy proceeds, he was not in "possession" at the time when the executor was seeking to recover the taxes.

Conversely, where the insurance carrier is making periodic payments to the beneficiary, and has not exhausted the proceeds, then the executor can sue the insurance company for a portion of the taxes. *In re Shea's Will,* 63 Misc. 2d 741, 313 N.Y.S.2d 600 (Sur. Ct. Nassau Co., 1970). In *In re Shea's Will,* brother and sister beneficiaries were receiving installment payments while the insurance carrier maintained the balance. The court distinguished this situation from when the insurance carrier pays out all the proceeds, because here the carrier is still in possession of some of the proceeds. Therefore, the court held the beneficiaries had to pay their share of the taxes calculated from the money already received, and additionally the insurance carrier also had to pay the remaining estate taxes generated from the insurance policy in the gross estate.

As a general matter, the commentaries for EPTL 2-1.8 explain that "the beneficiaries of non-probate assets, such as life insurance, pensions, jointly owned property and lifetime trusts, must also bear a portion of the estate taxes, if those assets are included in the gross estate." EPTL. § 2-1.8(e) (McKinney, Commentary).

Note: "The Surrogate may direct the payment thereof to the fiduciary and may charge such payments against the interests of the persons benefited in any assets in the possession of the fiduciary or any other person. If the fiduciary cannot recover the amount of the tax and interest apportioned against a person benefited, such amount may be charged in such manner as the Surrogate determines." EPTL 2-1.8(e) (McKinney).

> 1. EPTL 13-3.2 Rights of beneficiaries of pension, retirement, death benefit, stock bonus and profit-sharing plans, systems or trusts and of beneficiaries of annuities and supplemental insurance contracts
>
> (a) If a person is entitled to receive (1) payment in money, securities or other property under a pension, retirement, death benefit, stock bonus or profit-sharing plan, system or trust or (2) money payable by an insurance company or a savings bank authorized to conduct the business of life insurance under an annuity or pure endowment contract or a policy of life, group life, industrial life or accident and health insurance, or if a contract made by such an insurer relating to the payment of proceeds or avails of such insurance designates a payee or beneficiary to receive such payment upon the death of the person making the designation or another, the rights of persons so entitled or designated and the ownership of money, securities or other property thereby received shall not be impaired or defeated by any statute or rule of law governing the transfer of property by will, gift or intestacy.
>
> (b) This section does not limit article 10 of the debtor and creditor law, articles 10-C and 26 of the tax law, or 2-1.8, 5-1.1-A or 13-3.6.
>
> (c) Paragraph (a) applies although a designation is revocable or subject to change by the person who makes it, and although the money, securities or other property receivable thereunder are not yet payable at the time the designation is made or are subject to withdrawal, collection or assignment by the person making the designation.
>
> (d) A person entitled to receive payment includes:
>
> (1) An employee or participant in a pension, retirement, death benefit, stock bonus or profit-sharing plan, system or trust.
>
> (2) The owner or person purchasing an annuity, the person insured or the person effecting insurance, the person effecting a contract relating to payment of the proceeds or avails of a policy of insurance or an annuity or pure endowment contract.
>
> (3) Any person entitled to receive payment by reason of a payee or beneficiary designation described in this section.

(e) A designation of a beneficiary or payee to receive payment upon death of the person making the designation or another must be made in writing and signed by the person making the designation and be:

(1) Agreed to by the employer or made in accordance with the rules prescribed for the pension, retirement, death benefit, stock bonus or profit-sharing plan, system or trust.

(2) Agreed to by the insurance company or the savings bank authorized to conduct the business of life insurance, as the case may be.

(f) This section applies to designations heretofore or hereafter made by persons who die on or after the date this section takes effect. This section does not invalidate any contract or designation which is valid without regard to this section.

B. Ability of a Decedent's IRA Beneficiary to Elect "Life Expectancy" Method of Distribution if the IRA Is, or May Be, Liable for Payment of Estate Taxes

When the employee under a qualified plan or IRA dies, whatever is left of that account generally must be paid to the designated beneficiary within five years after the death of the employee. The statute provides an exception to this rule, whereby the remaining interest may be distributed over the life expectancy of the designated beneficiary, thereby reducing the annual required minimum distributions and tempering the income tax effect on the beneficiary. IRC § 401(a)(9)(B)(iii). Only individuals can be "designated beneficiaries," but the regulations provide that if a trust meets certain requirements, the beneficiaries of that trust (known as a "see-through trust") will be considered "designated beneficiaries," and may therefore take advantage of the life expectancy method of determining required minimum distributions. This treatment will be given if 1) the trust is a valid trust under state law, or would be but for the fact that there is no corpus; 2) the trust is irrevocable, or will become irrevocable upon the employee's death; 3) the beneficiaries of the trust are identifiable; and 4) certain documentation is provided to the plan administrator by the regulatory due date. Treas. Reg. 1.401(a)(9)-4, A-5(b).

It is common, especially with *inter vivos* trusts and credit shelter trusts, to direct that taxes, debts and other administration expenses be paid from trust assets. This could pose a problem if such trusts are the beneficiaries of the decedent's IRA. Again, only individuals and qualifying trusts can be "designated beneficiaries." A person's estate explicitly may not be a designated beneficiary. Treas. Reg. 1.401(a)(9)-4, A-3. If the estate is the beneficiary then the life expectancy method of determining RMD is unavailable, and the entire account must be paid out over five years.

A number of private letter rulings addressing whether a given trust beneficiary could be treated as a designated beneficiary have raised speculation among practitioners that if a plan or IRA could be drawn on to pay taxes, administrative expenses or debts of the decedent, then the Service will consider the decedent's estate (rather than the trust) to be the beneficiary. If this is truly the Service's position, then the trust beneficiaries cannot be treated as designated beneficiaries when the tax clause does not exonerate qualified plans or IRAs. It is far from clear, however, whether this is the Service's position. They've never actually discussed it.

In a few rulings, the Service has made a note of what the trust provides with respect to taxes and expenses, but then no mention is made as to the significance of the provision, or whether it influenced the ruling in any way. In PLR 200010055, the ruling recited that decedent's trust specifically precluded the use of IRA assets to pay death taxes and expenses, requiring that such assets be distributed solely to the individual trust beneficiaries. Without further discussion of this provision, the Service allowed the trust beneficiary to be treated as the designated beneficiary. In another ruling, it was noted that the decedent's trust "does not provide that trust assets shall be used to pay . . . any estate and inheritance taxes and generation skipping transfer taxes." The trust was named beneficiary of decedent's two IRAs. There was no express prohibition against using IRA assets to pay taxes, or against using the trust corpus to pay taxes, and no indication whether or not taxes, administration expenses or debts were actually paid from the trust (though such payment is unlikely, since a separate trust was made subject to that burden). In this case, the Service again found the see-through trust requirements had been met, and included no further discussion about the IRA's availability for taxes. PLR 9809059.

In PLR 9623056, the trust provided that the trustee could make payments from principal "to facilitate the settlement of the estate," including the payment of taxes and expenses. The trust was funded with an IRA which comprised over 70% of his estate. However, there were sufficient probate assets to cover the taxes, debts, and administration expenses, so the IRA was not used for this purpose. Again without any indication of the significance of these circumstances, the Service found that the trust qualified.

In PLR 9820021, the trust provided for the trustee to pay all death taxes, expenses and debts from the trust. The trust was funded with qualified plan assets, a portion of which was actually used to satisfy those payments. The Service ruled that there was no designated beneficiary here, but opted to rule on the basis that there were charitable remaindermen. They took no position on the impact of the trust provisions or the actual payment of taxes from plan assets. They noted, however, that "this ruling does not address whether or not there are other provisions in Trust M that result in Individual B not being the designated beneficiary . . . of Individual A's account under Plan X." There may be other reasons to flunk the trust, but the IRS refuses to say what they are.

The IRS has also indicated that state law can impact the existence of a designated beneficiary. Maybe. It appears that if the law of the state exempts IRA and plan assets from creditor's claims and estate expenses, then the trust beneficiaries will be treated as designated beneficiaries. PLR 199912041, PLR 200131033, PLR 200018055, PLR 200223065. Even in these rulings, though, the state law is mentioned but never commented upon. It is never clear that this circumstance is relevant to the Service's analysis.

Despite the half-suggestions of a pitfall, the issue has never been addressed. If the IRA or plan is subject to the payment of death taxes, will the estate be considered the beneficiary of part of the assets? The Service has not even really acknowledged that such a use of plan assets is considered at all for determining the existence of a designated beneficiary. Do we, as practitioners, need to start drafting around the chance that it *is* considered? Can we, or should we, extract general principles or attempt to formulate the IRS's position from these private rulings?

These questions are relevant not only to people funding trusts with their retirement accounts, but also to people in states where equitable apportionment is the rule. That situation has not yet been the subject of a private ruling, but the same analysis would apply. If a decedent has chosen to allow straight apportionment rather than to include an exoneration clause in his will, then the IRA assets will be responsible for contributing their pro rata share of taxes. If the estate can be considered the beneficiary in that event, then there can be no designated beneficiary and the five year rule applies for distributions.

Endnotes

1. But see *In re Beebe,* 268 A.D.2d 943, 702 N.Y.S.2d 683 (3d Dep't, 2000), in which the testator had provided that all taxes were to be charged against the residue, but then further directed that "there shall be no proration or apportionment of said taxes." The court found this to be an unambiguous direction against apportionment with respect to the entire estate and consequently that the residue had to be reduced by the full amount of death taxes. As a result, the charity receiving 1/3 of the residuary estate was denied the full benefit of the charitable deduction. Even when taxes are charged to the residue, it is possible (though usually undesirable) to direct against apportionment among residuary assets.
2. In *In re McKinney,* 101 A.D.2d 477, 477 N.Y.S.2d 367 (2d Dep't 1984), the Second Department appears to have mis-cited *Olson*. After correctly stating the rule that taxes on pre-residuary dispositions must be deducted from the residue prior to computing the residuary shares, the court went on to say that if the testator bequeaths a fractional share of the residue to a charity or spouse, then the non-exonerated residuary bequests must bear the full burden of taxes, both on the non-exonerated residue *and* the exonerated pre-residuary dispositions. This is exactly opposite of established precedent, no cases were cited in adducing it, and no cases have cited *McKinney* since for this principle. There may be no alternative to simply regarding the statement as dicta, and to focus instead on what the court did, rather than what it said to get there. In the original proceeding to settle the final accounting, the executors treated all taxes as administration expenses and deducted them off the top. The will directed that taxes be paid from the residue. St. Agnes Hospital, a charitable beneficiary of 70% of the residue, objected to the accounting, arguing that the tax on the residuary property should have been apportioned to the non-charitable residuary beneficiary. The Hospital *did not* argue that the taxes on the pre-residuary bequests and the *inter vivos* trust be apportioned, but only the taxes on the residue. In fact, the Surrogate cited *Shubert*'s rule that the tax on this property should be charged against the residue before the residuary shares are computed when the will contains a tax clause like the one in this case. It was also noted that the parties had agreed that was the proper way to do it, so the issue was not even before the court. *In re McKinney,* 117 Misc. 2d 173, 458 N.Y.S.2d 144 (Sur. Ct. Westchester Co., 1982). The Surrogate sustained the charity's objections, and the Second Department affirmed without modification. Thus, in the very situation that the court describes in its misstatement of the rule with respect to fractional charitable bequests, the court has affirmed a decision which allows the tax on pre-residuary bequests to reduce the entire residue, including the charitable share. Although the *McKinney* court's reasoning may be at odds with established precedent, its holding is in accord with the rules as stated in *Shubert,* et al.
3. *See* US Trust, *Practical Drafting*, Richard Covey, Esq.

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Non-U.S. Trusts With U.S. Beneficiaries

By G. Warren Whitaker

The following is a fact pattern frequently encountered in international trust planning: a non-U.S. person (a "nonresident alien" or NRA in U.S. tax parlance) creates a trust for his family in an offshore jurisdiction without giving any thought to U.S. tax issues, since none of his family members have any U.S. connections. Subsequently, he sends one of his sons to a school in the United States, the son decides to work on Wall Street for a couple of years after graduating, he meets an American girl, and suddenly this non-U.S. family has little U.S. citizen grandchildren running around the house. A trust that was not designed for U.S. beneficiaries now has them. This article deals with the U.S. tax considerations that arise with regard to these trusts.

A. Grantor Trusts

A foreign (non-U.S.) trust is not subject to U.S. income tax, except for withholding tax on any U.S. source income. However, distributions from the foreign trust to a U.S. person (a U.S. citizen or a U.S. resident) will carry out distributable net income to that person, with adverse tax treatment of accumulated income, unless the trust qualifies as a "grantor trust" under U.S. law. (U.S. Internal Revenue Code (I.R.C.) § 671-677.) If the trust does qualify as a grantor trust, the U.S. beneficiary pays no tax on the income distributed to him from the trust (although he must report the income to the IRS). Therefore, a U.S. beneficiary of a foreign trust will greatly prefer that the trust be a grantor trust with a non-U.S. person as grantor.

Effective August 20, 1996, a non-U.S. person will be treated as the grantor of a trust only if one of the following requirements is met (I.R.C. § 672(f)(1)):

1. If the Grantor has the full power to revoke the trust without the consent of any person, or with the consent of a subservient third party (I.R.C. § 672(f)(2)(A)(i)). (Upon the Grantor's incapacity, his or her guardian or another person must possess the power to revoke in order for the trust to continue to qualify as a grantor trust.)
2. If the Grantor (and, if desired, the Grantor's spouse) are the sole beneficiaries of the trust during the life of the Grantor. (In this case, the Grantor and the Grantor's wife could receive distributions from the trust and could then make gifts to the U.S. relative. The U.S. person would then have to report the receipt of the gifts if they met the applicable threshold, but they would not be taxable.) (I.R.C. § 672(f)(2)(A)(ii).)
3. If the trust was created on or before September 19, 1995, but only as to funds already in the trust as of that date, **and** only if the trust was a grantor trust pursuant to either I.R.C. § 676 (concerning the grantor's power to revoke) or I.R.C. § 677 (concerning the grantor's retained possibility of receiving income), but excluding I.R.C. § 677(a)(3) (income may be used to pay premiums on insurance policies on the grantor's life).

Once the NRA grantor dies, the offshore trust which previously qualified as a grantor trust under one of the exceptions is no longer a grantor trust, and all income distributed to the U.S. beneficiary will be taxed to him or her.

B. Foreign Non-Grantor Trusts; Accumulations

If a foreign trust falls into one of the above exceptions and so is a grantor trust, there is no accumulated income issue: any income accumulated in the trust may be added to principal and distributed later without U.S. tax consequences.

If a foreign trust with U.S. beneficiaries does not fall within one of the exceptions, and so is not a grantor trust, and if it distributes the current year's income (including capital gains) to a U.S. beneficiary, the income is taxed to the beneficiary and it retains its character (capital gains, interest, dividends, etc.).

It should be noted that under U.S. tax law *any* distribution from a discretionary trust to a beneficiary carries out with it distributable net income (DNI) to the extent that the trust has income. It makes no difference that the trustee characterizes the distribution as one of corpus or of capital gains. (U.S. law differs from the tax law of the United Kingdom in this respect.) If two beneficiaries receive distributions from the trust in the same calendar year, each is treated as receiving a proportionate share of the trust's DNI for that year. After all current income of the trust has been carried out to the beneficiaries, further distributions are treated as distributions of corpus and are not taxed (assuming the trust has no accumulated income from prior years).

If a foreign trust accumulates income, the trust pays no U.S. income tax on that income (other than withholding tax on U.S. source income paid to the trust) and there is no U.S. income tax currently payable by any potential beneficiary on that income. However, the trust is building up accumulated income which will have tax consequences if it is distributed to a U.S. beneficiary in a future year.

When a foreign trust has accumulated income from prior years, and it distributes an amount not exceeding the current year's income to the beneficiaries (including U.S. beneficiaries), the income is taxed to the beneficiaries. For this purpose the term "income" includes realized capital gains, and the capital gains retain their character and are taxed at the lower capital gains rate (currently 20%).

When a foreign trust with accumulated income pays out to the beneficiaries in a calendar year an amount in excess of the income received by the trust for that year, accumulated income is passed out to the beneficiaries. Accumulated income paid to U.S. beneficiaries is fully subject to U.S. income tax, and has the following additional negative consequences:

1. All capital gains realized by the trust in prior years constitute part of the trust's distributable net income and are carried out to the beneficiary, but at *ordinary* income rates (currently up to 38.6%).
2. An interest charge is imposed on the tax due by the beneficiary on the accumulated income per annum from the date the income was originally earned by the trust. The interest charge was previously 6% simple interest; under the new 1996 law the interest is pegged at market rate (currently about 9%) and is compounded daily.
3. Finally, the "throwback" rules apply, so that the income may be taxed at the beneficiary's tax bracket for the year in which the income was earned, rather than the year in which the distribution is received.

In short, distributions of accumulated income from a foreign trust to a U.S. beneficiary are subject to a significant tax burden.

C. Use of Intermediaries

Because it is now more difficult for a foreign trust to qualify as a grantor trust, and because distributions of accumulated income from a foreign non-grantor trust to a U.S. beneficiary have such negative tax consequences, trustees will look for ways to cleanse accumulated income in a trust. One idea that has occurred to some is to distribute the accumulated income to a foreign intermediary (either an individual, corporation or another trust), which can then later pay it to the U.S. beneficiary in the guise of current income, principal distribution or a gift.

However, if the IRS determines that an intermediary is being used to avoid U.S. taxes, it will disregard the intermediary and treat the gift as a distribution from the trust. The IRS will assume that there is a plan to avoid taxes if (1) the intermediary is "related" to the grantor of the foreign trust, (2) the U.S. person receives property from the intermediary within 24 months before or after the intermediary receives property from the foreign trust, and (3) the U.S. person cannot establish that the intermediary acted independently.

Cleansing accumulated income is an important consideration in trust planning, and other techniques can still be used. For instance, if a foreign trust with accumulated income distributes to a non-U.S. person or trust an amount equal to the accumulated income, the original trust becomes cleansed of accumulated income and can make a large principal distribution to a U.S. beneficiary in the next calendar year without carrying out accumulated income. The question remains of what to do with the "dirty" funds if they are added to a new trust: there is no problem if they remain with the offshore beneficiaries or trusts, but it will be difficult for those funds to find their way to the U.S. beneficiaries without running afoul of the intermediary rules. Undoubtedly there will be many close fact patterns which may or may not fall within these rules.

D. Loans from Foreign Trusts

If a trust has large accumulated income, a U.S. beneficiary may seek to avoid income tax by asking the trustee for loans, rather than outright distributions. Unfortunately, if a non-U.S. trust *loans* cash or marketable securities to a U.S. beneficiary or settlor or to a U.S. relative of the trust settlor, the loan will be treated as a distribution to the person receiving it, and will be taxed accordingly, even if the loan is later repaid (I.R.C. § 643(i)).

There is an exception for "qualified obligations." A loan is a qualified obligation if the term of the obligation does not exceed five years; it bears market interest, and it is reported annually to the IRS.

There was consideration in Congress of extending the provision treating loans as distributions to *any* trust property that is used by a beneficiary; however, the final law is limited to loans of cash and marketable securities. Therefore, for instance, an offshore trust can own residential real property and permit U.S. beneficiaries to use it. There is an unresolved question as to whether, if the real property is held in a corporation within the trust, this use by a beneficiary constitutes a taxable dividend by the corporation.

E. Reporting Distributions from Foreign Trusts

Any U.S. person who receives *any* distribution from a foreign trust after August 20, 1996 must report that distribution to the IRS on Form 3520. There is no threshold amount below which distributions need not be reported. The report must explain the tax treatment of the distribution.

If the distribution is not reported, the U.S. recipient may be subject to a penalty of 35% of the gross amount of the distribution (I.R.C. § 6677(a)). In addition, the distribution may be recharacterized by the IRS as an income distribution to the recipient, even if it would have qualified for grantor trust treatment.

Any distribution from a foreign trust, whether from income or corpus, to a U.S. beneficiary may be treated as an accumulation distribution includible in the gross income of the U.S. beneficiary if adequate records are not provided to determine the proper treatment of the distribution (I.R.C. § 6048(c)(2).)

F. Estate, Gift and Generation-Skipping Transfer Taxes

Transfers by an NRA may be subject to reporting, but they are not subject to U.S. estate, gift or generation-skipping transfer tax except as to assets that have U.S. situs. For this reason the NRA should consider creating a multigenerational trust that will avoid transfer taxes on the future deaths of the U.S. beneficiaries. Because a longer term results in a longer avoidance of transfer taxes, the trust should be created in a jurisdiction that has a long perpetuities period. In the Cayman Islands, the perpetuities period is 150 years (Perpetuities Law § 4 paragraph 109 (1995); in Bermuda it is 100 years (Perpetuities and Accumulations Act § 3). In Turks & Caicos (Trusts Ordinance § 4, paragraph 101) there is *no* perpetuities period, and a trust created by an NRA can continue in perpetuity and never be subject to U.S. estate, gift or GST tax. (A special type of Cayman Islands trust, the STAR Trust, also is not subject to a perpetuities period.)

G. Planning Ideas

In light of the foregoing, a good strategy for a NRA grantor who wants to benefit a U.S. beneficiary through an offshore trust would be the following:

1. Make the grantor (and the grantor's spouse) the sole trust beneficiaries during their lives. They can receive trust distributions and make gifts to the U.S. beneficiary as needed. The U.S. beneficiary must report the gifts if they exceed $100,000, but no income or gift tax is due.

   Alternatively, the trust could be fully revocable by the grantor, and could then make payments directly to a U.S. beneficiary without being subject to U.S. income tax. However, in this case the beneficiary would be required to report receipt of *any* trust distributions, identify the trust and possibly produce a copy of the trust agreement to prove that it is in fact a grantor trust. The grantor may not want this for privacy purposes. (To avoid this, the grantor could partially revoke the trust as to certain assets and then make a gift to the U.S. beneficiary of those assets.)

2. After the death of the survivor of the grantor and the grantor's spouse, the trust should continue for the U.S. beneficiary and descendants for the longest term permissible, possibly with a limited power of appointment granted to the beneficiaries at each generational level. For income tax purposes, the following options are available:

   (a) Pay all current income (including capital gains) to the U.S. beneficiary, who then pays U.S. income tax on the income, thus avoiding any accumulations problem. This, however, increases the assets that are distributed to the U.S. beneficiary and will ultimately be subject to estate tax on the beneficiary's death, particularly if there are high realized capital gains that must be distributed. To avoid this, the trust income can be paid to a U.S. trust, rather than outright to the U.S. beneficiary.

   (b) Move the trust situs to the United States. If this is done all income will be taxed currently, but income can be accumulated without resulting in an interest charge, and realized gains can be accumulated without being converted to ordinary income when later distributed.

   (c) If the U.S. beneficiary is not a U.S. citizen and expects to leave the U.S. in the future, or is a citizen who expects to expatriate, and so will no longer be subject to U.S. income tax, the trustee should leave the trust offshore, accumulate the trust income free of U.S. income tax, and make a qualified loan to the beneficiary if necessary. Once the beneficiary leaves the U.S. the trust can pay out current and accumulated income without U.S. income tax.

   (d) Invest the trust assets in annuity or variable life insurance products. Investments in these policies can build up income and avoid the interest charge on accumulations. In addition, if non-Modified Endowment Contract life insurance policies are used, distributions can be made to the beneficiaries without U.S. income tax up to the amount of the premiums.

Conclusion: When a non-U.S. family gains a U.S. member, the family's financial structure enters the perilous and previously uncharted waters of the U.S. tax code. However, with good planning the family can successfully navigate these treacherous shoals.

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Concentrated Stock Positions—An Estate Planner's Perspective

By Richard S. Rothberg

I. The Problem—Concentration and Low Basis

Concentrated low-basis stock positions in publicly traded companies can arise in many ways. Owners of family-controlled enterprises may face pressure to sell from business partners, a desire for a comfortable retirement, or the demands of an estate plan. There may be no one in future generations willing or able to take over the business and protect its value for the benefit of a spouse or other family members. Fairness among children, some of whom are in the business and some not, may dictate a sale. Whatever the reason, the family may sell the business in exchange for stock in an acquiring company whose shares are publicly traded, or may "take the company public," in either event resulting in a concentrated low-basis stock position in a public company.

Concentrated low-basis stock positions in publicly traded companies can arise in other ways as well. A large block of public stock might have been left as an inheritance many years ago, outright or in trust, and might have appreciated significantly over time. An executive of a public company may accumulate a large position over a career at the company. A minority owner of a business may find that the interest has been converted into publicly traded stock upon a sale of the business. Indeed, some of America's largest fortunes are comprised to a significant extent of concentrated positions in a single company.

The problem, if one would consider it a problem, is twofold. Some issues arise because the position is concentrated. Other issues arise because the position is low-basis. Although these circumstances often occur together, they are separate and should be separately analyzed.

II. Risks of Concentration

A year ago, when Enron collapsed, the *Times* had an article about one family that had an estimated $2 billion of its wealth in Enron stock. The position was acquired years before on a sale to Enron of the family oil business. According to the article, the family won't starve, but it had to hurt at least a little.

This is but one graphic example of "event risk," the risk that some isolated event, unrelated to the overall economy or the general level of stock prices, and unrelated even to the specific conditions in the industry sector of which the company is a member, may bring the company down. Enron is a catastrophic recent example of event risk, apparently predicated on outright fraud. Other kinds of risk threaten stock price in relation to appropriate benchmarks, either within an industry sector or in comparison with the general level of stock prices. Total business failure is only the worst case example. Events can significantly affect the price of a stock, in comparison with its peers, even absent a total business failure (consider, for example, Tyco, AOL, Cisco and AT&T).

We have seen too many examples recently, but the phenomenon is not new. In June, 2002, JPMorgan Private Bank circulated a study on the management of concentrated stock positions (the "JPMorgan Study"). The JPMorgan Study identified a number of well-known public companies which have recently experienced severe declines in stock price, much more severe than the general decline in market averages. This study runs only through the end of 2001 and thus does not reflect the disasters of most recent memory. These declines cut across many industry sectors and arose for many reasons.

Here are just a few examples, classified by type of industry: in basic materials, Du Pont (reassessment of growth rates, overpayment for acquisitions), Borden (poor product positioning), and Bethlehem Steel (labor problems, foreign competition); in retail, JC Penney (inferior marketing strategies), and Kmart (mismanagement of store locations and merchandising); in pharmaceuticals, Lilly (generic competition) and Bristol Myers (FDA actions); and in technology and communications, Corning (fiber-optic overcapitalization), Motorola (cell phone saturation) and Compaq (declining PC growth).

Volatility, much in evidence recently, is a much more serious problem in a concentrated stock position. During the 12 years considered in the JPMorgan Study, ending in 2001, the worst one-quarter decline in the S&P 500 index was a 15% drop in the third quarter of 2001. The study examined 450 individual stocks and found that 236 of the stocks experienced a 15% decline (from one quarter to the next) at least 5 times, 64 of the stocks experienced such a decline at least 10 times, and 18 of the stocks experienced such a decline at least 15 times. This illustrates the extreme volatility of a concentrated position as compared with the diversification of an index.

Finally, the JPMorgan Study highlighted the vulnerable nature of individual stocks in the U.S. markets. It noted, for example, that a high predominance of the negative "events" causing significant stock price decline were outside the control of management; that mature companies tend to look outside their core area of expertise for further growth, and often stumble; and that free capital flows across international boundaries, opening U.S. companies to substantial foreign competition.

Considerations such as these strongly suggest that the risks of concentration are serious, and wealth management strategies which reduce these risks deserve careful study.

III. The Problem of Low Basis

The obvious solution to the problem of concentration is to diversify, which generally means sell. Very often, there are no significant impediments to sale other than the prospect of a substantial capital gains tax. However, non-tax problems which might also impede sale could include securities law restrictions on the sale of privately-placed stock, contractual restrictions arising from employment or sales contract clauses, regulatory impediments, strategic considerations (such as a desire not to be seen as "bailing out"), or market effects from the sale of a large position.

The simplest solution to the tax problem of low basis, of course, is to bite the bullet, sell and pay the tax. One very substantial impediment to such an approach is the emotional distaste of some clients for the payment of any tax which is "voluntary," in the sense that the tax results from the taxpayer's own decision (to sell rather than to hold), rather than from the inevitable operation of the system (withholding of tax on salaries and bonuses, or quarterly estimated payments of tax on recurring income).

Another impediment to sale is a by-product of the ultimate involuntary act, the act of dying. Unpleasant as it is, the contemplation of one's mortality can be eased a bit by the knowledge that death heals all wounds, including the capital gains tax. Under I.R.C. § 1014, as currently in effect, property passing at death (with some exceptions) gets a new basis, generally measured as fair market value at date of death (or at a six-month alternate valuation date if that election is made).

The basis change at death cuts both ways, of course, which is why dying with loss positions is almost as bad an idea as dying itself. But the concentrated stock position is not a problem (at least not a tax problem) if value is below basis. So it will be assumed that for this one purpose at least, death is a blessing.

The basis change at death is part of the Internal Revenue Code for at least two different reasons. First, it may be viewed as an offset to the pain of the estate tax. This is an imperfect rationalization, at best. For one thing, the degree of relief afforded by the forgiveness of capital gain bears no relation to the pain of the estate tax. After all, the estate tax on a security with a built-in loss is the same as the estate tax on a security with the same value but an imbedded gain. For another thing, the basis change happens even if there is no estate tax, as often happens with bequests to a surviving spouse or bequests protected by "exemptions" built into the estate tax law.

Second, the basis change at death is a form of relief from the often-impossible task of documenting basis of assets acquired years, or even generations, before. The last time (before the current one, discussed below) that Congress tried "carry over" basis, it was roundly derided, and eventually eliminated before taking effect, by the howls of pain heard from many quarters. This rationalization for the basis change is also inconsistently applied, since there are many instances in which it is no help at all. (Try, for example, to determine the basis of securities held for 50 years in a trust that has not been subjected to estate tax.)

Having said all that, the fact remains that under current law, the holder of a concentrated stock position, knowing that a substantial tax will result from sale, also knows that by departing this mortal coil (which eventually he must) he can make the capital gains tax disappear. This leads to strategies which might hopefully reduce or eliminate the market risk, but without a sale subject to capital gains tax, so that death can work its magic. Such planning will be of little interest to the average dot-commer, sitting on a position in his company stock which has (or, more frequently, once had) more tens of millions in value than he has birthdays. But for the more traditional executive or entrepreneur, having invested a real lifetime accumulating a concentrated stock position, the choice between death and taxes is a more realistic one.

As if this confused situation were not enough, Congress has complicated it further by its prospective "repeal" of the "death tax," as part of the Bush tax cut package of 2001. The trade-off for estate tax repeal is the repeal, at the same time, of the basis change rules in I.R.C. § 1014, and the creation instead of a "carryover basis" regime under new I.R.C. § 1022, effective 1/1/10. This means that if estate tax repeal happens, the holder of a concentrated stock position cannot escape the prospect of capital gains tax by dying. At first blush, carryover basis may seem a reasonable trade-off for estate tax relief. But on closer examination, it doesn't work that way. First of all, the family that inherits a concentrated stock position gets relief from estate taxes at (say) 50%, at the price of capital gains taxes at (say) 25%, whereas a family that inherits a bond portfolio or other package of high-basis assets gets the same estate tax relief but no comparable capital gains tax hit. Second, carryover basis will apply in exactly the same way to a family that would otherwise have had basis step-up but no estate tax, for example on the bequest of the concentrated stock position to a spouse.

There are some limited exceptions to the new carryover basis regime. A "step up" of $1,300,000 is available on the bequest of assets to any person, and a step-up of an additional $3,000,000 is available on bequests to a spouse. Although helpful to a degree, these relief provisions are of comparatively little interest to high-net-worth holders of concentrated stock positions who attract the firepower of highly paid lawyers, accountants and investment bankers.

As enacted last year, the repeal of the death tax, with its concomitant enactment of carryover basis, is effective for one year, 2010. As I have been advising my clients who consider this bit of legislative nonsense, if you plan on spending Thanksgiving of 2010 with your children, do your own cooking. We had thought that the prospects for permanent enactment of death tax repeal were poor. Based on the last election, I believe they went up a bit. The House has already passed permanent repeal, and the Senate will follow if the Republicans can pick up a half-dozen or so Democratic votes. A rate reduction can be reversed, but I believe that politically the reenactment of a category of tax, namely estate taxes, which has been completely repealed, is much harder. So I am starting to pay more attention to the planning implications of estate tax repeal and its corollary, carryover basis. Among these implications is the realization that death will no longer bail out a concentrated low-basis stock position, and other approaches assume renewed importance.

IV. Strategies for Coping With a Concentrated Stock Position

I am an estate planning attorney, not an investment banker. The detailed workings of some "derivative" or "hedging" strategies are beyond my expertise. The suggested strategies which follow are based on my own experience as an estate planner and a general knowledge of the tax environment in which detailed strategies are constantly being developed and refined.

Three general categories of strategies are considered: first, strategies based on charitable giving and the purchase of life insurance; second, strategies which hedge the economic risk of the position but do not diversify it; and finally, strategies which may attempt to accomplish diversification without incurring capital gains tax.

A. Charitable Giving and Life Insurance

The holder of a concentrated stock position (herein, hopefully, called the "client") may contribute all or any portion of it to a charitable remainder trust (CRT). The client may be the sole trustee of the trust and remain in complete control (assuming the obvious circumstance that the stock is publicly traded and thus easily valued). The CRT is a tax-exempt entity; it may sell the stock without capital gains tax, and it may acquire fixed-income securities or a diversified investment portfolio. (For technical reasons, a CRT should avoid owning assets which give rise to unrelated business taxable income, but a portfolio of marketable securities should generally present no problem.) The client may, within limits, prescribe a retained interest for himself or his family, defined either as a fixed sum (an "annuity interest") or as a fixed percentage of the CRT value determined from year to year (a "unitrust interest"). The annuity or unitrust interest is taxed to the recipient as it is distributed, at either ordinary income or capital gain rates (depending on the investment history of the CRT), but the investment portfolio is not saddled with an immediate capital gains tax on its entire value. Diversification is thus achieved without tax.

The problem with the CRT, of course, is that the assets pass ultimately to charity, not to the family. This is of no concern to a client who plans ultimately to leave much of his fortune to charity in any event. In families having great wealth, this will often be the case. Where future generations are otherwise provided for, and the prime concern of the client is to protect only himself and his spouse from the risks of a concentrated stock position, the CRT alone may be an adequate solution.

In appropriate cases, the loss of an inheritance occasioned by the CRT may be managed by the purchase of life insurance. The enhanced cash flow which may result from selling a concentrated equity position and replacing it with income-producing assets may enable the purchase of a substantial amount of life insurance without financial sacrifice.

Recent developments in both the financial markets and the taxation of life insurance structures have made this strategy more difficult. The problem in the financial markets, of course, is that interest rates are at record lows, so a trade-off of equities for bonds may not enhance cash flow like it used to. The problem in the tax area is that the avoidance of estate tax on life insurance proceeds generally implies a gift of the premiums (either to younger-generation family members or to a trust for their benefit). Private "split dollar" strategies have evolved for managing the gift tax problem associated with paying large insurance premiums, but recent IRS rulings have called these strategies into question. If the estate tax is permanently repealed, a gift of the life insurance premiums will no longer be necessary. As a result, the use of a CRT for tax-exempt diversification, coupled with the use of life insurance for wealth replacement, may remain a viable strategy.

B. Hedging Strategies

Hedging strategies, sometimes called "derivatives," are financial structures and products designed to eliminate most of the market risk of a concentrated stock position without incurring tax on the disposition of the stock.

Amendments to the Internal Revenue Code effective June 8, 1997 substantially narrowed the use of hedging strategies, but did not eliminate them. The thrust of the 1997 legislation was to do away with strategies that eliminated market risk altogether, by triggering constructive sale treatment and a tax on the resulting embedded gain. To take a simple example, a short sale of securities held in the portfolio (a "short against the box") would result in equal and offsetting positions, thus eliminating the risk and triggering gain. I.R.C. § 1259.

However, some hedging strategies remain viable.

1. Put Options

A put option is simply the right to sell stock at a future date (the "maturity date") at a fixed price (the "strike price"), which is lower than the current price. The option may be purchased from an investment bank or other counterparty, for a premium which will depend on the spread between current market price and strike price (the greater the spread, the lower the premium) and on the time to maturity (the greater the time, the higher the premium). If at maturity the market price has dropped below the stock price, the option profit will have offset, at least to some extent, the option premium and the loss on the long position in the security. The effect is to limit the loss (for the period of the option) to the sum of the premium plus the initial spread. There is no limitation on the opportunity for future gain (which is offset only by the option premium), and there is some continued risk of further loss. Accordingly, acquiring the put option should not result in a constructive sale.

2. Collars

A collar is a combination of buying a put option and selling a call option. In a "cashless" collar transaction, compensation for the options is provided not as cash premiums but rather by giving up to the counterparty some of the upside potential. The investor determines the amount of downside risk he wants to accept, and the length of time he wants the position to remain open, just as in a put option. The counterparty buys an offsetting "call" option having a value equal to the put option. The greater the value of the put option, the more upside potential must be surrendered to compensate for it.

If the stock price rises above the collar, any further profit in the long position is offset by a loss in the call option, effectively limiting the profit to the spread between the price at issuance and the call option strike price.

If a collar is too narrow, it would effectively eliminate further risk in the underlying stock position, triggering constructive gain treatment. Regulations defining the necessary amount of retained risk have not been announced. The amount of risk which must be retained is therefore not known, but certainly must be more than minimal.

3. Prepaid Variable Forward Contracts

A prepaid variable forward contract (PVFC) is similar to a collar in that it limits downside risk at the cost of sacrificing some of the upside potential. The main difference is that the investor receives a significant percentage of the hedged stock value in cash. The transaction thus has some of the characteristics of a loan (similar to a borrowing against a collar position), and some of the characteristics of a sale, but hopefully no recognition of gain for tax purposes.

In a typical PVFC, the counterparty might make an up-front cash payment equal to 85% of the hedged position. The counterparty agrees to accept, on final settlement, either a number of shares defined by the contract or the return of an equivalent amount of cash. The number of shares required to be delivered will depend on the market price of the stock at maturity.

For example, if the market price has fallen below the "hedge" price (normally at or near the price when the contract is made), the entire hedged share position, or the cash equivalent, is returned to the counterparty. If the price has risen above the hedge price, but not above a defined upside limit, the counterparty receives shares, or a cash equivalent, equal to the original value of the hedged position, thus allowing the investor to retain the upside benefit. If the price has risen above the upside limit, the counterparty receives the additional appreciation.

To illustrate: the investor creates a hedged position in 50,000 shares of a stock having a value of $20 per share, or $1 million. The upside limit is $30 per share. The hedge price is $20. The payment for the contract is 90%, or $900,000. The following table illustrates the results for various prices at the end of the contract:

Price at end	Value of position at end of contract	Number of shares delivered	Value of shares delivered (or optional cash settlement)	Value of retained position after settlement	Total value received and retained	Net benefit or (cost) of contract
10	500,000	50,000	500,000	0	900,000	400,000
20	1,000,000	50,000	1,000,000	0	900,000	(100,000)
25	1,250,000	40,000	1,000,000	250,000	1,150,000	(100,000)
30	1,500,000	33,333	1,000,000	500,000	1,400,000	(100,000)
40	2,000,000	37,500	1,500,000	500,000	1,400,000	(600,000)

In the above example, the investor in effect paid a 10% "premium," and gave up any participation in upside exceeding 50%, and in return received complete protection against downside risk. As in a collar, the investor retained the attributes of the stock including voting rights and dividends. Unlike a collar, the investor also received a cash payment which he could invest to produce additional return.

4. Borrowing Against a Hedged Position

Once a concentrated stock position has been hedged to reduce the market risk, it becomes easier to borrow against the position, using it as collateral. In the current low-rate environment, it may be possible to borrow a significant proportion of the value of the collateral and profit from the reinvestment of the loan proceeds. As with any leveraged investment, the risk and reward are magnified as compared with an investment not supported by borrowed funds.

5. Equity Swaps

A total return equity swap is a transaction in which the holder of an equity position contracts with a counterparty, such as an investment bank, to make payments equivalent to dividends and stock price increases, and to receive "interest" on some "notional" value of the position plus decreases in the stock price. Effectively, the stock position has been replaced, to the extent provided in the contract, by the economic equivalent of a promissory note. If, by means of such a transaction, the client has effectively disposed of both the potential upside and the potential downside in the position, the transaction is a constructive sale, defined in I.R.C. § 1259 as an "offsetting notional principal contract."

6. Problem of Prearranged Hedges

If the concentrated stock position is being acquired as the result of a swap of the client's securities for publicly traded securities in a tax-free reorganization, care must be taken to avoid entering into a hedged position prior to completion of the tax-free exchange. So long as a meaningful upside benefit and downside risk are retained, the hedging transaction, even if prearranged, should not jeopardize the tax-free character of the reorganization.

7. Estate Tax Impact

A put option, or the combination of put and call options constituting a collar, has value which, at least in the case of publicly traded securities, can be measured by objective valuation criteria. If a client dies owning such contracts, they are subject to valuation, and thus subject to estate tax, like any other asset. If, as will commonly be the case, the per-share price of the concentrated position is between the put and call strike prices of the collar, both options will be "out of the money" in the sense that no profit would be realized on the exercise of such options at the date-of-death stock price. That does not mean, however, that the options are worthless. Options having a significant remaining life, in a stock with a volatile price history, may have substantial value even though technically out of money.

C. Diversification—Exchange Funds

At one time, a popular means of diversifying concentrated stock positions was to exchange the stock, in a privately arranged transaction (often through an investment bank), for interests in a private investment fund composed of similarly contributed positions in other companies. A transfer of property to an "investment company" as described in I.R.C. § 351(e), whether in exchange for stock or for a partnership interest or similar asset, is an exception to the general rule that transfers in exchange for equity interests are tax-free. Amendments to I.R.C. § 351(e), effective June 8, 1997, were intended to assure that diversification could not be accomplished tax-free. This attempted reform was accomplished by expanding the definition of "investment company" to take account of additional kinds of assets held by the entity and which could be used to accomplish diversification. Examples of such assets, in addition to equities, are money, foreign currency, precious metals, and most significantly "evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives." Under Treasury Regulation § 1.351-1(c), an "investment company" is a corporation (and, by extension, a partnership, by reason of I.R.C. § 721(b)) 80% or more of which consists of the prescribed kinds of property. A transfer to a partnership which is an investment company, and which "achieves diversification" (by giving the investor a partnership interest representing ownership of a share in the partnership portfolio) will trigger taxable gain. Since the transferor of a concentrated stock position to such an entity will "achieve diversification," the 1997 reform substantially impaired the ability to accomplish diversification in a tax-free manner.

Attempts may still be made to accomplish tax-free diversification by transfers in exchange for an interest in an entity which has been carefully designed to escape the new, expanded definition of an "investment company" under I.R.C. § 351(e). For example, some investment banking organizations assemble private partnerships which are designed to accomplish diversification within the parameters of tax and securities laws. The tax requirements, set forth in I.R.C. §§ 704 and 737, in effect permit the tax-free exchange of a concentrated stock position for an interest in a partnership holding other appreciated securities, provided the position is frozen for at least seven years. In order to avoid characterization as an "investment company," more than 20% of the entity must be comprised of assets not described in I.R.C. § 351(e). An example of such an asset is a preferred interest in a real estate partnership.

Other restrictions, arising from federal securities laws, include a minimum investment, generally $1 million, and a minimum investable net worth in excess of $5 million, plus other trappings of "private placements" such as a confidentiality agreement.

Such a private exchange fund accomplishes investment diversification, but does not increase tax basis. Eventually, upon the withdrawal of a diversified pool of assets from the fund, the investor will retain his original basis as if he had retained the contributed stock. By their nature, exchange funds are available only to a select universe of wealthy individuals who have large concentrated positions, who are "qualified purchasers" for securities law purposes, and who can afford to remain illiquid for a substantial period of time.

V. Summary

A clear thrust of the 1997 Tax Relief Act was to treat both the elimination of market risk in a concentrated stock position, by hedging, and a diversification of that position, as a taxable transaction. Any transaction undertaken with either such approach in mind is therefore subject to careful scrutiny and significant tax risk. At the same time, the prospective elimination of the estate tax, and the concomitant institution of carryover basis at death, would eliminate the one sure escape from capital gains tax on a low basis position, thus making other strategies for the reduction of concentration risk all the more important.

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Finding Unbiased Advisors—Helping Your Clients Become Connoisseurs of Talent and Trust

By Elizabeth L. Mathieu

1. Introduction

Over the years, many of us have been asked to assist clients with locating non-legal advisors such as investment consultants or managers, custodians, insurance agents, family wealth counselors and others. Providing clients with access to the best-of-the-best professionals in other fields deepens our understanding of our clients and thus our relationships with them. Being involved in a selection process, developing and asking the right questions to find the best-of-the best, and contributing to the assessment of how effective an advisor can be with a specific client, also helps us understand how these professionals can work with us to address client issues.

We (and our clients) have all heard presentations or read articles about how to choose specific types of advisors such as brokers, investment managers, trustees or even lawyers. However, few of us have had the opportunity (or time) to develop a list of generic questions about any advisor's fit with a client's goals, nature and extent of her or his impartiality, investment in expertise for the future, and investment in client service. Today these questions are essential. They should be part of an initial evaluation of any type of professional who is being engaged for more than an immediate and singular transaction. Also, a systematic process to annually reevaluate how the advisor is doing in these areas can improve the chances that clients do not later outgrow them.

This article identifies questions to ask when any professional is being considered for a client. The answers to these questions should increase the probability that the advisor will be appropriate to the client, her or his existing team of advisors, and the issues a client faces over time. Included also are additional questions that counsel should urge clients to ask themselves after an initial meeting with a proposed advisor, and of themselves and their advisors at least once a year.

2. Background

Today, the value of "unbiased advice" has risen sufficiently while at the same time appearing to be less and less available.

For example, some members of traditionally unbiased professions such as accounting firms now receive fees for recommending professionals such as bankers, securities houses and insurance agents to their clients. Some investment consultants have found it necessary to add investment products to improve financial returns. And to complicate matters, companies such as banks, trust companies, securities firms, insurance companies, and others that traditionally offered products created to meet the needs of client groups, are now positioning themselves as advisors who offer objective advice to each client.

These product companies generally accomplish this by acquiring firms that had developed a clientele based on independence and by leaving them to operate separately from the product company—at least for a while—or by creating new business units with newly hired or retrained staff. The problem is that, in at least some cases, the advisors in those companies, who for the most part are doing the best they can to give the best advice they can, are compensated for the number of new products they sell, and assets they bring in to be managed, rather than for the quality of the advice that they give. Further, often, the clients pay for the products they use and not for the advice they receive, encouraging clients to continue to undervalue advice.

As a result, there is confusion about the value of advice, who should offer it and, which of it is really objective.

Attorneys are in a unique position to remain unbiased and objective. The essence of what they do, and the ethical guidelines that bind them, is to provide advice which is in the best interests of the client. On the other hand, they also receive referrals from many of the types of advisors they are being asked to recommend to clients. Hence there is a heightened need today for attorneys to have a systematic and objective process to find the right advisor for each client and remove any hint of self-interest from referrals.

3. The Interrelationship of Issues and Advisors

Examples of clients' questions to counsel today are: "Can you help me choose and evaluate investment consultants or managers or custodians?" "How can I motivate my family to hold a first family meeting and who could help me with thinking that through and then actually facilitate the meeting?"

"How can I ensure that my children understand the ins and outs of credit cards?" "Who can help me with the accounting and management of my private foundation?" "How would you suggest that I involve the family in that?" "I would love to have the services of a 'family office' but don't think that we are a large enough family. Are there professionals that can provide such services without the costs associated with running such an 'office'?"

Clients' issues are often interrelated, requiring impartial and unbiased expertise in a number of disciplines to address. Further, specialization in specific disciplines is increasingly required for mastery in our complex world. Therefore, problems and issues brought to counsel by clients can, at least sometimes, require that a client have a number of advisors who both bring a specific expertise to the client and communicate with each other.

4. How Do Most People Choose Advisors?

People tend to choose advisors only when they need to address a specific transaction such as a will or fiduciary appointment or investment of funds. They usually do so when there is some major life change, something has gone wrong, or they realize that they should have addressed a specific issue long ago. They tend to solicit referrals from friends or other advisors, sometimes without being specific about the problem to be solved (generally a matter of privacy) or other requirements for a successful relationship with them or their family.

However, if they are not expert in the field in which they seek advice, or at least in a related field, more likely than not, they will not have access to the best sources to locate advisors or know all the questions necessary to evaluate the appropriateness of a particular advisor for them and their family. Hence, legal counsel can play an important role by recommending a systematic approach to the search both because of knowledge about, and access to, professionals familiar with most types of advisors, and also because of a natural orientation to a disciplined process of thinking.

This is not to say that all clients need a team of advisors. For many, DIY (e.g., "do it yourself") with friends, books, the Internet, and seminars is appropriate. For others, one advisor to address all the issues with them is appropriate and sufficient. However, for those who have complicated family, financial, philanthropic, or business affairs, a team of advisors led by the client or by another key advisor to the client can be useful.

5. The "Key Advisor" Role

The fact that the client has turned to her or his legal counsel to find a non-legal solution usually means that the attorney has evolved, or is evolving, from a trusted advisor with specific expertise and talent to a "key advisor." A key advisor is one who, in addition to that expertise and talent, is unbiased in her or his interest in the long-term welfare of the client in the context of the entire family situation and is willing to handle multiple, complex issues, both hard and soft. He or she knows the limits of her or his expertise and business model and will reach out to third parties when necessary.

The attorney also: (1) understands a client's needs in the context of his or her family situation; (2) responds to the client's level of understanding and interest in technical points; (3) provides information in a form the client likes the best (orally, written, numbers and/or words); (4) supports the client's decision-making process; and (5) has no product to sell. Further, and importantly, if the client asks for help in finding other professionals to assist with an issue, the client believes that such a key advisor has a process in place for helping choose and manage other professional experts.

6. Rewards for Client and Counsel of a Team of Trusted Advisors

The client's rewards for having a team of supporting experts are access to diverse points of view and more informed decisions. Further, with counsel—or other important professional in the client's life—serving as a key advisor, the client can choose—or not—to assemble and oversee the team personally. The rewards for a professional of being a client's key advisor, overseeing a team, is superior insight into evolving issues beyond existing expertise and an ever-deepening relationship with the client.

7. Search Process—Summary

The process of searching for an appropriate professional for a client can take a number of forms. One can design, and evaluate responses to a written "request for information," or one can formally interview different advisors with respect to specific criteria. Regardless of the approach, however, before suggesting an advisor to a client, there are some important interim steps. They are: a due diligence visit to the advisor's office and discussions with service providers supporting the advisor's business and other professionals who work with the advisor. Generally professionals are not comfortable with providing names of clients prior to being chosen by a client but once chosen, discussions with a few of the advisor's important clients whose issues and characteristics are similar to counsel's client is essential prior to formally engaging the advisor.

These steps improve the chances that a chosen advisor will remain with a family for a long time. However, developing and executing these steps on one's own—at least the first time—can be time-consuming. There are non-legal professionals with experience in choosing advisors such as those in family offices who have outsourced services or manage advisor teams for clients, and also private bankers in financial institutions with open architecture platforms. In many cases, they will lend a hand to counsel with respect to the design and implementation of the process both because such assistance can deepen their relationship with the lawyer and because it contributes to improving objectivity standards in the marketplace, which is in everyone's best interest. Such support, whether provided formally or informally, can increase a lawyer's efficiency and lower the total cost to the client of such a search.

8. Questions to Ask When a New Advisor Is Sought

There is a series of questions that apply in virtually all cases when a new advisor is sought. Some of these questions work well in a written "Request for Information" and others require a discussion with the advisor. The specific client situation will dictate the form and approach to gathering this type of information.

8.1 Fit with Goals

- How will the advisor's services/advice help your client achieve his or her goals?
- What percentage of the advisor's clients is like your client in terms of issues, net worth, and size of family and diversity of family members? How has that percentage changed in the last two and five years?
- Does the advisor normally deal with individuals or with families as a group? How?
- What is the average number of years a client stays with the advisor? How many clients have left the advisor in the last two years and for what reasons?
- What are some examples of how the advisor has helped clients with issues and characteristics like those of your client and also helped clients whose issues are more complicated?
- What are some examples of the advisor working within a team of professionals—as leader or as participant? What was the least successful team relationship?
- What type of client in terms of sophistication, age, sources of wealth (earned or inherited), methods of communication, location, etc., is the advisor most comfortable (and least comfortable) with?

8.2 Nature and Extent of Impartiality

- How does the advisor get paid and by whom?
- Is cross-selling other services or products part of the advisor's business goals?
- Does the advisor receive fees or referrals from other providers of product/advice recommended to clients?

8.3 Expertise—Now and Future

- What are the advisor's credentials/years of experience?
- Professional designations?
- How often does the advisor attend/present to professional association meetings?
- Is the advisor a member of any select professional body?
- Can the advisor provide client and professional references who can comment on service, communication skills and clarity of thinking about issues similar to, and also more complicated than, those of your client?

8.4 Process and Investment in the Future

- How often does the advisor communicate with clients and in what medium—phone, e-mail, fax, meetings?
- How does the advisor work with other professionals?
- How does the advisor motivate/compensate staff to serve clients' needs (decision-making process, compensation structure and continuing education)?
- What process is in place to ensure succession has been planned if the advisor retires?
- What investments has the advisor made in technology?
- What is the advisor known for (reputation)?
- What is the advisor doing to ensure that reputation continues?
- What controls are in place to protect client confidentiality and data integrity?

8.5 Compensation Structure

- What are the fees and have they changed in the last two years? If there has been a change, what were the clients' reactions?
- Are there any minimums and have they changed in the last two years? Why?

9. Questions Clients Should Ask Themselves after a First Meeting with a Proposed Advisor

- Did the advisor seem to listen/understand?
- Did she/he seem to have an answer too quickly?
- Did she/he seem committed to a particular solution?
- Were options discussed?
- Was I comfortable with the advisor?
- Did she/he seem comfortable?
- How will my family members feel about him or her?
- Did the recommendations make sense?
- Did his or her recommendation about how to proceed after the initial meeting make sense?

10. Questions Clients Should Ask an Advisor at Least Annually

- New expertise?
- Changes in process?
- Changes in compensation of staff?
- Changes in continuing education of staff?
- Staff or client turnover?
- Changes in fee structure and/or minimums?
- Institutional change?

11. Questions Clients Should Ask Themselves at Least Annually

- Does the advisor's expertise and approach continue to fit with the client and her or his goals?
- Does the advisor still seem impartial?
- Do I still trust the advisor?

12. Conclusion

Just developing generic questions for existing and new advisors is, of course, not sufficient to find the right professionals for a client. Counsel needs to develop a view of a "baseline" good answer to each question in the context of the targeted discipline and assist the client's understanding of them. Questions specific to the discipline, reflecting sensitivity to the challenges and trends specific to the profession, are also useful in ensuring that the "best of the best" have been located. Reaching out to professionals in the targeted discipline to understand what are good baseline answers to the generic questions and to assist with developing additional specific questions, is also an important first step in designing an effective process.

In summary, taking a systematic approach to bringing together and managing a team of advisors for a client embarks counsel on an exciting and empowering new course of action for clients, deepens her or his understanding of both the client and solutions to problems, and gives her or him a unique opportunity to be of even more value to clients.

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RECENT NEW YORK STATE DECISIONS

John C. Welsh

WILLS

CONSTRUCTION—RESIDUARY BENEFICIARY OMITTED

Decedent's 1999 will contained the usual introductory wording for a residuary clause but failed to name any intended recipients. In her 1997 will, decedent left the residuary (about 10% of the existing estate) to her nephew, with his wife, the 1999 executrix, as the alternate beneficiary. The death of the nephew five days before the decedent caused his widow to claim that the 1997 residuary beneficiaries were inadvertently excluded so as to insert herself as the entitled residuary beneficiary. The Surrogate agreed and awarded her the residuary estate. A niece and a great-nephew were the unsuccessful distributees. The court found that evidence was clear and convincing that the 1997 residuary language was intended to be repeated since it had also appeared in wills executed by decedent in 1990 and 1992. The distributee-niece affirmatively acquiesced in the construction. The continuation of the nephew's wife as executrix is a clear indication that they remained on good terms. By affidavit, the attorney-draftsman agreed that decedent had intended no residuary change. In effect, reformation was judicially mandated. A partial intestacy would be inconsistent with decedent's intent. *In re Estate of Herceg*, 193 Misc. 2d 201, 747 N.Y.S.2d 901 (Sur. Ct., Broome Co. 2002).

PROOF OF PATERNITY

Decedent died leaving a will which named B, his adopted daughter, as executrix and sole beneficiary. K, claiming to be a non-marital daughter of decedent, sought a declaration to that effect thus entitling her to submit objections to probate of the will. To assist K in proving decedent's paternity, the identical twin brother of decedent offered to submit to DNA testing. Scientifically, the DNA configuration is unique for each person except for identical twins where it is the same for both. Using the DNA of the identical twin, testing results disclosed a 99.96% probability of paternity. Since the child's mother acknowledged a sexual relationship with decedent and denied any involvement with his twin, the court gave great weight to the test results as providing clear and convincing evidence that K was decedent's daughter with the right as distributee to examine the attesting witnesses to the will offered for probate as permitted by SCPA 1404. *In re Estate of Nasert*, 192 Misc. 2d 682, 748 N.Y.S.2d 654 (Sur. Ct., Richmond Co. 2002).

DESCENT AND DISTRIBUTION

PROOF OF PATERNITY

Upon the death of decedent intestate, his putative daughter successfully proved paternity so as to become sole distributee of his estate. The finding was based upon decedent's 1963 admission in a duly filed and accepted application to amend the child's birth certificate. Decedent was not under compulsion to make this acknowledgment and gained no advantage by doing so. It satisfied the requirement for clear and convincing evidence and no further inquiry was required. Letters of administration previously granted to a more remote relative were revoked. *In re Estate of Cipriani*, 298 A.D.2d 263, 748 N.Y.S.2d 735 (1st Dep't 2002).

ADMINISTRATION OF ESTATES

SUIT BARRED BY WAIVER

Co-administrators of the estate of decedent were barred from maintaining an action to recover a mortgage debt owed to decedent. In their accounting proceeding in Surrogate's Court, they had explicitly stated that the premises had been returned to decedent's estate in full satisfaction of the debt. The record also contained additional assertions that the defendants had been released from their debt. This unrebutted evidence showed an intentional relinquishment by plaintiffs of a known right and was binding upon them. Proof of this waiver was not barred by the statute of frauds or the parol evidence rule where the admitted contract had been acted upon to completion. The alternative ground of judicial estoppel as asserted by defendants did not apply. Under that concept, a party to an action who has secured a favorable judgment by adopting a certain position cannot thereafter take a contrary position because it has become advantageous to do so. Here no favorable judgment or decree was obtained in Surrogate's Court. *Bono v. Cucinella*, 298 A.D.2d 483, 748 N.Y.S.2d 610 (2d Dep't 2002).

CLAIMS AGAINST ESTATE—STATUTE OF LIMITATIONS

When H and W were divorced in 1981, the judgment of divorce provided for payments by H to W for alimony and child support, including a sum in arrears, together with equal division of the proceeds of sale of their former marital residence. After the death of H in 2000, W asserted claims against the estate for the required payments, none of which had been made. She also requested that the former residence be sold and her share be paid to her. W2, the widow of H, urged that W's claims be barred by the six-year statute of limitations. In reviewing the terms of the judgment, the Surrogate found that no time frame for the sale of the realty was set forth. Although the six-year statute was applicable, the period did not begin to run until H refused W's demand to sell or refused W's demand for her share of the proceeds after sale. Since neither refusal ever occurred, no cause of action accrued. No evidence supported W2's claim that W had waived her rights under the judgment or was barred by laches from enforcing them. Inaction alone will not create a waiver. No prejudice to W2 resulted from the delay. The claim for one-half of the proceeds to be obtained from the real property sale was allowed. W was also successful in her claim for alimony due within the six-year period prior to filing her claim, child support due within the same period until her son became emancipated and $1,000 in support arrears subject to the 20-year statute for enforcing a money judgment. *In re Estate of Paternostro*, 193 Misc. 2d 310, 748 N.Y.S.2d 228 (Sur. Ct., Richmond Co. 2002).

TRUSTS

MEDICAL ASSISTANCE ELIGIBILITY

In 1986, the grantor created an irrevocable living trust which provided that the trustees could use income and principal to maintain her standard of living so long as she was not confined to a nursing home or similar long-term care facility. If the grantor entered such a facility, the trust would end and the assets would be distributed to named beneficiaries. The grantor retained the right to change beneficiaries at any time during the continuance of the trust by naming anyone except her spouse, her creditors, or creditors of her spouse, his estate or her estate. More than 15 years later, the grantor, by then a nursing home resident, applied for medical assistance benefits and was denied by the local Department of Social Services. A Fair Hearing before the State Department of Health sustained the determination. Although this type of automatic termination trust can no longer be effective to provide Medicaid eligibility under EPTL 7-3.1(c), this provision remained effective because it preceded the statutory prohibition. However, the provision authorizing the grantor to make changes in beneficiaries did not preclude her from naming herself. Consequently, the trust assets were within her control and constituted available resources under Medicaid regulations. Although the trust had terminated through nursing home entry prior to filing the application for assistance, the "look back" period had not expired and the failure to take control of the assets was properly treated as a transfer so as to create ineligibility under the regulations. *Ferrugia v. N.Y.S. Dep't of Health*, 192 Misc. 2d 709, 747 N.Y.S.2d 314 (Sup. Ct., Chautauqua Co. 2002).

MISCELLANEOUS

RULE AGAINST PERPETUITIES

The Appellate Division held that an agreement to provide the plaintiff with a future right to receive additional compensation for the sale of his interest in real property violated the remoteness of vesting provisions of the rule against perpetuities. Since the agreement had no time limit and the benefit would also accrue to the "successors, heirs or assigns" of the plaintiff, it appeared that this future right was intended to last indefinitely. There was no suspension of the absolute power of alienation because the parties to the agreement or their successors could have joined at any time to convey a fee simple in the premises. *Dimon v. Starr*, 299 A.D.2d 313, 749 N.Y.S.2d 78 (2d Dep't 2002).

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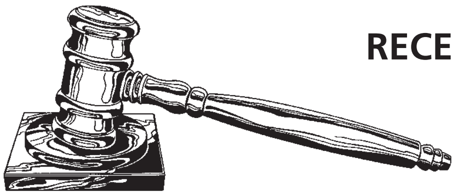

CASE NOTES—RECENT NEW YORK STATE SURROGATE'S AND SUPREME COURT DECISIONS

Ilene Sherwyn Cooper and Donald S. Klein

Accounting Proceeding—Summary Judgment

In a contested accounting proceeding, the objectant moved for partial summary judgment with respect to his claims, *inter alia*, that petitioner engaged in self-dealing by making improper distributions of trust securities, and that petitioner improperly paid himself annual trustee's commissions.

With respect to the issue of self-dealing, objectant argued that the petitioner made in-kind distributions to himself which constituted virtually all the unrealized capital gains in the trust. Objectant claimed that the petitioner avoided this exposure by distributing to himself the unappreciated securities in the trust. Based thereon, objectant maintained that petitioner engaged in self-dealing and breached his fiduciary duty by giving himself preferential treatment regarding the division of the assets of the trust. In his defense, the petitioner maintained that the objectant made a specific request for the in-kind distribution, and that he was authorized to make the distribution pursuant to the terms of the trust.

The Court held that the petitioner had a duty of undivided loyalty to the trust and to each of its beneficiaries. This duty is designed to prevent self-dealing. Hence, where a trustee is given absolute discretion, he must not use it to "feather his own nest." He must avoid all situations where his interests or those of a third party with whom he is aligned conflict with those of the beneficiaries.

Based on the foregoing standards, the Court found that the petitioner breached his duty of undivided loyalty when he distributed the assets in issue in-kind to the objectant. The Court found that a reading of the trust so as to absolve the petitioner from any liability for such breach would be contrary to public policy as a violation of EPTL 11-1.7. Accordingly, objectant's motion for summary judgment on this issue was granted.

With respect to objectant's motion for summary judgment on the issue of commissions for the period 1983 to 1999, objectant maintained that petitioner overpaid himself commissions for this period contrary to the provisions of SCPA 2309(4). This statute provides, in pertinent part, that a trustee who distributes all trust income in a given year waives his right to any unpaid annual commissions payable from income. Notably, petitioner did not dispute this point on commissions, but simply attributed the miscalculation to his accountant. Accordingly, based on the record, the Court found that since the petitioner failed to retain any income for the years 1983 through 1999, commissions payable from income were waived, and petitioner was surcharged in the amount of the overpayment. *In re Estate of Louise Gould*, N.Y.L.J., October 21, 2002, p. 26 (Sur. Ct., Nassau Co., Surr. Riordan)

Construction Proceeding

In a miscellaneous proceeding, the petitioners sought a construction of the decedent's will in order to find that trusts were created thereunder for the benefit of the residuary legatees, one of whom was an infant. Upon review of the instrument, the Court denied the petitioners' request. The Court determined that the language of the paragraphs in issue was sufficiently clear to give their plain meaning effect, to wit, that the fiduciary had the power and the discretion under the will to retain the residuary legatee's share until they reach the age of 25, or alternatively, to pay the legatees share to the legatee upon his or her attaining majority in the state of his or her domicile, or to pay the legatee's funds to the guardian of the legatee's property. Nowhere from the plain language of the will could the Court construe that the decedent intended to create a trust for the residuary legatees' benefit. *In re Estate of Timmons*, N.Y.L.J., October 10, 2002, p. 22 (Sur. Ct., Kings Co., Surr. Feinberg)

Disqualification of Spouse

In a contested proceeding for letters of administration, the decedent's daughter requested the issuance of letters to herself, and the decedent's alleged spouse cross-petitioned for the issuance of letters to him, and a New York domiciliary who was not a distributee. The issue at trial was whether the respondent was disqualified as the decedent's surviving spouse.

Although the petitioner conceded that the decedent and respondent had entered into a ceremonial marriage, she contended that the respondent was disqualified on the grounds that the alleged marriage was a sham green card marriage to gain green card status, or alternatively, that the marriage was void as bigamous both because the decedent was never validly divorced from her first husband, or because the respondent was never validly divorced from his second wife.

The Court found that even though the marriage was entered into for immigration purposes, these circumstances did not disqualify respondent as a surviving spouse pursuant to EPTL 5-1.2.

However, based upon the proof adduced, the Court found that the respondent and his second wife were never validly divorced, and that the respondent was disqualified on the grounds that his marriage to the decedent was void as bigamous. In view thereof, he was not a distributee of the decedent and was not eligible to receive letters of administration. *In re Estate of Julia Dominguez*, N.Y.L.J., November 25, 2002, p. 20 (Sur. Ct., Bronx Co., Surr. Holzman)

Ejectment

Before the Court was a motion by petitioner in the underlying proceeding for an order dismissing the answer filed. The underlying proceeding was brought by the executrix for an order, *inter alia*, approving the sale of a parcel of realty and ejecting the respondent from the premises.

In her motion to dismiss, the movant/petitioner advised the court that she lost the prospective purchaser for the property, that the respondent never indicated that he wished to purchase the property, that he has been living there rent-free, and that he has been interfering with the realtors who need to show the property. The movant alleged that without a sale, the estate lacked sufficient assets to satisfy the debts of the estate.

In opposition to the motion, respondent asserted that he had a right to reside on the property until title closing, and that he was willing to pay "full value" for the property.

The Court held that a fiduciary has a superior right to that of a beneficiary to possess and manage the decedent's realty for the purposes of sale, as well as to collect the rents thereof, and otherwise to preserve and make it productive for all those with beneficial interests therein. Additionally, estate beneficiaries do not have the right of first refusal with respect to estate realty, simply by virtue of their status as residuary beneficiaries.

Accordingly, the Court determined that while the respondent had the right to make a good faith offer for the purchase of the premises while the petitioner was in the process of finding a qualified buyer, he had no right to reside on the premises indefinitely and interfere with the fiduciary's attempts at sale. The petitioner's request for ejectment of the respondent was, therefore, granted. *In re Estate of Pastorelli*, N.Y.L.J., November 21, 2002, p. 25 (Sur. Ct., Suffolk Co., Surr. Czygier)

Interest on Payment of Legacies

In a contested miscellaneous proceeding, the petitioner sought payment of her testamentary cash legacy and the cash legacies of her six children together with statutory interest, as well as removal of the executrix. Petitioner's motion for summary judgment was granted in part and denied in part.

The record revealed that the decedent's will was admitted to probate without objection by the petitioner in July, 2000. In January, 2001, petitioner commenced a proceeding to vacate the probate decree and admit a prior will to probate. That proceeding went to a hearing, and the Court's decision was pending.

During the pendency of the vacatur proceeding, petitioner made a demand on her behalf and on behalf of her children for payment of their legacies, indicating, however, that she would not insist on payment until the sooner of the vacatur proceeding or a distribution by the executrix of estate funds to herself and her brother as the residuary legatees under the will. In October, 2001, petitioner made a similar conditional demand.

In February, 2002, petitioner learned that in December, 2000, the executrix sold a parcel of estate realty for $190,000, and thereafter, purchased her brother's one-half share in the decedent's home for $90,000, allegedly using funds from the prior sale. Based thereon, petitioner instituted the miscellaneous proceeding for payment of her and her children's legacies and for the executrix's removal on the grounds of self-dealing.

As to the payment of the legacies and interest, the Court found that summary judgment was warranted. Contrary to the fiduciary's position, the Court found that the pendency of the vacatur proceeding did not alter the statutory time limitations and requirements of EPTL 11-1.5. Further, the Court found that upon the expiration of the seven-month period after letters testamentary were issued, the legacies in issue had matured, there were sufficient funds available to pay them, and due demand for payment had been made. Respondent's excuse for the delay in payment, to wit, that she was following the advice of counsel, was held to be insufficient as a matter of law. Accordingly, the Court determined the fiduciary's actions in withholding payment of the petitioner's legacy to be unreasonable, and imposed interest at the penalty rate of 9 per cent per annum, payable by the fiduciary individually. As to the interest of the petitioner's children, the Court found that since they were adults, not under a disability, and had not appeared in the proceeding, its determination had to be limited to petitioner only. Petitioner's children were advised to institute a plenary proceeding for the same relief as petitioner if they chose, or by appropriate application join in the underlying proceeding. *In re Estate of Grillo*, N.Y.L.J., November 13, 2002, p. 24 (Sur. Ct., Westchester Co., Surr. Scarpino)

Jurisdiction—Non-Domiciliary Estate

Before the Court was a proceeding to probate the will of a Florida domiciliary. The Court entertained the petition on the basis of allegations that the assets of the decedent subject to probate consist solely of assets located in Suffolk Co., that the distributees are the same under Florida and under New York law, and that the will has not been and will not be offered for probate elsewhere. The Court held that it had the discretion to entertain a petition for original probate of the will of a non-domiciliary, and that the relevant factors favored granting jurisdiction. *In re Estate of Dougherty*, N.Y.L.J., November 21, 2002, p. 25 (Sur. Ct., Suffolk Co., Surr. Czygier)

Letters of Administration

Before the Court was a contested proceeding between the decedent's son, on the one hand, and four of his siblings on the other, for letters of administration. A building was the only asset of the estate. On August 25, 1997, the Supreme Court issued an order which incorporated a stipulation that the building's title was to be transferred to the decedent as life tenant, with a remainder to his former wife and two of their eight children as joint tenants with rights of survivorship. Additionally, the stipulation required that the mortgage on the property was to be transferred to the decedent's former wife and two children. The petitioner for letters was one of the two children referred to in the stipulation.

On the date of the decedent's death, neither the transfer of the property nor the transfer of the mortgage had taken place. The petitioner for letters sought his appointment in order to enforce the terms of the stipulation. The cross-petitioners sought letters to conduct discovery as to whether there were any defenses to the enforceability of the agreement.

In determining the issue as to whom letters of administration should issue, the Court referred to the universal rule that administration should be given to those who are eventually entitled to the property. The Court noted that the petitioner would receive an interest in the principal asset of the estate whether or not the asset was part of the estate. That is, petitioner would receive one-third of the property if the agreement was upheld, and a one-eighth interest if it were not. On the other hand, the cross-petitioners would receive a one-eighth interest in the estate only if they were successful in their attempt to declare the agreement non-enforceable. Accordingly, the Court granted restricted letters of administration to the petitioner. *In re Estate of Hirallal,* N.Y.L.J., September 26, 2002, p. 25 (Sur. Ct., Kings Co., Surr. Feinberg)

Power of Attorney—Gift

Before the Court were two summary judgment motions seeking the return of funds removed from the estate before the death of the decedent.

The movants claimed that the respondent removed the funds in bank accounts in the decedent's name alone or in the name of the decedent jointly with another contrary to the terms of the power of attorney granted to her by the decedent. They argued that the power of attorney was for banking transactions only and did not authorize the making of gifts.

Respondent claimed that the removal of funds by her created a presumption of impropriety which she was entitled to rebut by proof that she was adhering to the decedent's expressed wishes that the funds were intended to be a gift. The only evidence which the respondent offered in this regard was an affidavit of her sister-in-law that the decedent had said in her presence that she wanted the respondent to have the funds in the account after respondent was finished paying her expenses.

The Court found that the evidence merely reflected the decedent's intentions of making a gift of the funds in issue at some time in the future, and thus did not satisfy the requisites of a valid *inter vivos* gift. Accordingly, the Court found that to the extent that the funds were not utilized to pay the decedent's expenses, they were unauthorizedly withdrawn from the decedent's bank accounts and had to be refunded to the estate. *In re Estate of Paternostro*, N.Y.L.J., October 16, 2002, p. 24 (Sur. Ct., Westchester Co., Surr. Scarpino)

Probate Proceeding—Summary Judgment

In a contested probate proceeding, the petitioners moved for summary judgment dismissing the objections to probate. The Court granted the motion as to the issues of testamentary capacity, undue influence, and fraud, and denied the motion on the issues of due execution and forgery.

As to the issue of due execution, the Court held that although it appeared that the petitioners had clearly established all the usual elements of due execution, in view of the objectants' allegations that the person who signed the will was not the decedent and that the signature was a forgery, the petitioners' motion for summary judgment had to be denied.

With regard to the allegation of forgery, the Court held that the objectants had the burden of proof. In opposition to the motion, objectants alleged that the signature on the will was a forgery. However, they did not produce any competent evidence from any expert or other person familiar with decedent's handwriting. Moreover, an affidavit from a handwriting expert stated that she could not make a conclusive determination based on the exemplars which she had reviewed. Nevertheless, the Court found that the opposing affidavits from decedent's daughters, though excludable at trial pursuant to the dead man's statute, were sufficient to deny the motion to dismiss the objections to the propounded instrument on the basis of forgery. *In re Estate of James*, N.Y.L.J., October 23, 2002, p. 24 (Sur. Ct., Kings Co., Surr. Feinberg)

Subpoena—Third Party

In a contested accounting proceeding, a non-party to the proceeding moved to vacate a subpoena *duces tecum* served upon him by the objectant. The objectant opposed the motion.

The subpoena at issue required the appearance of the non-party, who was married to one of the executors and trustees of the decedent's will, at a deposition, and requested that he bring with him the corporate records of entities in which he and others had an interest.

The non-party claimed that none of the records sought were relevant to the proceeding, in that neither the decedent nor his estate were corporate shareholders. The objectant maintained that she was entitled to inquire into possible assets of the estate, and annexed a document which suggested that the decedent loaned $20,000 to one of the entities about which information was sought.

The Court held that while the standard for disclosure is liberal, the mere assertion that the material sought might prove relevant was insufficient to require disclosure. Further, the Court found that the subpoena sought documents, such as tax returns, shareholder agreements, and corporate books and minutes, not generally available to creditors, and thus was improper as well as irrelevant.

Accordingly, the subpoena was vacated. *In re Estate of Gould*, N.Y.L.J., October 8, 2002, p. 22 (Sur. Ct., Westchester Co., Surr. Scarpino)

Totten Trusts

In a contested accounting proceeding, the petitioner moved for summary judgment dismissing the objections. The objectants took issue with the validity of certain Totten trust accounts established by the decedent for the benefit of the petitioner.

In determining the motion, the Court referred to the provisions of EPTL 7-5.2(1) which provides that a trust can be revoked, terminated or modified by a depositor during his lifetime by withdrawing the funds from the account or by executing a writing which names the beneficiary and the financial institution. The Court concluded that the executrix met her burden of substantiating the accounts in issue as valid Totten trust accounts by submitting the passbooks and the bank documents. The Court held that the objectants failed to demonstrate any triable issue of fact with regard to the establishment of the accounts as Totten trust accounts, or that the executrix, as the decedent's attorney in fact, had abused her authority by making gifts to herself of the funds in issue. Further, the Court determined that there was no evidence that the accounts in issue were convenience accounts, or that any attempted revocation was in compliance with the statute.

Accordingly, the petitioner's motion for summary judgment was granted. *In re Estate of Osiurak,* N.Y.L.J., September 27, 2002, p. 23 (Sur. Ct., Westchester Co., Surr. Scarpino)

Validity of Claim

In a contested proceeding to determine the validity of a claim, the executrix moved for summary judgment seeking dismissal of the claim on the grounds that it was barred by the statute of limitations, and that the purported promissory notes in issue were usurious and unenforceable.

The notes, which were four in number, were dated during the period 1991 through 1994. The petitioner's claim against the estate of the decedent, who died in 1997, was filed in 1998.

The Court noted that the statute of limitations for claims based upon promissory notes is six years, and that a creditor's filing against an estate constitutes the interposition of the claim and stops the running of the statutory time period. Hence the Court found that as to the notes dated in 1993 and 1994, the claims were timely. As to the note dated in 1991, the Court found that petitioner's claims of partial payment on the note created an issue of fact as to the tolling of the statute of limitations, the Court holding that partial payment constitutes an acknowledgment of a debt, a promise to pay the remainder, and a revival of the debt for statute of limitations purposes.

As to the movant's claims that three of the notes were usurious, the Court held that intent is an element of usury, and is a question of fact unless the instrument is clearly usurious on its face. If so, usurious intent may be implied from the charging or receiving of interest greater than the legal rate. Where, however, an instrument is not clearly usurious on its face, the presumption of intent is not conclusive, and may be rebutted by evidence that the excessive charge was the result of a mistake or inadvertence.

In this context, the Court found that Notes 1 and 2 were not facially usurious, as they simply provided that the creditor's outstanding bills were forgiven, without specifying their amount. Accordingly, this branch of the motion, as to Notes 1 and 2, was denied.

As to Note 3, the Court found the conflicting evidence regarding whether the amount charged on the loan was interest or a penalty designed to induce payment also created a question of fact which required that the motion regarding this note be denied. *In re Estate of Walsh*, N.Y.L.J., October 22, 2002, p. 23 (Sur. Ct., Westchester Co., Surr. Scarpino)

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The *Newsletter* welcomes the submission of articles of timely interest to members of the Section. Articles should be submitted to Magdalen Gaynor, 10 Bank Street, Suite 650, White Plains, NY 10606. Authors should submit a 3½" floppy disk (preferably in Microsoft Word or WordPerfect) along with a printed original and biographical information. Please contact Ms. Gaynor regarding further requirements for the submission of articles.

Unless stated to the contrary, all published articles represent the viewpoint of the author and should not be regarded as representing the views of the Editor or the Trusts and Estates Law Section or substantive approval of the contents therein.

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